BAT KENYA PLC.

New Industry Entrant, Increased Threats on the Market Leader

INVESTMENT SUMMARY:

We issue a **BUY** recommendation on BAT Kenya based on a target price of SHS 643.36. This represents a 27% upside from the current of SHS. 506.00 as at 27th June 2019. This is mainly informed by the possibilities of increased competition from the possible entry of Philip Morris International into the Kenyan market, reduced disposable income amongst Kenyans as well increased turmoil among their key export markets.

Key Considerations:

- Increased competition within industry with the possible entry of Philip Morris international into market. Philip Morris are considering a buyout of Mastermind Company. The deal if successful is expected to eventually shake up the 70% market share held by BAT.

- Rampant Illicit Trade is a threat to the business . According to the BAT annual report 2017, illicit trade stood at 12.4%. In 2018, it rose to 14.1% in 2018. This is expected to continue to rise if no tangible action comes to life.

- Reduced household income among Kenyans is expected to decrease the volume growth within the Kenyan market. With increased inflation leading up to increased food prices, has reduced affordability of Kenyans.

- Political unrest in Sudan, a key export market has been undergoing tense political instability. The environment is a little harsh for business which could affect their top line significantly. The same applies to other markets that they export to.

- Tightening Regulations both within and beyond Kenya are expected to increase pressure on the manufacturer's sales. The operating environment is quite hostile with increased regulations both in Kenya as well as the export markets. These ultimately leads to reduced sales for the tobacco manufacturer.

DATE: 28th June 2019

Recommendation: BUY

Target Price: Kshs 643.36

Current Price: 506.00

Potential Upside: 27%

52-week Trading Range:

Kshs 500 to Kshs 725

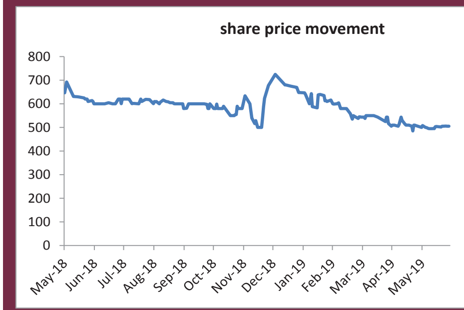
EPS: 40.85

P/E: 12.46

ROaE: 0.44

ROaA: 0.33

Dividend Yield: 6%



Analysts:
Carolyne Mugo
nyawiram@aibcapital.com

wangas@aibcapital.com
+25411047105

The Mastermind Buyout is expected to increase competition

Philip Morris International, a top tobacco manufacturer in NewYork is considering a 51% buyout of Mastermind Kenya. From the transaction, MasterMind is expected get a cash injection that will allow them do a factory upgrade and eventually start the production of Marlboro. The success of the transaction will be a huge threat to BAT's model of large scale manufacturing of premium brands.

Marlboro is a premium brand with numerous segments based on their flavors. Besides having an assortment of tastes to take care of different consumers, it also prides itself in a finely tuned distribution network with highly competitive sales representatives who internationally compete for shelf space in convenience stores.

Marlboro is also known for its strategic marketing communications. Initially, they were an all women brand. They then decided to venture into the male market carving out the Marlboro man who is well known for his well chiseled looks. This led to an increase in its market share from less than 1% to the 4th best-selling brand. It's also associated with popular sports e.g. formula one where they dressed all members of the Ferrari team as well as Nascar and motor car racing.

The entry of Marlboro into the market will therefore rival their premium BAT's global brands including PallMall, Dunhill, Benson & Hedges as well as Rothmans.

Philip Morris which currently holds 17% of the global market share has used different entry strategies into various countries:

- In China, they employed joint venturing and this increased their sales by 13% to 26 billion and a 14% rise in profits translating to 7 billion.

- In Indonesia, they did a direct investment of 22 billion shillings (84% of their sales) made 2.4 billion. They also employed the gueriilla marketing strategy by doing ads all over the county. Guerilla marketing strategy also called buzz or viral marketing is marketing that is intended not to look like an advertisement but instead creates an environment consistent with the brand's identity , in which "coincidentally' the brand appears. The method was also used in Australia where they organized a dance party featuring a wide range of feminine products, including cigarettes. It was promoted using street press and followed by questionnaires to the party goers on their smoking habits. Philip Morris (Australia) Ltd later confirmed in court that the latter event was indeed cigarette advertising.

We therefore expect that upon entry, they will shake up BAT's 71.5 % market share.

In Africa, Philip Morris is in seven countries namely; Algeria, Egypt, La Reunion, Morocco, Senegal, South Africa and Tunisia.

Algeria was their first point of entry in Africa through a joint Venture that allowed them 49% stake in Arab Investors with a cash injection of USD 65 million.

In Tanzania, Philip Morris has commissioned a USD 30 million factory that is set to produce 400 million cigarettes in a year in a signed agreement with Mansoor Industries.

Company	Global Market Share	Annual Revenue	Profits
China Tobacco (Beijing, China)	37.10%	$91.70	$16.00
Philip Morris International (New York City , USA)	17.40%	$67.70	$7.50
British American Tobacco (London , United Kingdom)	12.00%	$58.10	$4.20
Japan Tobacco International (Geneva , Switzerland)	9.60%	$65.90	$1.50
Imperial Tobacco (Bristol, United Kingdom)	4.90%	$38.40	$2.00
Altria Group (Richmond, Virginia)	2.80%	$24.40	$3.90

Increased regulations expected to pressure sales

BAT's operating environment has proven quite hostile in the recent past both locally and within their export markets.

- Kenya is looking at the City Tobacco Bill that will introduce extreme restrictions at the point of sale. At the point of sale, a number of promotional marketing method are used including; price discounts, branded product giveaways, tobacco advertising signs, branded functional items as well as display of the tobacco products themselves. With targeted marketing , POS promotion is equally easier. Should the bill go forward limiting distributors from all these activities, then business will be tougher for them.

- Mauritius has introduced plain packaging for tobacco products effective June 2019. This should have an impact on the export sales to the country.

These regulatory changes have tied down the tobacco manufacturer in legal battles that could potentially hurt their reputation and increase their costs. They currently have two court cases. One, opposing the April 2017, 87% increase in the cost of tax stamps The second is a legal challenge against the 2014 Tobacco Control Regulations. Having been heard on April 2018, the Supreme Court is yet to issue a judgement.

The management, however, claim that the resolution of these cases might not have material effect on the financial statements.

In Uganda, BAT won a legal battle opposing the Kampala Tobacco Control Act against the government

Illicit trade expected to be on the rise in the near future.

According to a 2017 BAT research, 12.4% of cigarettes sold in Kenya are illicit either smuggled into the country ,having been destined for a lower tax market but never left the country or produced within the country under fake tax stamps. By end of 2018, this figure was estimated at 14.1% with fake tax stamps accounting for 12.2% of this figure and 87.8% being cigarettes smuggled across borders. This has also reduced the revenue to the government by significant portions. Kenya Revenue Authority(KRA) has an app 'Soma label' while Kenya Bureau of Statistics(KEBS) has the KEBS tracker. These apps are intended to ensure that individuals ascertain the legitimacy of cigarettes as well as other consumer products by scanning the bar code. The uptake of these apps so far is low. It is important that all state agencies are involved to further fight against illicit trade.
In Uganda, 22% of all cigarettes sold in the market were from illicit trade.

Political unrest rampant within key export markets.

BAT has export markets in Southern Sudan, DRC, Somalia, and Egypt among others. All these have one thing in common; they were classified as fragile situation areas under the International Monetary Fund, 2019 Sub Saharan Africa Economic Outlook. South Sudan recently had their government overthrown and as such the export market may be highly volatile reducing their sales volume downwards. Last year, Sudan was a key contributor to BAT's export revenue. DRC has also been experiencing political instability and as such, trade in the country is expected to be low.

Low Growth Rate In Smoker Numbers

According to the 2015 WHO Global Report on the prevalence of tobacco smoking, the number of smokers in Kenya in 2010 was estimated at 3,174,500. In 2025, the smoking population is estimated to increase to 4,063,400. This represents a CAGR of 1.78% which is pretty low. This is in line with the global smoking prevalence trend that was estimated at 22.1% in 2010. In 2025, it's estimated at 18.9%.

Dividend play and marginal volume growth

BAT Kenya serves 9 export markets within the African market that have been contributing on average, 45% of the total revenue. With the current focus on accessing Free Trade Agreements as well as elimination of trade barriers at the regional level, these initiatives should enable greater market access as well as further growth. We are therefore on the look out to see how this pans out.

In FY18, they declared a final dividend of KSH 31.50 net of withholding tax to a total of KSH 35.00. For the last four years, BAT has had an average of 91% dividend payout ratio. In addition, the average dividend per share has been KSH 38.25 which is attractive for their shareholders. These attractive and consistent dividend payments keep the company on a top radar with investors.

The local Safari brand was transformed into the Pall Mall global brand. According to their annual report, this transformation is already delivering impressive results. This brand is likely to experience competition with the entrant of a new premium brand in the market.

VALUATION

We derive a target price of KES 643.36 using a combination of both absolute and relative valuation. The weighting was 30% each for DCF and DDM and 20% each for P/E and P/B methods.

Methods	Current Price	Target Price	Weights	
DCF	548.45	552.81	30%	165.84
P/B	647.78	707.70	20%	141.54
DDM	505.48	552.24	30%	165.67
P/E	851.55	772.78	20%	170.31
			1	643.36
	Price 28.07.2019			506.00
	Upside			27%

The assumptions are as follows:

Assumptions:	
Total Debt	2,976,976
Equity	8,796,789
Cost of Equity	
Risk free rate	12.4%
Beta	0.57
Risk premium	5.00%
Cost of Equity	15.25%
Cost of debt	13.41%
WACC	14.78%
Terminal Growth	6.00%
Days of the year	365

RESEARCH DISCLOSURE

Though utmost care has been taken in the preparation of this report, we do not guarantee the accuracy or completeness of the information contained herein nor will AIB Capital Ltd be held liable for the information contained herein.

The views expressed in this report are solely those of the Research Department and are subject to change without notice.

The information in this report is not an offer for the sale or purchase of any security. This document should only be considered a single factor used by investors in making their investment decisions.

This publication may not be distributed to the public media or quoted or used by the public media without prior and express written consent of AIB Capital Ltd.

NOTICE TO US INVESTORS

This report was prepared, approved, published and distributed by AIB Capital Limited Company located outside of the United States (a non-US Group Company"). This report is distributed in the U.S. by LXM LLP USA, a U.S. registered broker-dealer, on behalf of AIB Capital Limited only to major U.S. institutional investors (as defined in Rule 15a-6 under the U.S. Securities Exchange Act of 1934 (the "Exchange Act")) pursuant to the exemption in Rule 15a-6 and any transaction effected by a U.S. customer in the securities described in this report must be effected through LXM LLP USA.

Neither the report nor any analyst who prepared or approved the report is subject to U.S. legal requirements or the Financial Industry Regulatory Authority, Inc. ("FINRA") or other regulatory requirements pertaining to research reports or research analysts. No non-US Group Company is registered as a broker-dealer under the Exchange Act or is a member of the Financial Industry Regulatory Authority, Inc. or any other U.S. self-regulatory organization.

Analyst Certification. Each of the analysts identified in this report certifies, with respect to the companies or securities that the individual analyses, that (1) the views expressed in this report reflect his or her personal views about all of the subject companies and securities and (2) no part of his or her compensation was, is or will be directly or indirectly dependent on the specific recommendations or views expressed in this report. Please bear in mind that (i) AIB Capital Limited is the employer of the research analysts responsible for the content of this report and (ii) research analysts preparing this report are resident outside the United States and are not associated persons of any US regulated broker-dealer and that therefore the analysts are not subject to supervision by a US broker-dealer, and are not required to satisfy the regulatory licensing requirements of FINRA or required to otherwise comply with US rules or regulations regarding, among other things, communications with a subject company, public appearances and trading securities held by a research analyst account.

Important US Regulatory Disclosures on Subject Companies. This material was produced by Analysis AIB Capital Limited solely for information purposes and for the use of the recipient. It is not to be reproduced under any circumstances and is not to be copied or made available to any person other than the recipient. It is distributed in the United States of America by LXM LLP USA and elsewhere in the world by AIB Capital Limited or an authorized affiliate of AIB Capital Limited. This document does not constitute an offer of, or an invitation by or on behalf of AIB Capital or its affiliates or any other company to any person, to buy or sell any security. The information contained herein has been obtained from published information and other sources, which AIB Capital Limited or its Affiliates consider to be reliable. None of AIB Capital Limited accepts any liability or responsibility whatsoever for the accuracy or completeness of any such information.

All estimates, expressions of opinion and other subjective judgments contained herein are made as of the date of this document. Emerging securities markets may be subject to risks significantly higher than more established markets. In particular, the political and economic environment, company practices and market prices and volumes may be subject to significant variations. The ability to assess such risks may also be limited due to significantly lower information quantity and quality. By accepting this document, you agree to be bound by all the foregoing provisions.

LXM LLP USA assumes responsibility for the research reports content in regards to research distributed in the U.S. LXM LLP USA or its affiliates has not managed or co-managed a public offering of securities for the subject company in the past 12 months, has not received compensation for investment banking services from the subject company in the past 12 months, does not expect to receive and does not intend to seek compensation for investment banking services from the subject company in the next 3 months. LXM LLP USA has never owned any class of equity securities of the subject company. There are not any other actual, material conflicts of interest of LXM LLP USA at the time of the publication of this research report. As of the publication of this report LXM LLP USA, does not make a market in the subject securities.