BAT KENYA
FY16 RESULTS NOTE

AIB CAPITAL LTD
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BAT Kenya released a set of **disappointing** numbers for FY 16. The company hosted an investor briefing today. Profit after Tax declined 15% to Kes 4.2 Bn on the back of increases in excise duty and VAT. A 24 % increase in excise duty and VAT saw Net revenues decline 11% to Kes 19.9 Bn. The Board declared a total dividend of Kes 43 which was 7% lower than the previous year.

Gross revenues increased 2% to Kes 36.7 Bn, buoyed by a 7% increase in domestic revenues. The increase in domestic gross revenues was due to **changes in pricing** following the implementation of the **new excise bill 2015**. Management indicated that **local volumes actually declined** during the year, due to the pricing effects of the new bill. BAT products are categorized in 4 products segments. Premium, aspiring premium, value and low price. Amongst the 4 product categories, value products which include Sportsman and SM saw the biggest decline in volumes due to down trading to low price products. Premium products saw volume increase after the company introduced new products during the year. Despite the decrease in volumes, management noted that they were able to acquire 1.24% of the market share during the year.

The exports markets saw 11% decline in revenues following low volume sales. This was occasioned by the drought that hit Somaliland in 2015 which is one of their biggest export markets. The political and economic uncertainty in the DRC also contributed heavily to the decline in export volumes. The cut rug business was reported to be on a slow recovery currently selling 1.1 million KGs valued at about USD 8.8Mn (Kes 906 million). Egypt is currently their principal market for cut rug. Currently revenue is split 56: 44 between domestic and exports.

Profitability was also affected by a one off reorganization cost of Kes 340 Million.

Operational costs however declined 9%, to Kes 13.3 Bn to offer some reprieve to declining net revenues. Management attributed this to stringent cost management, productivity and overhead savings. The company was able to deliver productivity savings of Kes 686 mn. This was mainly attributed to

- Price negotiations and change in specifications of wrapping materials-Kes 207 mn
- Savings in IT supplies, spare parts etc.-Kes 255Mn
- 5% reduction in energy usage-Kes 80mn
- Logistical efficiencies-Kes 36Mn
- And substitutions between local and imported leaf-Kes 47Mn

Cash generated from operations improved 40% to Kes 8 Bn on the back of improved working capital efficiencies.

RATING: SELL

Bloomberg ticker	**BATK KN**
Last close (KES)	900.00
Target price (KES)	587.12
Downside potential	35%
Market cap(Kes BN)	90.17
Dividend Yield	5%
52-week range	765 - 920

Key Highlights

- *Profit after tax decline 15%*
- *24% increase in excise & VAT*
- *11% decline in Net revenues*
- *9% reduction in operating costs*

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Outlook

Management notes that Domestic volumes stabilized towards the end of 2016. They therefore expect volumes to remain stable in 2017 with a slight upward bias. For the export market, the challenges affecting their principal export markets are yet to wade off. The drought situation in Somali land is still persisting, while political instability in DRC continues to affect consumption patterns negatively. Following the decision by the mother company to shut down the Uganda, Rwanda and Malawi factories, some new opportunities have emerged in the region. The company is looking into ways of venturing in Tanzania although Management admits that the barriers to entry for Kenyan companies are unfairly high.

Management is also anticipating for more regulations in 2017. Tobacco Control Law 2014 for instance is still under implementation and is a key source of uncertainty in the industry. The excise bill has however been simplified in structure and is now well predictable and easy to plan for due to the excise indexing, meaning future excise increments will be benchmarked to a known metric (inflation in this case).

Valuation

With low capital expenditures and high dividend payout (89%), we categorize BAT as a mature company with limited growth prospects. We therefore expect flat earnings growth in 2015 due to lack of volume growth and wading effects of cost cutting measures. In our IOC for BAT, we estimated the fair value of BAT at **Kes 587** per share which represents **a 35% downside** from the current price of **Kes 900** Per share. **Click on this link the full IOC.** BAT is currently trading at a P/E of 18.56 and a dividend yield of 5%.

Management comments

On BAT PLC

- BAT Plc is looking to increase its stake in RJ Reynolds from 48% to 100% at a cost of USD 48 bn (Kes 4.9 Trillion)
- Transaction expected to close in Q3 2017

On the operating environment

- Consumption power on the decline due to higher taxes and persistent inflation
- Kenya's regulation on Tobacco is very active
- BAT supported the new excise structure but disagree with the level of taxation

On exports

- Severe drought in Somaliland reduced consumption
- Political turmoil in DRC is negatively affecting consumption
- Tanzania is an attractive market but their exists some illegal and unfair barriers to entry for Kenyan companies

On Operations

- The company has had 4 years without an accident
- Energy consumption down 5%
- The company retrenched 20-50 people in 2016 due to improved efficiencies

On regulation

- It is uncertain whether the 2% turnover tax will be charged on Gross sales on Net sales
- BAT went ahead with implementing the picture graphics on their products

On Illicit trade

- The illicit trade market share is hard to measure
- BAT estimates it to be 5% in 2016 and growing
- Illicit trade is highest in western Kenya in Towns bordering

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