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# BAT's 4QFY18 performance within expectations

**British American Tobacco (Malaysia) Bhd (Feb 22, RM36.30)**

**Maintain sell with a target price (TP) of RM29.00:** British American Tobacco (Malaysia) Bhd's (BAT) fourth quarter of financial year 2018 (4QFY18) results were within expectations. Notably, illicit activity heightened amid greater government clampdowns. Against the backdrop of enhanced competition from heat-not-burn (HNB) products and regulatory risk, BAT faces challenging headwinds going forward. Maintain sell with a higher target price of RM29.

BAT's 4QFY18 sales volume grew 4.8% quarter-on-quarter (q-o-q). BAT's q-o-q sales growth outstripped volume growth of 2.2% q-o-q. This was attributed to higher average selling prices (ASPs) which were raised by 40 sen per pack or 2.4% in early November. Meanwhile, BAT's volume sales grew 2.2% year-on-year (y-o-y) amid the broader industry contracting 1%. It suggests BAT gained a market share of two percentage points (ppts) to 55%, suggesting possible trade restocking ahead of raised ASPs. Amid higher ASPs due to the sales and service tax (SST), illicit market share gained 1ppt to 64% against 9M18 with 63% despite increased government clampdown efforts.

Although 4QFY18 sales grew 4.8% q-o-q, core net profit fell by 8.4% q-o-q due to margin contraction from downtrading to low-

er-margin value-for-money (VFM) brand Rothmans (which is priced at RM12 per pack versus (vs) aspirational premium product at RM15.50 per pack and premium product at RM17 per pack); and introduction of SST crimped margins relative to the zero-rated goods and services tax (GST) period.

During Budget 2019, the government indicated its intention to recoup at least RM1 billion in tax leakages lost to illicit cigarettes.

**We expect an illicit market share to remain elevated at an average of 60%.**

This implies the removal of 2.5 billion illicit cigarette sticks from the market or drastically lowering the illicit trade's market share down to 48% (from 63%). During the briefing, management did point out significantly stronger enforcement efforts from the authorities. However, the illicit market share deteriorated to an all-time high of 64% from 63% in 3Q18. Due to the shortcomings in enforcement effectiveness, we raise our 2019 illicit market share assumption to 60% from 57% previously. The value disparity between legal and illicit cigarettes remains severe, at

up to RM12-14 per pack. On the back of the aforementioned and an established distribution network, illicit trade continues to thrive.

On Jan 1, 2019, the no smoking ruling at all eateries and restaurants took effect. Smokers are only permitted to smoke three metres away from establishments. Management estimates the new regulations had reduced volumes by 1% since Jan 1. The tightening of regulations on aspects such as plain packaging and the World Health Organization's (WHO) recommended excise duty rate (at least 70% of the final end-consumer price [Malaysia: 46%]) are ever-present regulatory risks to BAT. We expect the eventual adherence to WHO guidelines to further undermine BAT in the long run.

In summary, we expect conditions to remain challenging over the course of 2019. We expect an illicit market share to remain elevated at an average of 60%. Meanwhile, recent SST-raised ASPs would catalyse downtrading in the margin-dilutive VFM segment. Factoring in these new developments translates into flattish sales volume growth of 0.2% for 2019. Apart from that, we anticipate the emergence of iQOS, a smoke-free electronic device designed from Philip Morris International (PMI), to gain 5% market share and dilute BAT's market share to 52% in the process (vs 2018: 54%). — UOB Kay Hian, Feb 22