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Affordability expected to remain a concern for BAT

British American Tobacco (Malaysia) Bhd
(July 26, RM26.20)

Maintain reduce with a lower target price (TP) of RM21.88: British American Tobacco (Malaysia) Bhd (BAT)'s first half of financial year ended June 30, 2019 (1HFY19) core net profit fell short of expectations; it accounted for 43% of our full-year expectations, and 37% of *Bloomberg* consensus.

1HFY19 core net profit fell 18% year-on-year (y-o-y) as a result of a 10% y-o-y fall in sales volume, and margin erosion (-2.2 percentage points [ppts] y-o-y) from the down-trading of premium cigarettes to the value-for-money (VFM) segment and higher investments in new products.

After removing the GST (goods and services tax) collection in 1HFY18, BAT's revenue fell 10% y-o-y. Second quarter ended June 30, 2019 (2QFY19) dividend per share of 26 sen was below expectations.

Although BAT's top line inched up 3.2% quarter-on-quarter (q-o-q), its core net profit regressed 14.5% q-o-q. Operating expenses rose 6.6% q-o-q, slicing its earnings before interest and tax margin by 2.7 ppts q-o-q.

BAT said there were higher distribution expenses for its new products, namely the Dunhill cigarillos that it is piloting in Sarawak, and the Glo heat-not-burn line that is set to be launched in 4QFY19.

BAT credited the q-o-q sales growth to growing Rothmans sales, which unfortunately came at the expense of smokers switching from the premium Dunhill brand.

Evidently, the 3-ppt drop in the illicit market share year to date to 60% was not enough to reverse BAT's woes.

The group is aware that the overwhelming demand for contrabands is a corollary to legal cigarettes becoming unaffordable to many smokers.

In our view, the best measure to tackle the contraband malaise is by narrowing the pricing gap between legal and illegal cigarettes — but it is easier said than done as public

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backlash may ensue.

We cut our financial year ending Dec 31, 2019 (FY19) to FY21 earnings per share (EPS) by 12% to 24% as we slash our sales volume forecast by around 15%.

Our projection is still susceptible to risks of more smokers down-trading to value-for-money (VFM) cigarettes; and total cigarette volume contracting on the back of vapes' rising popularity.

Admittedly, Glo may provide some upside to earnings, provided that its sales pick up quickly. We have yet to factor in Glo's sales to our forecasts.

The EPS cut leads to our dividend discount model-based TP being lowered by 23% to RM21.88.

While we commend BAT's relentless effort to combat declining sales, the affordability issue would continue to haunt the group for the foreseeable future.

Upside risks to our call are registering higher sales, wage growth, and a more palatable excise duty rate. — *CGSCIMB Research, July 26*

British American Tobacco (Malaysia) Bhd

FYE DEC (RM MIL)	2017A	2018A	2019F	2020F	2021F
Revenue	2,916	2,823	2,707	2,738	2,835
Operating Ebitda	654.7	603.9	466.6	456.8	501.1
Net profit	492.6	430.2	340.8	334.2	368.2
Core EPS (RM)	1.73	1.51	1.19	1.17	1.29
Core EPS growth (%)	(21.7)	(12.7)	(20.8)	(1.9)	10.2
FD core PER (x)	17.16	19.65	24.80	25.29	22.96
DPS (RM)	1.69	1.55	1.17	1.15	1.26
Dividend yield (%)	5.71	5.24	3.95	3.87	4.27
EV/Ebitda (x)	13.47	14.55	18.77	19.13	17.39
P/FCFE (x)	12.43	16.96	31.34	28.94	25.27
Net gearing (%)	95.4	78.6	71.8	66.4	59.2
P/BV (x)	22.01	20.04	19.74	19.44	19.11
ROE (%)	99	107	80	77	84
% change in core EPS estimates			(11.7)	(23.2)	(23.8)
CIMB/consensus EPS (x)			0.77	0.69	0.70

Sources: CGSCIMB Research, company reports