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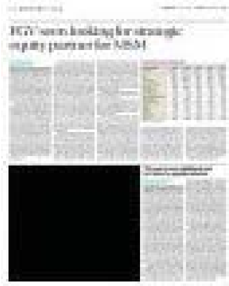

BAT earnings likely to improve

British American Tobacco (Malaysia) Bhd
(July 29, RM23.82)

Upgrade to buy with an unchanged target price (TP) of RM33.30: First half of 2019 (1H19) results were disappointing due to the lower-than-expected sales volume and margin. However, we see positives in the quarter-on-quarter (q-o-q) volume pickup, the long-awaited approval for Glo, and the continuous reduction in illicit trade. Sequential earnings improvement on sustained volume growth and moderation in marketing expenses, and the launching of Glo in the fourth quarter 2019 (4Q19) which opens up a new revenue stream, could catalyse the share price.

British American Tobacco (Malaysia) Bhd (BAT) reported first half of financial year 2019 (1HFY19) core net profit of RM164.9 million (-19.5% year-on-year [y-o-y]) which was below both our and consensus expectations at 34% to 38% of full-year forecasts. The negative deviation can be attributed to lower-than-expected sales volume and lower-than-expected gross margin as a result of continuous downtrading.

1HFY19 revenue fell 4.2% to RM1.3 billion as BAT's sales volume declined by 10%, but this was mitigated by the impact of sales and service tax, which is embedded in revenue. However, we highlight that the second quarter of 2019 (2QFY19) sales volume picked up 4% q-o-q, mainly driven by the robust growth of the Rothmans range. 1HFY19 core net profit was primarily dragged by the 20% spike in operating expenses. This is due to the front-loading or phasing of marketing spending and prelaunch investment for the tobacco heated product (THP) — Glo, which has been approved by the health ministry and will be launched in 4Q19.

We highlight that the 2QFY19 sales volume picked up 4% q-o-q, mainly driven by the robust growth of the Rothmans range. 1HFY19 core net profit was primarily dragged by the 20% spike in operating expenses.

Post-results, we cut our FY19F (forecast) to FY21F earnings by 13.8%, 6.6% and 3.5%, after factoring in a more realistic total industry volume and margin. However, our discounted cash flow-driven TP is kept unchanged at RM33.30 despite the earnings cut as we impute the contribution from Glo to our forecasts. Glo to give competitor a run for its money. The share price may react negatively to the lacklustre 2QFY19 results, but we believe investors should capitalise on any potential weakness. Earnings are likely to see sequential improvement in coming quarters, as volume growth in 2QFY19 is deemed sustainable and operating expenses will moderate from the high base in 1HFY19.

Looking further ahead, the launching of Glo will provide a much needed boost for BAT as a new revenue stream. We also foresee margin expansion, as the Glo product attracts 40% lower excise duty as compared with conventional ones.

We estimate the excise duty/selling price for Glo to be at 34% versus 46% to 65% for the latter. Although its competitor has gotten a headstart over BAT with the earlier launch, the management is bullish on Glo's sales ramp-up, given the product quality and proliferation of THPs as a healthier smoking option.

Risks to our recommendation include a rise in illicit trade market share and weaker-than-expected sales pickup for Glo. — *RHB Research Institute, July 26*