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BAT still awaiting nod for 'heat-not-burn' product pricing

British American Tobacco (Malaysia) Bhd (May 29, RM31)

Downgrade to underperform with a lower target price (TP) of RM29.55: British American Tobacco (Malaysia) Bhd's (BAT) first quarter of financial year 2019 (1QFY19) net profit of RM88.6 million is below our and consensus estimates, making up 19%/18% of respective full-year forecasts.

The negative deviation was due to the decline in overall market size, lower premium brand mix and down-trading to lower margin value-for-money (VFM) offerings. An interim dividend of 30 sen was declared. We deem this to be within our initial FY19 payment of RM1.55.

Year-on-year (y-o-y), first three months of financial year 2019 (3MFY19) revenue of RM621 million was weaker by 3%. Despite some improvement of illicit trade proportions at 61% (1QFY18: 63%), total legal industry volumes diminished by 6% to 543 million sticks/month in 3MFY19.

This could be a result of the smoking ban in eateries and higher sales and service tax (SST)-priced products in November 2018, which undermined affordability.

This led to poorer demand of premium brands (estimated by 14%), with a consequential down-trading boosting a higher mix of VFM products (estimated at 60% volume; 8% of total group volume, versus 5% in 3MFY18).

Dragged down by the lower top line and poorer product mix, 3MFY19 net earnings closed at RM88.6 million.

Quarter-on-quarter (q-o-q), 1Q19 sales declined by 19% against 4Q18, led by the similar above mentioned reasons. 1QFY19 net profit was lower by 24% from lower volumes sold and poorer product mix.

Overall, while it appears that illicit trades are taking a step back from stricter enforcement, the legal market share is also experiencing a decline as higher post-SST prices impair affordability (with rural areas being a key market for premium brands) and smoking ban at eateries adding to the lower consumption.

While regulators believe that clamping down on illicit trade channels could channel purchases to legal duty-paid products, we are not on board with this point of view as affordability was the key reason for the spurt in its market share.

In the meantime, the management is still in the process of obtaining the pricing approval from regulators for its "heat-not-burn" products to be introduced into the market. Additionally, the group is testing the market reception of its cheaper cigarillo variant in East Malaysia before a larger-scale introduction.

Post-results, we cut our FY19/FY20 estimated earnings by 11.1%/12.5% to account for more cautious sales volumes and product mix.

Downgrade to "underperform" with a lower TP of RM29.55 (from RM32.65 previously). We ascribe an unchanged valuation of 20 times price-earnings ratio (closely in line with stock's -1 standard deviation over its three-year mean) on a rolled over valuation base-year to FY20.

While the stock could offer fair dividend yield of around 4%, the lack of clear signals of industry volume improvement, stubborn illicit market share and poor affordability are main hurdles to the group's profitability.

Risks to our call include (i) faster-than-expected recovery of legal market share; (ii) lower-than-expected conversion towards less premium brands; and (iii) significant decrease in forex to improve cost of sales. — *Kenanga Research, May 29*

British American Tobacco (Malaysia) Bhd

FYE DEC (RM MIL)	2018A	2019E	2020E
Turnover	2,822.9	2,649.8	2,721.9
Ebit	635.3	563.6	572.4
PBT	623.0	552.8	562.5
Net profit	468.5	414.6	421.9
Core net profit	468.5	414.6	421.9
Consensus (NP)	-	487.0	526.8
Earnings revision (%)	-	-11.1	-12.5
Core EPS (sen)	164.1	145.2	147.8
Core EPS growth (%)	-10.3	-11.5	1.8
NDPS (sen)	155.0	137.0	140.0
BVPS (RM)	1.5	1.5	1.6
PER (x)	20.4	23.0	22.6
PBV (x)	22.6	21.6	20.6
Net gearing (x)	0.8	0.5	0.6
Net dividend yield (%)	4.6	4.1	4.2

Source: Kenanga Research