

BAT KENYA : REDUCED TO A HOLD, MARGINS PRESSURE AND MULTIPLES DE-RATING

We issue a HOLD recommendation on BAT Kenya (BATK: KN) from a BUY. Our new FV of KES 460.00 (previous FV of KES 544.27) implies an upside of 13.6%. Compared to our initial estimates, we forecast lower volumes and margins on account of subdued demand and escalating costs. However, we forecast an increased dividend payout of about 95.3% vs. 82.7% previously, driven by improved cashflows. At its current EV/EBITDA multiple of 3.6x and PE multiple of 5.9x, the implied long-term growth rates range between 2.0% and 4.0%. With our earnings growth averaging 2.4%, we think the HOLD rating is largely justified.

The key risk to our recommendation is the continued loss of the cigarette business momentum, largely in the domestic market, without the acceleration of new markets and products.

KEY POSITIVES

- **We expect a recovery in net revenue growth in the Kenyan cigarettes market – average annual growth rate of 3.3%, over our forecast period, after an expected 1.8% y/y dip in FY23.** We expect improved performance on account of; 1) recovery in cigarette consumption per capita, 2) population growth, 3) excise-led price increments in FY25 – after a relief from the annual inflationary adjustment of excise duty in FY23, (an adjustment in excise-duty can't be ruled out in subsequent years,) and 3) regaining market share in the value segments as the effects of downtrading ease. While lobbying for a more predictable excise duty regime, industry players in Kenya sought for adjustments in excise duty after every two years. Through the Finance Act 2023, Tanzania guided for a three-year period.
- **We expect a rebound in cut rag volumes, stable cigarette export volumes and pricing benefits from a weaker KES to sustain export revenues – average annual growth rate of 2.1% over our forecast period.** In FY23 though, we expect volumes of export cigarettes and cut rag to decline 10.1% and 10.2%, respectively, owing largely to reduced demand arising from political unrest in select export markets. However, we expect the appreciating USD to offset some of the impact from lost volumes – we estimate average depreciation of KES against USD of 20% in FY23. Looking ahead, we have modelled in a 1.0% yearly depreciation.
- **We expect EBITDA margins to average 33.2% over our forecast period, on the back of continued operational efficiencies.** In 2021 and 2022, there was significant excise increments, which pushed margins to an average of 38.8%. While we forecast a moderation in margins over our forecast period, we still expect margins to be 70bps higher compared to the levels seen between 2014 and 2020.
- **We expect BAT's excess returns above cost of capital and a higher dividend pay-out to drive a re-rating on the stock price.** We forecast BAT's dividend pay-out to average 95.3% between FY24 and FY26, up from an average of 82.3% in the last three years - our view on higher dividend pay-out is predicated on lower forecast CAPEX requirements and a de-levered balance sheet. On returns front, BAT's return on invested capital exceeds its WACC by, 12.7ppt, on average.

KEY NEGATIVES

- **We expect affordability pressures to result in subdued domestic consumption, and reverse some of the gains achieved from premiumisation.** We expect downtrading to impair margins. Further, we suspect the downtrading could lead to loss of market share to competitors, especially within the mainstream and value segments.
- **We expect illicit trading of cigarettes to remain stubbornly high, currently at historical records of 26.0%.** This is on account of continued excise duty differentials between Kenya, Uganda and Tanzania; weak border controls and the illegal sale of cigarettes meant for exports locally at cheaper prices. In FY23/24 fiscal years, Uganda retained its excise duty rates while Tanzania increased its excise duty rates. However, compared to Kenya, excise duty rates in Tanzania and Uganda are still 57.8% and 45.0% lower, respectively, reflecting the huge differential.
- **We expect regulatory and tax pressures to continue weighing on the business climate.** Excise Regulations 2023 seeks to increase the cost of excise stamps by 79.0%. However, we note that the courts have stayed the implementation of the cost of the new excise stamps.
- **We expect a weaker 2H23 compared to 1H23 -a 20% decline.** In our view, we expect the squeeze on margins and volumes to be largely felt in the 2H23, as result of affordability pressures and downtrading as new taxes came into effect and macro conditions weakened.

ESTIMATED KEY STATISTICS

	FY20E	FY21E	FY22E	FY23E	FY24E	FY25E	FY26E
Smoking Prevalence, Total (Ages 15+)	11.7%	11.6%	11.4%	11.2%	11.1%	10.9%	10.8%
Assumed Smoking Population '000	3,404	3,458	3,451	3,474	3,496	3,518	3,540
y/y	1.9%	1.6%	-0.2%	0.7%	0.7%	0.7%	0.7%
No. of sticks per person per day	5.5	5.6	5.3	5.0	5.0	5.1	5.2
Estimated no.of total packs sold in Kenya (m)	281	290	274	261	262	269	276
y/y	-6.6%	3.4%	-5.5%	-5.0%	0.6%	2.6%	2.6%
Illicit % of total sticks sold	22.0%	23.8%	25.0%	26.0%	26.0%	26.0%	26.0%
Estimated sticks sold in legal market (m)	219	221	206	193	194	199	204
y/y	-17.9%	1.0%	-7.0%	-6.3%	0.6%	2.6%	2.6%
Estimated Volumes of packs sold by BAT (m)	174	176	164	152	153	158	163
y/y	-22.7%	1.2%	-6.9%	-7.0%	0.6%	3.0%	3.0%
Estimated ex-factory cigarette prices (KES)	124.82	137.89	181.55	182.25	182.83	193.45	194.20
y/y	7.7%	10.5%	31.7%	0.4%	0.3%	5.8%	0.4%
Excise duty per pack (KES)	61.55	64.61	79.33	79.36	79.38	83.61	83.64
y/y	14.2%	4.97%	22.8%	0.0%	0.0%	5.3%	0.0%
Cut Rag Volumes (Metric Tons)	5,100	5,496	5,099	4,577	4,805	5,043	5,294
y/y	30.8%	7.8%	-7.2%	-10.2%	5.0%	5.0%	5.0%
Price Per Metric Ton (KES)	668	450	572	672	679	686	694
y/y	25.1%	-32.6%	26.9%	17.5%	1.1%	1.1%	1.1%
Estimated cut rug exports revenue (KES bn)	2.1	3.4	2.5	2.9	3.1	3.3	3.5
y/y	37.0%	63.6%	-27.3%	17.8%	5.5%	6.1%	6.1%
USDKES Movements (y/y)	-4.6%	-4.0%	-6.2%	-20.2%	-1.0%	-1.0%	-1.0%

Source: Kestrel Estimates, Kestrel Research

KEY METRICS

	FY20A	FY21A	FY22A	FY23F	FY24F	FY25F	FY26F
EPS	55.17	64.83	68.92	59.80	59.90	62.10	64.21
y/y	42.0%	17.5%	6.3%	-13.2%	0.2%	3.7%	3.4%
DPS	45.00	53.50	57.00	57.00	57.09	59.19	61.20
y/y	34.3%	18.9%	6.5%	0.0%	0.2%	3.7%	3.4%
Payout	81.6%	82.5%	82.7%	95.3%	95.3%	95.3%	95.3%
EV/EBITDA (x)	4.8	3.8	3.6	4.1	4.1	3.9	3.8
P/E (x)	7.3	6.2	5.9	6.8	6.8	6.5	6.3
Div. Yield	11.1%	13.2%	14.1%	14.1%	14.1%	14.6%	15.1%
RoAE	51.2%	48.3%	44.0%	36.2%	35.6%	36.1%	36.3%
RoAA	25.3%	28.3%	28.7%	24.1%	23.1%	23.3%	23.4%
ROIC	45.1%	43.0%	38.8%	31.7%	31.3%	31.8%	32.0%

Source: Company, Kestrel Research

VALUATION APPROACH

DCF:

- We discounted the free cash flows and the terminal value over our forecast period using a weighted average cost of capital (WACC) of 19.0%.
- We applied an exit EV/EBITDA multiple of 6.5x to our final year EBITDA determined from an average of 9.4x and 3.5x. Based off EV/EBITDA, EBITDA margins and ROIC relationship, we used BAT's own historical EV/EBITDA, EBITDA margins and ROIC, and the projected EBITDA margins and ROIC to arrive at an EV/EBITDA multiple of 9.4x. Based off BAT's projected ROIC, growth and WACC, we arrived at a target multiple of 3.5x.

KES (000s)		FY24F	FY25F	FY26F	TV*
Operating Profit		8,438,095	8,750,461	9,049,577	
Adjustments for:					
Depreciation and amortisation		675,649	699,876	724,971	
Working capital movements		(32,777)	(136,301)	(100,636)	
CAPEX		(791,221)	(819,591)	(848,979)	
Cash tax		(2,563,865)	(2,658,140)	(2,748,573)	
Free cash flow		5,725,882	5,836,305	6,076,360	
3 Year Exit Value					63,329,870
WACC		19.0%	19.0%	19.0%	
Discount period		19.0%	19.0%	19.0%	
Discount factor		0.8	0.7	0.6	
Present value of cash flow		4,754,676	4,072,580	3,563,101	
Cumulative PV of FCF	12,390,357				
PV of Terminal Value	37,135,841				
Value of operations	49,526,198				
add: net cash & less minorities	(2,925,092)				
Equity value	46,601,106				
No. of shares (000s)	100,000				
Fair value (KES)	466.01				
Current share price (KES)	405.00				
Upside/ (downside)	15.1%				

Source: Company, Kestrel Research, *Terminal Value

DDM:

- We discounted the forecast dividends and the terminal value using our estimated cost of equity of 19.0%.
- We applied an exit PE of 8.9x to our final year owner’s earnings determined from average of PE multiples of 11.4x, 5.5x and 9.9x. Based off PE and ROE relationship, we used BAT’s own historical PE and ROE, and the projected ROE to arrive at a PE multiple of 11.4x. Based off BAT’s projected ROE, growth and cost of equity, we arrived at a target PE multiple of 5.5x. Assessing its comparable peers, we arrived at a PE multiple of 9.9x.

KES (000s)		FY24F	FY25F	FY26F	TV*
Dividend Per Share		54.24	56.23	58.14	
3 Year Exit Value					572
Discount Period		1.1	2.1	3.1	
Discount Rate		19.0%	19.0%	19.0%	
Discount Factor		0.8	0.7	0.6	
Present Value of Dividends		45.04	39.24	34.09	
Cumulative PV of Dividends	118.37				
PV of Terminal Value	335.63				
Fair Value (KES)	454.00				
Current Share price (KES)	405.00				
Upside (downside)	12.1%				
Assumptions					
Exit PE	8.9x				
Risk free rate	13.0%				
Risk premium	6.0%				
Beta	1.0				
Cost of equity	19.0%				

Source: Company, Kestrel Research, *Terminal Value

Valuation Approach	Fair Value Estimate
Discounted Cashflows	466.01
Dividend discount Model	454.00
Average	460.00
Current Share Price	405.00
Upside/ (downside)	13.6%

Source: Kestrel Estimates

FINANCIALS

Income Statement

KES (m)	FY20	FY21	FY22	FY23	FY24	FY25	FY26
Gross Revenue	38,845	40,049	42,247	42,833	43,423	46,283	47,654
Net Revenue	25,339	25,427	27,378	26,874	27,342	28,811	29,642
Operating Costs	(17,882)	(16,212)	(17,618)	(18,568)	(19,027)	(20,192)	(20,728)
EBITDA	8,098	9,960	10,510	9,080	9,114	9,450	9,775
Operating Profit	7,589	9,370	9,880	8,428	8,438	8,750	9,050
Net Finance Costs	(173)	(82)	33	112	115	118	120
Profit Before Tax	7,416	9,288	9,913	8,540	8,554	8,868	9,170
Taxation	(1,898)	(2,805)	(3,021)	(2,560)	(2,564)	(2,658)	(2,749)
Profit After Tax	5,517	6,483	6,892	5,980	5,990	6,210	6,421
Dividends Proposed	5,517	6,483	6,892	5,980	5,990	6,210	6,421

Balance Sheet

KES (m)	FY20	FY21	FY22	FY23	FY24	FY25	FY26
Non-Current Assets	10,914	12,305	12,096	12,207	12,323	12,443	12,567
Current Assets	10,792	11,814	11,851	13,518	13,864	14,694	15,243
Total Assets	21,706	24,119	23,947	25,725	26,187	27,136	27,810
Non-Current Liabilities	1,576	1,939	2,084	2,081	2,076	2,073	2,070
Current Liabilities	8,273	7,206	5,481	6,982	7,159	7,611	7,785
Total Liabilities	9,850	9,144	7,565	9,063	9,235	9,684	9,855
Working Capital	2,518	4,608	6,370	6,536	6,705	7,083	7,458
Shareholders' Equity	11,856	14,974	16,382	16,662	16,952	17,453	17,955
Total Equity & Liabilities	21,706	24,119	23,947	25,725	26,187	27,136	27,810

Cash Flow Statement

KES (m)	FY20	FY21	FY22	FY23	FY24	FY25	FY26
Cashflows from operations	7,418	8,571	9,205	9,571	9,176	9,409	9,769
Net Operating cashflows	4,746	6,235	5,619	7,028	6,633	6,773	7,046
Net investing cashflows	(1,280)	(570)	(752)	(764)	(791)	(820)	(849)
Net financing cashflows	(3,394)	(4,521)	(5,528)	(5,707)	(5,709)	(5,716)	(5,926)
Year-end cash	1,884	3,029	2,368	2,925	3,057	3,295	3,566

Source: Company, Kestrel Research

KEY RATIOS

Growth % (y-o-y)

	FY20	FY21	FY22	FY23	FY24	FY25	FY26
Total Assets	-1.1%	11.1%	-0.7%	7.4%	1.8%	3.6%	2.5%
Total Liabilities	-19.4%	-7.2%	-17.3%	19.8%	1.9%	4.9%	1.8%
Total Equity	22.0%	26.3%	9.4%	1.7%	1.7%	3.0%	2.9%
Gross Revenue	-2.5%	3.1%	5.5%	1.4%	1.4%	6.6%	3.0%
Net Revenue	5.4%	0.3%	7.7%	-1.8%	1.7%	5.4%	2.9%
Operating Costs	-4.1%	-9.3%	8.7%	5.4%	2.5%	6.1%	2.7%
Operating Profit	29.1%	23.0%	5.5%	-13.6%	0.4%	3.7%	3.4%
Profit Before Tax	32.5%	23.5%	5.5%	-14.7%	0.1%	3.7%	3.4%
EPS	34.0%	25.2%	6.7%	-13.8%	0.2%	3.7%	3.4%
DPS	42.0%	17.5%	6.3%	-13.2%	0.2%	3.7%	3.4%

Revenue Mix

	FY20	FY21	FY22	FY23	FY24	FY25	FY26
Kenya cigarette Sales/Net Revenue	45.8%	49.1%	48.3%	44.4%	44.2%	46.0%	46.4%
Export Cigarette Sales/Net Revenue	54.2%	50.9%	51.7%	55.6%	55.8%	54.0%	53.6%
Total Cigarette Sales/Net Revenue	86.6%	90.3%	89.0%	88.2%	87.7%	87.6%	87.2%
Cut Rag Sales/Net Revenue	13.4%	9.7%	10.6%	11.4%	11.9%	12.0%	12.4%
Velo sales/ Net revenue	0.0%	0.0%	0.3%	0.4%	0.4%	0.4%	0.4%

Profitability

	FY20	FY21	FY22	FY23	FY24	FY25	FY26
EBITDA margins	32.0%	39.2%	38.4%	33.8%	33.3%	32.8%	33.0%
Operating Costs/Operating Income	70.6%	63.8%	64.3%	69.1%	69.6%	70.1%	69.9%
Operating Profit Margin	29.9%	36.8%	36.1%	31.4%	30.9%	30.4%	30.5%
PBT Margin	29.3%	36.5%	36.2%	31.8%	31.3%	30.8%	30.9%
Effective Tax Rate	25.6%	30.2%	30.5%	30.0%	30.0%	30.0%	30.0%
PAT Margin	21.8%	25.5%	25.2%	22.3%	21.9%	21.6%	21.7%

Leverage

	FY20	FY21	FY22	FY23	FY24	FY25	FY26
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt/EBITDA (x)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net Debt/EBITDA (x)	-0.2	-0.3	-0.2	-0.3	-0.3	-0.3	-0.4

Activity

	FY20	FY21	FY22	FY23	FY24	FY25	FY26
Asset Turnover (x)	1.2	1.1	1.1	1.1	1.1	1.1	1.1
Inventories Turnover (x)	3.2	3.4	3.8	3.0	3.0	3.0	3.0
Receivables Turnover (x)	6.1	5.6	5.8	5.4	5.4	5.4	5.4
Payables Turnover (x)	2.1	2.2	2.6	2.2	2.2	2.2	2.2
Cash Conversion Cycle (Days)	-2.5	2.8	19.8	25.1	25.1	25.1	25.1

Source: Company, Kestrel Research

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Kestrel Capital E.A. Ltd.

Orbit Place, 2nd Floor
Westlands Road

Tel: +254 20 2251758

research@kestrelcapital.com
www.kestrelcapital.com

Bloomberg: KEST <GO>

Equity Sales & Trading

Chris Miriti
chrism@kestrelcapital.com

Sally Kotut
sallyk@kestrelcapital.com

Amanda Onyango
amandao@kestrelcapital.com

Research

Ephantus Maina
ephantusm@kestrelcapital.com

Fixed Income Sales & Trading

Alexander Muiruri
alexanderm@kestrelcapital.com

Edwin Muthaura
edwinm@kestrelcapital.com

CEO & Executive Director

Francis Mwangi
francism@kestrelcapital.com