

Carreras Limited (CAR)

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INFRINGEMENT IN THE APPENDIX**

Executive Summary

Carreras Limited is incorporated and domiciled in Jamaica and is a 50.4% subsidiary of Rothmans Holdings (Caricom) Limited. The principal activities of the company are the marketing and distribution of cigarettes.

For the 2017/18 financial year, Carreras reported a decline of 7.1% or \$959.10M in revenues, which amounted to \$12.55B. The cost of operating revenue amounted to \$6.25B, a 10.3% decrease year-over-year but this improvement was not enough to offset the decline in revenues as gross profits fell 3.6% to \$6.30B. As such, pre-tax profits fell 7.4% or \$372.56M to \$4.64B while net profits attributable to shareholders declined by 8.5% or \$321.69M, to \$3.81B. Carreras's underperformance for the year has been attributed to diminishing market share as the company contends with the rise of the illicit cigarette trade.

Going forward, the illicit trade will continue to be the biggest impediment to growth as it siphons away market share from Carreras. The company must also be wary of the possibility of a further increase in taxes on cigarettes which is always likely as sin taxes are low-hanging fruits for governments strapped for revenues.

We continue to recommend Carreras Limited as a HOLD as the stock trades near to our estimate of its intrinsic value. Our recommendation is supported by CAR's history of consistently paying out almost 100% of earnings to shareholders in dividends, making it suitable for the income-seeking investors.

Company Background

Carreras Limited (CAR) is incorporated and domiciled in Jamaica and is listed on the Jamaica Stock Exchange. It is a 50.4% subsidiary of Rothmans Holdings (Caricom) Limited, which is incorporated in St. Lucia. The ultimate parent company is British American Tobacco plc, incorporated in the United Kingdom and listed on the London Stock Exchange. The principal activities of the company are the marketing and distribution of cigarettes.

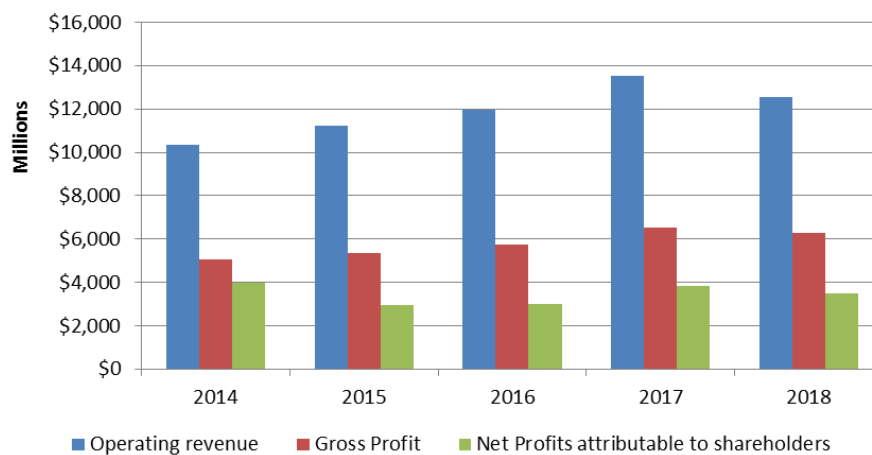
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Financial Performance – Year ended March 31, 2018

Profitability

Carreras reported a decline of 7.1% or \$959.10M in revenues for the 2017/18 financial year, which amounted to \$12.55B. The cost of operating revenue amounted to \$6.25B, a 10.3% decrease year-over-year. This improvement was not enough to offset the decline in revenues as gross profits fell 3.6% to \$6.30B. The decline in cost of operating revenues led to an improvement in CAR's gross profit margin, which moved from 48.4% in the 2017FY to 50.2% in the 2018FY.

CAR 5-year Operating Performance



Operating expenses were relatively unchanged at \$1.85B, up just 0.4% from the previous year. Administrative expense rose 1.5% to \$1.09B while distribution & marketing expenses fell 1.0% to \$761.41M. Employee benefits expenses rose 21.7% to \$39.30M. As such, pre-tax profits fell 7.4% or \$372.56M to \$4.64B while net profits attributable to shareholders declined by 8.5% or \$321.69M, to \$3.81B, which corresponds to earnings per share of \$0.72 (shares outstanding: 4,854,400,000). The effective tax rate was 24.9%, up from 24.0% a year earlier even as income tax fell 4.2% to \$1.15B. The return on average equity was 167.1%, which compared to 195.0% for the prior year, while the return on average assets fell from 96.5% in the previous year to 85.4% for the 2018FY.

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Liquidity & Solvency

Total assets declined by 4.5% or \$188.53M to \$3.99B as at March 31, 2018. Cash & cash equivalents fell by 10.7% to \$2.31B and inventories fell by 50.7% to \$233.18M while accounts receivable rose 48.9% to \$911.0M. Property plant & equipment amounted to \$337.25M, a 12.4% increase year-over-year. The increase in accounts receivable is of concern as it suggests the company has extended more favourable credit terms to customers but this has not translated to an improvement in sales. Trade receivables amounted to \$865.74M as at Mar. 2018 (2017: \$543.11M) while allowance for impairment losses surged from \$555M to \$2.65B.

The cash ratio fell to 1.36x in the 2018FY, compared to 1.46x a year prior due to the fall in cash, which outweighed the 4.6% decline in current liabilities to \$1.69B. The current ratio was relatively unchanged at 2.05x as current assets fell by 5.8% to \$3.46B.

Total liabilities were down 5.0% to \$1.95B. CAR was debt free at year's end with accounts payable amounting to \$840.44M, up 5.6% year-over-year while income tax payable fell 12.8% to \$851.26M. Shareholders' equity fell 4.1% to \$2.04B as unappropriated profits fell by \$86.72M to \$1.92B. The book value per share stood at \$0.42 as at March 31, 2018.

Forecast and Valuation

Carreras's underperformance for the year has been attributed to diminishing market share as the company contends with the rise of the illicit cigarette trade. Carreras noted that the latest \$3 or 21.4% increase in the excise tax on cigarettes has reduced the attractiveness of Carreras products relative to the prices available in the illicit trade. The Company is of the belief that the consecutive years of increases in the excise tax has outstripped wage growth, making illicit cigarettes more attractive to consumers.

To combat this reality, the Company has pressed the government to reconsider the level of the levy as it estimated that the government would collect \$1.0B less this financial year versus the previous. However, the government has expressed its intention to implement further restrictions on the smoking industry as it sees the side effects of cigarette smoking as deleterious to the overall health of the populace. Carreras has

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also pushed for the crackdown of the illicit trade by the relevant authorities, which the Company estimates is now a \$5B business and accounts for approximately 30% of the tobacco market.

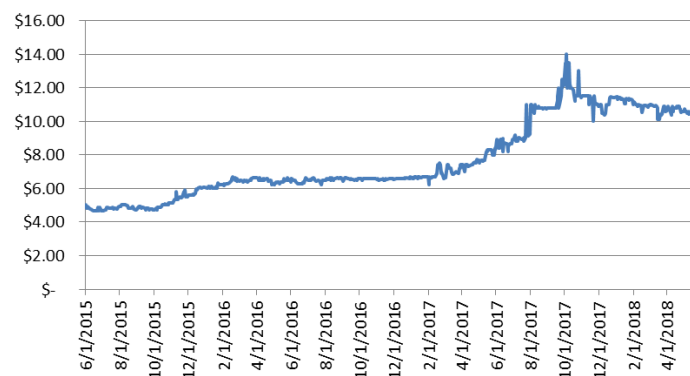
Internally, the company launched two new cigarette variants during the year, Craven “A” Wild Rush and Matterhorn Mojito Vybz and reintroduced “Fyah Grabba”, a raw tobacco product. In the previous financial year, the company incorporated into the organization the previously contracted bike sales team as it implemented a route-to-market structure to better serve hard to reach sections of the country.

Going forward, the illicit trade will continue to be the biggest impediment to growth as it siphons away market share from Carreras. The company must also be wary of the possibility of further increases in taxes on cigarettes which is always likely as sin taxes are a low-hanging fruit for governments strapped for revenues.

Based on these assumptions, we are forecasting a 0.5% increase in revenues for the year ended March 31, 2019, amounting to \$12.61B. Net profits attributable to shareholders are expected to fall 3.1% to \$3.38B, an EPS of \$0.70. Shareholders’ equity is estimated to close the year at \$1.96B, a 1.9% improvement, year-over-year.

We utilized the Gordon Growth Model to determine the intrinsic value of Carreras given it fits the criteria for the model as a mature, dividend-paying company. We assigned a required rate of return of 8.48% and a constant growth rate of 3.1% to derive a price of \$13.62 per share. The 3 year P/E ratio average is 11.04x while the P/B ratio 3 year average is 18.34x. Applying these averages to our estimates yields prices of \$7.68 and \$7.85, respectively. The average of these estimates is \$9.72, 6.57% below the last traded price of \$10.40 on June 1, 2018.

CAR 3-yr Stock Performance



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Recommendation

We continue to recommend Carreras Limited as a HOLD as the stock trades near to our estimate of its intrinsic value. Our recommendation is supported by CAR's history of consistently paying out almost 100% of earnings to shareholders in dividends, making it suitable for the income-seeking investor. The company has also revised its route-to-market strategy which has allowed the Company to more efficiently distribute its goods. Investors should be wary of any further laws which may be passed which could further limit CAR's revenues as it is highly likely to increase volatility in the stock price. The government has expressed its intent to introduce a ban on tobacco advertising, promotion and sponsorship, however, CAR has scaled down its marketing activities in recent years so the impact is not expected to be as great as the public smoking ban. The illicit trade is a growing issue and is a strain on revenues as the ill-gotten incentives from this practice increase with higher levies on cigarette consumption.

Abridged Financials

J\$000 Year	Year Ended March					% Change
	2014	2015	2016	2017	2018	
Revenue	10,342,006	11,208,369	11,980,138	13,509,228	12,550,132	-7.1%
Cost of Operating Revenue	5,268,780	5,867,203	6,243,890	6,969,933	6,249,282	-10.3%
Gross Profit	5,073,226	5,341,166	5,736,248	6,539,295	6,300,850	-3.6%
Pre-tax Profit	5,184,471	3,938,362	3,903,562	5,009,889	4,637,326	-7.4%
Net Income available to shareholders	3,999,992	2,942,914	3,011,191	3,806,233	3,484,596	-8.5%
Total Assets	7,026,620	6,189,819	3,712,189	4,176,698	3,988,170	-4.5%
Total Liabilities	2,825,397	3,014,782	1,935,375	2,047,342	1,945,501	-5.0%
Shareholders' equity	4,194,489	3,171,756	1,775,662	2,128,115	2,041,394	-4.1%
EPS (\$)	0.82	0.61	0.62	0.78	0.72	
EPS from normal operations (\$)	5.48	6.06	6.20	0.78	0.72	
Book Value per share (\$)	0.86	0.65	0.37	0.44	0.42	
Key Ratios						
Gross profit margin	49.1%	47.7%	47.9%	48.4%	50.2%	
Pre-tax profit margin	50.1%	35.1%	32.6%	37.1%	37.0%	
Net profit margin	38.7%	26.3%	25.1%	28.2%	27.8%	
Return on average assets	56.8%	44.5%	60.8%	96.5%	85.4%	
Return on average equity	101.5%	79.9%	121.7%	195.0%	167.1%	
Cash ratio (x)	1.43	1.49	1.54	1.46	1.36	
Current ratio (x)	2.88	2.27	1.94	2.07	2.05	

Source: <http://www.Jamstockex.com>, JMMB Investment & Research, Bloomberg, Various Company

Financial Statements.

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APPENDIX

IMPORTANT DISCLOSURES

ABSTRACT—As a part of our new Portfolio Strategy we are recommending strict adherence to the following Portfolio Allocation **DEFINITIONS/RECOMMENDATIONS**.

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SELL—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO.

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