# JMMB INVESTMENT & SOVEREIGN RESEARCH

# CARRERAS LIMITED (CAR)

CARRERAS LIMITED

**PLEASE SEE IMPORTANT DISCLOSURES & COPYRIGHT INFRINGEMENT IN THE APPENDIX**

## EXECUTIVE SUMMARY

**Carreras Ltd. (CAR),** is incorporated and domiciled in Jamaica and is a 50.4% subsidiary of Rothmans Holding (Caricom) Limited. The company's principal activities are the marketing and distribution of cigarettes. The ultimate parent company is British American Tobacco plc, incorporated in the United Kingdom and listed on the London Stock Exchange. Carreras' operations have been affected by several government actions taken which include but are not limited to, the banning of smoking in public spaces and a 21.4% increase in excise duty.

For the 3 year period (2017YE – 2019YE), CAR's revenues have fallen at a CAGR of -2%, moving from $13.5 billion to $12.9 billion. The 2019YE profits when compared to 2018YE profits, were down marginally, as for 2019YE, profits were $3.406 billion, a year-over-year decrease of 2%. Looking at the most recent numbers, (9 months ended December 2019) revenues increased by 3% from the previous comparable period, but profits however fell by 4%.

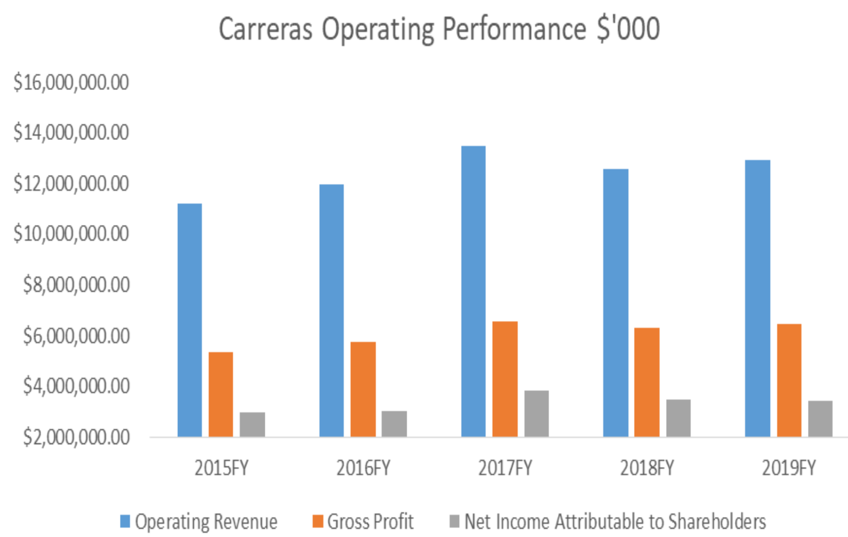
Carreras has established itself as a consistent dividend payer, which has made the stock attractive to investors. Although the absolute value of dividends have declined by a rate of 3% over the past 3 years, the ordinary dividend payout ratio has risen from 91% in 2017FY to 105% in 2019FY.

We attach a ***MARKETPERFORM*** recommendation to CAR. Although profits have remained stable since the implementation of several tobacco laws, the company still maintains a strong dividend policy, which offers a yield above the current market yield. It is not forecasted that Covid-19 will materially decrease demand for cigarettes, however supply lines may be compromised and as such, keen attention will be placed on how the management of Carreras tries to mitigate the impact of such. Carreras' operations may not take a material hit from the global pandemic, however, distribution channels will likely be disrupted due to the measures put in place to limit the spread of the virus.

## *Financial Performance - 2019FY & 9Month ended December 2019*

### *Profitability*

CAR reported revenues of $12.9 billion for the year ended March 31, 2019. This represents a 3% increase over the revenue recorded in the 2018 financial year. For the 9 months ended December 2019, operating revenue stood at $10.2 billion, which was a 4% increase when compared to the previous 9 months ended December 2018. The steady uptick in operating income for these periods are attributable to higher sales volumes and management explains that there has been a "recovery of the underlying core business." This marginal revenue increase however, did not translate to an increase in profits.




Operating expenses increased proportionally with revenue, as there was a 4% increase for the 2019FY and 4.9% increase for the 9 months ended December 2019. For the 2019 FY, administrative and distribution expenditure increased by 9% and employee benefit expense increased by 10%. These expenses contributed to the decrease in net profit. Management had noted that the increase in these expenses were due to their investment in staff and processes to improve their distribution networks. Expenses have also increased because of their new route to market strategy and an improvement of the Matterhorn portfolio.

2019FY net profits stood at $3.406billion, down from $3.48billion in the previous financial year. For the 9Months ended December 2019, net profits fell from $2.5 billion to $2.4billion, a decrease of 4%.  Carreras has still managed to maintain healthy margins, as gross profit margin for FY 2019 and 9Months ended Dec 2019 stood at 49.9% and 49.6% respectively. These margins are in line with previously recorded margins but are above pre-2017 levels. These margins fell to 2016 levels as the 2019 FY pretax and net profit margins were 35% and 26% while 9-month margins stood at 33% and 24.8%.

Earnings per share for the 2019FY came in at $0.702, down from $0.718 from the previous FY. The 9 months period ended December 2019, EPS stood at $0.505, down from $0.526. The twelve month trailing EPS for CAR stands at $0.68 which underpins that the company's profitability continues to decline.

### *Liquidity & Solvency*

Carreras' total assets declined in the 2019FY from $3.9 billion to $3.4billion. This was attributable to a 12.5% decrease in cash and cash equivalents from $2.3billion to $1.7billion. Total assets for the 9 months ended December 31, 2019 soared to $4.1billion; a 15% increase from the previous comparable period. This increase was buoyed by cash and cash equivalents increasing to $2.1 billion. Additionally, accounts receivable stood at over $1 billion, for the first time since 2013. This increase in trade receivables suggests that more favourable credit terms may have been granted to customers, which may also be a reason why sales volumes have increased.

The cash ratio fell below 1 in the 2019FY; it came in at 0.925. For the 9months ended December 31, 2019, this ratio was far less, as it was 0.887. The current ratio also fell, declining from 2.04 to 1.51 for the 2019YE while for the 9 months ended December 2019, it stood at 1.42.

Total liabilities increased 10.8% for the 2019FY as liabilities climbed to $2.1 billion, up from $1.9 billion. The 9months figure came in way higher as it stood at $2.7billion. A massive increase in accounts payable, by 35% in both periods vis-à-vis their comparable periods, was the main reason for this climb. Equity attributable to shareholders continued to fall as it stood at $1.3billion for 2019 and $1.4 billion for the 9 months ended December 2019.

### *Dividends*

Carreras continues to maintain its status as a strong dividend payer. It has increased its ordinary dividend payout ratio from 91% YE 2017 to 103% YE 2019. Carreras also paid a special dividend of $0.11 in 2019FY. Carreras has been paying out more dividends than earnings in recent quarters and this has been drawing the attention of investors. Carreras' dividend yield for their 2019FY stands at 8.87% while for the 2019 calendar year, the dividend yield was 7.738%.

## Outlook & Valuation

Carreras has consistently been underperforming as it has reached the maturity stage in the business' life cycle. Revenues only marginally increase and this increase rarely translates to an increase in after tax profits. Since the increase in the excise duty from $14 to $17 per stick of cigarette, Carreras profits have suffered. Additionally, illicit cigarettes have taken market share away from Carreras. It is estimated that the illicit trade accounts for 30% of the tobacco market. It has also been noted that illicit cigarettes are able to undercut Carreras by as much as $35 as one stick may cost as low as $20 when compared to $55 for a Carreras brand cigarette.

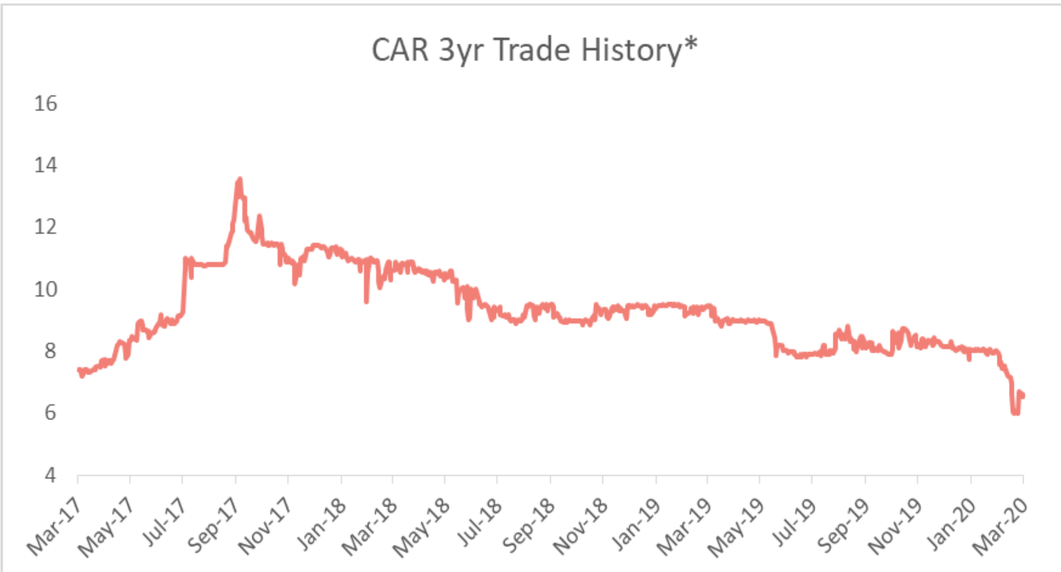
Carreras has continuously lobbied the government to prevent any further increase in the excise duty as they are of the view that the move to increase duties not only reduced CAR's revenue but government revenue as well. Illicit cigarettes escape the duty at the ports and they in turn end up being cheaper, which is why some persons switch to consumption of these cigarettes.

Carreras has implemented a new route to market distribution strategy which they say has already been reaping rewards, as sales volumes have been consistently increasing. They have also upgraded their 'Matterhorn' portfolio which they report that they have received positive consumer feedback about.

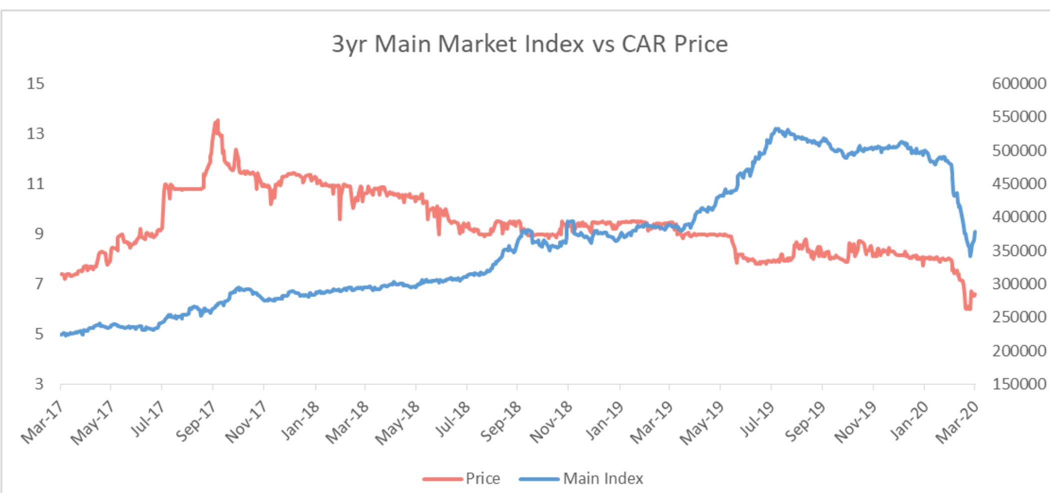
The illicit trade is the number one impediment to the growth of Carreras and especially in an environment of economic downturn, tobacco consumers may decide to just go with the cheaper alternative. The COVID-19 pandemic, will not materially decrease the demand for the tobacco products of Carreras, however the main challenge will stem from distribution lines which will likely be affected as restrictions are put in place to stem the spread of this pandemic. Social distancing rules, curfews and work from home orders will affect the distribution of Carreras' cigarettes. Additionally, the government has also been vocal that additional anti-tobacco laws are going to be brought forward which will have a disrupting effect on the distribution of cigarettes by Carreras.

The aforementioned assumptions were considered in forecasting a 10% decrease in revenues for the FY ending March 31 2021. We forecast that net profit attributable to shareholders will fall to $3.2billion, giving an ESP of $0.67 cents. Shareholders Equity is expected to come in at $1.4 billion. We applied our forecasted EPS of $0.68, and forecasted BVPS of $0.29 to the 2017FY average P/E ratio of 9.60x and P/B ratio of 17.09x. This gave us a price range between $6.52 and $4.99.

Given that CAR is a strong and consistent dividend payer, we sought to utilize the Gordon Growth model. Carreras traditionally pays out close to and even above 100% of earnings as dividends. However, given the forecasted economic climate, it is expected that this payout ratio will fall as the company may choose to hold cash as a liquidity buffer. We assigned a required rate of return of 8.49% and a constant growth rate of 1.7% to derive a price of $8.11. **Averaging these forecasted prices gives us a price of $6.54**




*Adjusted for 10 to 1 stock split which took place on September 20, 2017




CAR's stock price YTD is down 18.892% and y-o-y, down by 29.8%. This is attributable to investors reacting negatively to stagnating profits and little or no revenue growth. The general downturn in the local indices due to decreased liquidity and COVID-19 fears, provide an added explanation for the subpar performance of this stock in the last 3 months.

## RECOMMENDATION

We assign a **MARKETPERFORM** recommendation to CAR at this time. Carreras is currently trading below at our fair price estimate of $6.54 but is regarded a strong dividend payer. CAR however has challenges ahead, namely: increasing government legislation which could possibly ban tobacco promotion advertising and sponsorship, the continued growth of the illicit cigarette trade and the possible disruption of distribution channels due to COVID-19. These challenges may restrict any significant growth in the company's revenues especially if new tobacco laws are implemented.

CAR may be suited for risk neutral income seeking investors as they pay consistent dividends and dividend payout ratios currently stand at 100%. We are also estimating a dividend yield of close to 8% over the next year based on an expected payout of $0.53 for the 2021 FY. This stock could also serve as protection against volatility as it has a low beta. Notwithstanding, there has been a weakening of investor confidence in financial markets which may have an impact CAR getting to its fair price. Additionally, due to measures put in place to mitigate the impact of COVID-19, customers may not be able to readily access retailers which could negatively affect revenues.

***Source: www.jamstockex.com, Bloomberg, Company Financials, Company Prospectus, JMMB Investment Research.***

| CAR Abridged Financials | | | | | | | |
|---|---|---|---|---|---|---|---|
| | $'000<br>YE2015 | $'000<br>YE2016 | $'000<br>YE2017 | $'000<br>YE2018 | $'000<br>YE2019 | $'000<br>9M 2020 | $'000<br>Forecasted YE2021 |
| Operating revenue | $ 11,208,369.00 | $ 11,980,138.00 | $ 13,509,228.00 | $ 12,550,132.00 | $ 12,906,497.00 | $ 10,282,663.00 | $ 11,994,858.00 |
| Cost of operating revenue | $ (5,867,203.00) | $ (6,243,890.00) | $ (6,969,933.00) | $ (6,249,282.00) | $ (6,470,125.00) | $ (5,200,901.00) | $ (6,058,170.07) |
| Gross operating profit | $ 5,341,166.00 | $ 5,736,248.00 | $ 6,539,295.00 | $ 6,300,850.00 | $ 6,436,372.00 | $ 5,081,762.00 | $ 5,936,687.93 |
| Administrative distribution and marketing expense | $ (1,995,458.00) | $ (2,071,221.00) | $ (1,840,028.00) | $ (1,847,945.00) | $ (2,013,673.00) | $ (1,875,424.00) | $ (1,757,128.49) |
| Profit from Operations | $ 3,938,362.00 | $ 3,903,562.00 | $ 5,009,889.00 | $ 4,637,326.00 | $ 4,515,929.00 | $ 3,234,626.00 | $ 4,360,917.42 |
| Profit Before Tax | $ 3,938,362.00 | $ 3,903,562.00 | $ 5,009,889.00 | $ 4,637,326.00 | $ 4,515,929.00 | $ 3,275,654.00 | $ 4,360,917.42 |
| Stockholders' interest in parent | $ 2,942,914.00 | $ 3,011,191.00 | $ 3,806,233.00 | $ 3,484,596.00 | $ 3,406,849.00 | $ 2,449,794.00 | $ 3,293,381.54 |
| Shares Outstanding | 485440000 | 485440000 | 485440000 | 4854400000 | 4854400000 | 4854400000 | 4854400000 |
| EPS | $ 6.062 | $ 6.203 | $ 7.841 | $ 0.718 | $ 0.702 | $ 0.505 | $ 0.678 |
| BVPS | $ 6.35 | $ 3.66 | $ 4.38 | $ 0.42 | $ 0.28 | $ 0.29 | $ 0.29 |
| Price | $ 49.50 | $ 63.89 | $ 89.66 | $ 10.58 | $ 8.73 | | |
| PE | 10.54x | 10.3x | 11.43x | 14.74x | 12.44x | | |
| PB | 7.8x | 17.46x | 20.47x | 25.19x | 31.17x | | |
| Dividends | $ 8.09 | $ 8.94 | $ 7.10 | $ 0.74 | $ 0.85 | | |
| Ordinary Dividends | $ 5.75 | $ 6.40 | $ 7.10 | $ 0.74 | $ 0.74 | | |
| Dividend Payout Ratio | 133% | 144% | 91% | 103% | 121% | | |
| Ordinary Dividend Payout Ratio | 95% | 103% | 91% | 103% | 105% | | |
| gross profit margin | 47.7% | 47.9% | 48.4% | 50.2% | 49.9% | 49.4% | 49.5% |
| effective tax rate | 25.3% | 22.9% | 24.0% | 24.9% | 24.6% | 25% | |
| net profit margin | 26.3% | 25.1% | 28.2% | 27.8% | 26.4% | 24% | 27% |
| ROA | 45% | 61% | 96% | 85% | 91% | 59% | |
| ROE | 80% | 122% | 195% | 167% | 202% | 174% | |

# APPENDIX

## IMPORTANT DISCLOSURES

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

**PLEASE NOTE** THAT NO INDIVIDUAL ASSET IN YOUR PORTFOLIO SHOULD HAVE A WEIGHTING GREATER THAN 5% UNLESS OTHERWISE RECOMMENDED BY YOUR PORTFOLIO MANAGER OR A SPECIFIC JMMB RESEARCH REPORT. CONSEQUENTLY THE FOLLOWING **DEFINITIONS** ARE PROVIDED FOR CLARITY.

**STRONGLY UNDERPERFORM**—REDUCE EXPOSURE IN YOUR PORTFOLIO TO LESS THAN 2.5% FOR THIS PARTICULAR ASSET

**UNDERPERFORM**—REDUCE EXPOSURE IN YOUR PORTFOLIO TO 2.5% - 4.9% FOR THIS PARTICULAR ASSET

**SELL**—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO.

**HOLD/MARKETPERFORM**—EXPOSURE TO THE ASSET SHOULD BE EQUAL TO 5% OF YOUR TOTAL PORTFOLIO HELD AT JMMB.

**OUTPERFORM/BUY**—EXPOSURE TO THIS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

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