JMMB EQUITY RESEARCH

CARRERAS LIMITED (CAR)

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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 exercise duty.

For the 9 month period ended December 2020, CAR's recorded revenues of $4.9Bn, a 2.88% decrease year-over-year(y-o-y). Despite a reduction in revenue CAR's efficient cost management throughout the pandemic has led to profits for the 9 month period of $2.59Bn, up 5.91% y-o-y.

The absolute value of dividends paid by CAR has fell by 11% over the past 3 years. This has been as a result of a decline in the company's dividend payout ratio. This ratio has fallen from 105% in 2017 to 87% currently. The fall in dividends is also attributable to a decline in profits from record levels in 2017, due to the growing illicit drug trade. Notwithstanding this challenge, CAR's profits have begun to recover. The company has managed to retain its attractiveness as its high payout ratio of over 87% has led to the company consistently having one of the highest dividend yields on the local market.

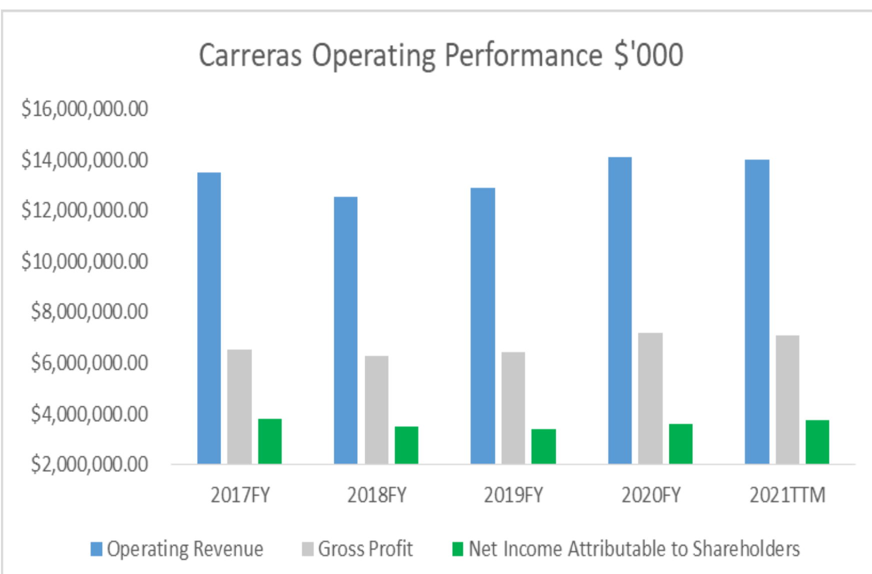
We attach a **MARKETPERFORM/HOLD/MARKETWEIGHT** recommendation to CAR. Although revenues have remained flat since the implementation of new tobacco laws, the company's cost reduction strategies have begun to positively affect profitability. CAR has additionally sought to increase its product lines in an attempt to broaden its revenue base. CAR still maintains a strong dividend policy, which offers an attractive yield which is usually around 7% on an annual basis. While Covid-19 has not materially affected demand for cigarettes the company has reported that supply lines which were compromised have returned to normal. We expect dividends from CAR to increase to $0.70 for their financial year ending March 2022, while net income is forecasted increase by 3.25%. Using these inputs, we have arrived at a price target of $8.35 for this stock.

Financial Performance – 9 Months ended December 2020

Profitability

CAR reported revenues of $10.16 billion for the nine months ended December 2020. This represents a 1.2% decrease when compared to the same period last year. CAR had a record financial year (FY) ended March 2020, as revenues amounted to $14.1bn, a 9.5% increase over the 12.9bn recorded in the 2019FY. CAR's trailing twelve month (TTM) revenues amount to $14Bn, a 1% decline when compared to the revenues of the 2020FY. The revenue figures for the period under review reflect a recovery in sales for the company which coincided with the economic recovery that took place in the last six months of the calendar year. Management noted that over the last six months of the financial year, the company has been able to rectify the disruptions to its supply chain caused by the effects of the pandemic.

Operating expenditure for the 9 month period ended December 2020, was flat when compared to the same period last year. As a result of this, gross profit for both the 9-months period and the trailing gross profit declined marginally given that revenue slightly dipped while expenditure growth was flat. Gross Profit for the 9 month period totaled $4.9Bn down from $5.08bn in the previous year while the TTM gross profit of $6.85bn, fell by 2.01%, when compared to the 2020FY gross profit of $6.99bn. With the slight falloff in revenues and operating expenses remaining relatively flat, CAR's gross margin fell below the 3 year average of 49.6% and currently stands at 48.6%.



Administrative and distribution expenses totaled $1.5bn for the 9 month period and $510m for the 3rd quarter. These figures represent a 19.52% and 39.3% fall when compared to the 9 months period and the 3rd quarter ended December 2020. Carreras' new route-to-market strategy has improved its distribution network and significantly reduced its related party costs.

The significant reduction in these costs has seen profit from operations increased by 7.1% for the 9M20period, as these profits totaled $3.46bn. The TTM profit before tax totals $4.99bn, which is a 4.8% increase over the 2020FY's result. Despite the significant reduction in costs, CAR's pretax and net income margins have slightly fallen below the 3 year averages of 35% and 26.6% respectively. For the 9 month period under review, pretax and net income margins stand at 32% and 23.8% respectively.

Earnings per share (EPS) for the 2020FY came in at $0.738, up from $0.702 from the previous financial year. EPS recorded for the nine-month period under review amounted to $0.534, up 5.9% year-over-year. The TTM EPS for CAR stands at $0.768 which when compared to the 2020FY represents an increase of 4%. The company's profitability continues to improve as revenue remains robust while cost containment measures begin to bear fruit.

Liquidity & Solvency

Carreras' total assets grew to $4.8bn as at December 2020, which represents a 15.54% increase y-o-y. A more granular look at the growth in total assets for the company reveals that y-o-y, fixed assets grew by 45.95% while current assets grew by 13.19%. Cash and Cash equivalents remained unchanged y-o-y as it amounted to $2.17bn for both periods. Inventories and accounts receivable changed materially over the past year. Inventories rose by 106% to $513M, up from $248M. Accounts receivable grew by 23% to $1.24bn. This could point to CAR allowing its customers more time to make payments as the pandemic would have had an effect on the cash flows of its clients. This could however pose problems in the future as a loosening of credit terms may decrease credit quality and may lead to bad debts. The growth in fixed assets was buoyed by a 42% y-o-y increase in Plant, Property and Equipment (PPE). PPE currently stands at $753M, up from $529M.

Total liabilities experienced minimal growth y-o-y as liabilities stood at $2.84bn up from $2.77bn a year before or 2.4%. Non-current liabilities grew by 65%, mainly due to lease liability growing by 173%, as it stood at 283M, up from 103M. However, current liabilities fell by 6.1%. The fall in current liabilities was mainly due to a 10.1% decline in accounts payable. Accounts payable totalled $1 .3bn for the period under review while for the year prior it stood at $1.5bn.

Since falling below 1xat the end of the 2019FY, the cash ratio has remained below 1x. There has been some improvement in this ratio in the past year however as it improved from 0.89x to now 0.95x. The current ratio has also improved y-o-y, standing at 1.71x, up from 1.42x.

Your Best Interest At Heart. Full Stop.

Since falling by 34.6% in the 2019FY, total equity has yet to pass the $2bn mark again. This fall in the 2019FY was mainly due to the payment of a special dividend of $0.11 ($533M) in the financial year. Total equity has recovered to $1.98bn, up 41.36% y-o-y. This boost in shareholders' equity is as a result of a 4% decrease in total dividends paid over the past year, despite a 6% rise in net income.

Dividends

Carreras continues to maintain its status as a strong dividend payer despite the challenges faced in 2020. While the ordinary dividend payout ratio has fallen from the highs of 105% in the 2019FY, it still remains above 85%. Carreras' dividend yield for their 2020FY was 7.77 % while for the 2020 calendar year, the dividend yield was 9.35%.

Outlook & Valuation

Carreras has reached the mature stage of its business cycle evidenced by its marginal rate of growth and its aggressive dividend policy. While the pandemic has had its impact on revenues, decreasing them by 1.2%, the company's cost management system has led to an increase in both gross and net income. The recently implemented route to market distribution strategy has led to a drastic reduction in expenses and been able to keep sales volumes in line with pre-covid levels.

The pandemic has not materially decreased the demand for the tobacco products of Carreras. However, Management highlighted that at the initial onset of Covid-19, distribution networks faced challenges which have since been rectified.

Carreras still continues to be significantly affected by the increase in the exercise duty from $14 to $17 per stick of cigarette. Profit margins have begun to decline while the illicit cigarette trade continues to take market share away from Carreras. It is estimated that the illicit trade accounts for 30% of the tobacco market. Illicit cigarettes, locally referred to as "cheapies" are able to undercut Carreras by as much as $35, as a single stick may retail for as low as $20 when compared to $55 for a Carreras branded cigarette.

In a corporate disclosure dated January 7th, 2020, Carreras advised the public that they intend to expand their product line, exploring the possibility of selling cigarette lighters, rolling paper, shavers and razors. This was slated to commence in January of 2021, which means the initial results of this operation will show up in the Q4 financial report of the company.

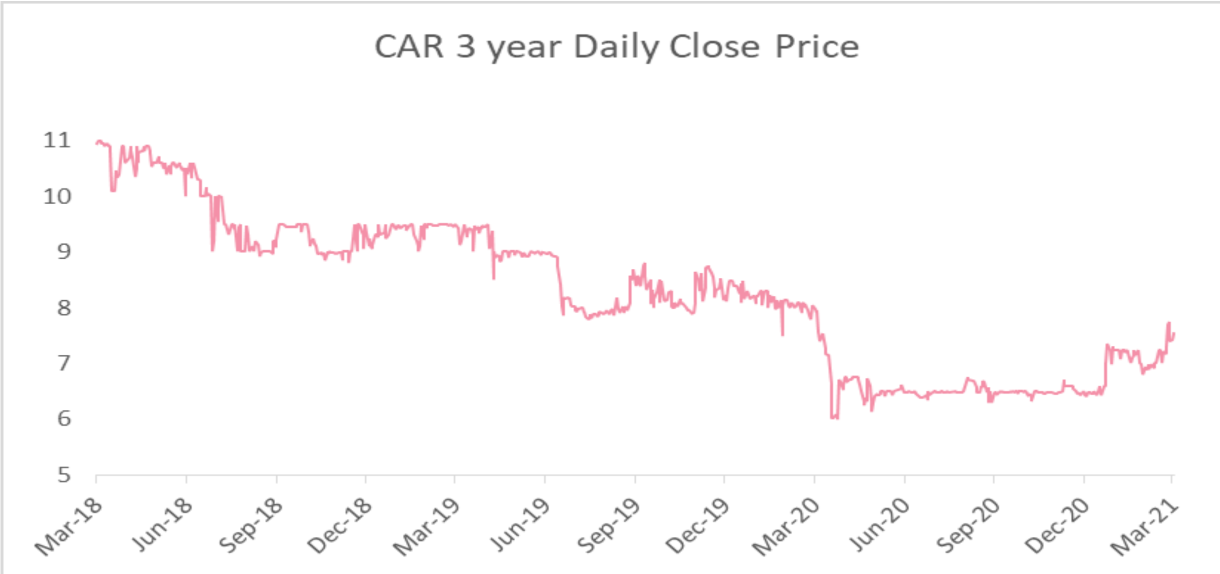
As at March 1st 2021, CAR has replaced its corporate logo of the three-lobed leaf. The new official corporate logo has the name of the entity spelled in bold with a double sail icon along with the tagline "A Better Tomorrow". A mature company changing its logo and expanding its product line points to an effort to maintain not only its presence but its foothold in the tobacco sector.

The government has started the process of putting forward a new tobacco control bill which Carreras has stated they are eager to work with the government on. This new comprehensive bill will seek to ban all forms of tobacco advertising, promotion, and sponsorship. Carreras has cautioned the government on implementing all the major aspects of the bill as not only does it affect Carreras but its retailers and may go further to boosting the illicit trade.

An additional aspect of the Tobacco Control Bill seeks ban all public servants' investment in the tobacco industry. This aspect of the bill has been faced with opposition even before it faces the joint select committee. The question of whether local authorities that manage public assets should own shares in the tobacco industry has risen as a result of the above mentioned aspect of the bill. In its current state, the bill does not prevent this as the authorities have noted that the managers of these public assets have a fiduciary duty and a legal obligation to make the best investment possible. Further discussions would be held to decide what measures will be taken in regards to this portion the bill. There has however been fierce pushback to this aspect of the bill even before it goes to the joint select committee.

We forecast that revenues for the 2022FY ending March 2022 will be $14.2bn which is 1.5% greater than the current TTM revenues. We also expect pretax profits to surpass $5bn for the first time since 2017. Our estimates point to net income attributable to shareholders of $3.85bn, with an EPS of $0.79. This represents a 3.25% growth in EPS over the current TTM EPS of $0.77. We expect the dividend payout ratio to be in-line with that of the 2020FY and current TTM at around 88%, which would see CAR paying $0.70 in dividends for the 2022FY.

We applied our forward EPS and BVPS to the 1 year average PE ratio of 9.73x and PB ratio of 18.34x. This yielded $7.88 and $8.25 respectively. Given that CAR remains strong and consistent dividend payer, we sought to utilize the Gordon Growth model as an additional valuation tool. With a cost of equity of 9.18% and expected growth rate of 1.4%, we arrived at a price of to derive a price of $9.09. **Averaging these forecasts gives us a price target of $8.35 which is 4% higher than the recent closing price of $7.97.**



CAR's stock price year to date is up 10.4% and flat y-o-y. This is attributable to investors reacting given that CAR is starting to once again increase the value of dividend payments. General optimism around the local equity markets and economic recovery are additional contributing factors to the increase in CAR's stock price.

Recommendation

We assign a **MARKETPERFORM/HOLD/MARKETWEIGHT** recommendation to CAR at this time. This asset is most suitable for equity investors seeking income. CAR continues to have the one of highest dividend yields on the local exchange. Over the past year 12 months CAR returned a dividend yield of 8.64% while offering capital gains of 1.75%. This represented a cumulative return to investors of 10.39%, which outperformed the Jamaica Stock Exchange Main Market Index, which has been down 17.48% over the past 12 months. Even though CAR is currently trading below our fair price estimate of $8.35, the entity may face negative headwinds in the near term. Increasing government legislation which could possibly ban tobacco promotion advertising and sponsorship coupled with the illicit cigarette trade could affect Carreras' revenues. While the new Tobacco bill may take a few quarters to a year to implements, illicit cigarettes slip through the ports daily.

We are however confident that demand for Carreras' cigarettes will remain strong as there is a high correlation between challenging economic times and the demand for this 'sin-good'. Additionally, CAR has taken initial steps to broaden their product line as they seek to increase revenues. CAR will benefit from its already established distribution channels as the target market for the new product line is exceedingly similar to that of its cigarettes.

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

CAR Abridged Financials

	Year Ended					9 Monts		
	$'000	$'000	$'000	$'000		$'000	$'000	%
	YE2016	YE2017	YE2018	YE2019	YE2020	9M 2020	9M2021	Change
Operating revenue	$ 11,980,138.00	$ 13,509,228.00	$ 12,550,132.00	$ 12,906,497.00	$ 14,126,523.00	$ 10,282,663.00	$ 10,158,507.00	-1.21%
Cost of operating revenue	$ (6,243,890.00)	$ (6,969,933.00)	$ (6,249,282.00)	$ (6,470,125.00)	$ (7,132,802.00)	$ (5,200,901.00)	$ (5,223,228.00)	0.43%
Gross operating profit	$ 5,736,248.00	$ 6,539,295.00	$ 6,300,850.00	$ 6,436,372.00	$ 6,993,721.00	$ 5,081,762.00	$ 4,935,279.00	-2.88%
Administrative distribution and marketing expense	$ (2,071,221.00)	$ (1,840,028.00)	$ (1,847,945.00)	$ (2,013,673.00)	$ (2,372,263.00)	$ (1,875,424.00)	$ (1,509,299.00)	-19.52%
Profit Before Tax	$ 3,903,562.00	$ 5,009,889.00	$ 4,637,326.00	$ 4,515,929.00	$ 4,759,942.00	$ 3,275,654.00	$ 3,481,394.00	6.28%
Stockholders' interest in parent	$ 3,011,191.00	$ 3,806,233.00	$ 3,484,596.00	$ 3,406,849.00	$ 3,583,183.00	$ 2,449,794.00	$ 2,594,650.00	5.91%
Shares Outstanding	485440000	485440000	4854400000	4854400000	4854400000	4854400000	4854400000	
EPS	$ 6.203	$ 7.841	$ 0.718	$ 0.702	$ 0.738	$ 0.505	$ 0.534	
BVPS	$ 3.66	$ 4.38	$ 0.42	$ 0.28	$ 0.37	$ 0.29	$ 0.41	
Price	$ 63.89	$ 89.66	$ 10.58	$ 8.73	$ 6.61	$ 8.20	$ 7.25	
PE	10.3x	11.43x	14.74x	12.44x	8.96x	16.25x	13.56x	
PB	17.46x	20.47x	25.19x	31.17x	18.11x	28.28x	17.68x	
Dividends	$ 8.94	$ 7.10	$ 0.74	$ 0.85	$ 0.64	$ 0.49	$ 0.49	
Ordinary Dividends	$ 6.40	$ 7.10	$ 0.74	$ 0.74	$ 0.64	$ 0.49	$ 0.49	
Dividend Payout Ratio	144%	91%	103%	121%	87%	97%	92%	
Ordinary Dividend Payout Ratio	103%	91%	103%	105%	87%	97%	92%	
gross profit margin	47.9%	48.4%	50.2%	49.9%	49.5%	49.4%	48.6%	
effective tax rate	22.9%	24.0%	24.9%	24.6%	25.2%	25%	26%	
net profit margin	25.1%	28.2%	27.8%	26.4%	23.8%	24%	26%	
ROA	61%	96%	85%	91%	59%	59%	62%	
ROE	122%	195%	167%	202%	174%	174%	184%	

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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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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