March-17-2022

JMMB INVESTMENT & SOVEREIGN RESEARCH

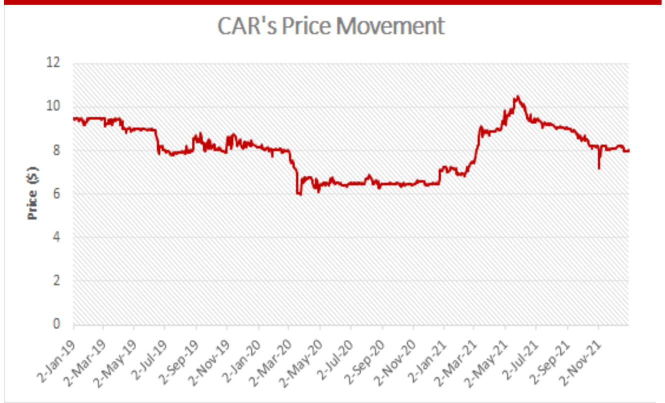
CARRERAS LIMITED (CAR)

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 which include but are not limited to, the banning of smoking in public spaces and a 21.4% increase in excise duty.

Carreras' Price Movement



Carreras' Statistics		
Financial Year End		March
Stock Price (14/02/2022)	$	8.20
Trailing EPS	$	0.84
Book Value per share	$	0.43
P/E		11.54x
P/B		20.54x
Net Profit FY2021 (millions)	$	3,726
Price Target	$	8.80
Divided Yield		7.87%

For the six month period ended September 2021, CAR's recorded revenues of $7.19B, a 16.8% growth year-over-year. This was driven by the increase in demand for cigarettes, as management maintained the prices of its products in an effort to not create a market opportunity for cheaper illicit cigarettes. Despite the increase in cost of operating revenue due to tobacco excise and supply chain issues, CAR has developed a strategy to contain expenses. This strategy has had a profitable impact on its bottom line, which led to profits for the six months 2021 period of $1.90B, up 21.8% year over year.

The absolute value of dividends paid by CAR has declined by 18% 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 121% in 2019 to 91% for the 2021FY. Though CAR's profit has been growing, the entity may have decided to retain a portion of its profits due to the uncertainty of the pandemic. Nevertheless, Carerras remains a consistent dividend payer with the highest dividend yield on the local exchange and signs of economic recovery is likely to further increase this dividend payout ratio.

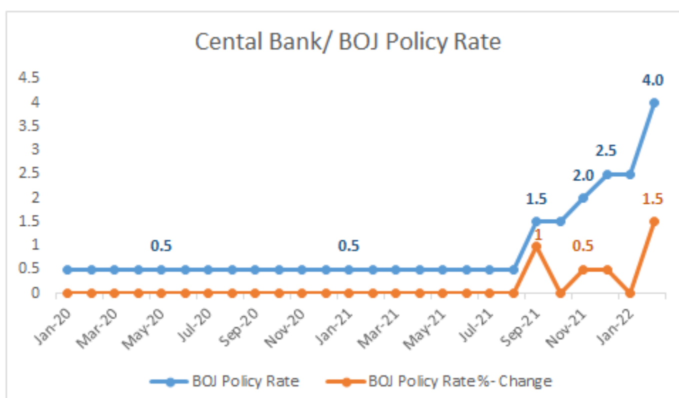
We attach a **HOLD/MARKETPERFORM** recommendation to CAR. Although revenues have been relatively stable since the implementation of new tobacco laws, the company's cost reduction strategies have begun to bear positively with effect on profitability. Additionally, CAR has sought to increase its product 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.

However, Carreras is faced with increased risk that could hinder revenue growth, future earnings and impact the volatility of its stock price. These risks include, the competition from the illicit cigarette trade that will continue to be an impediment to the company's revenue growth, the possibility of a further increase in taxes on cigarettes and the pending tobacco regulations.

Macroeconomic Overview

Local Economic Overview

BOJ Increases Interest Rates



The latest data from the Bank of Jamaica (BOJ) indicates that the outlook for Jamaica's economy is positive. The BOJ has acted on three (3) occasions to increase interest rates by a total of 350 basis points. The central bank during February 2022, increased the policy rate by 150 basis points to 4% per annum. This decision was based on the central banks' assessment that inflation continues to breach the upper limit of the Bank's target range of 4% to 6% and was likely to continue to breach the target range over the next 10 to 12 months. Due to recent policy adjustments, interest rates in the money market have increased and indications from the Bank of Jamaica's credit conditions survey are that deposit-taking institutions intend to increase interest rates on loans.

Furthermore, the BOJ has identified 12-month inflation at 9.7% as at January 2022, being above the upper bound of the BOJ's targeted inflation range of 4% to 6%. The Bank noted that the ongoing shock to international commodity prices and shipping prices have been the principal contributor to domestic inflation rising above the target range.

REAL VALUE ADDED IN THE GOODS PRODUCING INDUSTRIES (%)

	Oct-Dec 2020	Jan-Mar 2021	Apr-Jun 2021	Jul-Sep 2021	Oct-Dec 2021
Goods Producing	**0.2**	**2.7**	**12.9**	**2.4**	**0.4**
Agriculture, Forestry & Fishing	-7.2	-1.9	15.0	7.3	12.1
Mining & Quarrying	6.3	7.4	-9.2	-29.7	-64.7
Manufacturing	-0.4	-1.0	13.5	4.6	-0.9
Construction	6.3	10.5	17.4	4.4	6.4

February 16, 2022 Planning Institute of Jamaica

The Jamaican economy continued its recovery in Q4 2021 (October-December) recording a year over year increase of 6.0%. The goods producing sector recorded a 0.4% increase while the services sector recorded a strong 7.8% increase. Increased employment (up by 76,600 year over year), a relaxation of curfew and safety measures and increased business confidence, as firms adapt to operating during the pandemic, all contributed to the recovery.

The goods producing sector recorded marginal growth of 0.4% for the quarter, with Agriculture (12.1%), and Construction (6.4%) being the top performers. Notably, the Manufacturing sector contracted by an estimated 0.9% due to a reduction in output in the Other Manufacturing sub-industry, which outweighed an estimated increase in the Food, Beverages & Tobacco sub-industry. The contraction in other manufacturing was due to the closure of the petroleum refinery to facilitate maintenance activities, which lowered production of petroleum products.

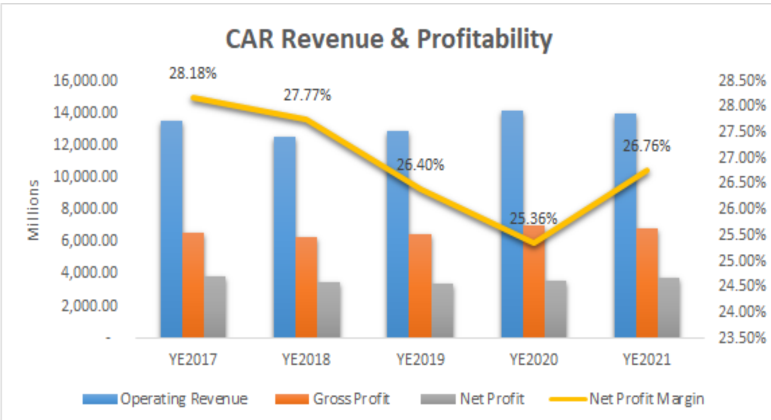
Global Economic Trends

It is estimated that global GDP made a solid recovery in 2021 recorded at 5.9%. Advanced economies are estimated to have experienced growth in the region of 5.2% while Emerging & Developing economies are estimated to have grown by a robust 6.4%.

The US has only recently begun its rate hiking cycle with a 25 basis point increase in March. The FED has shown its hand, indicating that rates may climb to as high as 1.5% by the end of 2022. The US 12-month inflation rate is at 7.5% as at January 2022, which is the highest rate since June 1982.

Financial Performance – 2021 Financial Year

Profitability



Carreras reported a marginal decline of 1.10% or $155.23M in revenues for the 2020/21 financial year, which amounted to $13.97B. The cost of operating revenue amounted to $7.16B (2020:$7.13B), which was relatively unchanged compared to the corresponding FY2020 period. As a result, gross profit for the 2021 financial year marginally declined by 2.6%, totaling $7.03B, down from $7.19B the previous year. Consequently, CAR's gross margin fell below the 3 year average of 49.6% and currently stands at 48.6%.

Administrative, distribution and marketing expenses fell 16%, which amounted to $1.99B (2020: $2.37B), this is likely due to the lockdown periods caused by the pandemic and CAR's initiative to contain expenses to improve its bottom line, especially since the imposition of the cigarette excise, which impacts their cost of operating revenue.

The reduction in these costs has seen profit from operations increase by 4.2% for the 2021 financial year, as these profits totaled $4.96B (2020: $4.76B). Consequently, pre-tax and net income margin improved to 35.5% and 26.8% respectively. Net income grew by 4.3%, amounting to $3.74B (2020: $3.58B), which was mainly driven by cost containment measures CAR adopted to improve its profitability.

Earnings per share (EPS) for the 2021FY came in at $0.77, up from $0.738 from the previous financial year.

Liquidity & Solvency

Carreras' total assets grew to $5.07B as at March 2021, which represents a 19.9% increase year over year. Of this, fixed assets grew from $744.7M to $893.2M, while current assets grew by 19.86%. Cash and cash equivalents improved from $2.02B to $2.23B. This growth in cash and cash equivalents in mainly attributable to the increase in cash provided by operating activities to $3.79B (2020: $3.34B). Moreover, inventories and accounts receivable both increased by 27.2% and 36.4% respectively, contributing to the increase in current assets for the period under review.

Total liabilities increased by 20.9% for the period, which was booked at $2.97B up from $2.46B in 2020. Of this, non-current liabilities grew by 26.6% due to an increase in lease liability and employee benefits of 26.6% and 26.5% respectively. Additionally, current liabilities grew by 19.5% which is mainly attributable to a 29.2% increase in accounts payable booked at $1.47M (2020: $1.14B).

Carreras' current ratio remained at 1.75x as at September 2021. The company's quick ratio was also relatively unchanged, from 1.52x to 1.51x indicating that CAR's assets, not including inventory, can cover its liabilities. However, its cash ratio fell from 0.82x to 0.75x. This indicates that CAR is still in a good liquidity position to cover its current liabilities.

Year to Date (6 Months ended September 2021)

Profitability

CAR reported revenues of $7.19B for the six months ended September 2021. This represents a 16.8% increase when compared to the same period last year. This growth in revenues was driven by the continued increase in demand for cigarettes. Additionally, despite the existence of illicit cigarette trade, CAR was able to improve revenue for the period under review, as management noted its intention to not increase its commodity prices as doing so is likely to create market opportunity for cheaper illicit cigarettes.

Cost of sales for the six months period amounted to $3.72B, a 19% year over year increase relative to $3.13B for the 2020 corresponding period. Quarter over quarter, cost of sales rose by 10.5% amounting to $1.94B relative to $1.76B booked in the corresponding quarter. Notably, this increase in cost is likely due to cigarette excise, higher inflation, rising shipping costs and supply chain disruptions. However, management noted that CAR benefited from large bulk purchases from its parent company, British American Tobacco Plc and manufacturing partner West Indian Tobacco Company (WITCO) which assists in containing its cost (lower shipping cost).

Gross profit for the period closed at $3.47B, up 14.6% year over year from the $3.03B booked in the corresponding six months 2020 period. However, gross margin for the six months period deteriorated marginally to 48.6%, down from 49.42% the corresponding 2020 quarter.

Administrative, distribution and marketing expenses totaled $999.19M (2020: $999.02M) for the six month period. Quarter over quarter administrative and distribution expenses was down 4.7% from $490.10M booked in 2020 to $467.31M, depicting CAR continued efforts to contain cost. Carreras' redesigned route-to-market strategy has improved its distribution network and significantly reduced its related party costs.

The increase in operating revenue and the reduction in cost has seen profit from operations increase by 22.3% for the six month 2021 period, amounting to $2.54B relative to $2.08B booked in 2020. Consequently, operating margin improved to 35.4%.

CAR's net finance cost declined by 15.6%, falling to $11.86M from $14.06M booked in the corresponding six month 2020 period. Of this, interest income amounted to $21.05M (2020: $23.73M), while interest expense amounted to $9.19M (2020:$9.66M).

Net income increased by 21.8% to $1.90B, up from $1.56B for the corresponding six months period ended September 2020. This improvement in net income was attributable mainly to the increase in demand for CAR's commodity, reduction in expenses and improvement in margins.

EPS recorded for the six-month period under review amounted to $0.392, up 22% year-over-year. The TTM EPS for CAR stands at $0.84 which when compared to the 2021FY represents an increase of 9.12%. 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 $4.51B as at September 2021, which represents a marginal 5% increase year over year. Of this, fixed assets grew from $756.5M to $890.4M, while there was a 2% uptick in current assets. Cash and cash equivalents deteriorated from $1.78B to $1.12B. This fall in cash and cash equivalents in mainly attributable to the decline in cash provided by operating activities to $998.31M (2020: $1.41B). Moreover, inventories and accounts receivable both increased significant by 49% and 40% respectively, which is an indication of the resulting decline in cash and cash equivalents for the period.

Total liabilities was relatively unchanged for the period, which stood at $2.49B down from $2.51B in 2020. Of this, non-current liabilities grew by 25% due to an increase in lease liability and employee benefits of 23% and 27% respectively. Conversely, current liabilities fell by 6% which is mainly attributable to a 23% fall in accounts payable booked at $944.69M (2020: $1.22B), indicating that CAR is paying vendors/suppliers sooner in comparison to the corresponding six months 2020 period.

Carreras has grown its current ratio from 1.72x to 1.88x as at September 2021. The company's quick ratio also improved from 1.48x to 1.50x indicating the CAR's assets, not including inventory, can cover its liabilities. Its cash ratio fell from 0.87x to 0.58x, though the company still has sufficient cash on hand to cover its current liabilities.

Cash Flow Adequacy

Cash from operating activities represented inflows of $998.31M for the six months period, relative to inflows of $1.41B in 2020. Cash from investing activities represented an outflow of $66.90M for the 2021 six months period, relative to an outflow of $37.67M in 2020. Cash from financing activities represented an outflow of $2.01B for the period, relative to an outflow of $1.59B in 2020.

Carreras' cash flow adequacy has deteriorated for the six month period. The company had a cash flow yield of 0.52x, a decrease from 0.90x booked in 2020, demonstrating a decline in CAR's ability to generate operating cash flows in relation to net income. Furthermore, cash flow to sales and cash flow to assets both deteriorated to 0.14x (2020: 0.23x) and 0.22x (2020: 0.33x) respectively. Furthermore, the entity had a free cash flow deficit of $994.80M, which was driven by dividends paid of $1.99B.

Dividends

Carreras continues to maintain its status as a strong dividend payer despite the challenges faced since the pandemic. While ordinary dividend payout ratio has fallen from pre pandemic levels of above 100%, it still remains relatively high at 91% (2020: 87%) for the 2021 financial year. Carreras' dividend yield for their 2021FY was 7.87%.

A special note of Carreras' recent dividend payments – the company's dividend payout ratio was above 100% for the 2018 and 2019 FY, this was due to the completion of the liquidation process of Cigarette Company of Jamaica Limited (CCJ), which commenced in 2004 and ended in the 2019 FY. CCJ was voluntarily dissolved by the Registrar of Companies and its final distribution of $534.0 million (net) during the 2018/2019FY allowed Carreras to make a special distribution to its stockholders on August 30th, 2018.

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 company has faced many challenges that comes with operating within the tobacco industry, such as regulatory and taxation risks that impacts their operating revenue, the company's cost management system has led to an increase in both gross and net income.

Furthermore, the economic conditions brought on by the pandemic, such as the global supply chain issues and lock down periods would have had an impact on the company's cost. Also, the company highlighted that the closure of entertainment spots, restaurants, bars and mass entertainment gatherings erased 5% of total sales.

Despite rising inflation and increased shipping cost since the pandemic, management noted that there is no intention to increase prices in the short term on their products, as this is likely to create market opportunity for illicit cigarette trades.

The company has continued to be plagued by illicit cigarette trades, either local taxes being evaded, smuggled illicit cigarettes or counterfeits. The affordability of cigarette is a major influence for its demand by Jamaican cigarette consumers, resulting from the macro-economic environment, as well as increasing prices of legal cigarette brands as a result of frequent and excessive excise increases. Illicit cigarettes are likely to become more attractive as they do not pay the requisite taxes, and as such, are sold at significantly lower prices than legitimate brands. This is likely to present a risk to the company's future earnings.

Notwithstanding, Carreras and the Government has been implementing initiatives and measures to combat the competition from the growing illicit cigarette trade. Carreras has implemented robust trade and public communication campaigns geared towards raising awareness of the consequences of the illicit trade. Furthermore, CAR's improvement in it's route to market model led to an improvement in operating revenue and allows the entity to be present in some areas where there is a high presence of illicit cigarettes. Additionally, the multi-industry approach to tackle the illicit trade has been adopted by the company.

The government plays a critical role in the fight against the growth of the illicit cigarette trade. The Tobacco Control Act (Bill) was tabled in parliament in 2020. The referenced bill introduced prohibitions on, among other things, tobacco sales, advertising, promotions and sponsorships, display bans, and ban on investment in the Tobacco Industry. This is likely to lower the CAR's sales volume and profit margins. Additionally, the tobacco excise policy is another measure imposed by the government, as one of the solutions to addressing the illicit cigarette trade in its quest to introduce comprehensive tobacco control legislation. However, the increase in tobacco excise has proven, in CAR's previous financial years (2015-2017), to have resulted in the transfer of volumes from the legal industry to the illicit trade in cigarettes. As such, significant increases in tobacco excise is likely to affect the ability of consumers to pay for legitimate brands, thus increasing the attractiveness and demand for low priced cigarettes. This ultimately results in reduced legal industry volumes as well as the erosion of the brand value of legitimate brands. Consequently, any excessive increase of tobacco excise, over time will pose a significant threat to Carreras future revenue and profit growth.

The company has introduced the improved image and brand of its most demanded product, Craven 'A' and Mattherhorn cigarettes. The Mattherhorn cigarette now allows consumers to choose how they want to enjoy the product with the imbedded capsule actions, with options of menthol and/or citrus flavors. This innovation in the tobacco market is expected to increase demand and boost revenues for the company.

Based on these assumptions, we forecast that revenues for the 2022FY ending March 2022 will likely be $14.52B which is 4% greater than the 2021FY revenues. We also expect pretax profits to surpass $5B for the first time since 2017. Our estimates point to net income attributable to shareholders of $3.91B, with an EPS of $0.81. We expect the dividend payout ratio to be in-line with that of the 2021FY at approximately 90%.

We applied our forward EPS and BVPS to the 3 year average PE ratio of 11.21x and PB ratio of 20.54x. This yielded $9.03 and $8.54 respectively. Given that CAR remains a strong and consistent dividend payer, we sought to utilize the Gordon Growth model as an additional valuation tool. With a cost of equity of 9.44% and expected growth rate of 1.4%, we arrived at a price of $8.83. **Averaging these forecasts gives us a price target of $8.80 which is 7% higher than the closing price of $8.20 on February 14, 2021.**

Recommendation

We assign a **HOLD/MARKETPERFORM** recommendation to CAR at this time. 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. CAR continues to have one of the highest dividend yields on the local exchange. Even though CAR is currently trading below our fair price estimate of $8.80, 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.

Though we anticipate a strain on revenue as a result of the illicit cigarette trade, CAR's cost containment measures, intentions of stable cigarette prices and the addictive nature of cigarettes to consumers, we expect the demand for Carreras' cigarettes to remain strong.

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.

Abridged Financials	YEAR END					SIX MONTHS		Change
	YE2017	YE2018	YE2019	YE2020	YE2021	Sep-20	Sep-21	
	$'000	$'000	$'000	$'000	$'000	$'000	$'000	
Operating revenue	13,509,228	12,550,132	12,906,497	14,126,523	13,971,292	6,154,026	7,189,724	16.8%
Cost of operating revenue	(6,969,933)	(6,249,282)	(6,470,125)	(7,132,802)	(7,158,983)	(3,127,599)	(3,720,558)	19.0%
Gross operating profit	6,539,295	6,300,850	6,436,372	6,993,721	6,812,309	3,026,427	3,469,166	14.6%
Administrative distribution and marketing expense	(1,840,028)	(1,847,945)	(2,013,673)	(2,372,263)	(1,991,389)	(999,017)	(999,191)	0.0%
Profit Before Tax	5,009,889	4,637,326	4,515,929	4,759,942	4,959,898	2,092,618	2,553,454	22.0%
Profit for the year	3,806,322	3,484,630	3,406,902	3,583,183	3,738,276	1,562,100	1,903,073	21.8%
Total Assets	4,176,698	3,988,170	3,492,653	4,231,468	5,072,430	4,289,578	4,507,820	5.1%
Total Liabilities	2,047,342	1,945,501	2,157,149	2,458,972	2,971,888	2,508,391	2,494,510	-0.6%
Total Shareholder's Equity	2,129,356	2,042,669	1,335,504	1,772,496	2,100,542	1,781,187	2,013,310	13.0%
EPS ($)	0.78	0.72	0.70	0.74	0.77	0.32	0.39	
Book Value per share ($)	0.44	0.42	0.28	0.37	0.43	0.37	0.41	
Price to Earnings (x)	9.44	14.78	13.05	9.02	11.54	20.20	21.66	
Price to Book (x)	16.87	25.21	33.30	18.24	20.54	17.71	20.47	
Key Ratios								
Gross Profit margin	48.4%	50.2%	49.9%	49.5%	48.8%	49.2%	48.3%	
Pretax Margin	37.1%	37.0%	35.0%	33.7%	35.5%	34.0%	35.5%	
Net Profit margin	28.2%	27.8%	26.4%	25.4%	26.8%	25.4%	26.5%	
Return on Assets	96.5%	85.4%	91.1%	92.8%	80.4%	36.4%	42.2%	
Return on Equity	194.9%	167.0%	201.7%	230.6%	193.0%	87.7%	100.3%	
Current ratio (x)	2.07	2.05	1.52	1.75	1.75	1.72	1.88	
Quick ratio (x)	1.81	1.91	1.33	1.52	1.51	1.48	1.50	
Cash ratio (x)	1.26	1.19	0.83	0.82	0.75	0.87	0.58	

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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