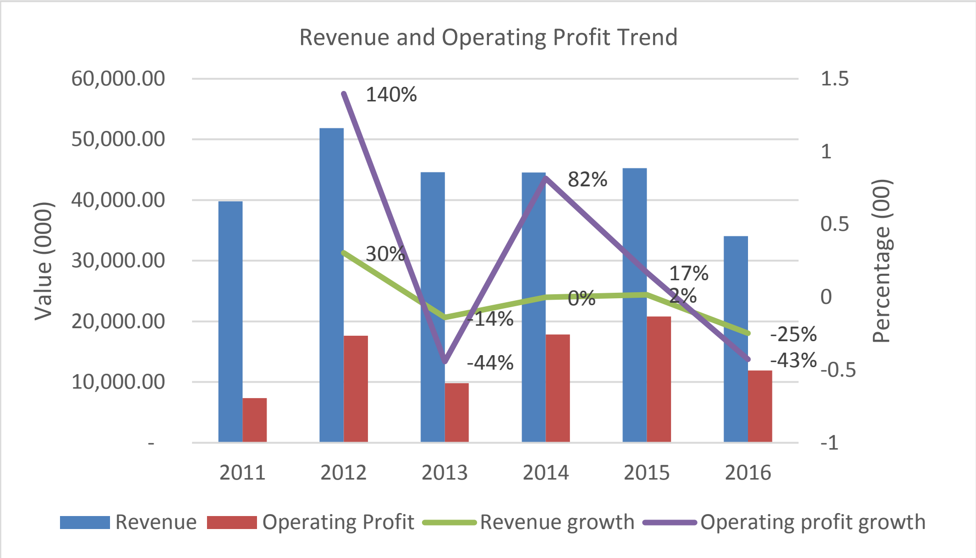
BAT Financial Year Ended 31 December 2016 Analysis

Market Data			
Current Share Price (USc)			**1505**
Fair Price (USc)			**894**
Shares in Issue			**20,675,610.00**
Market cap(US$)			**311,167,930.50**
Year high (USc)			**1525**
Year Low (USc)			**1500**
YTD			**-1.30%**
YOY			**30.90%**
EPS (USc)			**41**
Final Dividend (USc)			**33**
Income Statement	**FY2016**	**FY 2015**	**% Change**
	US$'000	**US$'000**	
Revenue	34,068.00	45,265.00	**-24.7%**
Operating profit	11,916.00	20,971.00	**-43.2%**
Profit After tax	8,477.00	15,476.00	**-45.2%**
Operating margin	35.0%	46.3%	**-24.5%**
Net Profit margin	24.9%	34.2%	**-27.2%**
Financial Position			
Total Assets	31,707.00	28,943.00	**9.5%**
Total Liabilites	19,457.00	14,289.00	**36.2%**
Attributable Equity	12,450.00	14,654.00	**-15.0%**
Cashflows and Ratios			
Cashflows from Operations	17,582.00	20,611.00	**-14.7%**
ROE	68.09%	105.61%	**-35.5%**
ROA	26.94%	53.65%	**-49.8%**
Current Assets to CLs	1.26	1.53	**-17.3%**
Total asset turnover	1.07	1.56	**-31.3%**
CFO/Net Income	2.07	1.33	**55.7%**

BAT Revenues take a 25% plunge

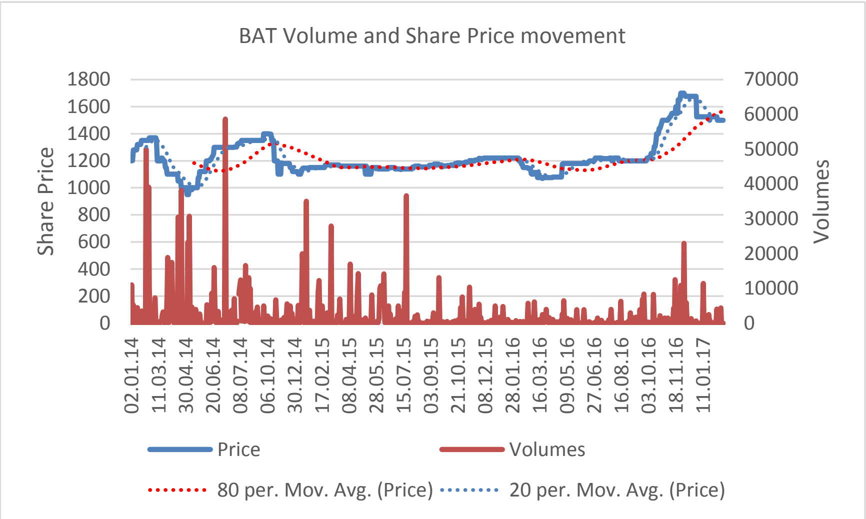
BAT revenues were down 25% pulled down by an overall volumes decline of 21% due to the depressed macro-economic environment. The BAT global brand, Dunhill recorded a 7.2% growth but this factor could not make a significant contribution towards supporting total volumes as it was growth from a low base. The operating environment in 2016 was significantly tougher for the company due to the compounded economic challenges that included shortages of physical notes in addition to the declining disposable incomes and the rise of competing brands from informal and formal players. Revenue decline was greater than volume decline as sales were greatly inclined towards low value products. Operating profit decline was much larger at 43% due to a 9% increase in selling and distribution costs and a decline in other income due to a non-recurring income component in 2015 from disposal of an asset. The group has no loans in its balance sheet and therefore has a minimal finance cost that could be arising from interest on some current payables. Ultimately earnings recorded a 45% decline to an EPS of 41 cents per share. Cashflow from operations recorded a decline of 15% mostly attributed to low net profits but were supported by improved receivables collections, delays in payments to creditors due to nostro challenges and lower inventory levels. CFO/Net Income, a ratio that reflects quality of earnings was 56% higher than in 2016 thereby indicating earnings that were supported by cash. As was highlighted earlier, some support came from a delay in payment to suppliers which is not necessarily good as it affects the possibility of future raw material supplies.

ROE remains quite high due to a decline in retained earnings as the company is currently tapping into these earnings to supplement the payment of its dividend. A final dividend of 33 cents per share was declared bringing the total dividend for 2016 to 51cents and a total payout ratio of 124%. Despite a 17% and 31% decline in the liquidity and activity ratios respectively, both ratios remain quite healthy.



The graph above indicates an overall negative trend in revenue and profit trends with the years 2013 and 2016 having the worst performance post dollarization. Revenue has declined by 14% from $39.8 million in 2011 to $34.1 million in 2016 whilst operating profits have improved by 62% from $7.3 million in 2011 to $12 million in 2016.

Technical Analysis



Technical Analysis

The graphs indicates a significant recovery in the BAT share price in the last quarter of 2016, a trend which is synonymous with most blue chip counters at that time. The recent share price trend however indicates a slight softening in prices from the peak price reached in Q4'16. The volumes traded have become thinner particularly from the last quarter of 2015 to date. This could mainly be attributed to the low level of investor participation on the ZSE. The short term moving average is currently showing signs of cutting the long term moving average from above which is a signal of an emerging downtrend. We do not however expect to see a significant decline in the share price because despite the challenges that the company is facing, its profit margins remain very strong and it continues to have a high dividend payout which has become an important source of yield for investors. Another key factor that supports a view of a limited downside in the share price is that the market currently has a very limited viable investment alternatives due to high risk in monetary developments and a high chance of a release of depressed financials from most bluechips.

Industry Competitive Analysis

1. **Threat of substitutes-Low**
   - Cigarettes have very limited substitutes especially in the local market. The awareness of the harmful effects of cigarettes has led to the growth of e-cigarettes but these are not yet popular in Zimbabwe.
2. **Intensity of rivalry-Low to Medium**
   - BAT Zimbabwe dominates the market with about 80% market share leaving other key players like Savanna Tobbacco, Cut Rag Processors and the new entrant Zark to share the other 20%.
   - There is however a new threat from grey imports which are being sold at unreasonably low prices.
3. **Bargaining Power of suppliers-Low**
   - Tobacco is a commodity that is traded globally and is also widely grown locally.
4. **Bargaining power of buyers-Low**
   - Buyers generally have a low bargaining power due to the addictive nature of cigarettes and the high level of brand loyalty as it is not easy

to switch from one brand to another for avid smokers. The small number of key players in this industry also limits the bargaining power of buyers.

5. Threat of new entrants-Low to Medium

- The barriers to entry are generally low in the sense that it is easy for smaller players to enter the market as has been observed by the infiltration of grey imports. However it may not be very viable for players to compete against big companies like BAT and Savanna Tobacco at a national level. These companies enjoy economies of scale in manufacturing, packaging, branding, distribution, and marketing, the costs associated with which, could be extremely high for a smaller company to undertake. This is why there has been a small number of formal players in the Tobacco industry over the years.

Investment case

- Despite the challenging economic environment the counter has been paying a regular dividend to its shareholders on both an interim and full year basis. The company has one of the highest payouts on the ZSE as has been observed in its latest results where total dividend payout is 124%.
- BAT is the leading cigarette manufacturer and distributor in the country and commands a market share of about 80%.
- According to our competitive analysis, BAT has a strong position in the tobacco industry which can allow it remain relatively profitable during these tough economic times.
- It has a very wide product range that appreciates the eclectic diversity in its consumers.
- The company has managed to remain quite profitable with very strong profit margins despite the decline in volumes.
- BAT has managed to clear up its interest bearing debt thus leaving less fixed obligations.
- It is a member if the Global BAT Group and has been able over the years to leverage on this position to manufacture and distribute its products with excellence.
- It has a very strong cash generating ability.
- Tobacco has a relatively high inelastic demand.

Investment Concerns

- BAT volumes have come under severe pressure from the depressed economic environment and the rising competing products from grey imports and new entrants.
- The very high payout ratios that have been eating into the company's retained earnings in 2015 (121%) and in 2016 (124%), are an indicator that the company currently has very limited growth and or investment opportunities.
- The decline in profitability also indicates a likelihood of a lower dividend going forward.
- The company is also facing challenges in making payments to foreign suppliers. This could affect future supply of key raw materials and possibly increase cost of sales.

Valuation and Recommendation

The operating environment is expected to remain challenging for BAT as volumes are expected to continue to take strain from the low levels of disposable incomes and the rising number of competing products. The company however remains in a position of great advantage in comparison to its competitors as it has the ability to sustain operations and remain profitable despite the challenging times given its market dominance. The Relative valuation method was used in valuing BAT with the use of the following multiples, Price to EPS (P/E), Price to Book Value (P/BV) and Price to Sales (P/S). Historical BAT valuation matrices were used as there is currently no company on the ZSE that can act as a direct comparable to BAT. BAT is currently trading at a trailing P/E of 37x against a historical average P/E of 17x, its trailing P/BV is 25x against a historical average of 16x and its trailing P/S is 9x against a historical average of 5x. This matrices indicate that the BAT share is overvalued with respect to all the matrices we used. We estimate a current fair price of 821cents which is 45% below the current price of 1505 cents and we therefore give a **SELL** recommendation.