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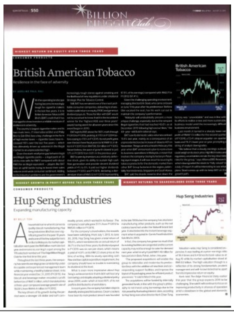

CONSUMER PRODUCTS

British American Tobacco

Resilience in the face of adversity

BY ADELINE PAUL RAJ

With the operating landscape having become increasingly tough for cigarette makers in the last few years, it is to British American Tobacco (M) Bhd's (BAT) credit that it has managed to show investors a reliable measure of resilience in adversity.

The country's largest cigarette maker and its two rivals here, JT International Bhd and Philip Morris Sdn Bhd, face a key challenge in the form of high excise taxes — cigarette taxes have increased 110% over the last five years — which has ultimately driven up volumes in the illegal market to an unprecedented high.

Given the stark retail price gap between legal and illegal cigarette packs — a legal pack of 20 sticks now sells for RM17 compared with about RM3 for an illegal equivalent — players like BAT face an uphill battle trying to boost their sales volume amid weak consumer sentiment. Adding to the industry's problems are the government's increasingly tough stance against smoking and the likelihood of new regulations under a National Strategic Plan for Tobacco Control.

Still, BAT has remained one of the most profitable consumer companies, delivering to shareholders solid return on equity (ROE) and generous dividend payouts. Those familiar with BAT would not be surprised to know that it is the incumbent winner for the "highest ROE over three years" award, having won it for all seven years since this award began in 2010.

BAT kept its ROE above the 160% mark through FY2012 to FY2015, peaking at 175% in FY2014 before easing to 170% in FY2015. Its net profit grew over the last three fiscal years to hit RM913.3 million in FY2015 from RM798.39 million in FY2012. Nevertheless, the pace of growth slowed to just 1.7% in FY2015 from 8.8% in the previous year.

BAT is seen by investors as a relatively defensive stock, given its ability to sustain high cash flow generation and provide decent dividend yields of 4% to 5%. It paid out higher dividends between FY2012 and FY2015, declaring a dividend per share of RM3.12 in FY2015 (representing 97.9% of its earnings) compared with RM2.71 in FY2012 (97.4%).

Given the challenging operating environment, managing director Erik Stoel, who came on board on June 1 this year after his predecessor Stefano Clini vacated the seat, has his work cut out to maintain the company's performance.

"Malaysia will undoubtedly present a more unique challenge, especially due to the rampant illegal cigarettes that had reached 45.6% as at December 2015 following high excise hikes," the 48-year-old Dutch national says.

BAT saw its domestic sales volumes contract 13.5% last year, mainly as a consequence of an unprecedented excise increase of close to 40% in November. Things came to a head in February this year when BAT announced a plan to restructure its business operations in Malaysia, a move that involves the company closing its factory in Petaling Jaya in stages. It will now resort to sourcing its tobacco products for the domestic market from other BAT Group factories in the region, potentially from Indonesia, Singapore and South Korea.

BAT said the drastic move to shut down the factory was "unavoidable" and was in line with its efforts to realise a new and more sustainable business model amid the increasingly difficult business environment.

Last month, it turned in a sharply lower net profit of RM47.72 million for the second quarter of FY2016, a 72.4% drop on a quarter-on-quarter basis and 78.2% lower year on year, prompting a string of analyst downgrades.

"We believe that a cloudy earnings outlook could weigh on its stock price. High illicit trades and regulatory uncertainties remain the key downside risks for the group," says AllianceDBS Research, which downgraded the stock to "fully valued" in a July 27 report. It will be interesting to see what plans Stoel comes up with to keep BAT on the growth path. E