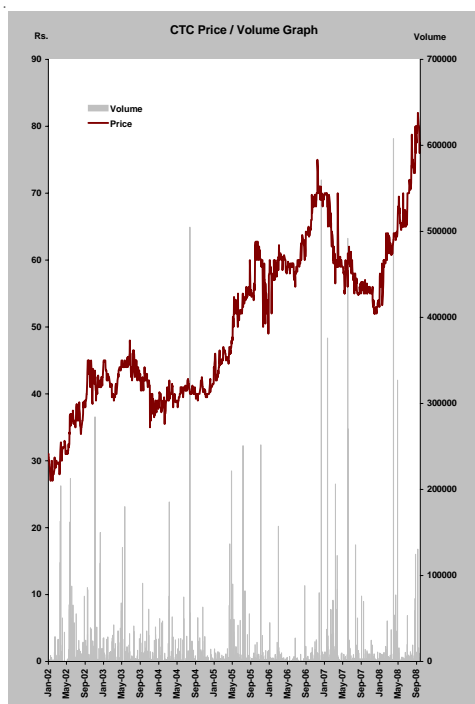


# Ceylon Tobacco Company (CTC)

Rs.78.00

Hold



Financial Year - Dec	NPAT (Rs m)	EPS (Rs)	EPS Growth (%)	PER (x)	Dividend yield (%)	DPS (Rs)
2005	1,256	6.71	16.09	11.62	8.21	6.40
2006	1,473	7.86	17.14	9.92	9.49	7.40
2007	1,894	10.11	28.63	7.72	12.31	9.60
2008E	2,212	11.81	16.78	6.61	14.37	11.21
2009E	2,475	13.21	11.90	5.90	16.08	12.54
2010E	2,695	14.39	8.90	5.42	17.51	13.66

- ✓ The Sri Lankan cigarette market is on a decline, with the pace of decline escalating because of the implementation of the National Alcohol and Tobacco Act in December 2006. During the period (Mar07-todate) there has been an almost 25% increase in prices of cigarettes in the country. Currently, the market approximates a total volume of about 5.2 billion sticks (also comprising of smuggled and illicit products). This does not account for the beedi markets which are not seen as contestable space given the demographics and spend.
- ✓ The 84% British American Tobacco owned CTC is the only legal cigarette manufacturer in Sri Lanka. The total marketable space is 4.8 billion sticks. The beedi market is around 2.3 billion sticks. According to the company it has 96% of the total market with 4% to illicit trade.
- ✓ BAT's decision to concentrate efforts on six Global Drive Brands has resulted in changes in CTC's brand portfolio, with newer brands like Dunhill and Viceroy being introduced over the past few years. Viceroy replaced Bristol which was the leading low priced brand. Efforts to move consumers from Bristol to Goldleaf (CTC's largest brand) had mixed results over the past few years and the company says it has retained 83% of their Bristol market segment along with 70% of volumes. JPGL and Pall Mall together brings 70% of the total sales.

CTC			
Reuters Code	CTC.CM		
Bloomberg Code	CTC.SL		
Share Price LKR	78.00		
Issued Share Capital (Shares)	187,323,751		
12 mth High/Low (Rs.)	82 / 52		
Average Daily Volume	11,475		
Market Capitalisation Rs. mn	14,611		
Price Performance (%)	1 mth	6 mth	12mth
ASPI	-8.18	-13.09	-14.32
CTC	-3.13	27.05	37.78

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- ✓ Ceylon Tobacco Company has reported a turnover of Rs.46.8 bn for FY07 and Rs.27 bn for 1H08, mainly benefiting from the increase in average sales price and improved brand mix towards high price brands which also offset the impact of decline in volumes. Company's profit after tax was Rs. 894 m in 1H08 registering a growth of 28% and 37 % in comparison to previous periods.
- ✓ Through the sharp increase in the agility of the value chain the company is expected to achieve a steady increase in productivity and efficiency. However, as continued excise led price increases are making legal products unaffordable to the consumers, it will create an atmosphere conducive for the growth of illicit cigarettes. For financial year 2008 the earnings are foreseen to yield a growth of 17% to reach Rs.2,211 mn through the strategy of value creation despite the threat of counterfeit tobacco products.
- ✓ CTC's dividend yield for 2007 was 12.31% and it is expected to yield 14.37% in 2008, that is superior to most of the tobacco firms in the region where it stands below 8.5%. CTC's PE for 2007 was 7.72 and at Rs.78 the counter is trading at 6.61x FY08E earnings, which is at a discount to the regional figures. We recommend HOLD.

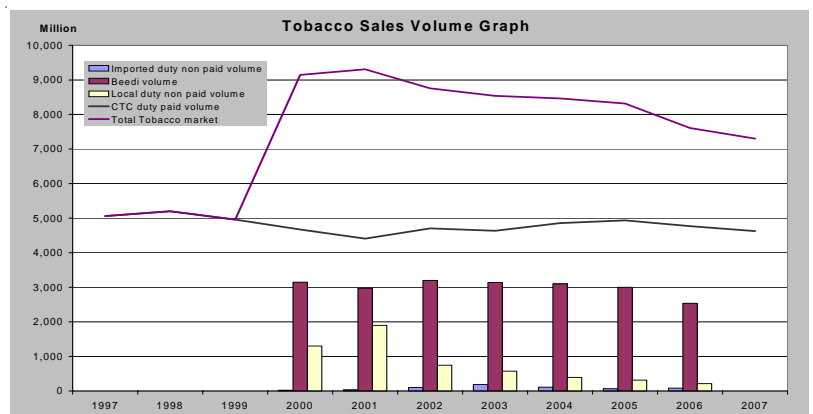
September 2008



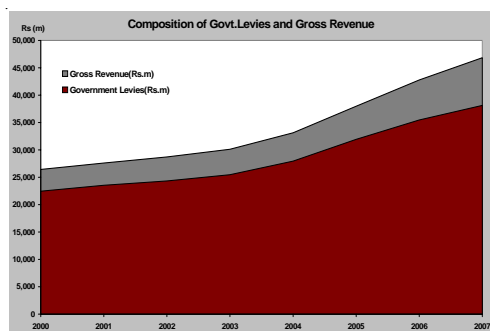
## The Tobacco Industry in Sri Lanka

- ✓ The Sri Lankan cigarette market is on a decline, with the pace of decline escalating because of the implementation of the National Alcohol and Tobacco Act in December 2006 which prohibits smoking and drinking in enclosed public places such as restaurants and social clubs and in public transport and as well as continuous excise led price increases. This trend is quite evident in the region as well where Pakistan Tobacco Company's, BAT Malaysia's & Indian Tobacco Company's revenue growth has declined.
- ✓ During the period (Mar07-todate) there has been an almost 25% increase in prices of cigarettes in the country. Currently, the market approximates a total volume of about 5.2 billion sticks (also comprising of smuggled and illicit sticks). This does not account for the beedi markets (cut tobacco rolled in Tendu leaf, duty paid, cottage industry, taste & price driven, used by 50+, rural, low income groups) which are not seen as contestable space given the demographics and spend. Illicit cigarettes are the main competition to the company.
- ✓ According to CTC the total marketable space is 4.8 billion sticks. The beedi market is around 2.3 billion sticks. CTC has a 96% of the total market with 4% to illicit trade. The illicit market includes illicit white cigarettes (hand rolled, cottage industry, 72mm, and bottom end focus), Chewing tobacco (rural low end, inferior tobacco, Beetle leaf chewing) and Smuggled cigarettes (duty not paid, counterfeits, mid-top segment focus).

## Tobacco product demand in Sri Lanka



- ✓ CTC is the only legal cigarette manufacturer in Sri Lanka. Whilst cigarettes are the most popular form of tobacco in the country, at least half of all smokers use beedi (cheap handmade cigarettes wrapped in tobacco leaf) – often in addition to cigarettes. About 60% of smokers are estimated to purchase single stick cigarettes.
- ✓ A study on *Health, Nutrition and Population (HNP)* by Nisha Arunatilake and Madumvanthi Opatha shows that, income is positively related to the probability of smoking, while those with less education are more likely to smoke. Higher income in the middle-income range and higher education are associated with falling consumption, as in many other countries.
- ✓ People in the lower income quintiles are clearly much more price-responsive to price changes; a 10% real price rise would cause total consumption (combining the effects of prevalence and smoking intensity) to fall by around 5%. Eventhough, tobacco is a relatively price inelastic product, higher prices are clearly (and statistically significantly) associated with lower consumption.



- ✓ Higher tobacco taxes that raise the price of cigarettes and other tobacco products have proved to be the single most effective tobacco control measure. With higher taxes, smaller quantities of cigarettes are sold, but the tax per pack is higher, generating larger total revenues.

### Company Profile

- ✓ Ceylon Tobacco Company is engaged in growing of leaf, manufacturing, marketing and distribution of cigarettes. They contribute around 10% of total government tax revenue and provide direct and indirect employment to a significant number of Sri-Lankans. The principal shareholder is British American Tobacco plc with a shareholding of 84.13% while FTR Holdings SA holds 8.32%

### Marketing and Distribution

- ✓ In order to get products to retail outlets, finished products are distributed to retail outlets throughout Sri Lanka by 41 distributors (Company is currently involved in the process of reducing the number). Retail outlets include supermarkets, convenience stores, hotels, restaurants, cafes.
- ✓ As per the rules and regulations on the industry the company doesn't do ATL at all and does a modest amount of BTL. The premium brands are sold in places like airport and hotels where for mid portfolio and VFM category brands loyalty programs, one-to-one marketing at outlets and developing supermarket channels are carried out.

### The Brands

- ✓ BAT's decision to concentrate efforts on six Global Drive Brands has resulted in changes in CTC's brand portfolio, with newer brands like Dunhill and Viceroy being introduced over the past few years. Viceroy replaced Bristol which was the leading low priced brand. Efforts to move consumers from Bristol to Goldleaf (CTC's largest brand) had mixed results over the past few years and the company says it has retained 83% of their Bristol market segment along with 70% of volumes. JPGL and Pall Mall together brings 70% of the total sales.
- ✓ Dunhill was introduced to Sri Lanka on the 1<sup>st</sup> of October 2005. Dunhill is placed in the premium / super premium category market category.
- ✓ Benson & Hedges is the Company's international premium offering in its brand portfolio. This brand was re-launched in August 2003 incorporating a new, improved product and was also made available in a handy 12's pack.
- ✓ JPGL is their key international mainstream brand and drives value growth in the Company's portfolio strategy. The brand dates back to the 1890s and for historical reasons British American Tobacco does not own the brand in the UK, continental Europe or the United States.
- ✓ Viceroy is the mid-priced brand in the VFM portfolio. Its role is to sustain profitable volume levels that will fund their key drive brands whilst protecting the Company's overall volume base. In the process of introducing global brands, the well known Bristol was re-launched as Viceroy.

- ✓ Three Roses, Capstan and Four Aces are CTC's value for money brands. Their main role is to contain the illicit cigarette market, there by protecting the Company's volume base from the threat posed by locally produced, bottom-end, cheap, handmade cigarettes (the illicit white cigarettes), which are currently outside the Government's excise net. A major threat to their Value for Money (VFM) brands could come from the implications of the amnesty granted to the white beedi manufacturers. However, CTC's brands are still strongly placed to compete with these products on quality and the strength of their distribution network.

### **Demographics**

- ✓ There is a general decline in volumes sold where there are more exits than entrants especially in the VFM category.
- ✓ The consumer segment of the company is shifting towards more aging category.
- ✓ The company claims that from the research conducted the daily consumption of cigarettes have dropped from 9 to 6 and the health consciousness is more among the public now.
- ✓ Tobacco is a masculine dominated industry and however, there is rising trend in female smokers which is negligible.

### **Regulatory System**

- ✓ In addition to the existing rules and regulations the newly imposed NATA(2006) had a significant negative impact on the industry. There has been a "Stop selling" campaign which affected sales of the company further.
- ✓ Sri Lanka is one of the most expensive markets for tobacco in Asia and although illicit cigarette volumes have declined about 40% from the estimated 504 mn sticks in 2004 to almost 307 mn sticks in 2006, the current draconian legislation and as well as the excise increases in 2007 are bound to push illicit volumes up on affordability.

### **Company's future strategy**

- ✓ Since company does not have much of a say and control in the prices they are concentrating on reducing and rationalizing the costs. The area that's in focus is the supply chain. The company has enjoyed and is still enjoying the benefits of the on going supply chain integration process. The future strategies include:
  - ✓ Integrated Logistics and retooling of supply chain and reducing the number of retailers from 40 to a lesser number which will be continuous.
  - ✓ The company is looking forward to outsource administration, IT, transport and etc in order to control increasing costs and focus more on value creating activities.

## Earnings

- ✓ Ceylon Tobacco Company has reported a turnover of Rs.46.8 bn for FY07 and Rs.27 bn for 1H08, mainly benefiting from the increase in average sales price and improved brand mix towards high price brands which also offset the impact of decline in volumes. Company's profit after tax was Rs. 894 m in 1H08 registering a growth of 28% and 37 % in comparison to the corresponding & adjacent previous periods. Gross Revenue for the second quarter of FY08 (2Q08) increased by 20% to reach Rs.13.9 bn and Earnings for the period grew by 43% to Rs.533m.
- ✓ The Revenue increase is mainly due to the excise led price increases which increased prices of most brands by Rs.4.00 on average. This resulted in a diminutive decline in sales volume compared to the same period last year. Despite the decline in sales volume Government levies exclusive of Provincial Council Taxes grew by Rs 3,360m to reach Rs. 21,785m during the first half of the year signifying the impact of excise led price increases.
- ✓ During the year 2007, the company's cash generation remained strong with a 73% increase (to Rs.3,040 mn) in net cash generated from operating activities in contrast to 2006. During the first half of 2008 also CTC continued to maintain strong cash generation with 41% increase (to Rs3,501m) .The increase was largely driven by growth in operating profit coupled with their continuously better managed working capital.
- ✓ The Dividend per share increased in line with net earnings growth while the dividend yield is at an attractive 13%.

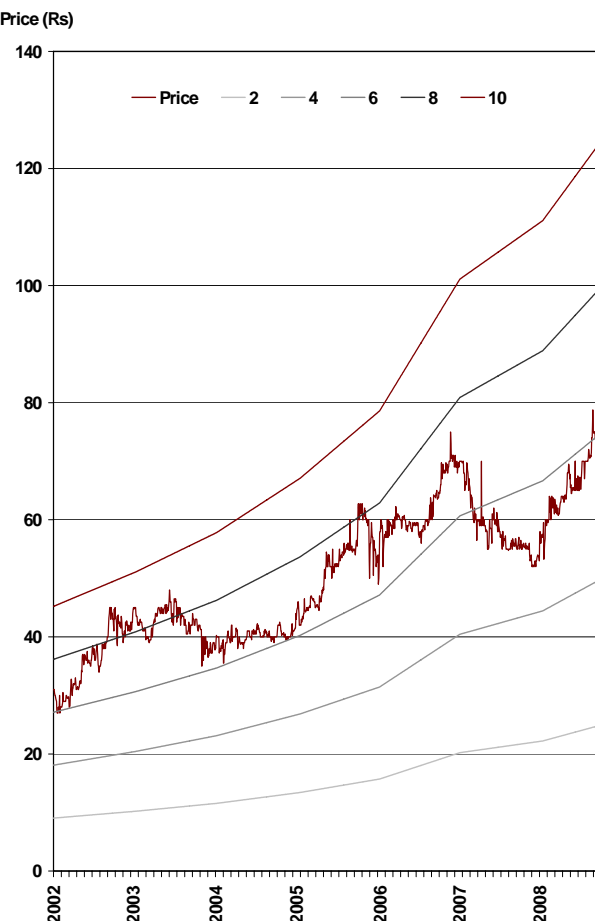
## Outlook

- ✓ Due to effective enforcement of law by the authorities in curbing the growth of counterfeit and smuggled cigarettes, the company is gaining the lost ground to illicit tobacco trade. This contributes towards not only protecting the legal tobacco industry but also the government revenue growth.
- ✓ Through the sharp increase in the agility of the value chain the company is expected to achieve a steady increase in productivity and efficiency. However, as continued excise led price increases are making legal products unaffordable to the consumers, it will create an atmosphere conducive for the growth of illicit cigarettes which is quite evident in the region for example Thailand tobacco, a monopoly loses sales worth about \$124 million a year to copycats

## Valuation

- ✓ For financial year 2008, CTC's earnings are foreseen to reach approximately Rs.2,211 m with the strategy of value creation through cost efficiencies. At Rs.78.00 the counter is trading at 6.61x FY08E earnings.
- ✓ CTC's PE for 2007 was 7.72 which in comparison is superior to the regional average where Pakistan Tobacco Company's PE was 16.47, BAT Malaysia's PE was 14.96, Indian Tobacco Company's was 18.5.
- ✓ CTC's dividend yield for 2007 was 12.31% and it is expected to yield 14.37% in 2008, where as in the region Pakistan Tobacco Company's was 8.11%, BAT Malaysia's was 7.27% & Indian Tobacco's was 1.75%.
- ✓ At 6.61x FY08E earnings the counter is at a discount of 25% to the Market and with a 14.3% dividend yield expected for 2008 and earnings growth through cost efficiencies via productivity initiatives in supply chain and retooling the distribution value chain., we recommend **HOLD**

CTC P/E Band Graph



<b>Income Statement</b>						
<b>For the year ended 31st December(Rs.'m)</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008E</b>	<b>2009E</b>	<b>2010E</b>
Revenue	37,982	42,781	46,827	54,788	64,102	74,999
Levies	31,928	35,448	38,116	45,041	52,689	61,541
Net Turnover	6,054	7,333	8,711	9,747	11,413	13,458
Total expenses	4,251	5,129	5,902	6,802	8,046	9,610
Operating Profit	1,803	2,204	2,809	2,945	3,367	3,848
PBT	1,857	2,333	3,094	3,616	4,049	4,411
Tax	600	860	1,200	1,404	1,574	1,715
<b>Profit to ordinary shareholders</b>	<b>1,256</b>	<b>1,473</b>	<b>1,894</b>	<b>2,212</b>	<b>2,475</b>	<b>2,695</b>
<b>Balance Sheet</b>						
<b>As at 31 December(Rs.'m)</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008E</b>	<b>2009E</b>	<b>2010E</b>
<b>Fixed Assets</b>						
PP&E	1,725	1,716	1,678	1,636	1,612	1,605
Intangible Assets	–	36	34	23	15	5
Receivables	175	168	194	229	270	318
<b>Total non-current assets</b>	<b>1,900</b>	<b>1,921</b>	<b>1,906</b>	<b>1,888</b>	<b>1,897</b>	<b>1,929</b>
<b>Current Assets</b>						
Inventories	1,581	1,796	2,110	2,381	2,816	3,363
Trade and Other receivables	686	586	1,237	1,644	1,923	2,250
Cash & cash equivalents	2,497	2,567	4,082	4,626	4,587	4,514
<b>Total current assets</b>	<b>4,764</b>	<b>4,949</b>	<b>7,428</b>	<b>8,650</b>	<b>9,326</b>	<b>10,127</b>
<b>Total Assets</b>	<b>6,664</b>	<b>6,870</b>	<b>9,335</b>	<b>10,537</b>	<b>11,223</b>	<b>12,056</b>
<b>Equity</b>						
Issued share capital	1,873	1,873	1,873	1,873	1,873	1,873
Capital reserves	15	15	15	15	15	15
Retained earnings	188	278	374	926	1,588	747
<b>Total equity</b>	<b>2,079</b>	<b>2,166</b>	<b>2,262</b>	<b>2,814</b>	<b>3,476</b>	<b>2,636</b>
<b>Non-current Liabilities</b>						
Provision for retiring gratuity	13	11	8	7	5	4
Deferred tax	320	315	310	306	303	300
<b>Total non-current liabilities</b>	<b>333</b>	<b>327</b>	<b>318</b>	<b>313</b>	<b>308</b>	<b>304</b>
<b>Current Liabilities</b>						
Trade & other payables	2,895	3,067	5,012	4,985	4,961	4,993
Income tax payable	500	637	883	928	974	1,023
Dividend payable	514	476	768	1,188	1,658	2,170
Unclaimed dividend	27	24	29	35	29	35
Bank overdraft	344	199	62	501	339	183
<b>Total current liabilities</b>	<b>4,252</b>	<b>4,377</b>	<b>6,755</b>	<b>7,851</b>	<b>8,416</b>	<b>9,116</b>
<b>Total Liabilities</b>	<b>4,585</b>	<b>4,704</b>	<b>7,073</b>	<b>8,163</b>	<b>8,724</b>	<b>9,420</b>
<b>Total Equity &amp; Liabilities</b>	<b>6,664</b>	<b>6,870</b>	<b>9,335</b>	<b>10,537</b>	<b>11,223</b>	<b>12,056</b>
<b>Cashflow Statement</b>						
<b>As at 31st December(Rs.'m)</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008E</b>	<b>2009E</b>	<b>2010E</b>
Cashflow from Operating Activities	1,739	1,757	3,040	1,266	1,497	1,654
Net Cashflow from Investing	-158	-125	91	519	506	476
Net Cashflow from Financing	-1,081	-1,418	-1,480	-1,680	-1,880	-2,047
<b>Net Cashflow Generation</b>	<b>500</b>	<b>214</b>	<b>1,652</b>	<b>105</b>	<b>123</b>	<b>83</b>
Cash & Equivalents b/f	1,653	2,153	2,368	4,020	4,125	4,248
<b>Cash &amp; Equivalents c/f</b>	<b>2,153</b>	<b>2,368</b>	<b>4,020</b>	<b>4,125</b>	<b>4,248</b>	<b>4,331</b>