



CEYLON TOBACCO COMPANY PLC

CSE: CTC.N0000

Bloomberg: CTC SL

Maintain **SELL**

Jan 2018

Current Price – LKR 1,030.0

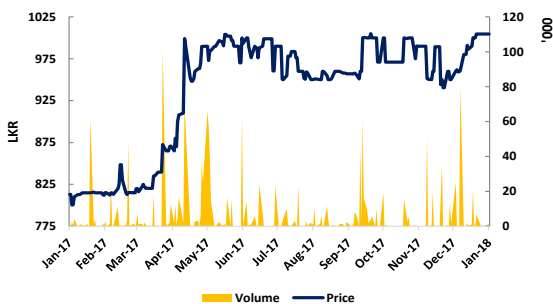
Fair value – LKR 958 [2018E]

Buy Below Price - LKR 911.87 3Q2017 Earnings **↓12%YoY**

KEY DATA			
Share Price (LKR)	1,030.00		
52w High/Low (LKR)	1,004.10 / 800.40		
Average Daily Volume (Shares)	6,040		
Average Daily Turnover (LKR)	5,538,593		
Issued Share Capital (Shares mn)	187.3		
Market Capitalisation (LKR mn)	192,943		
Price Performance (%)	1 mth	3 mths	12mths
CTC	11%	10%	31%
ASPI	2%	0%	6%
Major Shareholders as at 30th Sep 2017			
British American Tobacco Holdings	84.13%		
FTR Holdings SA	8.32%		
Pershing LLL SA Averbach Grauson & Co.	0.88%		
HSBC INT NOM Ltd - State Street London	0.39%		
RBC Investor Services Bank-COELI SICAV	0.19%		
Estimated Free Float	15.87%		

“Persistent challenges from the regulatory environment leads to a difficult road ahead”

Price-Volume Chart



Source: CSE

ANALYST CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 6.

P/E 31 December	2015	2016	2017E	2018E	2019E
Revenue (LKR mn)	26,099	31,748	33,711	36,826	40,117
Net Profit (LKR mn)	10,634	12,559	11,814	12,957	15,086
EPS (LKR)	56.8	67.1	63.1	69.2	80.5
YoY % Growth	23%	18%	-6%	10%	16%
Valuations					
PER (x)	18.1	15.4	16.3	14.9	12.8
PBV (x)	66.9	55.4	33.0	24.8	19.2
Div Yield (%)	3.9%	5.5%	4.9%	5.7%	6.6%
NAVPS	15.4	18.6	31.2	41.6	53.7
DPS (LKR)	40.55	56.92	50.5	58.8	68.5
Div Payout	71%	85%	80%	85%	85%

LKR (Mn)	3Q2017	3Q2016	YoY	2Q2017	QoQ	9M 2017	9M 2016	YoY
Gross Revenue	36,192	39,481	-8%	36,334	-0.4%	103,394	99,124	4%
Net Revenue	8,198	9,232	-11%	8,242	-0.5%	23,471	24,187	-3%
Operating Profit	5,985	7,088	-16%	6,246	-4.2%	17,468	17,206	2%
PBIT	6,385	7,359	-13%	6,033	5.8%	17,919	17,801	1%
Net Profit	3,937	4,472	-12%	2,957	33.1%	10,090	10,578	-5%

LKR (Mn)	4Q2016	1Q2017	2Q2017	3Q2017
Gross Revenue	24,717	30,868	36,334	36,192
Net Revenue	7,561	7,032	8,242	8,198
EBITDA	3,215	5,290	5,683	6,047
EBITDA Margin	13%	17%	16%	17%
PBT	3,418	5,502	6,033	6,385
Net Profit	1,981	3,197	2,957	3,937
Net Margin	8%	10%	8%	11%

Disclosure on Shareholding: First Capital Group and its affiliates does not hold shares of CTC and will not trade in this share for the three trading days following the issue of this document

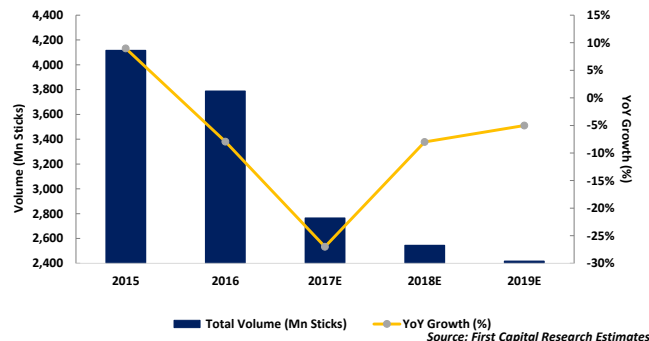
Increase in taxes weigh heavily on Volume and earnings

CTC Remains to be a SELL: CTC's 3Q2017 results showed an adverse performance in earnings which is in line with our expectations resulting from negative impacts from heavy increase of taxes. We maintain our expectations of a net earnings of LKR 11,814 for 2017E. With the Government's determined attitude to discourage smoking and also maximize Government Revenue amidst tight fiscal conditions was clearly witnessed in 2016 when CTC faced dual impacts of a 28% hike in excise duties, the introduction of a 15% VAT and LKR 5.0 production tax per cigarette. While tax led price increases are affecting volumes, the production tax is affecting CTC margins. However, CTC has managed tightly control production costs keep their margins under check. CTC volumes have been on a declining phase with 9 months 2017 volumes dipping by 28.7% on top of an 8% dip in 2016. We expect a downtrend in volumes to continue for 2018E (-8%) & 2019E (-5%) as well although slowing down in pace. However, we expect CTC Net Revenue/Gross Revenue margins to revert back to the slow improvement it had prior to 2016 where price increases were slightly above tax increases improving Net Revenue/Gross Revenue margins. First Capital Research estimates a fair value price of LKR 958 providing an annualized return of -1% (Capital gain of -7% and a dividend yield of 6% is expected for 2018E). The recommendation by First Capital Research on CTC remains to be a **SELL**.

Budget Move: To combat the smuggling of illicit cigarettes, during the 2018 Budget presentation, the Government proposed to issue new licenses to import cigarettes whilst clamping down on smuggling.



Volume-Growth Chart



Earnings Performance

Earnings down by 12%YoY: CTC recorded earnings of LKR 3.94Bn for 3Q2017, down by 12% compared with 3Q2016 which recorded earnings of LKR 4.47Bn. However, on a QoQ basis earnings grew by 33.1% compared to LKR 2.96Bn recorded in 2Q2017.

Volume decline: The volume decline is due to higher price of cigarettes following an excise duty increase in the fourth quarter of last year.

Rise of internal cost: In 2016 operating expenses increased due to the production tax that was imposed per cigarette. During the 3Q2017 other operating expenses increased by 43% compared to the same period in 2016, this is due to the market investment committed behind John Player brand house.

Overall comparisons: When comparing QoQ basis there is a Net profit increase of 33.1% in 3Q of 2017 compared to 2Q of 2017, this is due to the significant expenditure suffered in the 2Q2017 due to increase levels of unlawful

enforcements in the market which posed a threat to the business. However on YoY basis there is a decline of 12% in Net profit margins. This is due to the decline in volumes which was a result of government taxes being increased last year.

Investment Case

Fair value estimation: FC Research estimates a fair value for CTC at LKR 958 for the year 2018E. [DCF based LKR 1,174.8, PER based LKR 968.4 and DDM based LKR 730.7]. CTC expects a total return of c.-1% which includes a Dividend Yield of c.6%.

Taxes affect volume growth: CTC's traditional revenue streams were majorly affected by the large increase of taxes in 4Q2016. This resulted in the market contracting due to the persistent pressure on the disposable income following the excise increases. This will inevitably affect the volume performance of CTC in the long run.

Net earnings to grow at a CAGR OF c.6% 2016-2019E: FC Research expects Net earnings of CTC to grow at a CAGR OF c.6% through 2016-2019E. Government levies are expected to grow at a CAGR of 6% during the said period.

Next generation products: CTC is looking at sustainable products with a high quality that provide consumers less risky alternatives for smoking. They intend to share their research and findings and are open to collaboration with external parties to sustain the highest standards of quality and regulatory requirements.

Investment risks

Regulatory Risks: A fall in volume is expected since government proposed to issue new licenses to import cigarettes there by creating competition for CTC and will result in a drop in revenue.

Competitive Risks: CTC currently has a monopolized market position however CTC faces stiff competition from illegal brands such as Gold Seal and numerous counterfeits that are imported into the country. This is driven by the gap between the price of legal and illicit products available in the market as well as current macroeconomic factors that are impacting consumer spending power. Official sources state that, in the first six months of 2017, law enforcement agencies confiscated 40.5Mn illicit cigarettes, compared to the 4Mn sticks seized during the full year of 2016.

"Beedi": still remains a key threat to CTC as it still remains as an under regulated and low taxed product. Another growing concern is the rising incidence of the growth of "beedi" as an increasingly cheaper alternative to cigarettes.



Valuation Summary

Expected CTC price for 2018E	
DCF Valuation based target price	1,174.8
PER based target price	968.4
DDM based target price	730.7
Average Target Price	958.0
Target price (Rounded up)	958.0

Return	
Target Price	958.0
Current Price	1,030.0
Capital Gain (LKR)	-72.0
Dividend FY18E (LKR)	58.8
Capital Gain %	-7%
Dividend Yield %	6%
Total Return %	-1%

DCF Valuation

DCF Valuations	2018E
NPV	192,638
(+) Cash	27,437
(-) Debt	-
Total Value of Equity	220,075
No. of shares	187
Value of Equity per share	1,175

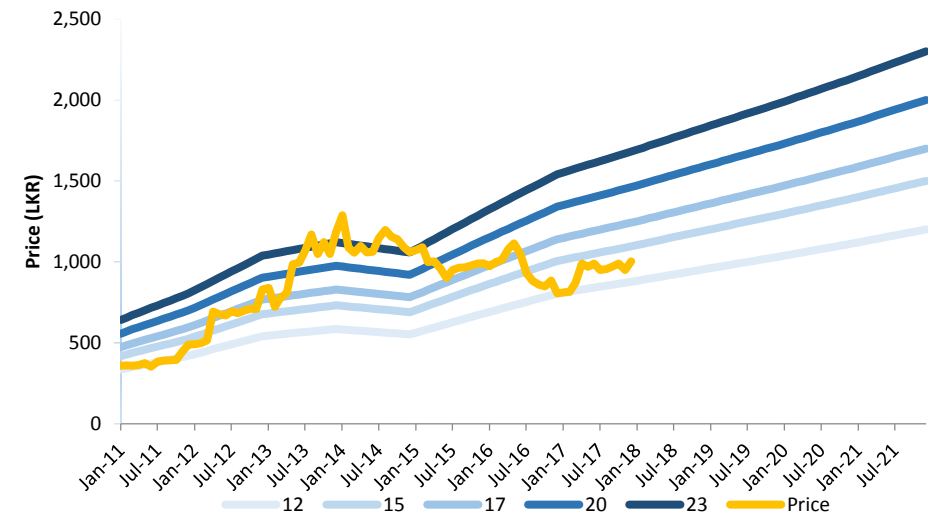
COE (K_e)	
R_f	9%
R_m	17%
β	1.1
$K_e = R_f + \beta (R_m - R_f)$	17%

WACC	
K_e	17%
K_d	6%
D/E Assumption	40 / 60
Terminal Growth (%)	3%
WACC	13%

Scenario Analysis

		WACC				
		9%	11%	13%	15%	17%
Terminal Growth (%)	1%	948	765	643	556	491
	2%	1053	827	683	584	511
	3%	1192	904	731	616	533
	4%	1386	1002	789	653	559
	5%	1678	1134	862	699	590

PER Valuation



Source: CSE and First Capital research Estimates

PER based Valuation	
FY18E Earnings (LKR 'Mn)	12,957
No. of Shares ('Mn)	187
FY18E EPS	69.17
Expected Average PER	14.0x
Price at 14x FY18E Earnings	968.4

Recommendation Criteria

Category	Company Category	Strong Buy	Buy	Hold	Sell
Grade A	S&P SL20 Companies	T.Bill + 10% & Above	T.Bill + 5% & Above	T.Bill + 1% & Above	Below T.Bill + 1%
Grade B	Rest of the Companies	T.Bill + 13% & Above	T.Bill + 8% & Above	T.Bill + 3% & Above	Below T.Bill + 3%
Grade C	Companies less than LKR 1Bn Market Cap	T.Bill + 16% & Above	T.Bill + 11% & Above	T.Bill + 6% & Above	Below T.Bill + 6%

*1 Year T Bill rate as of 22-01-2018 – 8.95%



Annex I – Income Statement

Income Statement (LKR mn) Y/E 31st December	2015	2016	2017E	2018E	2019E
Gross Revenue	106,491	121,525	137,987	142,894	149,919
Government Levies	-80,391	-89,777	-104,276	-106,068	-109,803
Net Revenue	26,099	31,748	33,711	36,826	40,117
Other operating income	23	24	51	55	60
Raw materials	-2,977	-3,274	-3,251	-4,067	-2,973
Employee benefits	-1,418	-1,401	-1,471	-1,545	-1,622
Depreciation and amortization	-214	-218	-231	-250	-269
Other operating expenses	-3,996	-6,510	-7,745	-7,838	-8,190
Operating profit	17,517	20,369	21,064	23,182	27,123
Net interest income	561	850	814	814	814
PBT	18,078	21,219	21,878	23,995	27,936
Tax	-7,444	-8,660	-10,064	-11,038	-12,851
Net earnings	10,634	12,559	11,814	12,957	15,086
-Super Gains Tax	0	0	0	0	0
Net earnings	10,634	12,559	11,814	12,957	15,086
EPS	56.8	67.1	63.1	69.2	80.5

Source: Company reports and First Capital Research Estimates

Annex II – Balance Sheet

Balance Sheet (LKR mn) As at 31st December	2015	2016	2017E	2018E	2019E
Assets					
Non Current Assets					
Property plant and equipment	2,063	2,269.81	2,491	2,697	2,885
Intangible assets	9	1	-1	-2	-4
Investments in subsidiaries	0	0	0	0	0
Net surplus assets on retirement benefit plan	531	652	652	652	652
Receivables	138	142	142	142	142
Total Non Current Assets	2,742	3,065	3,285	3,489	3,676
Current Assets					
Inventories	3,532	2,068	2,760	2,858	2,998
Trade & other receivables	1,020	2,372	1,500	1,554	1,630
Assets held for sale		0.279	0.279	0.279	0.279
Cash & cash equivalents	11,378	15,050	29,158	27,437	28,320
Total Current Assets	15,930	19,490	33,418	31,848	32,949
Total Assets	18,672	22,556	36,703	35,337	36,624
Equity and Liabilities					
Equity					
Stated capital	1,873	1,873	1,875	1,875	1,875
Retained earnings	1,012	1,612	3,974	5,918	8,181
Total equity	2,885	3,485	5,850	7,793	10,056
Non - Current Liabilities					
Unfunded retirement benefit obligations		1	1	1	1
Deferred tax	408	447	447	447	447
Total Non - Current Liabilities	408	448	448	448	448
Current Liabilities					
Trade & other payables	10,374	11,992	23,777	20,466	19,491
Current tax Liabilities	3,872	4,094	4,094	4,094	4,094
Dividends payable	937	2,342	2,342	2,342	2,342
Unclaimed dividends	195	194	194	194	194
Total Current Liabilities	15,378	18,622	30,406	27,095	26,120
Total Liabilities	15,786	19,070	30,854	27,544	26,568
Total Equity & Liabilities	18,672	22,556	36,703	35,337	36,624

Source: Company reports and First Capital Research Estimates



Annex III – Statement of Cash flows

Cashflow Statement (LKR mn) Y/E 31st December	2015	2016	2017E	2018E	2019E
Cash Flow from Operating Activities					
Profit before tax	18,078	21,219	21,878	23,995	27,936
Depreciation & amortization expenses	214	218	231	250	269
Net interest Income	-561	-850	-814	-814	-814
Write off of PPE	0	1	0	0	0
Provision for consumables	6	9	0	0	0
Notional interest income	0	0	0	0	0
Amortisation of employee benefit expenses	0	0	0	0	0
Actuarial gain on defined benefit obligation	-26	-9	0	0	0
(Profit)/Loss on disposal of PPE	-10	-19	0	0	0
Operating profit before working capital changes	17,702	20,571	21,295	23,431	27,391
(Increase)/Decrease in Inventories	-467	1,465	-692	-98	-141
(Increase)/Decrease in Trade & Other Receivable	-75	-1,356	872	-53	-76
Increase/(Decrease) in Trade & Other Payables	3,250	1,618	11,784	-3,310	-975
Net Change in Working Capital	2,708	1,726	11,964	-3,462	-1,192
Operating Activities					
Cash generated from operations	20,410	22,297	33,259	19,970	26,199
Interest paid	0	0	0	0	0
Income taxes paid	-6,638	-8,381	-10,064	-11,038	-12,851
Gratuity paid	0	0	0	0	0
Net Cash from Operating Activities	9,962	13,916	23,195	8,932	13,348
Investing Activities					
Purchase of PPE	-563	-420	-448	-450	-452
Return on investment subsidiary	0	0	0	0	0
Proceeds from sale of PPE	12	21	0	0	0
Interest received	561	823	814	814	814
Net Cash from Investing Activities	10	424	363	360	358
Financing Activities					
Dividends paid	-7,596	-10,663	-9,451	-11,014	-12,823
Unclaimed dividends paid	-7	-4	0	0	0
Net Cash from Financing Activities	-7,603	-10,667	-9,451	-11,014	-12,823
Net cash during the year	2,368	3,673	14,107	-1,722	884
Net cash at beginning	9,010	11,378	15,052	29,158	27,437
Net cash at end	11,378	15,052	29,158	27,437	28,320

Source: Company reports and First Capital Research Estimates

Annex IV – Key Ratios

Y/E 31st Dec	2015	2016	2017E	2018E	2019E	
Growth	Gross Revenue	21%	14%	14%	4%	5%
	Net Revenue	20%	22%	6%	9%	9%
	Operating Profit	24%	16%	3%	10%	17%
	Net Profit	23%	18%	-6%	10%	16%
Margin	OP Margin	16%	17%	15%	16%	18%
	PBT Margin	17%	17%	16%	17%	19%
	NP Margin	10%	10%	9%	9%	10%

Source: Company reports and First Capital Research Estimates



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