VM Wealth Management Limited

Company Analysis: Carreras Limited (CAR) 6M 2023-24

VMWM Research | November 21, 2023

876-960-5000 vmwmclientservices@myvmgroup.com vmwealth.myvmgroup.com 53 Knutsford Boulevard, Kingston 5

CARRERAS

- Stock Recommendation: **OVERWEIGHT**
- Target Price: **$ 10.88**
- Current Price: $ 8.11

- Shares Outstanding: **4,854,400,000 units**
- Financial Year End: **March 31**

ABOUT THE COMPANY

Carreras Ltd (CAR) is a distribution company that provides local consumers with access to tobacco products from its ultimate beneficial owner, British American Tobacco (BAT); a British multinational cigarette and tobacco manufacturing company with locations in over 180 countries. Rothman Holdings (CARICOM) Limited, a subsidiary of BAT, owns and operates Carreras Ltd. Carreras is considered the leading promoter and distributor of cigarettes locally, establishing Craven A and Matterhorn as prominent brands in the local market.

Registered in 1962, Carreras has developed a reputation of good performance through consistent growth in both revenues and profits over the years. The company is renowned for its consistency in rewarding shareholders with admirable dividend payments each year.

In 2021, CAR and gaming and entertainment company, Supreme Ventures Ltd, entered into a US$600,000 partnership which allows them to push their products via micro-entrepreneurs.

FINANCIAL PERFORMANCE SUMMARY

J$'000	FY 2021/22	FY 2022/23	6M 2022/23	6M 2023/23
Operating Revenue	15,754,978	16,225,315	7,526,156	8,382,313
Operating Profit	5,443,810	4,897,965	2,161,041	2,796,042
Net Profit	4,073,279	3,635,715	1,619,472	2,148,889
Total Assets	5,228,027	5,501,514	4,609,028	6,004,710
Total Liabilities	3,141,521	3,459,000	2,650,634	3,755,067
Total Equity	2,086,506	2,042,514	1,958,394	2,249,643

Dividend Policy

Although Carreras does not have a definitive dividend policy, the company maintains steady dividend payments and over the last five years paid out on average 98% of its annual earnings to Shareholders.

Outlook

Carreras faces risks such as competition from illegal cigarette dealers and government taxes and regulations. However, due to the habit-forming nature of nicotine, the demand for tobacco products is expected to continue. To meet this demand, parent company British American Tobacco plans to invest in research and development and expand its range of flavours, such as the Matterhorn Double Click variant. Carreras aims to support its reliable Craven A brand through promotional events and items. Although net profit declined compared to last year, it is anticipated that earnings should recover in the short term as revenues grow and operating costs decline. Carreras also intends to distribute reduced-risk products and explore non-nicotine products in the future. Overall, with these strategic initiatives and growth prospects, Carreras is expected to remain a defensive investment option, especially for those seeking stable and regular dividend payments.

Projections and Valuation

A Discounted Cash Flow (DCF) valuation method was used to establish an intrinsic value for CAR. After projecting business operations for the next five years, a cost of equity of 12.86% was used to discount the expected levered free cash flows after which a target share value of **$10.88** was obtained.

Risks to Price Target

We anticipate that our target price would not be realized if the growing illicit cigarette market continues to erode CAR's dominant market share. Also, a general shift in focus to healthier living is likely to weaken the demand for cigarettes which result in overstated revenue projections. On the other hand, any significant improvements in the business' supply and distribution chains would position the company to achieve more growth in revenues and would therefore exceed our price target.

SIX MONTHS ENDED SEPTEMBER 30, 2023

For the six months ended September 30, 2023, the Company recorded Operating Revenues of $8.4 billion. This represents a growth of 11.3%, or an increase of $0.9 billion, in comparison with the same timeframe of the previous year. Cost of Operating Revenue also increased over the previous year by $255.0 million, from $4.0 billion to $4.3 billion (an increase of approximately 6.3%). Due to the foregoing, Gross Profit increased by $600.7 million, from $3.4 billion to $4.0 billion (an increase of approximately 17.4%). The Gross Profit margin for the period was approximately 48.34%, compared to 45.87% in the previous year, indicating an improvement year-over-year (YoY). An improved Gross Profit margin is generally a positive indicator of financial health, as it suggests the Company is managing its core business operations effectively and generating more value from its sales.

Administrative, Distribution, and Marketing Expenses increased marginally from $1.30 billion to $1.35 billion (an increase of approximately 3.5%) and the Company's Impairment Loss on Trade Receivables increased from $1.4 million to $1.7 million (an increase of approximately 20.3%). Despite higher operating expenses, Profit from Operations increasing by $635.0 million, from $2.1 billion to $2.7 billion (an increase of approximately 29.4%). This resulted in an Operating Profit margin of approximately 33.36% during the period compared to last year's margin of approximately 28.72%, representing an improvement YoY. An improved Operating Profit margin is usually a positive sign, suggesting that the company is successful in its primary business activities.

Profit Before Taxation increased from $2.1 billion to $2.8 billion (an increase of approximately 31.5%). Taxation increased from $558.5 million to $714.9 million (an increase of approximately 28.0%). Net Profit for the Period increased from $1.6 billion to $2.1 billion (an increase of approximately 32.7%). Earnings per Ordinary Stock Unit increased by 10.9 cents, from 33.4 cents to 44.3 cents (an increase of approximately 32.6%). Overall, these indicators suggest that the Company is experiencing significant growth in profitability.

Total Assets increased by approximately 30.28%, from $4.6 billion to $6.0 billion. The increase was driven by a significant rise in Accounts Receivable, which went up from $2.1 billion to $2.7 billion, indicating that the Company might have extended more credit to its customers or increased sales on credit terms. Higher Total Assets was also stimulated by an increase in Cash and Cash Equivalents, from $1.0 billion to $1.9 billion, which could result from improved cash flow management or higher cash inflows from operations. Inventory also rose from $458.6 million to $557.4 million, which might reflect an increase in stock to support higher sales volumes or stocking up in anticipation of future sales.

Total Liabilities increased by approximately 41.67%, from $2.6 billion to $3.7 billion. This was mainly due to a substantial increase in Accounts Payable, from $1.0 billion to $2.3 billion, which could suggest that the Company has increased its purchases on credit or is taking longer to pay its suppliers. Total Equity increased by approximately 14.87%, from $1.9 billion to $2.2 billion. This reflects an increase in Unappropriated Profits, from $1.8 billion to $2.1 billion, reflecting the retention of earnings which were not distributed as dividends. This growth signifies that CAR has retained more of its earnings and strengthened its financial position.

The Current ratio for the period was approximately 1.56x compared to 1.80x during the same period last year. The Current ratio has decreased year-over-year, indicating a lower proportion of current assets to current liabilities compared to the previous year. This could suggest that the Company has a reduced buffer to cover short-term obligations with its short-term assets or that it has increased its short-term liabilities more than its short-term assets. During the period, CAR continued to have virtually no debt on the balance sheet, which signals that shareholders have a substantial claim on the Company's cashflows. It also signals that the Company has significant financial flexibility. A company with minimal debt obligations is not heavily burdened with interest payments, which provides flexibility in how it uses its cash flow, whether for investment, expansion, or returning value to shareholders.

OUTLOOK

Mature Company Supported by Habit-Forming Nature of Nicotine and an Improving Economy

CAR has established a strong presence in the market with well-known brands such as Craven-A and Matterhorn. This gives CAR a competitive advantage over newer entrants in the industry. The habit-forming nature of nicotine products supports a loyal customer base. The recent decline in energy prices and an improved global supply chain environment should allow the company to benefit from cost reductions in the coming years. The revitalization of core brands and the stabilization of costs are projected to contribute positively to earnings in the next financial year. Although the local economy's growth rate may be lower compared to the previous year, it is still anticipated to expand in 2023, leading to sustained levels of employment and disposable income. This economic stability should support consumer demand for nicotine products.

Illicit Trade is Persistent and continues to Invade the Trading Environment

The presence of illicit cigarettes in the market continues to be the greatest threat to the safety and sustainability of CAR's trading environment. The persistence of illicit cigarettes in the market negatively affects businesses distributing legitimate cigarettes. It creates a competitive disadvantage due to lower prices of illicit products, leading to reduced sales and market share for legitimate distributors. Financially, it also results in decreased revenue and profitability for legitimate distributors. Reputational risks arise as the association with the illicit trade can damage trust and brand perception. To mitigate these impacts, CAR continues to proactively collaborate with stakeholders.

Carreras Expands Distribution of New Products for Operational Performance and Reduced Health Risks

As subsidiary of British American Tobacco Company (BAT), CAR is poised to achieve improved operational performance and address health concerns related to smoking by expanding its distribution of new products. Like its competitors, BAT has been investing in newer nicotine and tobacco products that, unlike cigarettes, have potential for growth. BAT's new product lines include snus, nicotine pouches, e-cigarettes, and heated tobacco products (HTPs). With a focus on reduced-risk options that eliminate harmful toxins, CAR can meet evolving consumer preferences. Additionally, CAR plans to venture beyond nicotine products by distributing items such as razors and shavers. Being a distributor, CAR avoids research and development risks and can prioritize returning profits to shareholders as dividends. With British American Tobacco's flavour innovation strategy in alternative products, Carreras is anticipated to attract new customers and reclaim market share.

INVESTMENT POSITIVES

1. **Revenue Growth:** Operating Revenues grew by 11.3%, indicating strong sales performance and market demand.
2. **Improved Profitability:** Gross Operating Profit increased by 17.4%, and the gross profit margin improved from 45.87% to 48.34%, suggesting effective cost management and operational efficiency.
3. **Robust Operational Performance:** Operating profit increased by 29.4%, reflecting healthy core business operations.
4. **Strong Cash Position:** An increase in Cash and Cash Equivalents from $1.0 billion to $1.9 billion demonstrates improved liquidity and financial stability.
5. **Substantial Equity Increase**: Total Equity grew by 14.87%, indicating a solid financial position and the potential for sustained growth and shareholder value.

INVESTMENT NEGATIVES

1. **Increased Expenses:** Administrative, Distribution, and Marketing Expenses, as well as Impairment Loss on Trade Receivables, have increased, indicating higher operational costs that could affect net income.
2. **Decreased Current Ratio**: The current ratio decreased from 1.80 to 1.56, suggesting a diminished ability to cover short-term obligations.
3. **Rising Liabilities:** Total Liabilities increased by approximately 41.67%, which could indicate a higher financial risk if not managed properly.
4. **Illicit Trade Challenges:** The persistent illicit trade presents a significant risk to the company's market share and revenue, requiring ongoing vigilance and resources to combat.
5. **Lower Growth Rate in Local Economy:** Although still growing, the local economy's lower growth rate could potentially dampen consumer demand and affect sales volume.

CONCLUSION

Despite supply chains and distribution channels disruptions for most of the reporting period, along with increased competition from the illicit cigarette market, we believe that the company has a stable business model and is still likely to continue generating profits in the foreseeable future. Due to consistently high dividend payouts and stable growth in revenue, we view CAR as having reached the mature phase of its business life cycle. We anticipate continued stable earnings, albeit at a slow rate of growth given that we view the market as being saturated and becoming increasingly health conscious.

Based on our assessment of the current state of the company and future expectations, we have established a price target of $10.88, which represents a 34.2% upside relative to the stock's current market price.

Therefore, we recommend retail investors to **OVERWEIGHT** the stock in their portfolio, as there is room for capital appreciation gains. In addition, it is important to note that CAR is one of the highest paying dividends stocks on the market which may present an opportunity for institutional and value investors who can withstand short-term price volatility and have the capacity to receive more value by way of dividend payments.

SOURCES

Carreras Limited Annual & Quarterly Reports, Jamaica Stock Exchange (JSE), The Gleaner Company, Loop News Jamaica, The Jamaica Observer, and the Financial Services Commission (FSC), Tobacco Tactics (University of Bath), British American Tobacco Company Website.

DEFINITIONS

- **OVERWEIGHT** - Security is deemed to be undervalued and is expected to outperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **MARKETWEIGHT** – Security is expected to provide similar returns compared to the market in general or at the same pace as comparable companies; neither strongly positive nor negative.
- **UNDERWEIGHT** – Security is deemed to be overvalued and is expected to underperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **ZEROWEIGHT** – This security is substantially distressed or at risk of a shock which may significantly impair its value.