CARRERAS LIMITED

ANALYSIS FOR THE FINANCIAL YEAR ENDING MARCH 2009

RECOMMENDATION: HOLD

Overview

Vital Statistics	
Current Price	$41.09
Trailing EPS	$7.27
Projected EPS	$6.59
Current P/E	5.65X
Market Average P/E	7.90X
P/B	4.73X
ROE	98.06%
ROA	53.35%

Carreras Limited is 50.4% owned by Rothmans Holdings Limited, incorporated in Trinidad. The ultimate parent company is British America Tobacco (BAT), the second largest cigarette company with approximately 14.6% of the world market share. The principal activity of Carreras is the distribution and marketing of cigarettes. This follows the company's decision to restructure its tobacco operations by out-sourcing the manufacturing of its cigarette brands to its sister company, West Indian Tobacco Company (WITCO). The decision translated the company into a low cost operation and meant significant improvements in margins and profitability.

S.W.O.T Analysis

Strengths

- Strong Brand Identification - The existing brands in Carreras' product line such as Craven A and Matterhorn are well established and highly recognized in Jamaica. This gives the company a distinct advantage over competing imported brands.
- Affiliation with British American Tobacco – BAT is one of the largest cigarette producers in the world. The group has over 300 cigarette brands in its portfolio which should help Carreras to satisfy the varying needs of smokers.
- Low Cost Structure - Carreras Produces in a low cost territory (Trinidad) and distributes elsewhere.

Weaknesses

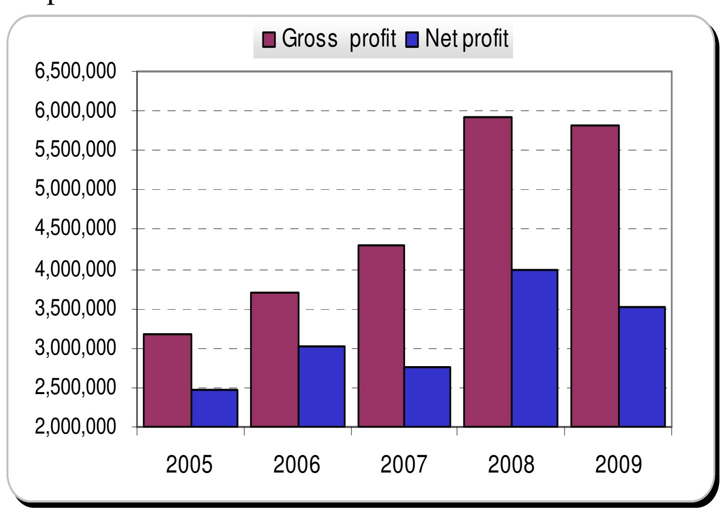
- Restrictions on advertising – means that the company has had to focus on growing volumes through it distribution channels. This has significantly limited the scope for growth in the industry.
- Volatility of Earnings - Carreras net profit has not registered steady growth since 1999. Further, the company has already maximized efficiency gains from outsourcing cigarette production. Sustainable earnings growth will have to come from volume growth.
- Mature Market- The market does not appear to hold high long term growth potential due to greater consumer awareness of the health hazards associated with smoking.

Opportunities	Threats
▪ Increase distribution of light cigarettes - Due to increasing health concerns, the demand for tobacco products with lower nicotine content has been on the increase. A number of tobacco companies have shifted focus from manufacturing regular cigarettes to manufacturing cigarettes with low nicotine levels. The company can thus leverage the growing popularity of light cigarettes. ▪ Higher domestic interest rates – the company holds most of its cash resources in short-term fixed income instruments and as such stands to benefit from the current high interest rate environment.	▪ Unfavourable Government Policies – In light of efforts by the government to stifle cigarette smoking by increasing SCT and banning advertisement of cigarettes, growth potential of Carreras tobacco operations is seriously limited. There is also another potential threat from current attempts to ban smoking of cigarette in some public spaces. ▪ Increasing health concerns- Increasing health concerns worldwide, due to the anti-smoking campaigns highlighting devastating effects of smoking, have reduced consumer demand for tobacco products. ▪ Weakening Local Currency – Given that the company currently imports cigarettes from Trinidad, the depreciation of the Jamaican currency is expected to drive up direct costs and weigh on margins. ▪ Growing Trade of contraband and illicit cigarettes- the growing underground trade of counterfeit cigarettes in Jamaica has the potential to erode the company's market share.

Financial Performance

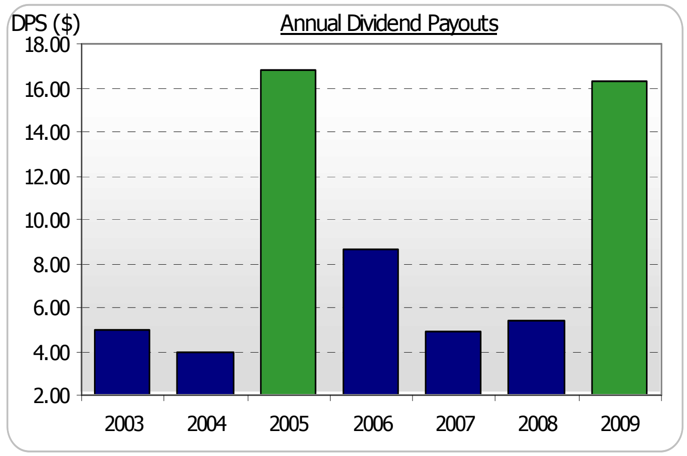
Over the last five years earnings have been very volatile with a modest CAGR (compound annual growth rate) of just 7%. Revenues have grown at a slightly faster pace, averaging 13% over the five year period, but were greatly impacted in 2007/08 and 2008/09 by the increase in SCT on cigarettes. Over these two years, revenues jumped 29% and 21%, respectively. Investment income has also shown significant volatility over the last five year due to low interest rates and a prolonged period of relatively stable exchange rate.

Graph 1

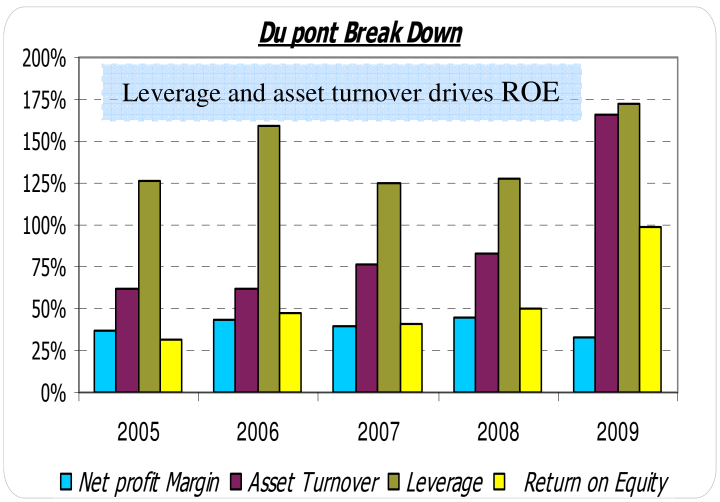


Carreras' dividend policy of paying out at least 65% of earnings in dividends has made the stock extremely attractive to investors. At the end of the 2008/09 financial year, the company paid $4.029Bn ($8.30 per share) in special dividends to bring the total dividends for the year to $16.30. Outside of these periods (2005 Special DPS of $16.80), dividends have been fairly inline with profitability of the company.

Graph 2



Graph 3



Post the sale of its subsidiary Twickenham Insurance and the group's hotel Sans Souci Resort, the company witnessed considerable cost efficiencies. There was improvement in margins, but this has been very volatile since 2005. Liquidity ratios have fallen steadily over the period, based on both the current and quick ratio. However, the generous dividend payments of the company in recent times have resulted in a 55% decline in shareholders equity to $3.8Bn (Book value: $7.41) compared to $8.4Bn in 2005 ($15.97)

Return on (ROE), a key metric for profitability has improved significantly over the 07/08 financial year from 31.6% to 98.1%. The high ROE is due to the 50% decline in shareholders equity in the most recent financial year. Looking at the Du Pont model, the main drivers behind ROE over the last five years have been its asset turnover and leverage multiplier.

Financial Year ending 2008/09

The 2008/09 financial performance was characterized by several major challenges. At the beginning of the FY2008/09, the GOJ doubled the SCT on cigarettes. This tax came at the most inopportune time as consumers were already feeling the pinch of declining disposable incomes due to spiraling commodity prices. During the 12-month period, inflation reached an all time high of 26.5%.

Due primarily to an increase in the SCT on cigarette during the year as well as a decline in investment income, Carreras Limited recorded an 11.8% reduction in net profit for the FY2008/09. Net profit fell from $4.0Bn ($8.24) to $3.5Bn ($7.27).

Gross margins declined to 53.2% from 65.7% the previous year in the face of an increase in direct costs. Cost of operating revenue increased by 64.7% to $5.11Bn. The price of cigarettes were increased to offset the increased taxes as well as a 25% exchange loss due to the depreciation of the J$ versus the TT$. As a result, although sales volume declined, operating revenues increased by 20.9% ($1.89Bn) to $10.92Bn.

Despite a 25.1% increase in foreign exchange gains ($209.9Mn) and an 11.5% increase in interest income, the 18.5% drawdown on resale agreements to facilitate the payment of a special capital distribution during the year led to a sharp decline in other operating income. Other operating income fell by 23.4% to $821.09Mn. However, excluding a one-off gain on the sale of investments in the previous year the decline would have been less precipitous at 6.23%.

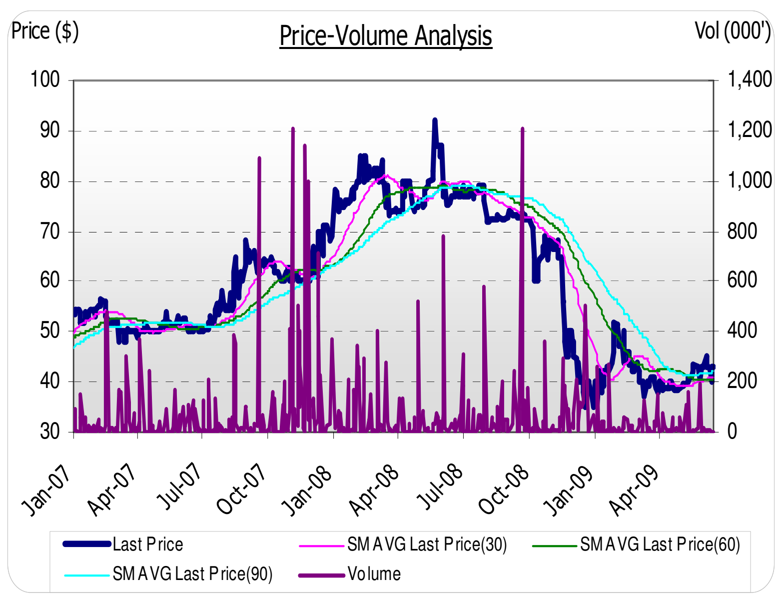
The increase in operating expenses during the period also contributed to Carreras' performance during the period. Operating expenses grew by 19.2% to $1.40Bn on the back of a 12% increase in distribution related expenses and a 26.6% jump in administrative expenses.

A reduction in cash and cash equivalents and resale agreements has led to a 39.2% decline in the value of Total Assets which now stands at $6.61Bn. Shareholders equity fell from $7.77Bn to $3.47Bn reflecting the large capital distribution and the resulting decline in retained earnings.

Technical Analysis

Statistics as at June 25, 2009	
Stock Code	CAR
Financial Yr End	31-Mar
# of shares outstanding	485,400,000
Market Capitalization	19,945,086,000
Current Price ($)	$41.09
Dividends Paid (2008)	$16.30
Bid/Ask	$41.00/$44.21
Hi/Low	$79.20/35.00
Dividend payout ratio	224%
Year to date % change	17.40%
Month to date % change	2.70%
Beta	$0.85
Average Volume	23,871

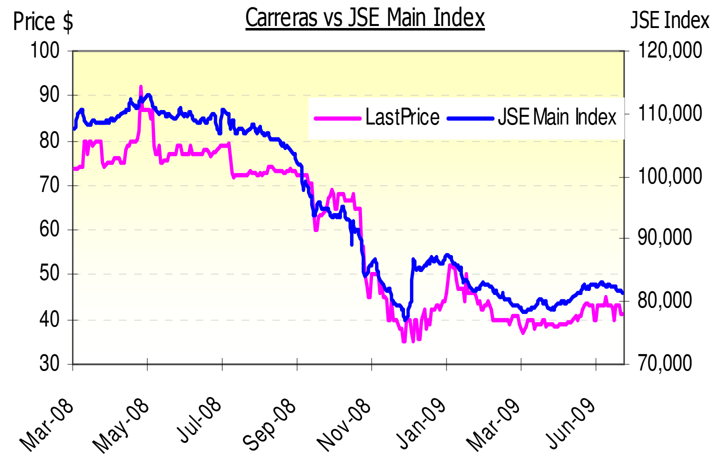
Graph 4



There have been two distinct trends in the share price over the last 12-18 months. During the period January 2008 and July 2008, the share price appreciated by 42%, led by positive earnings results and generous dividend payments. However, the global financial crisis resulted in increased risk aversion among investors in both the global and local stock market. After peaking at approximately $92 per share (May 22, 2008), the share price declined by as much as 47% to roughly $41 per share. Of note, this is a significant recovery from its 52-week low of $35 per share. Volumes have been moderate and the stock has traded consistently over the past 12-months.

The movement of the share price of Carreras has for the most part been inline with the trend of the main JSE Index. Over the last 12-months, CAR has shown to have a relatively low R^2 of 5.3% (correlation of 23%) and a beta of 0.851. The low R^2 may suggest that outside market forces are the main drivers behind price movements. The valuations on the local market remain well below previous levels with the average market P/E currently now at 9.0X, more than half the P/E of 21X witnessed around the same time last year.

Graph



Valuation Methodology

Cost of Equity

Cost of equity was calculated using the Capital Asset Pricing Model. The risk free rate used in the valuation model was taken from a long term government of Jamaica bond. The adjusted beta of 0.851 was taken over a three year period using daily price data, which we believe would give a more accurate measure given the change in the company's business model.[1] The equity premium was collected from an external source that provided equity premiums on various countries worldwide.[2]

Terminal growth rate

The terminal growth is a difficult assumption to make given that there are many factors that could significantly change the growth forecast. In theory the company should be able to grow at a sustainable growth rate of 18.7% based on the average ROE over the last five years and a retention ratio of 35%. However, due to external factors such as rising unemployment, a contracting local economy as well as adverse government policies, we believe a more conservative growth of 10% will be more reflective of the company's long term growth potential.

Valuation models

The two valuation models that were used within this analysis are the 1) Residual Income Model and 2) Discounted Cash Flow (FCFE).Both these models have their advantages and disadvantages but nevertheless, we've deemed these to be the most appropriate valuation models because:

1) Clean surplus accounting holds- the company does not have any financial assets that it accounts for through shareholders equity; therefore the clean surplus accounting should give a fairly accurate ending book value.

[1] 07/10/06-6/26/09

[2] http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ctryprem.html

2) Both models are good for companies which have a set dividend payment (outside of special dividends) in line with profitability.

Residual Income (Table 1)

		2010	2011	2012
Book Value		7.40	9.71	12.07
EPS		6.59	6.76	7.44
Dividends		4.28	4.39	4.83
Ending Book Value		9.71	12.07	14.68
Cost of Equity		0.24	0.24	0.24
Residual Income		4.81	4.43	4.54
			30.09	
		4.81	34.52	
PV of RI + Beginning BV	33.73	3.88	22.45	

<u>Sensitivity Analysis</u>

Cost of Equity	Intrinsic Value
26%	32.43
25%	33.07
24%	33.73
23%	34.42
22%	35.12
21%	35.85

Given that clean surplus accounting holds, the only major assumption is that relating to the terminal value. The assumption made in this valuation is that at the end of 2012, the stock will trade at a premium of 4.09X its book value, a ratio which is inline with the 4 year average P/B ratio. The other assumptions appear to be fairly conservative, especially the decline in earnings expected over the current fiscal year and moderate growth thereafter; assuming that there are no more tax increases implemented by the government.

Discounted Cash Flow Approach (Table 2)

000'	2010	2011	2012
NI	3,200,031	3,280,957	3,609,053
DEP	25,833	26,608	27,407
FC	119,673	131,641	144,805
WC	335,335	352,101	369,706
FCFE	2,770,856	2,823,824	3,121,949
			24,529,596
	2,770,856	2,823,824	27,651,545
NPV	2,234,562	1,836,514	14,502,883
Total Value	18,573,959		
Value Per Share	38.27		

Free Cash Flow approach uses similar assumptions from the residual income valuation model. Assuming moderate increase in capital expenditure and working capital over the next two years a terminal growth rate of 10% after 2012 gives an intrinsic value of $38.27 per share.

<u>Justified P/E Approach</u>

The company has stated that its dividend policy will be to pay at least 65% of its earnings in dividends and given the huge payout last year, regular and special dividends totaling $14.30, this has significantly limited the company's ability to pay such a huge dividend in the upcoming year. Using the same cost of equity used in the previous valuations models, against a sustainable growth rate of 12%; the Gordon growth model gives a justified P/E ratio of 5.40X; below the current P/E of 5.90X. *Applying this P/E to the projected earnings over the next 12-months of $6.59 gives a forward price of $35.59 per share.*

Fair Value Estimate

The valuation models, using similar assumption have given fair values that are relatively close. The price under each model is $33.73 and $38.27, respectively, while using the justified P/E approach gives a price of $35.59. The range between the highest and lowest fair value is fairly narrow and represents an 18% and 7% decline from the current price of $41.09 per share. While this could suggest a SELL recommendation, the high dividend payouts by the company could provide price support because of its attractive dividend yield and keep prices well above justified levels as investors will pay a higher price to hold the shares. If the stock price is to converge to the lower end of $32.28, investors would require at least $7.40 per share while the upper end would require a dividend payout of $2.88 per share to compensate them for the decline in the share price. While it is difficult to gauge the exact dividend payout of the company, based on projected EPS of $6.59 and projected end of year book value of $9.71 the total possible dividend payout per share is $16.30. While this is highly unlikely as it would wipe out the company's shareholder equity, dividend payments are expected to remain significant due to the company's dividend policy and its historical record. **As such, despite the expectation of declining earnings over the coming financial year, we are recommending a HOLD on Carreras Limited.** *This stock is more suited for investors who seek frequent cash flows for liquidity purposes. With a current dividend yield of 10%, a fall off in the share price below the target prices could be deemed as an excellent buying opportunity.*

Outlook and Conclusion

In the current financial year, the company now has to contend with another round of increase in the SCT. The increase in the price of cigarettes, at a time when the local economy is projected to contract between 2.5% and 3.5% for the 2009 calendar year (2.8% contraction in the Q1 2009) and increasing job losses will result in a decline in sales volumes for the company. This will also contribute to the decrease in consumer disposable incomes. Even though inflation has fallen from its peak registered last year (26.5% in Aug 2008), declining consumer disposable income in the face of the downturn in the local economy is expected to put further downward pressure on the demand for cigarettes. As such, revenue growth rate is expected to moderate significantly over the near term despite the increase in prices.

On the upside, we anticipate that management will pay even closer attention to containment of operating overheads which should temper the effects of slower revenue growth in the current year. Operating expenses could also decline as price pressures are expected to remain below that of the prior year.

Nevertheless, the industry remains susceptible to further increases in the SCT by the government. At the same time, although the local market is not faced with the level of lobbying seen in other countries, the industry is likely to face increased awareness of the ill-effects of direct smoking and second hand smoke inhalation; possibly fuelling further negative social perspectives and policy on smoking. Despite tobacco control regulations that restrict the company's ability to advertise, the company's strategy of focusing on improvements in distribution and strengthening its presence in the trade, could provide some support for sales volumes going forward.

Risks

- **Changes in interest rates** - Higher domestic interest rates remains one of the key risks to our price target as this could continue to adversely impact investor demand for equities. However, a significant decline in interest rates could result in a greater than anticipated decline in investment income.

- **Exchange Rate risk** - Carreras imports manufactured cigarettes from its sister company – West Indies Tobacco Company in Trinidad & Tobago. As such, further weakening in the local currency could lead to a larger increase in direct cost than projected.

- **Further increases in SCT**- This may force the company to raise prices, which in turn would possibly slow volume growth.

- An increase in product liability lawsuits in international markets could significantly hurt the firm's profitability.

References

1) http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ctryprem.html
2) www.morganmarkets.com
3) Carreras Limited Annual Report
4) Stowe, John D., Thomas Robinson, Jerald Pinto and Dennis Mcleavey.2002. "*Analysis of Equity Investments*: Valuation".
5) Bloomberg.

Appendix

FUNDAMENTALS					
J$'000	YEAR ENDED MARCH				
	2006	2007	2008	2009	**2010 Projections**
Gross operating revenue	6,955,087	7,005,159	9,037,241	10,923,530	12,999,001
Cost of operating revenue	(3,247,658)	(2,696,393)	(3,103,185)	(5,112,316)	(7,259,489)
Gross operating profit	3,707,429	4,308,766	5,934,056	5,811,214	**5,739,512**
Admin. & marketing expenses	(1,173,214)	(1,135,986)	(1,177,889)	(1,403,611)	(1,620,221)
Profit before taxation	4,146,834	4,037,882	5,827,735	5,228,696	4,776,165
Net profit	3,033,553	2,766,914	4,000,020	3,528,444	3,200,031
Total Assets	11,133,806	9,104,523	10,880,010	6,613,504	
Shareholders' Equity	6,450,382	6,642,746	7,768,667	3,598,194	
EPS ($)	6.25	5.70	8.24	7.27	
Book Value	13.26	13.93	16.25	7.40	
Key Ratios					
Net Margin	43.6%	39.5%	44.3%	32.3%	
Gross Profit margin	53.3%	61.5%	65.7%	53.2%	
Pre-tax Margin	59.6%	57.6%	64.5%	47.9%	
P/E Ratio	5.51	8.71	8.92	5.19	
Price to Book ratio	2.59	3.56	4.52	5.10	
Return on Assets	27.2%	30.4%	36.8%	53.4%	
Return on Average Equity	72.2%	42.3%	55.5%	62.1%	
Price	34.40	49.61	73.51	37.76	