

Date: September 14th, 2007

Ceylon Tobacco Company

Dividend yield not attractive compared to fixed income returns

Recommendation
SELL

Ticker
CTC

Share Price*
Rs.56.00

Market Cap*
Rs.10,490mn

52 Week High
Rs.80.00

ASPI*
2646.13

MPI*
3610.55

Analysts

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Sajeewa Premaratne

*CSE DATA on 13th
September 2007



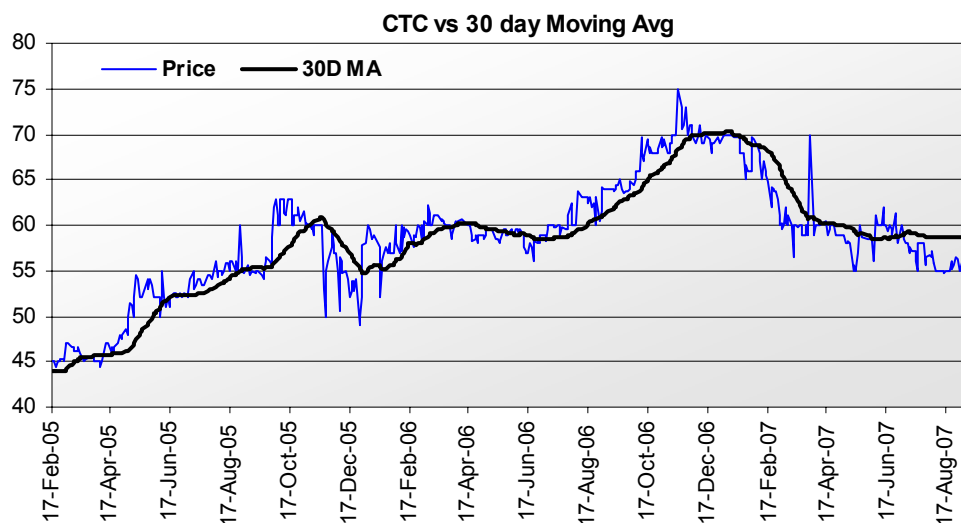
- ◆ We are initiating coverage on CTC with a SELL recommendation as the current long term real interest rates place a major dampener on the prospects of most equity investments including CTC.
- ◆ With increased fiscal pressures we also believe that there is a significant risk of a rise in taxation of tobacco over the next twelve months, with the rate of tax increase above what was seen in the last two years.
- ◆ The counter offers a projected dividend yield of 15% which is well above that offered by most counters in the market, but below that offered by risk free fixed income instruments.
- ◆ Given that the total expected returns by capital gains and dividend yield over a twelve month horizon, is less than the risk free rate, we believe investors should exit from the counter and switch to fixed income instruments.
- ◆ However given that we expect the equity market to fall further in the next 12 months, the counter clearly would outperform the overall market in bearish conditions, as the high dividend and expected maintenance of its share price is much better than our expectations for the overall market. As such within a Sri Lanka Equity portfolio CTC would be an overweight position.
- ◆ Provisions in the new Companies Act could potentially be utilized by the company for a capital repositioning and such an action could however lead to significant value creation beyond that projected and is a factor that could create more upside than we have projected if it were to occur.
- ◆ Our DDM based base case current fair value for the company is Rs54.75 while on a twelve month horizon our target price of Rs57.00 for the company is similar to the current trading price of Rs56.00

Valuation

Our primary valuation of CTC is on a two stage dividend discount model (DDM). We have discounted dividends of CTC by a required return on equity of 23%. We have projected dividends until 2010 and taken a base case long term dividend growth rate of 8%. Due to the increased regulation of the tobacco industry and falling volumes, unlike for most counters we have taken a long term growth rate for dividends, below the expected inflation rate of 12% and substantially below the expected long term nominal growth rate in GDP of 17%.

The value of a CTC share under these base case assumptions is Rs54.75 per share. Investors who believe the company can grow dividends in line with an inflation projection of 12% would however believe the counter would be worth Rs67.89. The valuation of the counter is also sensitive to the discount rate but less so than most growth counters. Should the discount rate fall by 200 basis points the counter's fair value would be Rs64 but a rise in the discount rate by a similar magnitude would see its fair value fall to Rs48.96.

Sensitivity of DDM Valuation								
Dividend Growth Rate	COE							
	21%	22%	23%	24.0%	25%	26%	27%	
4%	53.31	50.28	47.08	45.15	42.95	40.96	39.14	
6%	57.94	54.29	50.47	48.20	45.64	43.34	41.25	
8%	64.00	59.43	54.75	52.01	48.96	46.24	43.81	
12%	84.19	75.90	67.89	63.45	58.65	54.55	50.98	
17%	166.23	133.52	108.19	96.12	84.41	75.30	68.01	





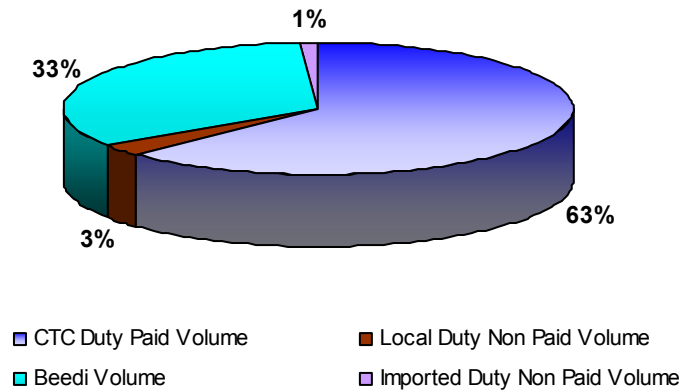
Industry View

In common with the industry globally, the Sri Lankan tobacco industry has been faced with increased regulation in recent time which has had significant impacts on the industry outlook. The industry is constituted as a monopoly consisting only one legal player; the Ceylon Tobacco Company (CTC) which is the local arm of the British American Tobacco (BAT) Holdings. Despite the increased regulation, the relative inelastic nature of the product has helped the industry maintain its position to some extent, though profit growth has been muted by the regulatory impacts. The company has also faced a considerable threat from the illicit counterfeit trade of tobacco in the country.

Over the years CTC has worked in partnerships with law enforcement authorities in developing strategies to contain the illicit trade in tobacco. In recent times these efforts have been quite successful with an increased commitment from the authorities, and it is believed that traded volumes of counterfeit cigarettes is showing a considerable reduction with legal (CTC) market share increasing relative to the illegal share.

However overall cigarette sales in the country have fallen considerably after the induction of strict legal measures by the law enforcement authorities under the 'National Authority on Tobacco and Alcohol' (NATA) Act. The Act enacted on the 1st of December 2006, incorporates the amendments determined by the Supreme Court, addressing the petitions filed by CTC, challenging certain aspects of the bill on grounds of constitutionality. The NATA Act prohibits smoking and drinking in certain areas. As such smokers are banned from lighting up in enclosed public spaces, and the airport, hotels or guest houses with over 30 rooms have to set aside an exclusive area for smoking. The same applies to a restaurant that can house 30 or more people, as long as all provide adequate ventilation and conform to prescribed air quality standards. Moreover all outdoor advertising of cigarettes is also banned by this Act, and the free distribution of tobacco or alcohol products is also a punishable offence.

Sri Lanka - Total Tobacco Market (2006)



Recent Results

Performance for the six months ended 30th June 2007

Gross Revenues for the first half of 2007 rose by a meagre 3.3%YoY to Rs.22.4bn. 2Q07 however saw a better performance than the first half as Gross Revenues rose by a somewhat higher 6.3%YoY to Rs.11.6bn. We believe the low growth in the top line was mainly due to the declining industry volumes which were largely driven by the reduction in the number of consumers and their average daily consumption levels.

Further the impact of two successive price increases in 4Q06 and the effect of tobacco regulations implemented in December 2006 contributed towards the repression of the Company's total sales volume during the period under review. Gross turnover for the year 2006 grew by 12.6% compared to 2005 and reached Rs.42.8bn.

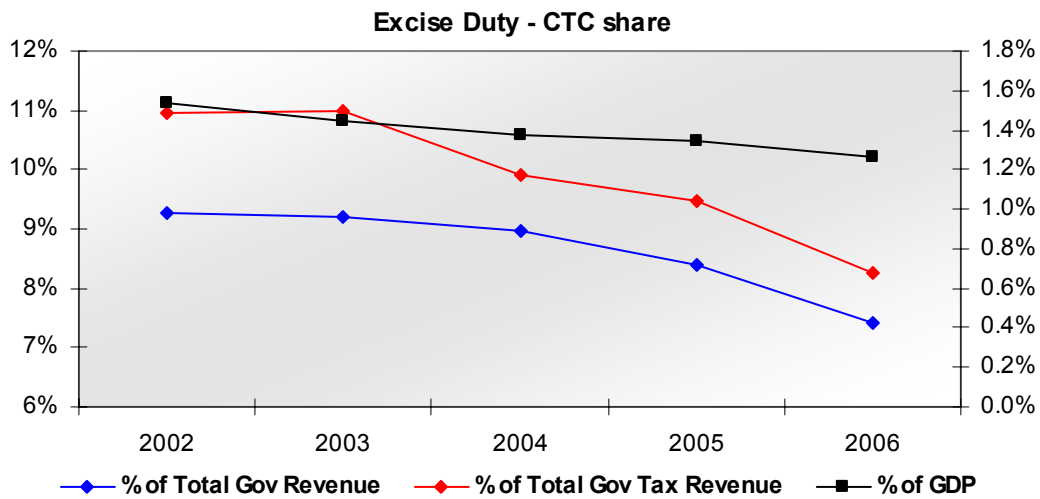
CTC contributed Rs.19.3bn to the government in the form of direct **Government Levies** in 1H07 (including Provincial Council Taxes), resulting in a YoY rise of Rs.1.3bn or 7.2%YoY. This growth in Government Revenue was mainly driven by the excise led price increases, the increased Provincial Council Tax and the richer brand mix. Government Revenue as a percentage of Gross Revenue



stood at 82.6% during the said period. The contribution to the Government's exchequer in 2Q07 stood at Rs.9.5bn, resulting in a YoY growth of 5.6% and a QoQ growth of 7.1%. During the last financial year ended 31 December 2006 CTC contributed over Rs.35bn to the government revenue which is equivalent to 82.9% of the Gross Turnover and a surge of 11% to that of 2005. This infusion represents approx. 7.4% of Total Government Revenue, 8.3% of Total Government Tax Revenue and

of the

1.27%
GDP.



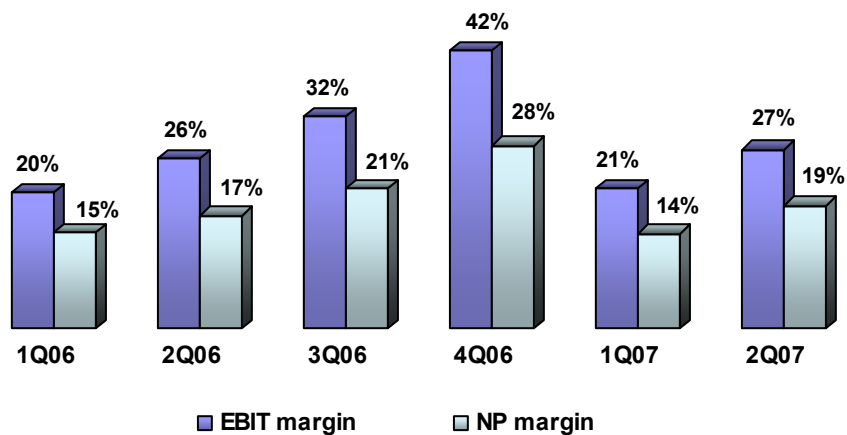
Apart from the regulatory impacts the challenge in delivering consistent Government Revenue growth has usually been due to the impact of illicit products in the market. Nevertheless, the commitment demonstrated and the measures undertaken by the law enforcement authorities over the years in curbing the counterfeit and smuggled cigarettes has seen a significant improvement on account of the need to protect the Government's revenue base. The company in a statement during 1H07 revealed over 281 raids were carried out by the authorities and over Rs.90mn worth of counterfeit and smuggled cigarettes were confiscated and destroyed.

CTC has recorded a 9.8% YoY growth in its 2Q07 **Net Revenue** to Rs.2.0bn, resulting in an 8.1%YoY growth in its 1H07 Net Revenue to Rs.3.96bn. Further, the Net Revenue for the year 2006 recorded a healthy Rs.7.3bn compared to Rs.6.1bn during 2005, a rise of 21%YoY. An increase in the company's gross revenue by 13%YoY and the reduction of growth in Government Levies to 11%YoY supported the Net Revenue to improve by 21%YoY.

Brand portfolio strategy implemented by the company in the recent past to reinforce some of the key global drive brands of the BAT Group in Sri Lanka has apparently been quite successful according to the company. 2006 saw the launch of their key international low price brand ‘Viceroy’ to replace its predecessor ‘Bristol’. Though this strategy was pursued amidst some of scepticism both internally and externally, the brand managed to derive impressive market success by the end of the year. Accordingly results reveal that ‘Viceroy’ managed to retain 83 percent of ‘Bristol’ customers and 70 percent of the volume.

Raw material consumption rose by a meagre 0.18%YoY in 1H07 to Rs.858mn compared to Rs.856mn posted in the same period last year. Further raw material consumption to Net Revenue reduced to 21.7 percent in 1H07 over 23.7 percent posted in 1H06. This improvement is much attributed to the upshots derived from an array of cost management initiatives and productivity improvement strategies which was implemented in FY2006 across the supply chain.

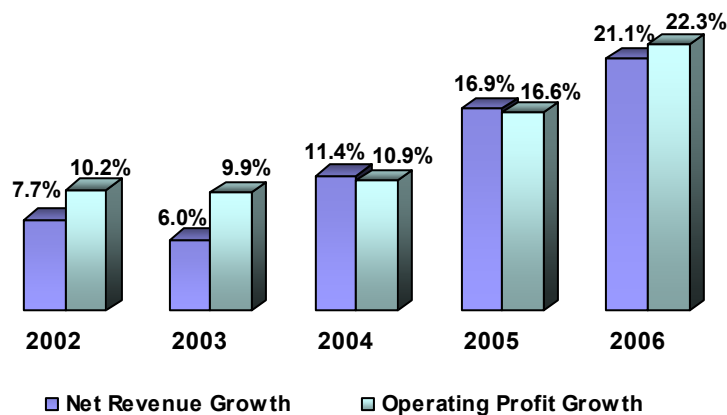
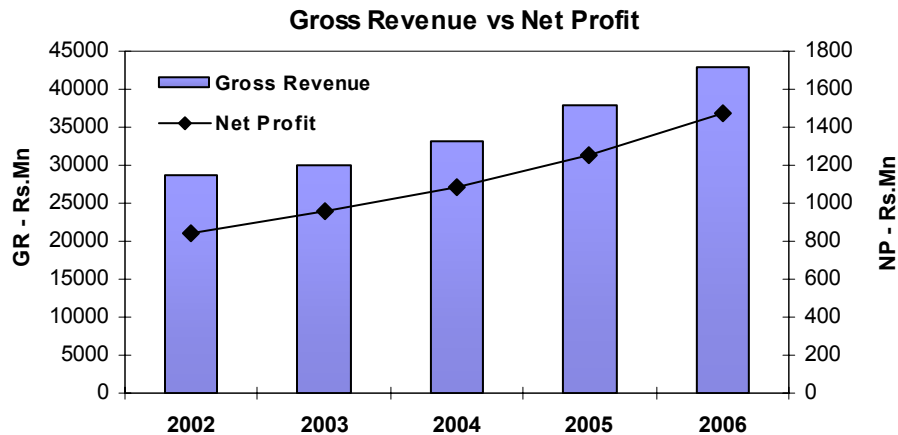
High inflation prevailing in the economy continued to exert pressure on Company’s cost base with **Operating Expenses** surging to Rs.1590mn in 1H07 from Rs.1428mn in the previous comparable period. Nevertheless organizational restructuring strategies and productivity improvement measures implemented and carried out during FY2006 facilitated to achieve considerable amount of cost savings in 1H07. We expect the positive contribution to continue in 2H07 and the firm to focus on constricting operating expenses to restrict straining bottom lines.

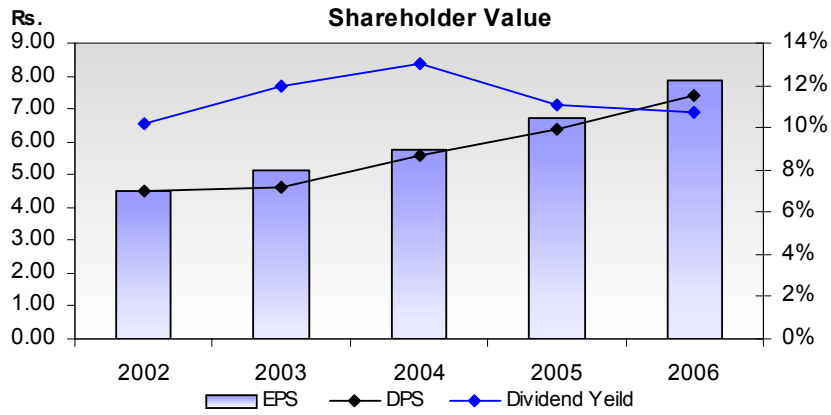
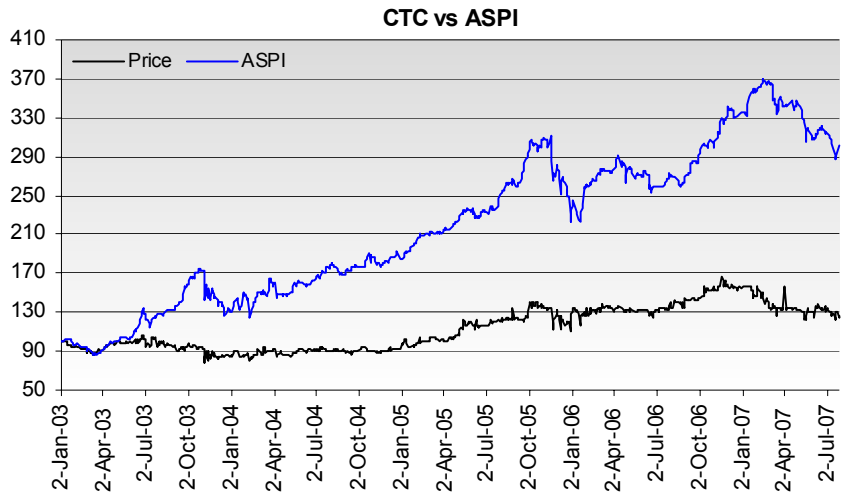




Operating profit has risen from Rs.842mn in 1H06 to Rs.953mn in 1H07, which is the equivalent to an increase of 13.2 percent. Further, for the 2Q07 the company posted 15.8 percent growth in operating profit to be at Rs.543mn. The QoQ growth in operating profit stood at 33 percent in 2Q07. The healthy growth in operating profit was mainly driven by the increase in gross revenue which resulted from a favourable brand mix and the reduction in total costs which resulted from factory wide productivity improvement initiatives and cost management efforts carried during the FY2006.

The **post tax profit** for the 1H07 registered Rs.654mn which was a 13.3 percent increase over the 2006 corresponding financials. On an interesting note, the post tax profit for 2Q07 posted a 20 percent growth to stand at Rs.374mn compensating for the relative sluggish growth reported in 1Q07.





Financial Summary	2Q06 Rs.Mn	2Q07 Rs.Mn	%	1H06 Rs.Mn	1H07 Rs.Mn	%	FY2005 Rs.Mn	FY2006 Rs.Mn	%	FY2007E Rs.Mn
Gross Revenue	10,861	11,550	6%	21,671	22,383	3%	37,982	42,781	13%	46,057
Government Levies	9,026	9,535	6%	18,009	18,425	2%	31,928	35,448	11%	37,974
Net Revenue	1,835	2,014	10%	3,671	3,958	8%	6,054	8,083	21%	8,083
Raw Material Used	454	333	-27%	856	858	0.2%	1,547	1,734	12%	1,682
Staff Cost	226	225	-0.4%	472	521	10%	791	901	14%	1,014
Operating Expenses	662	875	32%	1,428	1,590	11%	1,581	2,400	52%	2,845
Operating Profit	469	543	16%	842	953	13%	1,803	2,204	22%	2,446
Profit before tax	497	610	23%	893	1,062	19%	1,857	2,333	26%	2,651
Profit after tax	312	374	20%	577	654	13%	1,256	1,473	17%	1,670
EPS (annualized) [Rs]	6.66	7.99	20%	6.16	6.98	13%	6.71	7.86	17%	8.92
DPS [Rs]							6.40	7.40	16%	8.38
BVPS [Rs]							11.10	11.56	4%	12.10
EBIT Margin	26%	27%		23%	24%		30%	30%		30%
NP Margin	17%	19%		16%	17%		21%	20%		21%
ROE							60%	68%		74%
Dividend Payout							95%	94%		94%
Dividend Yield							11.1%	10.7%		15.0%
MPS [Rs]				59.00	58.00		57.75	69.00		54.75
PE Ratio [x]							8.6	8.8		6.3
PBV Ratio [x]							5.2	6.0		4.6

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