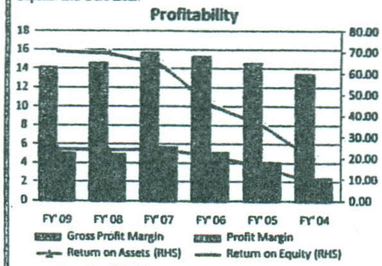
Pakistan Tobacco Company

Analysis of Financial Statements FY'03—3QFY'10

The tobacco industry in Pakistan operates in an oligopolistic market, with only two major players, Pakistan Tobacco Company (PTC) and Lakson Tobacco in the market. Incorporated in 1947, Pakistan Tobacco became the first multinational company to begin operations in Pakistan. Owned by British American Tobacco, a company operating in over 180 countries in the world, Pakistan Tobacco strives to maintain its reputation for making and marketing high quality tobacco brands for its consumers. The company is involved in every aspect of cigarette production, from tobacco cultivation to packaging. The company provides a number of brands catering to the diverse market of tobacco consumers, including Benson and Hedges, Embassy, Gold Flake, Capstan and Gold Leaf.



Financial results (3Q10)

The third quarter of 2010 ended with net sales touching Rs 15.7 billion, a decline of 2.4% as compared to 3Q09. Despite the drop in sales, cost of goods sold increased during the period, rising from Rs. 9.77 billion at the end of 3Q09, to Rs. 10.79 at the end of 3Q10. As a result, gross profit saw a considerable decline; dropping from Rs 6.3 billion to Rs 4.9 billion at the end of the third quarter this year. Selling and distribution expenses also rose over the period, and operating profit declined by 52% due to a combined effect of the increased costs.

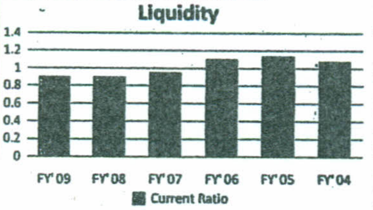
Profit for the period stood at Rs 1.14 billion, as compared to Rs 2.53 billion at the end of 3Q09. This decline of over 50% was reflected in the EPS, which fell from Rs 9.89 per share at the end of 3Q09, to Rs 4.47 per share at the end of 3Q10.

Adapting itself to the changing market, the company has expanded its portfolio, introducing a new Value for Money brand called "Capstan by Pall Mall Original", which has been well-received by the market and has been growing since its launch in June 2010. The strain on the company's finances continues to mount due to rising costs combined with the fact that the recent price increases were inadequate to cover increases in Excise duties as well as inflation. The company therefore has posted a loss during the three months period of Jul-Sep 2010.

Operating in a weak economy, further challenged by the widespread devastation of the recent floods, PTC aims to defend its market share through the low medium segment brands while enhancing its equity through focused marketing and trade activities throughout the year. To effectively leverage the opportunities in this area, the company has amplified its efforts, increasing its budget for selling and distribution, which can be seen from the company's income statement for the period.

Financial performance (FY09)

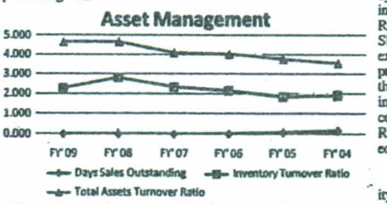
Over the years, Pakistan Tobacco has shown a steady pattern of growth as evident from the rising trend of gross, net and operating profits, with the operating profits as well as net profits growing by 19% in 2009 as compared to the previous year. The poor law and order situation, a sluggish economy, and rising inflation during the year impacted the efficiency and effectiveness of the company, yet a considerable profit was shown. While in previous years sales volumes were rising considerably, this year the company has only just [illegible] its sales. All the key brands however, registered growth [illegible] year, with a new brand Wills Kings launched in July that has captured 2.7% of the market within 5 months.



In terms of volume, Pakistan Tobacco Company (PTC) managed to sell 41.2 billion cigarette sticks, a slight decrease from the 41.5 billion sticks sold during 2008. The flattening of sales can be attributed to rising government duties leading to higher cigarette prices, and thus a movement towards trading in the illicit sector. Despite the decrease in sales volume, the company increased its market share by 1.2% raising it to 48.5%, further strengthening its position as market leader. The company's innovative efforts towards marketing and promotion of their brands paid off, with their new brand Wills Kings already capturing a position in the market and Gold Leaf and Gold Flake showing continued growth.

PTC managed to show growth in FY09 in spite of the adverse economic situation prevalent in the country during the time. Factors such as inflation, rupee devaluation, high fuel costs, increased government duties, working from a temporary head office and then moving to the new premises mid-year, and an overall recessionary trend did not dampen the sales of PTC. In fact, the Sales Turnover reached a new high of Rs 57 billion in FY09, up from Rs 49 billion in FY08. The Gross Profit was Rs 8.22 billion, an upsurge of 13% from the previous year's Rs 7.28 billion. The profit for the year increased by an astounding 19% to Rs 3.02 billion from Rs 2.53 billion a year earlier.

Profitability of Pakistan Tobacco Company has witnessed a very nominal change, with figures remaining similar to those seen last year. The Gross Profit Margin of PTC has dropped to 14.3%, from last year's 14.8%, a change of half a percentage point. Sales Turnover of the company grew by 17% but the growth in Gross Profit was only 13%. One of the factors contributing to this effect is the increased government levies for all tobacco product and producers in the form of custom duties, government sales tax and especially Federal Excise Duty (FED). Increases in excise duty as imposed by the budget of 2009-10 led to the company raising the prices of its products significantly. Secondly, the cost of sales increased 16%, primarily due to inflation, devaluation of rupee, and the increased use of generators due to power outages. Understandably, the purchase costs of raw material, fuel and power costs contributed a hefty portion of the increased cost of sales. The profit margin of the company was up to 5.25% from FY08's 5.16%. This slight increase is seen despite the increasing expenses. Administration Expenses rose by 18.6% while selling and distribution expenses by 16.2%. Within Administrative Expenses, a prominent increase was seen in Property Rentals, which can be attributed to the fact that the company operated from rented premises for the first six months of the year, as its head office was lost in the Marriott bombings in 2008. Selling and distribution expenses were higher as the company invested heavily in marketing and promotional efforts to counter the dropping sales due to increased taxes. Apart from this, there were prominent increases seen in the salaries and wages as well as in the fuel and power categories. These are quite obvious due to the prevalence of high inflation in the economy. The increasing expenses were however offset by an astounding rise of 274% in other operating income, a result of insurance claim against the head office damaged in the Marriott bombings, and a decrease in other operating expenses, which were high in the previous year due to restructuring. As a result, profit margin showed a nominal increase. The profit margin of PTC is well above that of its only major competitor, which boasts a margin of 3.1%, further proof that the company is performing well.



The net income showed a considerable increase of 19.3%, which was faster than the growth seen in Total Assets of the company. Return on Assets rose to 24.72%. The company's assets grew by an overall 17.6%, with current assets growing by 31.7% and fixed assets showing an increase of 5.82%. Return on equity showed only a marginal change, from 70.2% to 70.9%. Total equity rose by 18%, with a 61.9% rise in revenue reserves. The increase in net income is commendable, given the current situation of the economy and the fact that PTC's competitor showed a considerable decline in profits as compered to last year.

The liquidity position of PTC did not show any change in FY09. The Current Ratio was maintained at 0.91, mainly because Current Assets and Current Liabilities for the firm grew in a similar manner. Current Assets rose by 31.7% while Current Liabilities by 31.6%. The increase in Current Assets can be attributed mainly to increased Stocks-in-Trade, the largest component of Current Assets, which rose by 42%. The flattening of sales and higher raw material costs sue to inflation and rupee devaluation led to this sharp increase. The growth driver of current liabilities was trade and other payables, which grew at a rate of 16.5%. Trade and other payables constitute over 41% of total assets. If we analyse further, we find that payables as FED to the government form nearly half of trade and other payables, and they grew by 20%. Something similar was witnessed in the sub-heading of sales tax payable to the government. Thus, we find that a large part of the current liabilities grew because of the presence of payables to the government in the form of tax. The sharp increase in Current Liabilities is also attributed to the significant rise in short-term running finance, available to the company at 12% to 17.5% par annum.

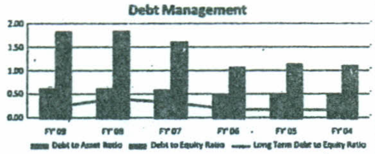
PTC's Asset Management has been very commendable in the recent past, and the same can be said about the year 2009. Inventory Turnover Ratio however, saw a decline from 2.86 to 2.33. This is mainly due to the sharp increase of 42% Stock-in-Trade, virtually the only component of Inventory, during the year, with no increase in Sales Volume for the year.

One of the most striking features of PTC's asset management is its Day Sales Outstanding Ratio, which has further decreased from an already low 0.02 days to 0.015 days. The ability to convert its credit sales into cash so quickly is a great achievement of the company.

In FY09, the Total Assets Turnover Ratio has been maintained, with a negligible movement from 4.72 to 4.71. The Ratio has been maintained due to the equal growth in Assets and Sales Turnover, both of around 17%.

The Debt Management ratios of the company were maintained at a similar level as last year. The Debt-to-Asset ratio remained the same as last year, at 0.65. Similarly, the Debt-to Equity Ratio showed a marginal decrease from 1.88 to 1.87. The reason for maintenance of these ratios is that Liabilities, Assets, and Equity all grew at a similar pace during the year, a growth of 17-18%. The increase in Liabilities was only due to the increases in Current Liabilities, while Long term Debt showed a decline. The effect of this is visible in the declining Long-term Debt to Equity Ratio which fell from the previous figure of 0.44 to 0.26 this year. Long term Liabilities fell by almost 30%, mostly due to the 100% decline in Retirement Benefits.

The Times Interest Earned ratio was at 107 in FY09 as compared to 150 a year earlier. The EBIT of the company was up by 19% while Finance Costs of PTC saw a much higher increase of 68%. However, more impactful was the increase of 72% in Finance Income, resulting in an increase of 19.4% in the after-tax profit. The TIE ratio though, deteriorated due to the sharp increase in finance cost which was a result of high interest rates prevailing in the economy. While short-term financing was available to the company last year at rates varying between 9.8% and 17%, interest rates for 2009 were between 12% and 17.5% per annum.



PTC has been lukewarm when it comes to its market value. It must be mentioned that its dividend payout ratio has been high, although its dividend for FY09 of Rs 9.55 is lower than that of 2008 by Rs 0.1. The Earnings per Share was up by 19.4% from Rs 9.91 in 2008 to Rs 11.83 in 2009. The Price-to-Earnings ratio tumbled to Rs 8.88 from Rs 10.73, mainly on account of a rise in Earnings per Share, as market price changed marginally in 2009.The stock exchange stabilized after the volatility of last year, and the share price only moved from Rs. 106 to Rs. 105 per share by the end of the year. The Book Value per Share has increased due to the increase in equity while number of outstanding shares remained constant. The Book Value per Share increased by almost 18%, from Rs. 14.15 to Rs. 16.71, which was similar to the 18% growth in equity.

Financial performance (FY03-FY08)

In 2008, the company posted a record level of sales and profitability. In terms of volume alone, PTC managed to sell 41.5 billion cigarette sticks, an increase of 12%. Compared to sales volume of the tobacco industry, which increased by only 2.4%, sales volume growth of PTC was remarkable. Due to this, the company increased its market share by 1.3% to a new level of 46.4%. This is thanks to two of the company's high performing brands, Gold Leaf and Gold Flake. Gold Leaf is the company's main value generator, growing at a healthy 10%. On the other hand, Gold Flake is the fastest growing brand in the market with a growth rate of 19%.

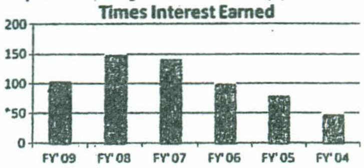
Cost of sales increased by 21% in 2008 over last year and this was mainly due to higher raw material costs as a result of rupee devaluation and inflation, as well as higher fuel costs. However, the Company was able to derive benefit from economies of scale (highest ever production) and various cost control initiatives in its supply chain. The Profit Margin of the company was down to 5.16% from FY07's 5.90%. Mainly, this can be attributed to a great increase in the Administration Expenses which rose by 26%.

Improved financial performance of the Company translated into a significant increase in its operating cash flows. Though they were partially offset by higher dividend payments and investment in plant and equipment during the same period, yet it resulted in a net increase in cash during 2008.

The Liquidity position of PTC worsened in the financial year 2008. Following a declining trend since 2006, the Current Ratio reached a level of 0.90 in 2008, down from 0.96 a year earlier. Despite improved profitability on account of strong financial performance the company's cash outflow remained higher than inflow mainly due to higher income tax, dividend payment and capital expenditure. Consequently, there was not a significant increase in the current assets as opposed to the current liabilities.

Pakistan Tobacco's asset management ratios depict a healthy trend of improving inventory management and improved credit policies. Both the inventory turnover (days) and the days sales outstanding have decreased, indicating that the company has been able to utilise its inventory at an optimally better level each year, and has been able to receive cash from its debtors over shorter periods of time subsequently over the lapse of time. Even though the inventory turnover has increased in 2007 the overall operating cycle has improved tremendously, falling from around 57 days in 2003 to around 31 days in 2008. As far as the fixed assets are concerned, the company has been seen to regularly invest in latest machinery to cater for increased demand and to facilitate up gradation in the technology footprint. With the phenomenal growth in sales over the past couple of years and efficient utilization of property plant and assets the overall total asset turnover ratio has also shown a rising trend over the years. The total asset turnover ratio exceeded 3 in all the six years, hence bearing substance to the efficient asset management practices of the company.

The Interest Coverage Ratio of Pakistan Tobacco has improved phenomenally over the past couple of years. It has increased from 50.6in 2004 to 150 in 2008, showing that over the years, the company, with improved operating margins, has improved on its ability to pay its financial costs pertaining to interest payments. However, the long term debt to equity ratio of the company increased over the years as well, primarily due to an increase in the deferred taxation of the company. However, the reliance of the company on long term debt is negligible, the only long-term debt arising through taxation. Total dependency on debt financing is on average 50%, the main component of debt being the short term loans and payables.



The book value of Pakistan Tobacco has improved over the years owing primarily to an increase in equity due to a rise in the revenues and reserves of the company. The dividends paid per share have also improved tremendously as the excellent performance of the company over the past couple of years allowed it to disburse dividends to its share holders. Similarly, the earnings per share of the company also increased significantly, marinating a steeply rising trend since 2003. This is due to an impressive growth in the net margin of the company over the course of the four years under consideration. The market price of the company has also improved significantly over the years. It was only Rs 29 in 2003, but soared up to Rs 106 by the end of 2008, despite the volatile conditions of the Pakistani stock market.

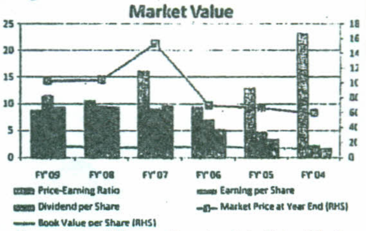
Future outlook

The ratification of Framework Convention for Tobacco Control (FCTC) by Pakistan, coupled with marketing restrictions of various kinds has not bid well for tobacco manufacturers. Furthermore there have been increased taxes and duties levied by the government on tobacco products and producers. The company is currently contributing Rs. 38 billion to the National Exchequer in the form of duties and taxes, which amounts to 65% of the Gross Turnover. The Budget of 2010-11 proposes an increase in the Federal Excise Duty on tobacco products, along with a tax of Re 1 per filter. This translates to an increase of Rs 20 in the price of cigarette packs. Considering that the cost of doing business will not subside in the near future for manufacturers due to prevalence of high inflation and fuel costs, these factors would hurt the future earnings of PTC.

A very serious threat to the tobacco manufacturers of Pakistan in general, and PTC in particular, is the scourge of smuggled cigarettes in the country. The sources of these illicit commodities are Afghanistan and Iran. According to an estimate around 15%-20% of all cigarettes sold in Pakistan are illegal in nature. A lot needs to be done on the enforcement of laws to curb this trade. Even a market leader like the PTC is being badly affected by smuggled products as it can gain a lot of market share if these smuggled products can be controlled by the government. Furthermore, increasing taxes and duties by the government are causing consumers to turn towards smuggled goods, expanding this market and resulting in revenue losses for both PTC and the government itself.

Lastly, there is also a lot of concern about the volatile situation in the NWFP due to terrorism activities. Much of PTC's tobacco growers are in the NWFP area and so is one of its manufacturing facilities, which creates a heavy risk for PTC.

In spite of the challenges faced, the company looks towards the coming year with great confidence, determined to continue progress on the path of long term shareholder value creation through sustainable growth.



Economics and Finance Department, Institute of Business Administration, Karachi, prepared this analytical report for Business Recorder.