



January 23, 2014

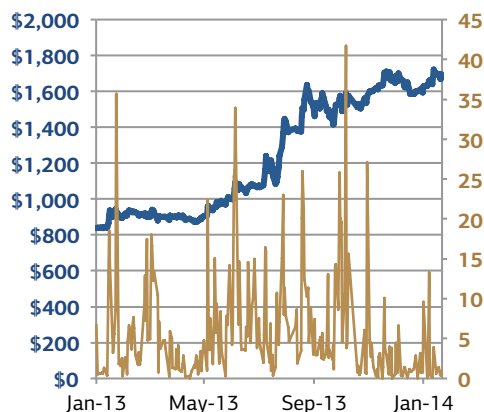
SE Asia | Consumer

British American Tobacco Bangladesh (BATBC BD)

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BAT Bangladesh (BATBC BD) one-year share price in BDT (blue) and volume (gold, in thousand shares)



Source: Bloomberg, January 23, 2014

BAT Bangladesh (BATBC BD)

Price	BDT 1,695 (USD 22)
Rating	Buy
Price target	BDT 2,400
Difference	40%
Market Cap	USD 1,300
Simple Moving Avg.	2313
P/E	23x (TTM)
Free Float	11%

Source: Bloomberg, January 23, 2014

+ A business for long-term owners

British American Tobacco Bangladesh (BATBC) offers investors the opportunity to own a high ROIC, high growth, consumer business with a dominant market share and an entrenched distribution channel at a compelling multiple. Despite limited liquidity, we anticipate that investors with a long-term investment horizon are likely to realize stronger capital appreciation with BATBC over more liquid tobacco investments such as the BAT Group (BATS LN) or ITC India (ITC IN).

+ Volume growth

Cigarette volumes for BAT Bangladesh grew at a 6.6% CAGR over the last three years, outpacing growth from other emerging markets of the BAT Group such as India (1.3%), Pakistan (-1%), and Malaysia (-4.4%). Cigarette volumes for the BAT Group as a whole have been declining by around 1% annually from 2008-2012.

+ Margin expansion

For 2012, gross margins for BAT Bangladesh stood at 42%. Margins for the BAT group as a whole stood at 78% for the same period and 68% for BAT Malaysia. Operating margins for BAT Bangladesh were 25% in 2012, compared to 50-60% for other listed BAT Group subsidiaries in Asia.

+ Conservative valuation

BATBC Bangladesh trades for 23x TTM earnings and 16x 2014 earnings on our estimates. From 2008-2012, BAT Bangladesh has achieved compound earnings growth of approx. 24%. Large cap peers such as the BAT Group, Altria, Philip Morris, and Lorillard trade between 14-15x 2014 earnings, but have only grown earnings between 6-12% annually over the same time period.

+ Initiation PT BDT 2400; rating: BUY

We initiate with a price target of BDT 2400, valuing BATBC on 20x 2015 earnings. We feel a 20x multiple is conservative based on industry comps and BATBC's current trading multiple.

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Overview & History

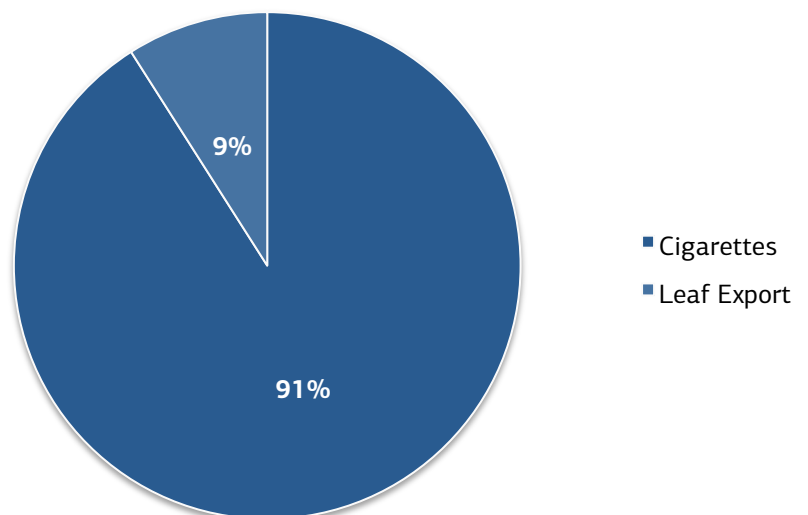
BAT Bangladesh (BATBC) is part of the BAT group, which has the largest global presence among international tobacco companies, with brands sold across 180 countries. Bangladesh is one of 68 countries where BAT Group has cigarette-manufacturing plants.

BATBC began operating in Bangladesh in 1910 as Imperial Tobacco—its first sales depot was in Armanitola in Dhaka. After the partition of India in 1947, the company became known as the Pakistan Tobacco Company. Following Bangladesh’s independence in 1972, the company became Bangladesh Tobacco Company Ltd. Finally, in 1998 the company changed its name again to British American Tobacco Bangladesh.

BATBC has 75% of Bangladesh’s market by value and ~50% by volume.

BATBC is the largest cigarette company in Bangladesh, accounting for 75% of the country’s market share by value, and approximately 50% of it by volume.

Chart 1. 2012 Sales (net of excise duties & VAT)



Source: Company filings

Roughly 90% of revenue comes from cigarettes; the remaining 10% comes from tobacco leaf exports. BATBC’s cigarettes are manufactured locally. Leaves are also primarily sourced locally, although premium brands leaves are sometimes imported. BATBC is gradually phasing in local leaf production into its premium brands.

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With approximately 70,000 retailers, BATBC has one of the most extensive and efficient distribution networks in Bangladesh.

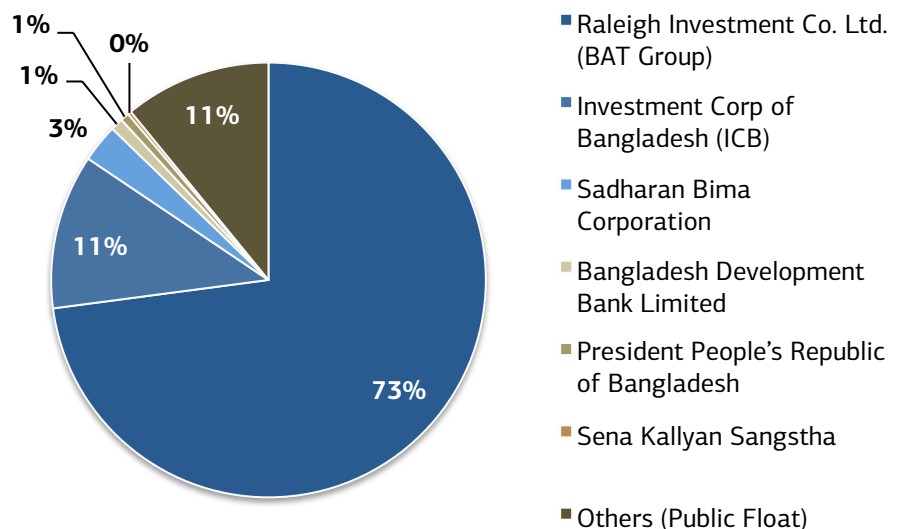
Due to its long operating history, BATBC has one of the most efficient and extensive distribution networks in Bangladesh with approximately 900,000 retailers. This distribution channel allows BATBC to spot market trends and adapt to changing business environments. Since 2009, BATBC has successfully introduced four new brands in the low and medium tier segments to take share in these faster growing segments of the market.

BATBC employs around 1,200 people directly, and about 50,000 people indirectly as farmers, distributors, and local suppliers.

Share Ownership

BAT Bangladesh is controlled by the BAT Group, which owns 73% of shares outstanding, ensuring corporate governance policies in line with the BAT Group. Another 11% of BATBC is owned by the Investment Corporation of Bangladesh, a government entity.¹

Chart 2. Share Ownership (2012)



Source: Company filings

In 2012, the BAT Group increased its stake in BAT Bangladesh from 65% to 73%. The shares were purchased from the Investment Corporation of Bangladesh (ICB), which previously held approximately 17% of the company. ICB has been steadily decreasing its stake since 2006, when it held approximately 24% of the company. Other key investors include Shadharan Bima Corp., Bangladesh Shilpa Rin Shangstha, Government of People's Republic of Bangladesh, and Sena Kalyan Shangstha.

¹ <http://www.icb.gov.bd/zindex.php>

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Only 11% of the company is free float, making the stock illiquid. Roughly 8,000 shares trade per day, or about USD 160,000

Brands

Table 1. BATBC's Brands

Brand	Launch	Comments
Premium segment		
Benson & Hedges	1997	The leading premium brand in Bangladesh.
Benson & Hedges Switch	2012	
High segment		
John Player Gold Leaf	1980	The leading value for money brand in Bangladesh. Also a leading brand in Pakistan.
Pall Mall	2006	
Capstan	N/A	
Medium segment		
Star	1972	Currently BATBC's highest volume generating brand, sales have declined since 2009 H2 as customers have been down-trading to cheaper brands following an excise tax hike on mid-tier brands.
Starlight	2012	Offers a smoother taste over the Star brand. Launched in 2012 to combat down-trading from the Star brand.
Scissors	N/A	
Low segment		
Pilot	2009	Launched to combat increased duties on mid-tier segment brands.
Bristol	2010	In certain regions of the country, the launch of Pilot did not meet management expectations in capturing down-trading customers. Bristol was launched to combat increased duties on mid-tier segment brands.
Hollywood	2011	Launched to capture market growth in the low tier segment.

Source: Company filings

Competition

The cigarette manufacturing industry is highly concentrated in Bangladesh, while bidi manufacturing is fragmented. Cigarettes are produced mainly by two companies: BATBC and the domestic Dhaka Tobacco Industries (DTI), a part of the Akij Group. The Akij Group is a large domestic conglomerate that is engaged in cement, computers, food and beverage, jute, textiles, and pharmaceuticals,

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among other businesses.²

DTI has historically focused on the low priced cigarette market. Brands include Sheikh, K-2, Five Star, Red & White, Real, and Surma. In 2007, DTI entered into an agreement with Philip Morris (PMI) to market Marlboro. As of 2010, Marlboro had not gained significant traction, which had less than 1% market share. DTI's share of the cigarette market is approximately 40%.

The table below lists the most popular cigarette brands in Bangladesh as found by a 2009 study. The most popular brand of cigarette by volume in Bangladesh is BATBC's Star brand, followed by DTI's Sheikh and Navy Brands. BATBC's Gold Leaf is also a high volume brand, which is especially noteworthy given its position in the high segment of the cigarette market.

Table 2. Cigarette brand shares based on household survey data

Brand	Company	2009
Star	BATBC	25.6%
Sheikh	DTI	18.3%
Navy	DTI	13.7%
Gold Leaf	BATBC	10.3%
Marise	AKTC	8.9%
Others	-	23.2%

Source: GTSS. Tobacco Taxation in Bangladesh, 2012

Reflects brand responses among smokers of manufactured cigarettes to a Global Adult Tobacco Survey (GATS) question on last brand purchased

In addition to BATBC and DTI, there are a host of smaller domestic cigarette manufacturers in Bangladesh, including Abul Khair Tobacco, Alpha Tobacco, Azizuddin, Sonali Tobacco, National Tobacco, and Nasir Tobacco. Together, they comprise 10-15% of the cigarette market.³

In recent years, BATBC has been losing market share.

In recent years, BAT Bangladesh has been losing some market share. As illustrated below, BATBC accounted for roughly 46% of cigarette consumption in Bangladesh in 2010, down from the 54% it controlled as of 2006.

² <http://www.akijgroup.com/>

³ Tobacco Taxation in Bangladesh, 2012

Table 3. Market share of cigarette companies (2000-2010)

Company	2000	2002	2004	2006	2008	2010
BATBC	55.0%	50.4%	51.6%	54.0%	45.5%	45.8%
Domestic manufacturers	44.7%	49.4%	48.1%	45.7%	54.3%	54.1%
Imports	0.3%	0.2%	0.3%	0.3%	0.2%	0.1%

Source: ERC Group, 2010. Tobacco Taxation in Bangladesh, 2012

BATBC's premium brand sales suffered as a result of increasing taxes targeting the mid and high segments of the industry.

BATBC has historically focused its efforts on the mid-tier and premium cigarette market, where it still controls some 75% share. However, increasing taxes on the mid and high segments (due in part to Bangladesh's sliding ad valorem tax structure) have incentivized consumers to down trade to low-end brands. Critically, investors should recognize that while the low end segment is experiencing the fastest growth due to these tax policies, the mid and high segments of the market in Bangladesh also continue to grow (just at a policy-induced lower rate).

To illustrate the significance of these tax increases on the mid-tier and premium market, the low-end segment of Bangladesh's cigarette industry represented almost 50% of sales in 2009. By 2012, just three years later, the low-end segment accounted for 60% of the industry's sales.

In its 2009 annual report, BATBC describes how a mid-year price/tax increase of 24% in the mid and high segment (without a corresponding increase for the low segment) contributed to down-trading and a decline in sales in the second half for the mid-tier segment. In response, management immediately rolled out Pilot in the second half of 2009, a new low-end brand for the group. Management further introduced Bristol in 2010 and Hollywood in 2011—both low-end brands seeking to capture growth in the low tier segment. Management has indicated that these brands have been successful and are achieving growth in line with their respective segment.

In 2010 and 2011 management observed a decline in sales in the mid-tier segment due to declining volumes of its Star brand. To combat this change, management introduced Starlight in 2012, another mid-tier brand with a smoother taste. Management has indicated that the introduction of this new mid-tier brand has successfully halted the decline in sales for the medium segment.

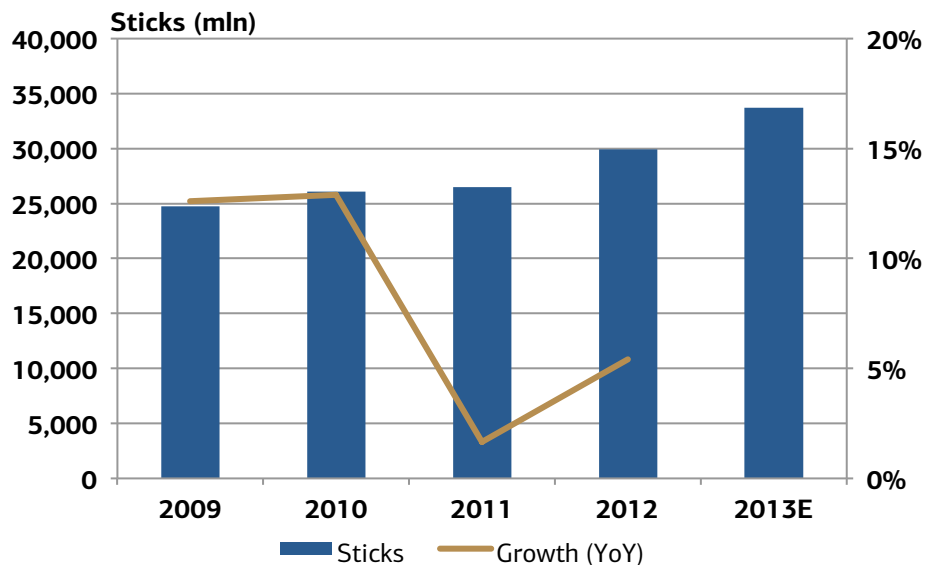
After reporting declining market share in 2010, the BAT Group

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indicated in its 2011 and 2012 annual reports that BAT Bangladesh had reversed this trend and was taking share as volumes increased. We believe this continued to be the case throughout 2013 Q3, as stick volumes appear to have increased at a 10-12% clip over 2012.

Chart 3. Growth in stick volumes



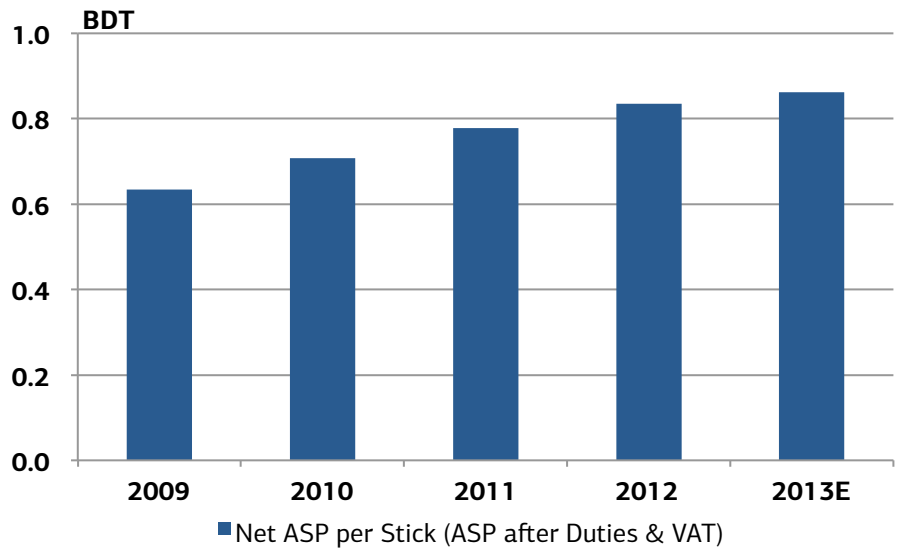
Source: Company filings

BATBC's share loss has not come at the expense of consumers switching away from its premium brands.

The takeaway for investors is that the low-end segment of the market has been outgrowing the mid and high segments in volume. While BATBC's mid-tier brand Star has suffered, the company's access to 900,000 retailer shops across Bangladesh has allowed management to respond to market shifts and push through new products to combat changes in consumer behavior. Since 2009, management has successfully introduced a new mid-tier brand to halt the decline of its Star brand sales and has introduced three new brands in the low-end segment to capture growth in the fastest growing segment of the market. Meanwhile, its high-end brands continue to perform well. Notably, *BATBC's share loss has not come at the expense of consumers switching away from BATBC's high-end (and most profitable) brands, which continue to meet management expectations.*

BATBC's financials support this view. The number of cigarettes sold by the company from 2009-2012 has increased annually by 6.6%, which is in line with Bangladesh's industry volume growth of approx. 5-6%. Furthermore, net ASPs per stick (net of duty and VAT taxes) have increased by 9.6% annually from 2009-2012, suggesting that the introduction of three new low-end brands has impacted margins and pricing power.

Chart 4. Net ASP per Stick (2009-2013)



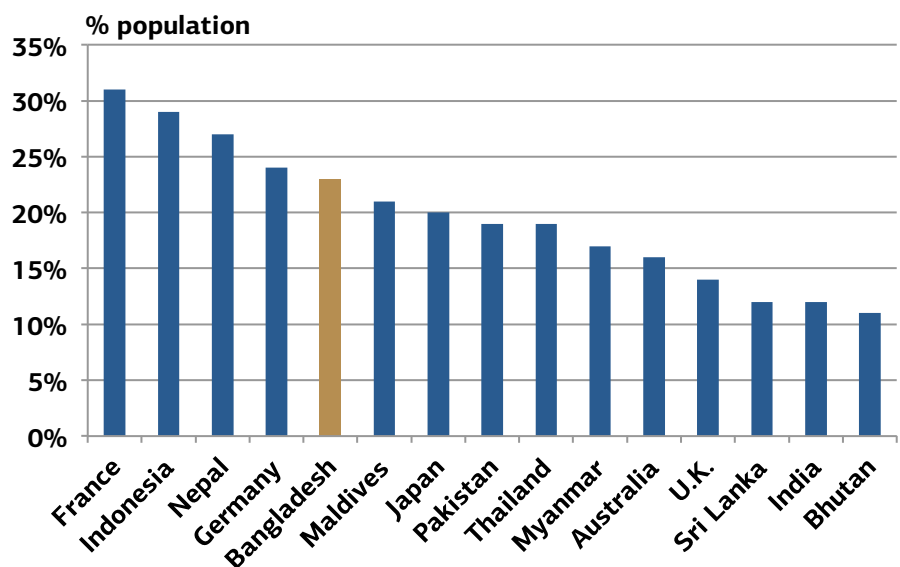
Source: Company filings

Bangladesh Tobacco Demographics

About 43% of Bangladesh's population consumes some form of tobacco. Only about 23% of the population consumes tobacco in a form that is smoked, while the rest consumes it by chewing betel quid. In an international context, the prevalence of tobacco smoking in Bangladesh is relatively high.

The prevalence of tobacco smoking in Bangladesh is relatively high when compared to other countries.

Chart 5. Daily smoking prevalence by country



Source: WHO Report on Tobacco, 2013

While 23% of the population smokes tobacco, only 14% consumes it in the form of manufactured cigarettes. Tobacco consumption in Bangladesh is summarized in the table below. Note that some users consume multiple forms of tobacco.

Table 4. Tobacco use in Bangladesh (2012)

Tobacco segment	% Men	Prevalence*	Type consumed	Prevalence
Smokeless tobacco	50%	27%	Betel Quid	
Tobacco smoking	95%+	23%	Manufactured cigarettes	14%
Tobacco smoking			Hand Rolled Cigarettes	0.40%
Tobacco smoking			Bidis	11%

Source: Tobacco Taxation in Bangladesh, 2012

* Prevalence for "smokeless tobacco" and "tobacco smoking" adds up to 50%, higher than the 43% of prevalence mentioned at the beginning of this section. Also, adding up the percentage prevalence of each type of tobacco that is smoked adds up to more than 23%. The reason for these differences is that some users consume multiple forms of tobacco, driving up the percentages of prevalence shown in this table.

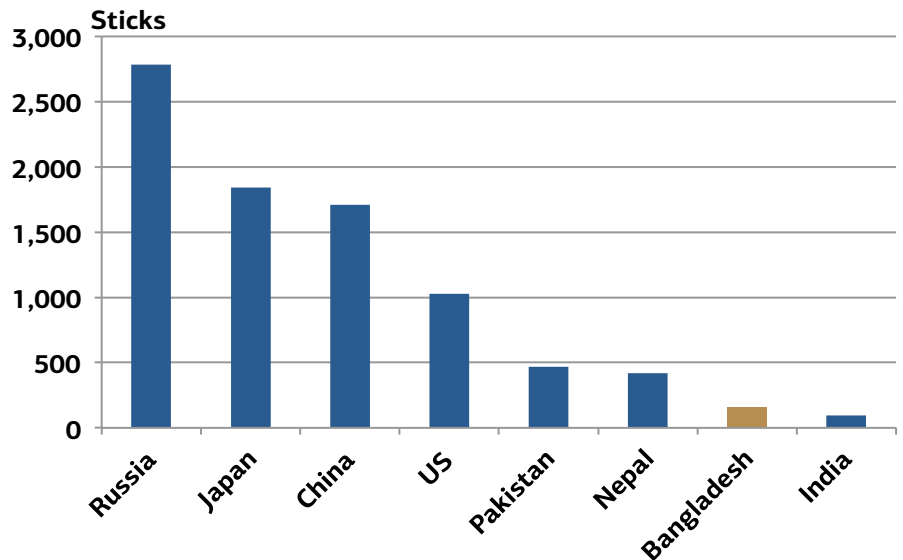
Smoking trends among Bangladesh's female population will benefit BATBC.

Women represent 35.7% of Bangladesh's smoking population—or 5% of the country's total population. Cigarette smoking is more prevalent among younger generations of women, which has raised concerns about increasing prevalence of cigarette smoking among women in future years.

Since 2000, the boom in garment manufacturing in Bangladesh has increased the employment prospects for women, who have traditionally experienced relatively few opportunities for work in male-dominated villages. According to WSJ, of the 4 million people employed in the garment manufacturing sector, over 80% are women.⁴ Increased opportunities in the work force and disposable income for women could potentially lead to greater prevalence of cigarette consumption among women and in the overall population over time.

⁴ <http://online.wsj.com/news/articles/SB10001424127887324049504578543391644877374>

Chart 6. Annual cigarette consumption per capita (2012)



Source: The Tobacco Atlas – 4th Edition, 2012

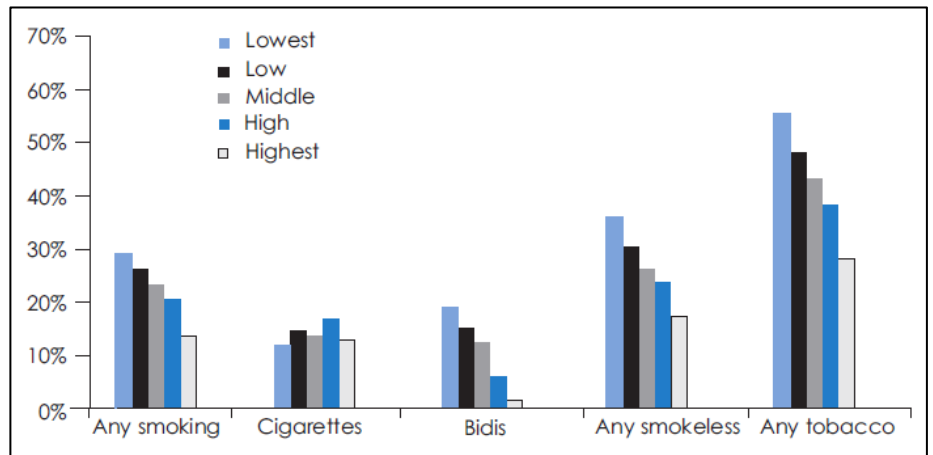
In a global context, Bangladesh’s cigarette consumption per capita remains low. While the above chart correctly depicts Bangladesh’s positioning as relatively low on a global scale, relative to India, per capita figures in Bangladesh may actually appear overstated due to the fact that only 5.7% of the population in India smokes cigarettes, whereas roughly 14% of the population in Bangladesh actively consumes tobacco in cigarette form.

Cigarette Smoking and trends in education and income

Higher levels of wealth and education only impact minimally cigarette consumption.

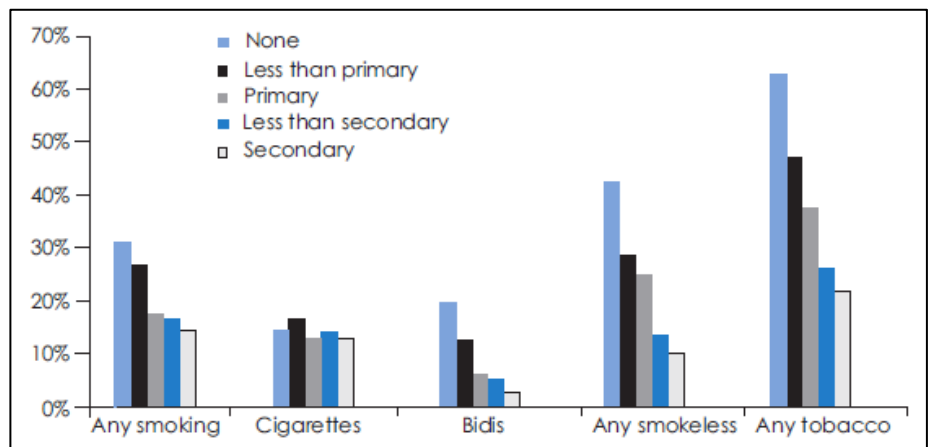
Education and wealth levels impact tobacco consumption in Bangladesh, as in other markets. However, it does so differently across segments. While the use of bidis and smokeless tobacco fall dramatically as levels of education and income rise, the consumption of cigarettes appears to be minimally impacted. This trend benefits BATBC’s position in the market.

Chart 7. Tobacco use prevalence by quintiles of wealth, Bangladesh (2009)



Source: GTSS, 2009, Tobacco Taxation in Bangladesh, 2012

Chart 8. Tobacco use prevalence by education, Bangladesh (2009)

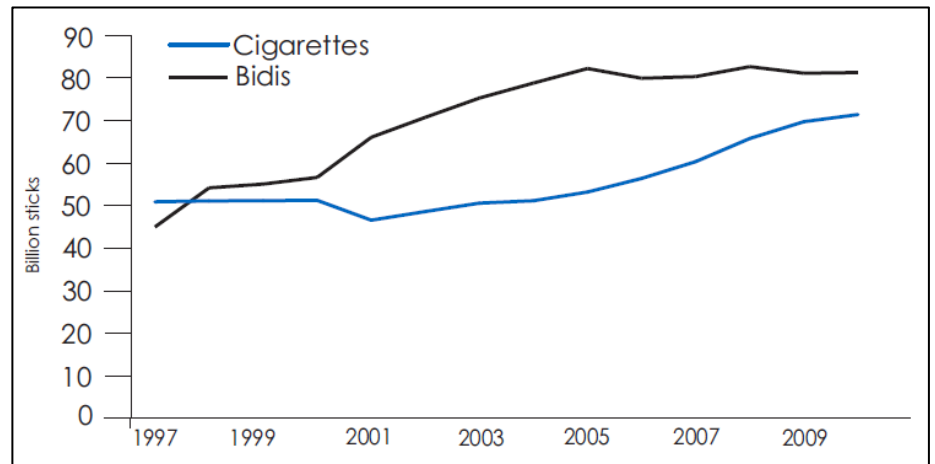


Source: GTSS, 2009. Tobacco Taxation in Bangladesh, 2012

Cigarette consumption is also higher for urban smokers, with an average daily consumption of 8.5 sticks versus 4 for rural smokers. The opposite is true for bidis, where the average daily consumption for smokers is 2.7 for urban smokers versus 8.3 for rural consumers. These consumption patterns fare well for long-term growth of cigarette consumption in Bangladesh as the population urbanizes and grows increasingly wealthy over time.

Given the high inelasticity of cigarette consumption with respect to rising wealth and education along with Bangladesh's 3x increase in GDP per capita over the last three decades, investors might assume that consumption of cigarettes has outpaced that of bidis. However, the opposite is true:

Chart 9. Cigarette and bidi consumption, Bangladesh (1997-2010)



Source: Euromonitor, 2011. Tobacco Taxation in Bangladesh, 2012

Bangladesh's tax structure has led to proliferation of low priced tobacco products.

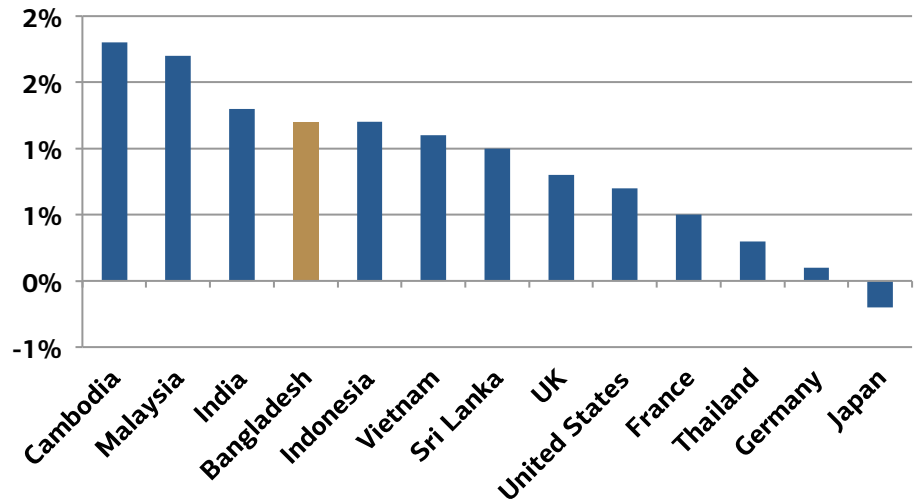
The above trend can be attributed to the affordability of bidis. Bidis consumption has increased at a faster rate than cigarettes due to a tax structure that encourages the proliferation of low priced tobacco products. This trend will be discussed in more detail below, under the section "Taxes." Interestingly, a similar trend has been observed in India, where bidis are taxed at about 5% the rate of cigarette prices. BATBC management has noted in recent annual reports that growth in bidis should continue to outpace growth in cigarettes in the near term as increases in excise taxes on cigarettes have consistently outpaced those imposed on bidis.

Bangladesh's Population Demographics

Bangladesh's population is growing at 1.1-1.2% per year, slightly below India's 1.4% and Malaysia's 1.6% but in line with Vietnam (1%), Indonesia (1%), Sri Lanka (1%), Cambodia (1.2%), and above Thailand (0.6%) and the United States (0.7%). These demographics are favorable for BATBC when compared to its parent company BAT, as well as Altria, Philip Morris, and Imperial Tobacco—all of which obtain a significant portion of sales and profits from mature markets.

Roughly one third of Bangladesh's ~160 mln population is under 15. This age distribution is similar to India (31%), and higher than in Thailand (21%), Malaysia (27%), Sri Lanka (25%), Indonesia (27%), and the United States (20%). This demographic lends favorable growth characteristics to BATBC—particularly in comparison with more mature markets in Europe/Japan where as little as 13-15% of the population is under 15.

Chart 10. Population growth by country (2012)



Source: World Bank

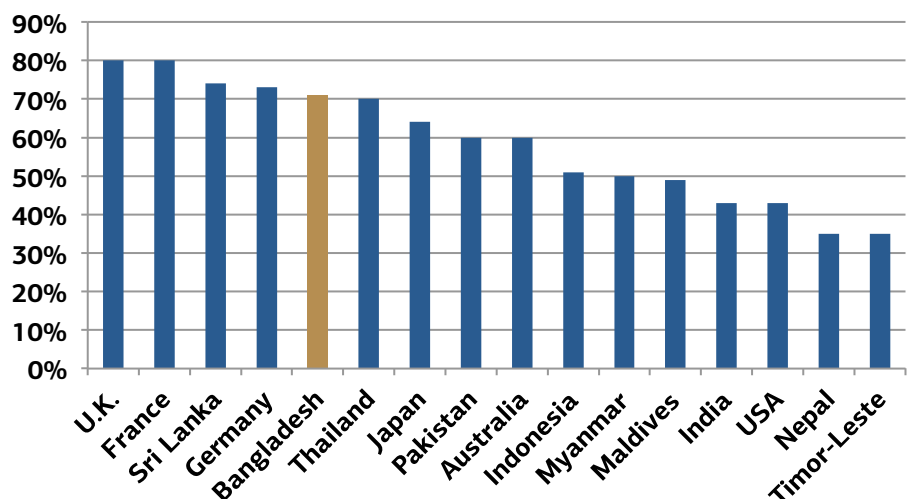
Bangladesh's population demographics suggest that that over the next 15 years, an additional 50-60 mln Bangladeshis will be eligible cigarette smokers. At current prevalence of 14%, another 7-8 million individuals would become cigarette smokers compared with today's market of 22Mn smokers.

Taxes

Bangladesh taxes cigarettes at high rates when compared to other nations such as Indonesia, India and US.

BATBC is the largest private sector taxpayer in Bangladesh, accounting for two thirds of the country's cigarette tax revenue. WHO data indicates that Bangladesh taxes cigarettes at high rates compared to other nations such as India, Indonesia, and US.

Chart 11. International Taxation on Cigarettes



Source: WHO Report on Tobacco, 2013

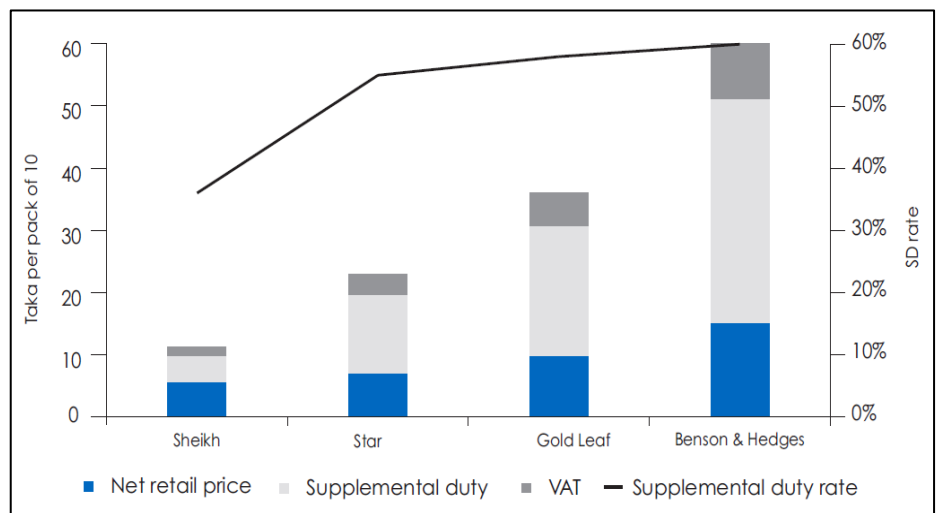
Tax Structure on Cigarettes in Bangladesh

In addition to VAT, Bangladesh imposes an ad valorem excise tax of 36-60% of the retail price for cigarettes.

Tobacco products in Bangladesh carry a flat VAT tax of 15% on retail prices. In addition to VAT, Bangladesh imposes an ad valorem excise tax (also called a supplemental duty) on cigarettes, which ranges between 36-60% of the retail price for cigarettes and 20-25% of the retail price for Bidi. The ad valorem tax is on a sliding scale, meaning that higher priced cigarettes pay a higher percentage of tax. This sliding tax scale incentivizes consumers to trade down to lower priced cigarettes and bidis, which are taxed at lower rates.

Generally speaking, manufacturers of premium cigarettes prefer specific taxes (or flat taxes per cigarette) as opposed to Bangladesh's system of ad valorem taxes. With ad valorem taxes, the tax per unit rises with prices so that the tax and revenue it generates are more likely to keep pace with inflation. With specific taxes, the rates have to be regularly adjusted to keep pace with inflation. In Bangladesh in particular, the *tiered* ad valorem tax scale, under which premium brands pay higher tax rates, results in even greater price differential between premium and low-end cigarettes. This tiered ad valorem tax scale in Bangladesh means that low priced cigarettes sell for nearly 20% of what premium brands sell for. The availability of inexpensive cigarettes and the large price gaps induced by hiking taxes on premium brands incentivize smokers to down-trade to cheaper brands in response to tax and price increases. This policy structure remains a key risk for BATBC's long-term earnings prospects.

Chart 12. Cigarette Taxes and Prices per Pack of 10 Cigarettes by Brand, Bangladesh (2012)



Source: Tobacco Taxation in Bangladesh, 2012

The chart above outlines the differing tax structure for three of BAT Bangladesh's key brands (Star, Gold Leaf, and Benson & Hedges) and one of its key competitors, DTI's Sheikh brand. Critically, supplemental duty rates constitute approximately 60% of the retail price for premium brands such as Benson & Hedges. For lower priced brands such as Sheikh, this rate stands at about 35%. Notice that while net retail prices (in blue) charged by the manufacturer only vary by 10 Bangladesh taka (BDT) between the least expensive and most expensive brands, the retail price charged to consumers varies by approximately BDT 50 due to the ad valorem sliding tax scale.

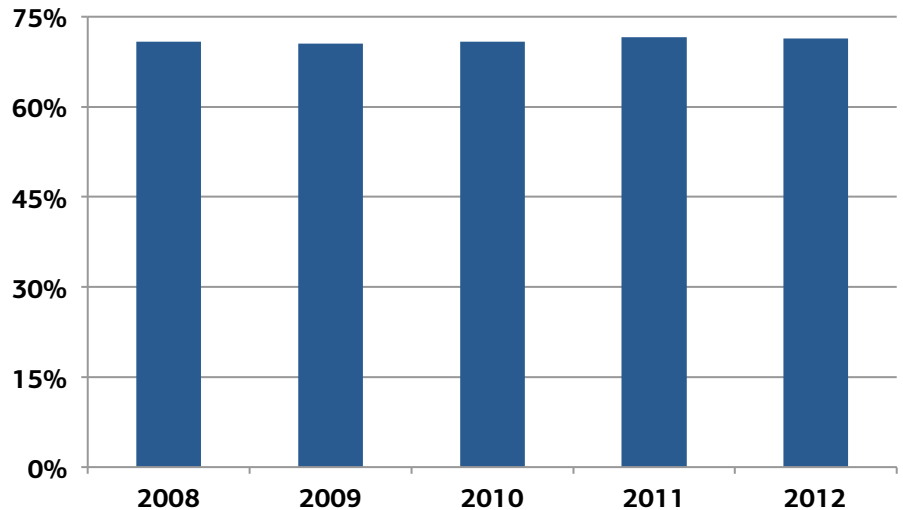
In addition to incentivizing consumers to purchase lower priced cigarettes through a tiered ad valorem tax structure, the Bangladeshi government also indirectly incentivizes consumption of bidis by taxing them at a lower rate than cigarettes. Excise and VAT tax on bidis are not applied to the retail price, but to a tariff value, which is usually half the retail price. Taxes on bidis are lower presumably due to government efforts to protect the bidi industry and employment.

Investors would be remiss to ignore the incentives this tax structure provides. India imposes similar incentives for bidi consumption—although in greater exaggeration, where excise taxes represent 5% of that on cigarettes. In the 1970s, cigarettes formed 25% of tobacco consumption in India, but today cigarettes represent only 15% of India's tobacco consumption. This trend runs contrary to expectations that rising income per capita would lead to conversion from bidi to cigarette consumption, and can be attributed to the distorted tax structure India imposes on cigarettes.

**VAT and supplementary
duty taxes average
71-72% of BATBC's
retail prices.**

Under Bangladesh's existing tax structure, total taxes on cigarettes comprise about 66% of retail prices for the most popular brands. For BATBC, VAT and supplementary duty taxes are slightly higher, averaging 71-72% of retail prices over the last five years.

Chart 13. Duty & VAT as percentage of gross sales (2008-2012)

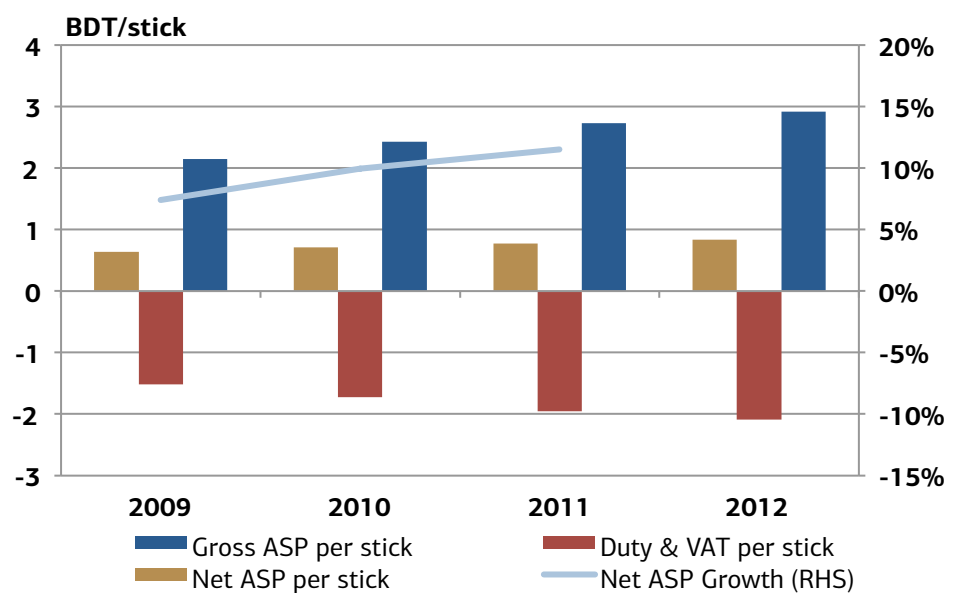


Source: Company filings

Although BATBC's premium positioning and Bangladesh's sliding ad valorem tax scale positions the company at a consumer price disadvantage, the group has steadfastly passed on increases in excise duties to consumers. The chart below shows that BATBC has consistently managed to increase ASP growth net of all duties and VAT.

Even with the existence of such heavy taxation policies, BATBC has consistently managed to increase ASP growth.

Chart 14. ASP growth after duties & VAT



Source: Company filings

Financial Metrics and Valuation

At a current price of approximately BDT 1640 per share, BATBC trades for about 22x TTM earnings. The company has not yet announced full year financials, but earnings grew 16% YoY through Q3 2013.

Table 5. Trailing 3 Quarters Performance (YoY)

BDT 000's	Jan – Sept 2013	Jan-Sept 2012	YoY Growth
Net Revenue	23,136,199	19,935,831	16.1%
Gross Profit	10,303,234	8,439,034	22.1%
Operating Profit	7,011,031	5,300,649	32.3%
PBT	6,758,213	4,914,549	37.5%
Net Profit	3,443,068	2,962,925	16.2%

Source: Company Filings

Readers may observe that PBT grew 38% YoY while net profit grew only 16%. This is due to corporate tax consuming 48% of PBT in the first three quarters of 2013, rather than a long-term average of 40%. We expect that over the next few quarters, BATBC's corporate tax rate should normalize to 40%. We expect taxes to largely return to their historical rate for the full year, and anticipate earnings growth of 30% YoY, in line with PBT growth.

Historical Business Performance

From 2008-2012, earnings have compounded at a 24% CAGR, driven by increasing volumes and prices. Share count has remained flat at 60 mln shares over the last 5 years. BATBC consistently pays 90-95% of its earnings out as dividends, offering investors a yield of around 4% at today's share price.

From 2009-2012, cigarette volumes have been growing approximately 6-7% annually and net ASPs (i.e. ASPs after excise tax and VAT) have been increasing by approximately 10% per year.

Table 6. BAT Bangladesh cigarette volume and ASP growth (2009-2012)

	Units	2012	2011	2010	2009	CAGR
Sticks	Mns	29,911	26,493	26,064	24,725	6.6%
Gross Revenue (Cigarettes Only)	BDT mln	87,411	72,416	63,279	53,188	18.0%
Duty & VAT	BDT mln	-62,420	-51,803	-44,837	-37,498	18.5%

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Net Revenue	BDT mln	24,991	20,613	18,443	15,690	16.8%
Duty & VAT (as % of Gross Revenue)	%	71%	72%	71%	71%	0.0%
Gross Revenue per Stick	BDT	2.92	2.73	2.43	2.15	10.7%
Duty & VAT per Stick	BDT	-2.09	-1.96	-1.72	-1.52	11.2%
Net ASP per Stick	BDT	0.84	0.78	0.71	0.63	10.1%

Source: Company filings

6-7% annual volume growth is unusual for a cigarette manufacturer. At best, most markets are experiencing flat to declining sales, and shareholders depend on increasing ASPs to drive shareholder returns. This is true not only for developed markets like the U.S. and Europe, but also in emerging markets such as India and Sri Lanka. ITC in India for instance is experiencing volume growth of only 1% annually (although ASP growth for ITC is similar to BATBC). Ceylon Tobacco in Sri Lanka (a monopoly in Sri Lanka 84% owned by the BAT Group) has also been experiencing declining volumes.

Table 7. Volume growth: Peer comparison

Company	Mkt. Share	Sticks Sold	Volume CAGR ('08-'12)
BAT Group	N/A	694bn	-1%
ITC India	~80%	80bn	1.3%
BATBC Bangladesh	~50%	30bn	6.6% ('09-'12)
BAT Malaysia	~60%	9bn*	-4.4%
Pakistan Tobacco	~50%	40bn	-1%
Ceylon Tobacco (Sri Lanka)	90%+**	4.3bn	-1%

Source: Company filings, Macquarie, Sri Lanka Department of Excise

* BAT Malaysia produces 23 bln sticks per year, 14 bln of which are for export

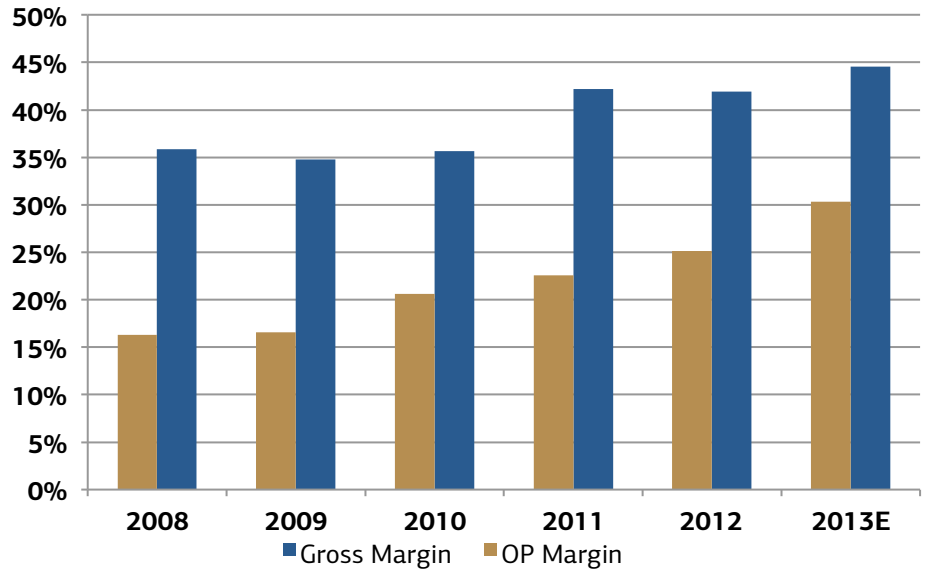
** Ceylon Tobacco is the only legal manufacturer of cigarettes in Sri Lanka

Low ASPs and margins create earnings potential

BATBC's comparatively low operating margins relative to industry peers understate its earnings power. Operating margins have expanded rapidly from ~16% in 2008 to ~25% in 2012, buoyed by strong ASP and volume growth, but long-term upside remains.

Chart 15. BAT Bangladesh margin growth

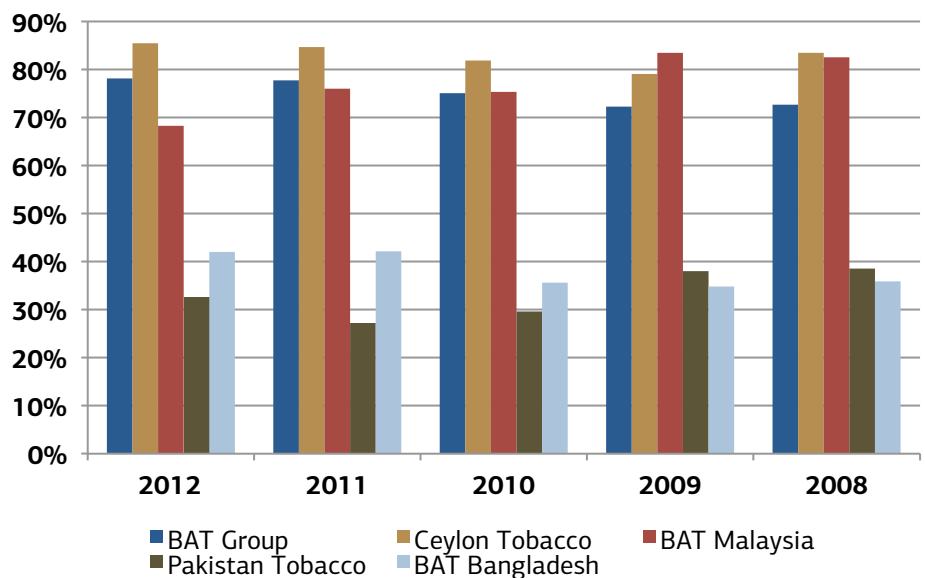
BATBC comparatively low margins relative to industry peers understate its earnings power.



Source: Company filings

Opportunity for margin expansion remains as ASPs significantly lag most other markets.

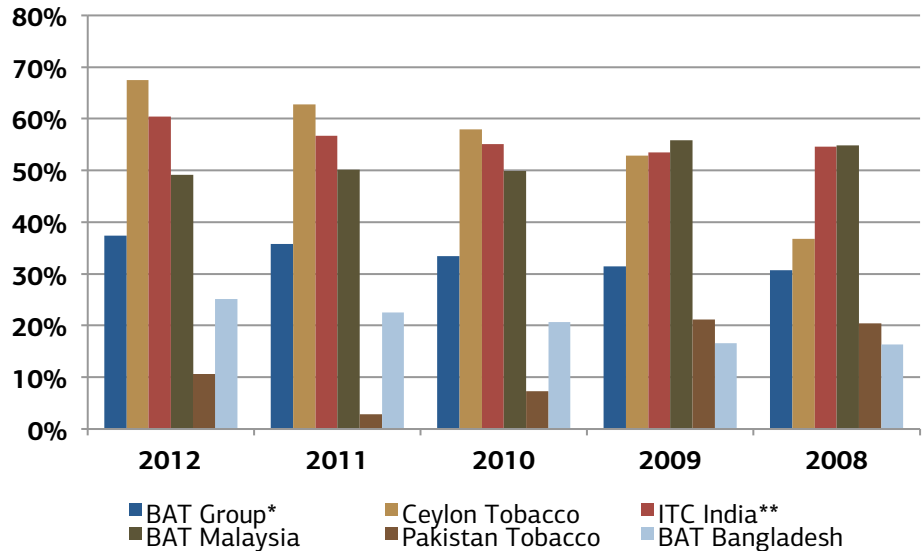
Chart 16. Gross margin: Peer analysis



Source: Company filings

* ITC India's gross profit for its cigarette business is undisclosed

Chart 17. Operating margin: Peer analysis



Source: Company filings

* Based on adjusted profit from operations after excluding restructuring & integration costs, and amortization & impairment of trademarks and similar intangibles. BAT Group enjoys high gross margins but relatively lower operating margins due to high management expenses

** Based on Profit before Income and Tax as disclosed in segment information in ITC's annual reports

The margin disparity between these businesses can be explained by BATBC's low ASPs. For example, ITC's gross ASP per cigarette is roughly 4 rupees per stick, or about USD 6.5 cents. BATBC's gross ASP as of 2012 is roughly equivalent to USD 3.7 cents per stick.

Readers familiar with the tobacco industry may observe that the BAT group, for example, has operating margins of ~36%, consistent with other large cap cigarette manufacturers with an exposure to mature markets. BAT Group's relatively lower operating margin compared to its emerging market subsidiaries (and associates) may be partially explained by higher management expenses.

A cursory glance across the market caps of a few of these companies relative to the populations they serve and the number of sticks sold tells an interesting narrative. Although this approach ignores differing margins, growth rates, cigarette prevalence, and tax regimes across these regions, it also demonstrates that the long-term earnings potential of BATBC is most likely several multiples higher than what its present valuation reflects. The market values Ceylon Tobacco, for instance, at USD 1.7 bln, with a total market of 4.3 bln sticks and a population of 20 mln. BAT Bangladesh on the other hand, is worth only USD 1.3 bln with 30 bln sticks in sales, and a 160 mln strong population. As ASPs in Bangladesh gradually increase and operating leverage expands, the

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market should gradually come to realize BATBC's underlying earnings power.

Table 8. Market capitalization to population and volumes: Peer comparison

Company	Sticks	Population	Mkt Cap (USD mln)	Volume CAGR (2008-'12)
ITC India*	80 bln	1.3 bln	41,350	1.30%
BATBC Bangladesh	30 bln	160 mln	1,270	6.6% ('09-'12)
BAT Malaysia**	9 bln	30 mln	5,480	-4.40%
Pakistan Tobacco	40 bln	180 mln	1,850	-1%
Ceylon Tobacco (Sri Lanka)	4.3 bln	20 mln	1,700	-1%

Source: Bloomberg, Company filings, Sri Lanka Department of Excise

* ITC also owns hotel, paper, agriculture, and consumer businesses, which contribute to its market capitalization. Cigarettes account for ~60% of sales and ~80% of earnings

** BAT Malaysia exports an additional 14 bln sticks on top of the 9 bln it produces for its domestic market

A forward multiple of 16x earnings for BATBC is reasonably close to large cap peers, which trade between 14x and 15x earnings. Considering BATBC's predictable cash flows, higher rate of long-term earnings growth, and understated margins relative to peers, we believe BATBC remains an attractive opportunity for investors to own. We conservatively value BATBC based on 20x 2015 earnings.

Table 9. Peer comparison

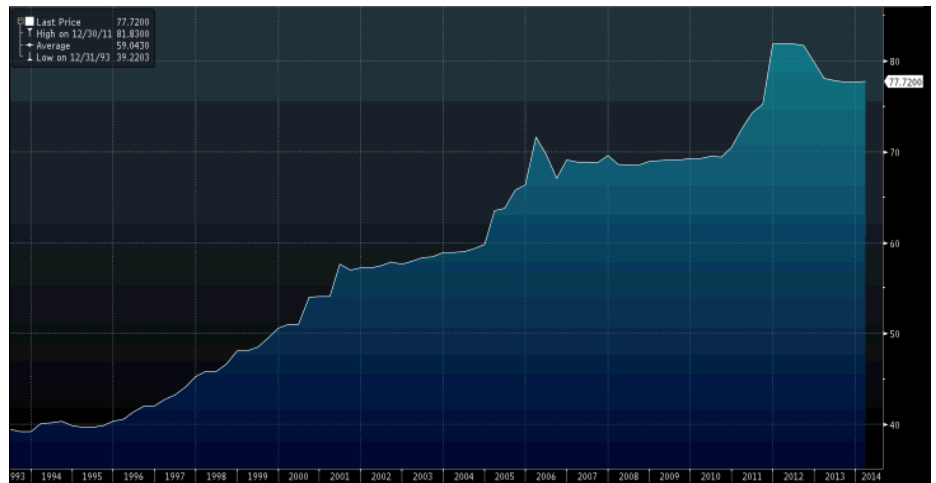
	Mkt. Cap (USD Mln)	PE (TTM)	Forward P/E	Earnings CAGR ('08-'12)
BAT Group	96,200	15x	14x (12/2014)	12%
Altria	74,700	15x	14x (3/2014)	-4%
Phillip Morris	133,500	16x	15x (3/2014)	6%
Lorillard	18,110	16x	14x (3/2014)	6%
ITC India	41,350	33x	24x (3/2015)	23%
BAT Bangladesh	1,270	23x	16x (12/2014)*	24%
BAT Malaysia	5,480	22x	21x (12/2014)	0%
Pakistan Tobacco	1,850	60x	n.a.	-9% TTM: 5%
Ceylon Tobacco (Sri Lanka)	1,700	26x	22x (12/2014)	31%

Source: Company filings, Bloomberg, J Capital Analysis

Risks

Currency

Chart 18. BDT/USD Exchange Rate (1993-2013)



Source: Bloomberg

Between 1993 and 2013, the Bangladesh taka depreciated against the US dollar from 40 to 78, or roughly 3.4% annually. Depreciation has been lumpy, however. In 2010 for instance, BDT 70 traded for USD 1. Today, the figure is about BDT 78. Currency depreciation is an ongoing concern, due to high inflation and a persistent trade deficit in Bangladesh.

Bangladesh mainly exports garments, as well as shrimp, jute goods, leather goods, and tea. Main imports include petroleum, machinery, soybean and palm oil, raw cotton, iron, and steel. According to WSJ, garment exports for the country were worth USD 20 bln in 2012-13, comprising 80% of Bangladesh's total exports and approximately 20% of Bangladesh's USD ~106 bln GDP.⁵

Cigarette ASP hikes have consistently outpaced inflation in Bangladesh by a healthy margin.

Fortunately, cigarette ASP hikes have consistently outpaced inflation in Bangladesh by a healthy margin. In spite of currency headwinds over the last 5 years, investors still would have been well rewarded for holding shares in BATBC as earnings per share has compounded ~24% annually. To put this in context, while the taka has depreciated a total of 14% from 2008-2012, earnings at BATBC increased by nearly 2.4 times over the same time period. Even conservative estimates of 15% annual earnings growth in the medium-term should still provide shareholders with adequate returns if the currency further depreciates.

⁵ <http://online.wsj.com/news/articles/SB10001424127887324767004578490861736695472>

Low labor costs and exports from its garment sector may relieve Bangladesh's persistent trade deficit.

Bangladesh's low labor costs and thriving garment export sector may offer some reprieve to its persistent trade deficit in the long-term. Steady appreciation of the RMB and wages in China continue to make Bangladesh an increasingly attractive country for labor-intensive exports, and Bangladesh has continued to gain ground in manufacturing of clothing.

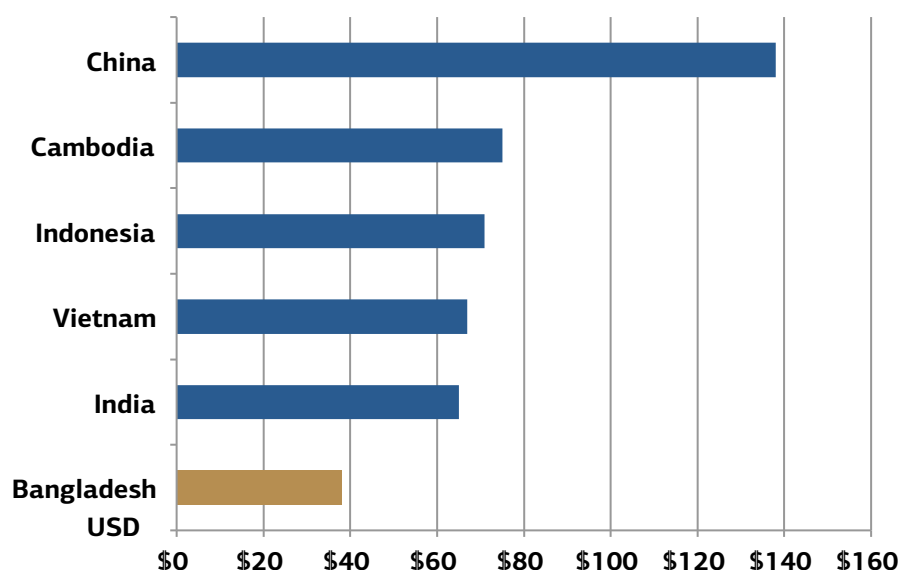
2005	2011*
China \$74.2 billion	China \$153.8 billion
Italy \$18.7	Italy \$23.3
Germany \$12.4	Bangladesh \$19.9
Turkey \$11.8	Germany \$19.6
India \$8.7	India \$14.4
France \$8.5	Turkey \$13.9
Mexico \$7.3	Vietnam \$13.2
Bangladesh \$6.9	France \$11.0
Belgium \$6.7	Spain \$9.2
U.S. \$5.0	Belgium \$9.1

*The most recent year available

Source: The Wall Street Journal⁶

Furthermore, labor rates (and the size of the labor pool) remain favorable relative to other emerging economies in South and Southeast Asia.

Chart 19. Minimum wage per month by Country



Source: State Department

⁶ <http://online.wsj.com/news/articles/SB10001424127887324766604578460833869722240>

In the long-term, competitive wages relative to other emerging economies should support growth in exports.

Bangladesh's trade deficit narrowed from USD 9.3 bln in FY 2011-12 to 7 bln in 2012-2013.⁷ Foreign currency reserves presently stand at an all-time high of USD 14 bln.⁸

Tax

Hikes in taxes remain a concern for BATBC shareholders.

Hikes in supplementary duty, VAT, corporate tax, and export tax are ongoing concerns for BATBC shareholders. Due to the premium pricing of its cigarettes and tiered ad valorem tax scale, BATBC faces an uphill battle relative to competitors focused on low and medium priced tobacco products. The recent corporate tax increase from 27.5% to 35% is a further concern, particularly as this tax hike applies only to listed cigarette manufacturers (DTI is not listed and is BATBC's main competitor).

Additionally, BATBC's tobacco leaf exports became subject to an export tax of 10% following the 2009-10 National Budget. While not a critical source of profit for BATBC, management notes that other neighboring countries to Bangladesh have not imposed any such export tax, which has put BATBC at a competitive disadvantage.

Most importantly, persistent hikes in supplementary duties for medium and high priced cigarettes have placed BATBC at a disadvantage to local manufacturers of low priced cigarettes and bidis. Investors have witnessed consumers down trade to brands outside BATBC's mid-tier Star brand, BATBC's largest brand by volume.

In spite of these headwinds, however, BATBC continues to grow its business in profitability and scale. BATBC discloses the company's total contribution to Bangladesh's exchequer annually, which includes payments of supplementary duty & VAT, customs duty, and income tax. From 2008 to 2012, these total contributions have compounded annually at 19%. Over the same period however, earnings per share have compounded at a 24% growth rate—suggesting that historically, the strength of BATBC's business continues to overcome tax headwinds.

Company disclosure further reveals that after netting duty and VAT

⁷ http://www.unnayan.org/reports/meu/october_meu_2013/MEU%20October%202013%20PDF.pdf

⁸ <http://www.tradingeconomics.com/bangladesh/foreign-exchange-reserves>

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expenses, net revenue per stick has grown by about 10% annually since 2009, making for steadily increasing profitability. Notably, these results have been achieved during a period in which BATBC suffered customer attrition to Star, its largest brand by volume. BATBC's success in introducing low and mid-end priced cigarettes in 2011 and 2012 while growing net revenue per stick lends confidence to management's ability to compete outside of the premium segment while maintaining pricing power and expanding profitability.

Illicit Cigarette Trade

In some developing countries, trade of illicit imports has undermined profitability for cigarette manufacturers. In Malaysia for instance, BAT estimates that the illegal cigarette trade comprises ~36% of the country's total cigarette consumption. In India, illicit cigarette trade comprises roughly 18% of industry volumes according to ITC, making it the 5th largest market in the world for illegal cigarettes. High taxes relative to affordability and weak enforcement both support illicit trade. To date, however, smuggling of cigarettes has made limited inroads in Bangladesh, partially due to the adoption of a tax stamp which is difficult to counterfeit and which allows for better tracking of tobacco products from the manufacturer to the retailer. According to a 2010 ERC Group report, tobacco smuggling rates in Bangladesh remains lower than in other neighboring countries. Still, shareholders in BATBC should be vigilant of increased illicit trade, particularly as VAT and supplementary duty tax rates inevitably increase over time.

Loss of Market Share

With an estimated 75% share in the premium segment, BATBC is likely to lose some of its dominance over time as other brands are introduced in the market. Marlboro's introduction to the market in 2010 has so far resulted in negligible traction (similar to Marlboro's track record in India), but investors should be vigilant of sustained share loss. However, BAT's brands have shown resilience in a number of mature markets, and with a deeply entrenched distribution system in Bangladesh, BATBC should be able to effectively compete and roll out new products. Management asserts that as of 2011 and 2012, the company was still gaining market share.

BATBC's business has shown remarkable resilience and should be able to effectively compete against new market entrants.

Health Risks

Paradoxically, increased concern over health risks of smoking and higher taxes could benefit BATBC shareholders. The most effective way to reduce consumption of tobacco in Bangladesh would involve introducing higher taxes for all forms of tobacco. Due to Bangladesh's ad valorem tax scale, BATBC's cigarettes are currently taxed at a dramatically higher rate when compared to bidis and lower priced cigarette brands (which currently represent approximately 60% of the cigarette market). BATBC already pays approximately 70% of gross sales in Duty & VAT taxes, which according to WHO is within the appropriate tax range that effectively discourages smoking. A flatter tax structure across the board for lower priced cigarettes and bidis would reduce the incentive for smoking in Bangladesh, while at the same time make BATBC's premium brands appear more affordable relative to mid-tier and low priced brands.

Pro forma Financials

Table 10. Balance sheet

BDT 000's	2011	2012	2013e	2014e	2015e	2016e	2017e
Non-Current Assets							
PPE	5,376,634	5,861,627	8,036,635	9,240,041	9,977,292	10,717,469	11,156,092
Current Assets							
Inventories	5,373,033	4,956,887	5,723,551	6,560,329	7,323,170	8,178,706	9,054,617
Trade & Receivables	973,825	937,873	1,175,433	1,367,031	1,561,502	1,784,132	2,019,990
Advance, deposit, & prepayment	590,164	1,007,539	1,007,539	1,007,539	1,007,539	1,007,539	1,007,539
Cash	837,393	2,270,567	1,032,557	599,361	826,347	1,503,925	2,438,938
Total Assets	13,151,049	15,034,493	16,975,714	18,774,301	20,695,851	23,191,771	25,677,176
Equity							
Share capital	600,000	600,000	600,000	600,000	600,000	600,000	600,000
Share reserve	64,896	64,896	64,896	64,896	64,896	64,896	64,896
Revenue reserve	5,246,404	6,368,044	7,749,242	8,989,976	10,402,965	12,328,528	14,229,993
Non-current liabilities							
Deferred liability (gratuity)	252,089	240,592	240,592	240,592	240,592	240,592	240,592
Deferred tax liability	669,079	723,643	723,643	723,643	723,643	723,643	723,643
Obligation under finance lease	17,876	7,541	7,540	7,540	7,540	7,540	7,540
Current liability							
Provision for expenses and taxes	1,838,021	2,188,035	2,188,035	2,188,035	2,188,035	2,188,035	2,188,035
Trade and other payables	3,467,716	3,245,676	3,815,700	4,373,553	4,882,114	5,452,471	6,036,412
Provision for corporate tax	977,943	1,585,731	1,585,731	1,585,731	1,585,731	1,585,731	1,585,731
Obligation under finance lease	17,025	10,335	335	335	335	335	335
Equity & Liabilities	13,151,049	15,034,493	16,975,714	18,774,301	20,695,851	23,191,771	25,677,176

Source: Company filings

Table 11. Income statement

BDT 000's	2011	2012	2013e	2014e	2015e	2016e	2017e
Gross Turnover	75,357,351	90,174,080	105,788,933	123,032,787	140,535,167	160,571,891	181,799,084
Duties & VAT	52,088,490	62,702,736	74,832,438	87,249,173	99,850,886	114,277,328	129,560,907
Net Turnover	23,268,861	27,471,344	30,956,495	35,783,614	40,684,280	46,294,563	52,238,177
COGS	13,455,535	15,946,224	17,170,652	19,680,988	21,969,511	24,536,118	27,163,852
Gross Profit	9,813,326	11,525,120	13,785,843	16,102,626	18,714,769	21,758,445	25,074,325
OPEX	4,567,237	4,612,418	4,405,005	5,009,706	5,695,799	6,018,293	6,790,963
Operating Profit	5,246,089	6,912,702	9,380,838	11,092,920	13,018,970	15,740,151	18,283,362
Other Income	36,868	50,820	84,108	84,108	84,108	84,108	84,108
Finance Expenses/Income	-110,687	-119,878	-100,000	-100,000	-100,000	-100,000	-100,000
Workers Profit Participation Fund	-258,614	-342,182	-355,695	-355,695	-355,695	-355,695	-355,695
PBT	4,913,656	6,501,462	9,009,251	10,721,333	12,647,383	15,368,564	17,911,775
Income Tax							
Current tax	2,211,975	2,505,258	3,828,932	4,556,567	5,375,138	6,531,640	7,612,504
Deferred tax	151,090	54,564	54,564	54,564	54,564	54,564	54,564
Tax	2,363,065	2,559,822	3,883,496	4,611,131	5,429,702	6,586,204	7,667,068
Profit for the year	2,550,591	3,941,640	5,125,756	6,110,203	7,217,681	8,782,361	10,244,707
EPS	42.51	65.69	85.43	101.84	120.29	146.37	170.75

Source: Company filings

Table 12. Cash flow

BDT 000's	2011	2012	2013e	2014e	2015e	2016e	2017e
Operations (Historical)							
Collection from distributors, leaf export, and others	74,950,453	90,283,106					
Payment for costs and expenses	-17,794,614	-21,590,921					
Supplementary duty and VAT paid	-52,099,969	-61,324,848					
Cash generated from operation	5,055,870	7,367,337					
Income tax paid	-1,880,970	-1,897,470					
Interest income (expense)	-110,687	-119,878					
Net	3,064,213	5,349,989					
Operations (Forecast)							
Net profit			5,125,756	6,110,203	7,217,681	8,782,361	10,244,707
Depreciation			800,816	921,962	984,298	1,084,664	1,173,321
Change in working capital							
Change in receivables			-237,560	-191,598	-194,471	-222,630	-235,858
Change in inventory			-766,664	-836,779	-762,841	-855,536	-875,911

Change in payables			570,024	557,852	508,561	570,357	583,941
Net cash from operations	3,064,213	5,349,989	5,492,373	6,561,640	7,753,227	9,359,216	10,890,199
Investing							
Acquisition of PPE	-707,823	-1,116,245	-2,975,825	-2,125,368	-1,721,548	-1,824,841	-1,611,943
Proceeds from sales of PPE	27,686	30,145	0	0	0	0	0
Financing							
Finance lease obligation	-17,085	-17,025	-10,000	0	0	0	0
Dividend paid	-2,873,451	-2,813,690	-3,744,558	-4,869,468	-5,804,693	-6,856,797	-8,343,242
Decrease/increase in cash	-506,460	1,433,174	-1,238,010	-433,196	226,986	677,577	935,014

Source: Company filings

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