MAT Kenya Case Study

Introduction

MAT Kenya is a Tobacco Manufacturing company that operates in East Africa. The company has been in operations for over 10 years. You are required to prepare a valuation model for the company as shareholders have received an offer from an international Tobacco company that is interested in purchasing a stake in MAT, they would like to explore their options.

Background on Region

Market

In Kenya approximately 19% of adult males and slightly less than 2% of women use tobacco; while the frequency rate for youths has gone up from 13%(10% girls and 16% boys) in 2001 to 15% (14.5% girls and 14.9% boys) in 2007 (GYTS). The per capita consumption of cigarettes in Kenya currently stands at 200.

A report produced by Euro monitor International in October 2014 displayed that the cigarette consumption rate in Kenya has continued to increase over the period. Taxes remained flat in 2014, with unit prices decreasing in constant value terms during the year.

The company has been expanding in the region and boasts of significant export revenues as can be seen in its financials.

Major Players in the region

1. Mastermind Tobacco (Kenya) (MTK)
2. Cut Tobacco
3. Alliance One – (Exporter) which has the lowest EV/EBITDA ratio of 6.83 in the Tobacco Industry

Overview of MAT in Kenya

Market Share

MAT controls 40% of the market share for finished tobacco products, other companies like Mastermind Tobacco (Kenya) share the rest.

Future Plans

MAT has projected to process 40.74% more tobacco leaves at its plants this year, 2014 compared to 2013.This follows the shutdown of its factories in Uganda and Congo effective this March 2014. The leaves from Uganda and DRC Congo will therefore be transported to the Kenya plant for processing.

In spite of a predicted decline in smoking prevalence over the forecast period, the absolute number of smokers in the region is expected to rise thanks to population growth. As a result, the outlook for tobacco volume sales is also positive.

Report of the independent auditor to the members of MAT Kenya Limited

Report on the consolidated financial statements

We have audited the accompanying consolidated financial statements of MAT Kenya Limited (the company) and its subsidiaries (together, the group), as set out on pages 38 to 67. These financial statements comprise the consolidated balance sheet at 31 December 2014 and the consolidated statement of comprehensive income, statement of changes in equity and the statement of cash flow for the year then ended, together with the balance sheet of the company standing alone as at 31 December 2014 and the statement of changes in equity of the company for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' responsibility for the financial statements

The directors are responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards and with the requirements of the Kenyan Companies Act. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

Our responsibility is to express an opinion on the financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform our audit to obtain reasonable assurance that the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Opinion

In our opinion the accompanying financial statements give a true and fair view of the state of the financial affairs of the group and of the company at 31 December 2014 and of the profit and cash flows of the group for the year then ended in accordance with International Financial Reporting Standards and the Kenyan Companies Act.

Report on other legal requirements

The Kenyan Companies Act requires that in carrying out our audit we consider and report to you on the following matters. We confirm that:

a) We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit;
b) In our opinion proper books of account have been kept by the company, so far as appears from our examination of those books;
c) The company's balance sheet is in agreement with the books of account.

Certified Public Accountants

1 March 2014

Nairobi

MAT LTD statement of comprehensive income

	Notes	Year ended 31 December 2014	2013
		Shs'000	Shs'000
Gross turnover		31,915,663	30,503,360
Excise duty and value added tax		(12,296,947)	(11,094,560)
Net Revenue	18	19,618,716	19,409,000
Cost of sales		(10,478,668)	(11,030,029)
Gross Profit		9,140,048	8,378,971
Other income		215,545	408,619
Gross Profit and Other Income		9,355,593	8,787,590
Marketing and distribution costs		(1,781,741)	(1,894,730)
Administrative and other operating expenses		(1,463,966)	(834,225)
Depreciation and Amortization of property, plant and equipment	5	(415,602)	(553,151)
Operating Profit		**5,732,231**	**5,523,620**
Finance costs	25	(262,276)	(304,350)
Profit before income tax		5,694,284	5,505,484
Income tax expense	13	(1,746,264)	(1,622,949)
Total comprehensive income for the year		3,685,745	3,578,185
Earnings per share			
Basic and diluted (Shs per share – 100,000 shares issued by company)		38	36
Dividends			
Interim dividend – paid in the year	20	350,000	350,000
Proposed Final dividend for the year		3,350,000	2,900,000
Total dividend paid out		3,700,000	3,250,000

InVhestia
FAST modelling, FAST decisions

MAT LTD Consolidated balance sheet

	Notes	At 31 December 2014 Shs'000	2013 Shs'000
Capital and reserves attributable to the company's equity holders			
Shareholder's funds		2,200,000	2,200,000
Retained earnings		2,021,608	1,997,917
Proposed dividend		3,350,000	2,900,000
Total equity		7,571,608	7,097,917
Non-current liabilities			
Borrowings	25	1,035,600	688,800
Deferred income tax liabilities	13	1,584,155	1,337,098
Total non-current liabilities		2,619,755	2,025,898
Total equity and non-current liabilities		10,191,363	9,123,815
Non-current assets			
Property, plant and equipment	19	8,454,193	5,568,001
		8,454,193	5,568,001
Current assets			
Inventories		4,482,067	4,393,589
Receivables and prepayments		3,838,060	2,541,925
Cash and cash equivalents	22	198,145	194,314
		8,518,272	7,129,828
Current liabilities			
Total Trade Payables		6,289,448	6,014,498
Borrowings	25	491,654	38,182
		6,781,102	6,052,680
Net current (liabilities)/assets		10,191,363	9,123,815
Total assets		16,972,465	15,176,495

InVhestia
FAST modelling, FAST decisions

Consolidated cash flow statement

	Notes	Year ended 31 December 2014 Shs'000	2013 Shs'000
Operating activities			
Cash generated from operations	26	4,858,093	6,506,016
Net Finance costs		(262,276)	(305,137)
Income tax paid		(1,746,264)	(1,622,949)
Net cash generated from operating activities		3,501,016	4,773,798
Investing activities			
Purchase of property, plant and equipment		(1,074,791)	(1,235,075)
Proceeds from disposal of property, plant and equipment		107,621	35,027
Net cash used in investing activities		(967,170)	(1,200,048)
Financing activities			
Dividends paid to the company's shareholders		(3,250,000)	(3,050,000)
Proceeds from Borrowing / (repayments)		1,115,807	(762,342)
Net Finance costs Actuals	25	(262,276)	(305,137)
Net cash used in financing activities		(2,396,469)	(4,117,479)
Net decrease in cash and cash equivalents		137,377	(543,729)
Movement in cash and cash equivalents			
At start of year		(430,886)	699,861
Increase / (Decrease)		137,377	(543,729)
At end of year	22	(293,509)	156,132

InVhestia
FAST modelling, FAST decisions

Notes

1. General Information

MAT Kenya Limited is incorporated in Kenya under the Companies Act as a public limited liability company, and is domiciled in Kenya.

2. Summary of Significant Accounting Policies

The principal accounting policies adopted in the preparation of these financial statements are set out below. These policies have been consistently applied to all years presented, unless otherwise stated.

3. Basis of Preparation

The financial statements are prepared in accordance with International Financial Reporting Standards (IFRS). The measurement basis applied is the historical cost basis, except where otherwise stated in the accounting policies below. The financial statements are presented in Kenya Shillings (Shs), rounded to the nearest thousand.

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires directors to exercise their judgment in the process of applying the group's accounting policies. The areas involving a higher degree of judgment or complexity, or where assumptions and estimates are significant to the financial statements, are disclosed in Note 3.

4. Revenue Recognition

Revenue comprises the fair value of the consideration received or receivable for the sale of goods and services in the ordinary course of the group's activities. Revenue is shown net of value added tax (VAT), returns, rebates and discounts and after eliminating sales within the group.

The group recognizes revenue when the amount of revenue can be reliably measured, it is probable that future economic benefits will flow to the group and when specific criteria have been met for each of the group's activities as described below. The amount of revenue is not considered to be reliably measurable until all contingencies relating to the sale have been resolved. The group bases its estimates on historical results, taking into consideration the type of customer, the type of transaction and the specifics of each arrangement.

Revenue is recognized as follows:

a. Sales of goods are recognized in the period in which the group delivers products to the customer, the customer has accepted the products and collectability of the related receivables is reasonably assured.
b. Sales of services are recognized in the period in which the services are rendered, by reference to completion of the specific transaction assessed on the basis of the actual service provided as a percentage of the total services to be provided.

Interest income is recognized using the effective interest method. Dividends are recognized as income in the period in which the right to receive payment is established.

5. Property, Plant and Equipment

All categories of property, plant and equipment are initially recorded at cost. Buildings and freehold land are subsequently shown at fair value, based on periodic, but at least once every five years, valuations by external independent values, less subsequent depreciation for buildings. All other property, plant and equipment are stated at historical cost less depreciation. Historical cost includes expenditure that is directly attributable to the acquisition of the items.

Subsequent costs are included in the asset's carrying amount or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the group and the cost of the item can be measured reliably. All other repairs and maintenance are charged to the statement of comprehensive income during the financial period in which they are incurred.

Increases in the carrying amount arising on revaluation are credited to a revaluation surplus reserve in equity. Decreases that offset previous increases of the same asset are charged against the revaluation surplus; all other decreases are charged to the statement of comprehensive income. Each year the difference between depreciation based on the revalued carrying amount of the asset (the depreciation charged to the statement of comprehensive income) and depreciation based on the asset's original cost is transferred from the revaluation surplus to retained earnings.

Freehold land is not depreciated. Depreciation on other assets is calculated using the straight line method to allocate their cost or revalued amounts less their residual values over their estimated useful lives, as follows:

Buildings: 2.5% - 10% per annum or over the period of the lease if less than 40 years.
Plant and machinery: 7% per annum
Vehicles and equipment: 10% to 25% per annum

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

The carrying amount of the group's non-current assets is written down immediately to its estimated recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount. Gains and losses on disposal of property, plant and equipment are determined by comparing proceeds with their carrying amount and are included in the statement of comprehensive income. On disposal of revalued assets, amounts in the revaluation surplus relating to that asset are transferred to retained earnings.

6. Intangible Assets

Computer software

Acquired computer software licenses are capitalized on the basis of the costs incurred to acquire and bring to use the specific software. These costs are amortized over their estimated useful lives (three to five years).

Costs associated with developing or maintaining computer software programs are recognized as an expense as incurred. Costs that are directly associated with the production of identifiable and unique software products controlled by the group, and that will probably generate economic benefits exceeding costs beyond one year, are recognized as intangible assets. Direct costs include the software development employee costs and an appropriate portion of relevant overheads. Computer software development costs recognized as assets are amortized over their estimated useful lives (four years).

7. Accounting for Leases

Leases of property, plant and equipment where the group assumes substantially all the risks and rewards of ownership are classified as finance leases.

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases are charged to the statement of comprehensive income on a straight-line basis over the period of the lease.

8. Inventories

Inventories are stated at the lower of cost and net realizable value. Cost is determined by the weighted average method. The cost of finished goods and work in progress comprises raw materials, direct labor, other direct costs and related production overheads (based on normal operating capacity), but excludes borrowing costs. Net realizable value is the estimated selling price in the ordinary course of business, less the costs of completion and applicable variable selling expenses.

9. Receivables

Receivables are recognized initially at fair value and subsequently measured at amortized cost using the effective interest method less provision for impairment. A provision for impairment of receivables is established when there is objective evidence that the group will not be able to collect all the amounts due according to the original terms of receivables. The amount of the provision is the difference between the carrying amount and the present value of estimated future cash flows, discounted at the effective interest rate. The amount of the provision is recognized in the statement of comprehensive income.

10. Payables

Payables are recognized initially at fair value and subsequently measured at amortized cost using the effective interest method.

11. Share Capital

Ordinary shares are classified as 'share capital' in equity. Any premium received over and above the par value of the shares is classified as 'share premium' in equity.

12. Cash and Cash Equivalents

Cash and cash equivalents includes cash in hand, deposits held at call with banks, other short term highly liquid investments with original maturities of three months or less, and bank overdrafts. Bank overdrafts are shown within borrowings in current liabilities on the balance sheet.

13. Income Tax

Income tax expense is the aggregate of the charge to the statement of comprehensive income in respect of current income tax and deferred income tax. Tax is recognized in the statement of comprehensive income unless it relates to items recognized directly in equity, in which case it is also recognized directly in equity.
Current income tax is the amount of income tax payable on the taxable profit for the year determined in accordance with the relevant tax legislation.

Deferred income tax is recognized, using the liability method, on all temporary differences arising between the tax bases of assets and liabilities and their carrying values for financial reporting purposes. However, if the deferred income tax is not accounted for if it arises from the initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects either accounting taxable profit or loss. Deferred income tax is determined using tax rates and laws that have been enacted or substantively enacted at the balance sheet date and are expected to apply when the related deferred income tax liability is settled or deferred income tax asset is realized.

Deferred income tax assets are recognized only to the extent that it is probable that future taxable profits will be available against which the temporary differences can be utilized.

Deferred income tax is provided on temporary differences arising on investments in subsidiaries and associates, except where the timing of the reversal of the temporary difference is controlled by the group and it is probable that the temporary difference will not reverse in the foreseeable future.

14. Borrowings

Fees paid on the establishment of loan facilities are recognized as transaction costs of the loan to the extent that it is probable that some or all of the facility will be drawn down. In this case, the fee is deferred until the draw-down occurs. To the extent that it is probable that some or all of the facility will be drawn down, the fee is capitalized as a pre-payment for liquidity services and amortized over the period of the facility to which it relates.

Borrowings are classified as current liabilities unless the group has an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.

15. Dividends Distribution

Dividends payable to the company's shareholders are recognized as a liability in the financial statements in the period in which dividends are approved by the Company's shareholders. Proposed dividends are shown as a separate component of equity until declared.

16. Provisions

Provisions are recognized when the Group and the Company have a present legal or constructive obligation as a result of past events; it is probable that an outflow of resources will be required to settle the obligation and the amount has been reliably estimated.
Provisions are not for future operating losses.

Provisions are measured at the present value of the expenditures expected to be required to settle the obligation using a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the obligation. The increase in the provision due to passage of time is recognized as interest expense.

17. Financial Risk Management

The group's activities expose it to a variety of financial risks, including credit risk and the effects of changes in foreign currency exchange rates and interest rates. The group's overall risk management programme focuses on the unpredictability of financial markets and seeks to minimize potential adverse effects on its financial performance.

Risk management is carried out by the treasury and tax committee under policies approved by the Board of Directors. The committee identifies and evaluates financial risks where applicable. The Board provides written principles for overall risk management, as well as written policies covering specific areas such as foreign exchange risk, interest rate risk, credit risk, use of derivative and non-derivative financial instruments and investing excess liquidity.

18. Segment Information

The group operates in one business segment - manufacture and sale of cigarettes and tobacco and one geographic segment based on the location of the manufacturing site in Kenya; hence no segmental information is presented.

The group's revenues by destination are as follows:

	2014	2013
	Shs '000	Shs '000
Local sales	10,914,303	9,630,357
Exports	8,704,413	9,778,643
	19,618,716	19,409,000

19. Property, Plant and Equipment- Group

Closing balances for PPE were as follows:

Closing balance as at 31st Dec 2014		Buildings and freehold land	Plant and machinery	Total
		Shs'000	Shs'000	Shs'000
Net book value		3,047,148	5,407,045	8,454,193
Depreciation rate		2.50%	11.00%	
Capex Plans				
Year 2015			1,000,000	1,000,000
Year 2016			500,000	500,000
Year 2017			500,000	500,000
Year 2018		2,000,000	500,000	2,500,000
		2,000,000	2,500,000	4,500,000

20. Dividends

Dividends payable to the company's shareholders are recognized as a liability in the financial statements in the period in which dividends are approved by the Company's shareholders. Proposed dividends are shown as a separate component of equity until declared. The company pays its interim dividends for the year together with the final dividends for the prior year once approved by the AGM.

21. Receivables and Prepayments

	Group	
	2014	2013
	Shs'000	Shs'000
Trade receivables	34,884	102,074
Less: Provision for impairment losses	(1,320)	(22,582)
	33,564	79,492
Prepayments and other receivables	523,348	529,876
Due from related parties	969,544	1,125,364
	1,526,456	1,734,732

Movements on the provision for impairment of trade receivables are as follows:

	Group	
	2014	2013
	Shs'000	Shs'000
At start of year	(22,582)	(6,842)
Provision in the year	-	(15,740)
Utilized in the year	21,262	-
At end of year	(1,320)	(22,582)

The fair values of the current receivables are as follows:

	Group	
	2014	2013
	Shs'000	Shs'000
Trade receivables	33,564	79,492
Due from related parties	969,544	1,125,364
Prepayments and other receivables	523,348	529,876
	1,526,456	1,734,732

22. Cash and Cash Equivalents

	Group	
	2014	2013
	Shs'000	Shs'000
Cash at bank and in hand	**198,145**	**194,314**

For the purposes of the consolidated cash flow statement, cash and cash equivalents comprise the following:

	2014
	Shs'000
Cash at bank and in hand	**198,145**
Bank overdrafts (Note 25)	**(491,654)**
	(293,509)

25. Borrowings

	Group	
	2014	2013
	Shs'000	Shs'000
The borrowings are made up as follows:		
Non-current		
Loan from MAT Investments	1,035,600	688,800

InVhestia
FAST modelling, FAST decisions

Current		
Bank overdrafts	491,654	38,182
	1,527,254	726,982

The loan from MAT Investments is Kenya Shilling loan repayable by December 2016 at an interest rate 15% per annum.

None of the borrowings was in default at any time during the year.

The group has the following undrawn borrowing facilities:

	2014 Shs'000	2013 Shs'000
Overdraft facilities	3,269,038	3,160,358
Bond guarantees	1,366,730	1,751,614
	4,635,768	4,911,972

The facilities expire within one year and are subject to review at various dates during the year. Bond guarantees are issued to cover import duty, VAT and excise payable for all imported goods that are utilized to manufacture cigarettes for the export market.

26. Cash Generated From Operations

Reconciliation of consolidated profit before income tax to cash generated from operations:

	2014 Shs'000	2013 Shs'000
Profit before income tax	5,469,955	4,754,302
Adjustments for:		
Net Finance costs	262,276	304,350
Depreciation and Amortization of property, plant and equipment	415,602	553,151
Loss on sale of property, plant and equipment	(37,947)	(18,166)
Changes in working capital		
− receivables and prepayments	(1,444,403)	(378,298)
− inventories	(88,478)	(18,812)
− payables and accrued expenses	281,088	844,491
Cash generated from operations	4,858,093	6,041,018