

Analysis



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Eastern Company (EC)

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Rating Table:

Category	Current Rating	Previous Rating
Entity Rating: Senior Unsecured	AA	AA
Rating Outlook	Stable	Stable

Operating Statistics:

Figures in EGP mn	FY04/05	FY05/06	FY06/07	FY07/08
ROA (%)	12.9%	13.1%	16.2%	13.3%
ROE (%)	32.3%	31.6%	35.9%	28.2%
Operating Margin (%)	23.55%	22.60%	28.15%	26.89%
EBITDA (in EGP mn)	881.8	872.8	1,114.9	1,110.3
EBITDA Margin (%)	23.9%	24.8%	30.6%	29.1%

Balance Sheet Statistics:

Turnover	FY04/05	FY05/06	FY06/07	FY07/08
Total Assets	3,514.6	3,885.4	4,293.7	5,693.6
Debt/EBITDA (x)	0.0	0.0	0.0	0.5
EBITDA/Interest Ex. (x)	21.6	42.0	275.9	33.6

Opportunities/Strengths

- EC monopoly position in the domestic market.
- Protected market by governmental restrictions over importing cigarettes.
- High profitability margins that improved significantly last year.
- Successful joint production agreement with the world's largest two cigarette manufacturers (Philip Morris & British American Tobacco) places EC at a higher rank internationally.
- On-going investment plan includes the implementation of new technology that would enable EC to realize cost efficiencies and maximize productivity
- Robust coverage ratios and sustainable financial flexibility.
- Hidden reserves of over EGP one billion in the lands that will be left behind after moving plants.

Risks/Weaknesses

- Increasing prices of imported raw materials might negatively affect margins.
- Continued high regulatory risk of anti-smoking legislation and its enforcement.
- Speculation regarding the privatization of the company might affect the overall strategy.
- Foreign currency risk exposure.

This Analysis provides a discussion of the factors underpinning the credit rating

Eastern Company (EC)**CORPORATE PROFILE**

Eastern Company (EC), which was established in 1920, continues to dominate the domestic cigarette industry in Egypt, being the country's largest manufacturer and distributor of tobacco products with total annual production 78.7 billion cigarettes representing over 1% of the international cigarette market. Its product range includes cigarettes, water pipe tobacco, cigars and minced tobacco.

The Egyptian Government continues to hold the majority of EC's shares through its Holding Company for Chemical Industries (52.8%) and exercises control over the company as a result. The majority of the remaining shares (47.2%) are free floating shares.

Management Strategy**A New Chairman and CEO for the company**

The management structure of the company has been stable for many years now as all of its senior management has vast experience in the tobacco business.

Heads of sectors meet almost on a daily/weekly basis to discuss progress in all business affairs. The Board of Directors (BoD) comprises five members including the Chairman and CEO; three nominees of the main sponsor, and two representatives of the employees. Recently, Eng. Nabil Abdel Aziz Abdel Meguid was appointed as the new Chairman and CEO, assuming office in April 2008 following the passing of Eng. Mohamed Sadek Ragab.

Eng. Nabil has vast experience in the tobacco industry for over 30 years, which allows him to provide technical assistance where and when required. Before, he was the Head of Purchasing & Warehouses Sectors.

Going forward towards moving its plants

EC has 21 plants in 7 different locations in Egypt with over 12,100 employees; the company is in the process of relocating its plants in Giza & Talibeya facilities, and its warehouses at Zomor and Manesterly to 6th of October industrial complex. In the meantime, Moharem Bek and el Rassafa plants in Alexandria will be relocated to a new region "Borg El Arab" in Alex. The current utilized capacity of EC's plants is 90% with one daily shift for 7 hours

The new integrated industrial complex is expected to improve operational efficiency by cutting production costs and increasing export sales of some types of raw tobacco. Relocation will be implemented through three phases and was originally expected to be complete by 2010. So far, the company is working in line with the original schedule.

The overall cost of the relocation is estimated to be EGP 3,200 million. So far, EC has financed the project internally and through financial leasing contracts with a percentage of completion around 70%; however, the remaining balances which are estimated to be around EGP 1.7 billion will be financed externally through EGP one billion 8-year leasing contracts with 3 years grace period, and the remaining amount will be financed through a medium term syndicated loan. The terms and conditions of the latter are not clear yet. It is worth mentioning that the lease obligation will be off balance sheet liability, accordingly will not affect EC's leverage position scientifically.

On the other hand, the company intends to invest in its resources of lands that will be left behind. Those assets could bring to the company sums of more than EGP 1 billion which will be another source of income to the company. EC is consulting one of the local banks on the best possible way on how to invest in these assets.

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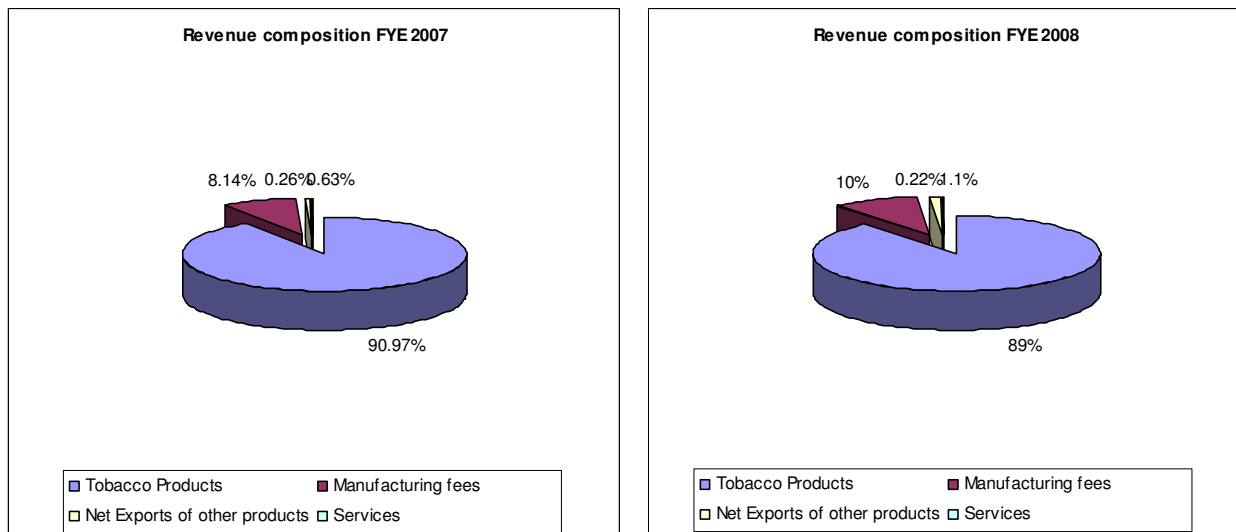
Key Rating Considerations

BUSINESS RISK FACTORS

Factor 1: Scale & diversification

With total revenue (net of excise taxes) of EGP 3.8 billion generated through EC's wide product mix including cigarettes, cigars, pipe tobacco and water-pipe tobacco, in addition to the manufacturing fees of international brands manufactured locally. EC also undertakes the production of related products such as filter rods, molasses, paper packets, printed materials and spare parts.

It is worth noting that cigarette sales contributed more than 97% of EC's total local sales for FY07/08 (local sales contributed 89% of total revenues in FY07/08 after deducting sales returns, taxes, and insurance).



Cigarettes:

EC's total production of all cigarettes (including that of domestic, export, and foreign) amounted to 78.7 billion cigarettes in FY2007/2008 compared to 75.5 billion cigarettes in FY2006/2007.

Figure1: Operational Highlights

	Unit	Sales			
		2004/2005	2005/2006	2006/2007	2007/2008
Local cigarette	Billion	61.7	63.6	63.9	65.1
Export cigarette	Billion	0.6	0.6	0.6	0.6
foreign cigarette produced locally	Billion	6.0	7.6	9.6	12.9
Total cigarette production	Billion	68.9	70.6	75.5	78.6

EC is estimated to dominate 80% of the Egyptian cigarette market through its local cigarette brands, producing 65.8 billion cigarettes. The remaining 18% were catered through EC's toll-manufacturing for

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the two foreign producers Philip Morris and British American Tobacco (BAT) with 12.9 billion cigarettes, and 2% through imported brands & smuggled cigarettes.

In FY 2007/2008, EC sold 65.1 billion cigarettes in the Egyptian market compared to 64.6 billion cigarettes in FY2006/2007.

International Brands Manufactured Locally:

EC has signed manufacturing agreements with two of the largest global cigarette producers: Philip Morris and British American Tobacco (BAT) with a proven track record over 6 years. According to these agreements, running until 2013, both foreign companies are responsible for the procurement of raw tobacco, pricing, distribution and marketing of their foreign cigarettes in Egypt. Production takes place at EC's existing facilities for a fee of around \$5.25 on average per 1000 cigarettes. Fees were paid previously in Egyptian pound (EGP) equivalent at the prevailing rate at the time of payment. Starting 2006, however, these fees started to be collected in US Dollars, which minimizes EC's risk of exposure to foreign currency. These brands target the upper income segment having a market share of 9% and are offered with relatively much higher prices than those of EC's brands which target medium and upper income segments; hence, they do not represent a threat to EC's brands competitiveness.

EC produces 13 cigarette brands on behalf/under license of the biggest 2 International tobacco companies at its plants with a mix of premium and mid price brands. The company charged fees of EGP 375.8 million in FY07/08 compared to EGP 296.3 million in FY06/07 (a 27% increase) for such service.

Going forward, Philip Morris controls about 88% of foreign cigarettes in the Egyptian market while BAT accounts for the remaining balance.

Other Products:

The only other relatively significant product that contributes to EC's sales is water-pipe tobacco. In terms of sales, water-pipe tobacco contributes less than 3% out of total sales. The company is losing its market share in water-pipe tobacco in favor of the other local producers year after year as a result of flexibility of those competitors in marketing and distributing their products directly to the end users, while EC sells its water-pipe products through agents.

The production of cigars, pipe tobacco and the like is negligible. On the other hand, tobacco products exports – which were about 1.7% of total sales in FY07/08 – decreased slightly compared to the previous financial year due to competition (EGP 57 mn FY07/08 vs. EGP 59 mn in FY06/07). Export sales mainly target African countries. Going forward, the management is undertaking initiatives to penetrate the Russian market with its cigarette brands.

In light of the latest governmental anti-tobacco regulations, EC is undertaking an initiative for 2 years to introduce smokeless tobacco(s) to offset any expected future declines in consumption of its traditional product.

The company has around 120 sales outlets and warehouses under EC management, which represent nearly 30% of its distribution channels, out of which 10% are owned and 90% are rented.

In fact, EC's distribution network extends to 400 sales outlets, 71% of which represent the channels of its wholesale or retail clients and their transportation means.

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Factor 2: Franchise strength and growth potential

The cigarette market is divided into three categories: economy, middle and premium brands. EC owns a wide range of brands that cater for the middle and lower end of the market.

EC has a solid market share that is estimated to be 80% of the Egyptian cigarette market through its local cigarette brands with a portfolio of 14 brands of cigarettes in which 60% of the sales volume is in one brand (Golden king) targeting the lower end of the market. The company's discount cigarette brands represent a much bigger percentage of EC's volume.

EC has four price categories for its 14 brands ranging from EGP 2.75 to EGP 4.25.

Egypt market is one of a few remaining markets in which volume sales of cigarettes are still set to rise as a result of growing smoking rates and the general acceptance of the habit in the country, driven by the increase in the youthful population (around 40% of the country is under the age of 15) and GDP growth.

The local industry is highly protected from both foreign manufacturers setting up their own factories in Egypt, as well as imports. Imports are around 2% of the total cigarette market, and are restricted by high ad-valorem tax (85%). In turn, imported brands are only affordable to a very small percentage of customers. For sometime now, foreign manufacturers have been unsuccessful at attaining permission from the Egyptian government to set up independent production facilities. At the moment, the likelihood of the government granting such permission seems remote, especially since EC continues to operate as a public business sector entity.

MERIS believes that the above mentioned factors will ensure the long-term growth of cigarette sales for the company.

Advertising: new local brand

As a result of government restrictions imposed on the use of media for tobacco advertising, EC couldn't reach its consumers with a new cigarette brand under the name of "Matinee" that was launched in December 2006, and which was supposed to compete in the middle income segment.

This third factor could also protect the company's products in case of liberalization of the tobacco market in Egypt.

Factor 3: Profitability

Egyptian government launched a campaign of tobacco's dangers

Earlier this year, Eastern Company voluntarily put pictures of diseased lungs on some of its packs, while the foreign brands manufacturing locally did not put the same picture; this action by EC left people confused about what was being shown and smokers in Egypt thought that those packs were the ones that were harmful and switched to others. This caused the locally manufactured foreign brands' volume to increase from 9.6 billion cigarettes in FY06/07 to 12.9 billion in FY07/08 (34% increase) which generated EGP 375.8 million to EC as fees from the manufacturing agreement.

Going forward, effective as of August 1, 2008 and according to law number 154/2007 and the Ministry of Health's anti-smoking regulations, cigarette packs of all brands manufactured in Egypt will feature graphic health warnings beside a photograph, informing smokers of the health hazards of smoking. However, the

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Egyptian die-hard smokers started to find ways to hide these health warnings by neat looking covers put over cigarette packs or by putting cigarettes in other empty packs that do not carry any health warnings. After the announcement by ministry of health of the new design and before EC introduced the new pack to the market, many vendors hoarding a large inventory of old packs sold them at significantly higher prices. This action increased the sales in July to 6.4 billion cigarettes compared to 5 billion cigarettes in June, and dropped the volume in August to 3.9 billion cigarettes.

In May 2008, the Egyptian People's Assembly imposed additional sales taxes over tobacco products including local and foreign branded cigarettes, increasing the prices of local brands by an average of 11% and foreign brands by an average of 22% or EGP 1.50/pack; but due to the flexibility of pricing of the biggest 2 International tobacco companies in Egypt, they increased only EGP 0.5/pack and bore EGP 1.00 for each pack sold from their profit margin. The two international companies became concerned that a shift might occur in the consumption towards lower priced local brands, which remain significantly cheaper than their foreign brands.

EC raises some cigarettes prices:

Recently EC announced a further 10% increase or EGP 0.25/pack in the retail price of 8 local cigarettes brands, effective September 1st. According to the management of the company, the decision to raise the prices of most local cigarette brands was due to an increase in the prices of raw materials by 20-40%, with 90% of the local industry depending on imported materials. This was mainly due to higher global tobacco leaf prices caused by supply shortages and the European Union's decision to eliminate subsidies to European tobacco growers and the restriction by EU towards exporting tobacco raw materials. EC now has a full control over the pricing of its brands and thus, to liberalize the prices, prices of locally produced cigarettes are not expected to stay the same in the near future according to the company's management.

According to the management of the company and after all that the tobacco industry in Egypt had been through, the volume of cigarettes sold did not change as expected due to the addictive nature of tobacco. Moreover, EC's products remain affordable.

Source of Income to the Government:

EC holds a very significant position in the economy as it operates 21 factories in 7 locations throughout Egypt, employs over 12,000 members of staff, and has provided the public treasury with more than EGP 5.1 billion in tax collections, government fees, and dividends paid to the holding company in FY07/08, averaging EGP 20 million per working-day plus EGP 1.1 billion as sales tax over the international brands manufactured locally. The government is protecting the market by not allowing the establishment of manufacturing facilities to produce cigarettes by foreign companies and imposing high duty on imports of cigarettes.

High exchange rate exposure:

EC relies on 100% imports of tobacco and 80% of other relevant raw materials in its manufacturing process. In this respect, foreign exposure constitutes a critical risk factor in the company's production process. EC has taken a number of measures trying to mitigate and combat foreign exchange risks.

1. In an effort to reduce its foreign currency requirements and cost of production, and enhance its revenues; starting 2006, EC has been charging its manufacturing fees for international brands produced in its own plants in USD instead of EGP.
2. EC usually keeps a large stock of tobacco to hedge against foreign exchange movements (local currency depreciation) and possible shortage in supply. The company maintains a strategic stock that ranges up to Three years according to government laws.
3. In 1999, EC introduced the puffing technology into its operations at the Giza facility to realize larger extraction of raw tobacco and reduce the quantity of raw tobacco used per cigarette, which

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has resulted in around 3% cost savings so far. This technology changes the mix of tobacco roots to leaves in a way to increase the production per weight of tobacco and reduce cost of imports; thus realizing around a minimum of 8% cost savings that is expected to be achieved within two to three years once EC moves to 6th of October City where there will be more room.

FINANCIAL RISK FACTORS

Accounting Quality

The Central Department/Bureau of Accountancy – a governmental body responsible for the audit of public business sector companies – audited the financial statements of EC, which are prepared in accordance with the Governmental Unified Accounting Standards (GUAS). However, starting from FY03, the company complies with the Egyptian Accounting Standards, which are not materially different from International Accounting Standards (IAS). The statements of cash flows were prepared on a direct method.

Earnings and Profitability

(FY June 30th)			
Figures in EGP mn	FY2005/2006	FY2006/2007	FY2007/2008
Net sales (in EGP mn)	3,513.5	3,641.2	3,818.9
Growth	3.3%	3.6%	4.8%
EBITDA	872.8	1,115.0	1,110.3
EBITDA Margin (%)	24.8%	30.6%	29.1%
EBIT	727.3	954.5	950.0
EBIT Margin	20.7%	26.2%	24.9%
Interest Expense	-17.30	-3.46	-28.23
Interest Income	5.87	23.19	12.62
Net Income	508.08	695.88	751.33
Net Income margin	14.5%	19.1%	19.7%
ROS	14.5%	19.1%	19.66%
ROA	13.1%	16.2%	13.3%

EC sales have been showing an upward trend over the past few years. Sales of cigarettes and tobacco products constituted over 90% of net revenues in FY2008. In manufacturing of foreign brands, EC realized EGP 375.8 mn in FY07/08 (EGP 296.3 mn in FY06/07) which constitutes a 27% increase.

EC cigarettes sales in quantity increased from 75.5 billion cigarettes in FY06/07 to 78.7 billion cigarettes in FY07/08.

On the export front, EC's exports decreased from EGP 59 mn in FY06/07 to EGP 57 mn in FY07/08 boosted by a decrease in the sales of water-pipe tobacco, mainly due to competition.

Revenue increased 4.8% to EGP 3.8 billion, and EBITDA almost stabilized at EGP 1.2 billion. The EBITDA margin dropped slightly to 29.1% from 30.6% in FY 06/07, mainly due to increase in wages and salaries by 22%. Although global raw tobacco prices have increased, nonetheless this hardly affected EC's margin, in light of the fact that EC relies on its huge stock of inventory. Moreover, despite the fact that **MERIS** had anticipated EC's margin to be affected, nevertheless, the expansion and the new technology that will be used in the new location will mitigate this risk.

The aggressive cut in provision expenses to only EGP 2.5 million in FY07/08 from EGP 125.5 million in the previous year was more than sufficient to boost net reported profit to EGP 751.3 million.

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Cash Flow & Coverages

(FY June 30th)			
Figures in EGP mn	FY05/06	FY06/07	FY07/08
EBITDA	872.8	1,115.0	1,110.3
Working Capital	-161.45	-160.43	-673.64
Tax	-116.25	-175.20	-155.56
Interest	-17.30	-3.46	-28.23
CAPEX	-474.93	-476.18	-1361.33
Dividends Paid	-299.98	-350.67	-400.87
NFCF	-197.10	-51.04	-1,509.08
Retained Cash Flow	713.13	504.12	793.79
RCF/CAPEX	1.5	1.1	0.6
Dividend Payout Ratio	59%	50%	53%

Although EBITDA figures have improved over the last three years, the company's cash generating ability was hampered by the excessive cash outflow associated with the new complex capex requirement and working capital needs. **MERIS** believes that the company's cash generating ability will be tight over the coming two years, and will be relatively relieved thereafter, backed by the improvement in the cash flow from operations and profitability margins.

In certain circumstances, EC relies on its outstanding tax and customs duties' obligations – payment of which is made over 60 days – allowing the company to partially meet its negative working capital.

Dividend Policy:

Historically, EC maintains an aggressive distribution policy, a trend which is anticipated to continue in the future. It is worth mentioning that EC has distributed cash/dividends of EGP 350 million (equivalent to EGP 14.0 per share), up from EGP 300 million (EGP 12.0 per share) in FY 06/07. **MERIS** views the distribution policy adversely, especially at a time of expansion mode, which necessitates significant cash injection.

Capital Expenditure (CAPEX):

As highlighted earlier, the company is in an expansion mode, which necessitates huge capex requirements to finalize the new plant facility. The total investment plan is equivalent to EGP 3.2 billion to be expensed over 5 years ending 2010, 70% of which was financed as of today. The investment scheme was financed mainly through a mix of internal and external resources (bank loans and off balance sheet obligation through leases).

For the remaining capex needs the company will depend mainly on external financing. As such, EC is planning to undertake new loans/leases obligations amounting to EGP 1.7 billion. The latter obligation will be financed through: EGP 1.005 billion as leasing contracts and EGP 672 million through syndicated loan (refer to the next section). Despite the fact that the abovementioned financial obligation is anticipated to affect notably the company's coverage ratios, **MERIS** believes that the new facility, along with the enhanced technology which will be applied, will reflect positively on EC's operating efficiency and margins.

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Financial Leverage

(FY June 30th)			
Figures in EGP mn	FY05/06	FY06/07	FY07/08
Short-term Debt	0	0	538.35
Long-term Debt	0	0	0
Total Bank Debt	0	0	538.35
Cash and Cash Equivalent	-421.86	-379.73	-224.13
Net Financial Debt	-421.86	-379.73	314.22
RCF/Net Debt	-1.7	-1.3	2.5
FCF/Debt	-0.6	-0.1	-1.8
DEBT / EQUITY %	0	0	23.9
Net Debt/EBITDA	-0.5	-0.3	0.3
EBIT/Gross interest expense (x)	42.0	275.9	33.6

Historically, EC was considered as an under-leveraged entity, however, in the last year the company undertook bank loans – overdraft – to finance its expansion plan which was reflected as a drop in its leverage position as measured by debt to equity (FY07/08: 20.2%, compared to FY06/07: 0%) and net debt to EBITDA (FY07/08: 0.3%, compared to FY06/07: -0.3%). In terms of EBIT to interest expenses, the ratio dropped significantly to 33.6x in FY07/08 compared to 275.9x in FY06/07, due to the increase in interest expense – increased to EGP 28.2 million compared to EGP 3.4 million a year ago – as a result of the new debt represented as (overdraft) with the amount of 538.4mn .

Going forward, this trend will continue in the medium to long term horizon, in light of the new debts which management is currently negotiating. The new debt structure will bear an eight year leasing contract amounting to EGP one billion, which will be classified according to Egyptian standards as an off-balance obligation. This is in addition to EGP 672mn through syndicated loan granted from local banks; the terms and conditions of this loan are not clear yet. In light of the fact that this financing mix will be a combination of on-balance sheet and off balance sheet obligations, **MERIS** believes that the company's leverage position will show some changes; however, it will still be maintained within the AA rating grade.

In terms of coverage ratios, the effect will be more severe; though the anticipated improvement in the company's margins is projected to relieve this pressure to a certain extent. On a proforma basis, **MERIS** stressed the company's future position through considering all the coming finance as an on-balance sheet obligation, the outcome was debt to EBITDA and EBIT to interest expenses ratio at 1.3X and 6.3X

On the other hand, **MERIS** noted a mismatch in the financing tenor between short and long term liabilities; as management financed its long term capital expenditures – the new complex – by EGP 497 million through a short term facility. Management attributed this to its strong daily cash collection, which from their point of view, does not urge acquiring long term facilities, which will engage/constrain the company in a tight repayment schedule. **MERIS** assesses this mismatch practice unfavorably.

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