June 4, 2020

Eastern Company S.A.E (EAST)

Business Description: Eastern Company S.A.E. (EAST) manufactures and trades in tobacco products in Egypt. The company offers cigarettes, cigars, and water pipe tobacco products, as well as smoke and moassel products. It also exports its products primarily to the Arab, African, and European countries, as well as Malaysia, Japan, Thailand, the United States, and Canada. The company was founded in 1920 and is based in Giza, Egypt. - *TIKR.com*

Thesis: EAST has 72% market share in the Egyptian tobacco industry. The company generates 40% gross margins, 35% operating margins and 32% FCF margins. They have $345M in net cash on the balance sheet and pay an 8% dividend. Tobacco use is woven into Egyptian culture and grows around 3%/year. There's also a manufacturing business (where it produces international tobacco products for other companies) that's growing at a 30% 3YR CAGR.

A Durable, Growing Monopoly: EAST controls the entire tobacco industry in Egypt. I'm not joking. The country smokes around 85 billion cigarette sticks annually. EAST produces every single one of those products. Smoking is part of Egyptian culture. 50% of Egyptian men smoke, and the number of women smokers rises every year. Given the cultural norms and its prevalence in society, we see no reason EAST can't grow ~3%/year for the next five years.

Contract Manufacturing: Making Up For The 28% Market Share EAST Doesn't Have

In one way or another, EAST controls 100% of the Egyptian tobacco market. They produce 72% of the tobacco products in Egypt. The other 28% come from companies like Philip Morris, British American Tobacco, Imperial Tobacco and Japan Tobacco.

These international competitors all use EAST's manufacturing facilities within Egypt to produce their tobacco products. In other words, if you want to sell tobacco products in Egypt, you have to pay the "toll", which is EAST. It's a capital-light, highly profitable and rapidly growing business. This segment generated $144M in revenue in 2019 (17% of total revenue).

Risks:

- Egyptian government dumps large % of holdings driving down share price in short term
- EAST loses key contract manufacturing licenses with PM (up for renewal in 2021)
- Government tax hikes reduce EAST margins

Valuation:

Our **base case** is zero top-line growth, gross margin compression to 26% and 21% FCF margins. That gets us $107M in 2024 FCF and around ~$1/share (24% upside).

Our **optimistic case** is 3% annual growth and gross margins expanding to 42% on higher contract manufacturing sales. This gets us $240M in FCF and ~$1.76/share (120% upside).