INTUITION

29 JULY 2022

BAT: rising from the ash

For years, British American Tobacco (BAT) formed a core of every portfolio, given its reliable profit growth and steadily rising dividend payments. It ticked all the boxes, and more. But in 2017, it fell into the same trap as many other global giants – the pursuit of size at all costs. It bought the remaining 60% of Reynolds American that it did not already own, to claim the title of the world's largest tobacco firm, using debt raised at ultra-low interest rates. Like AB-Inbev after its acquisition of SABMiller, it has suffered from chronic indigestion. Fortunately, the Gaviscon has kicked in. BAT shareholders should be more comfortable and sleep easier going forward. Let me explain why.

Michael Porter

After a quick glance at the chart below, you can easily understand why BAT was a core holding for local asset managers in the period from 2010 to 2017. Even though cigarette volumes were declining by a few percentage points a year, the share price rose steadily with little volatility, fueled by the predictability of its profit and dividend growth. That all changed in 2017 when BAT undertook its largest acquisition to date – the remaining 60% of Reynolds American that it did not already own. That catapulted the firm to the largest tobacco company in the world, and increased exposure to the US – the largest nicotine market globally outside of China. (Tobacco is controlled by the State in China, and hence that market is closed to foreign competition. It is therefore excluded from all analysis.)

BAT SHARE PRICE IN RANDS

For years BAT delivered consistent returns, making it a favourite amongst local fund managers. That changed in 2017 after the Reynolds American acquisition. The share price halved and has consolidated ever since. But now there are signs of new life.

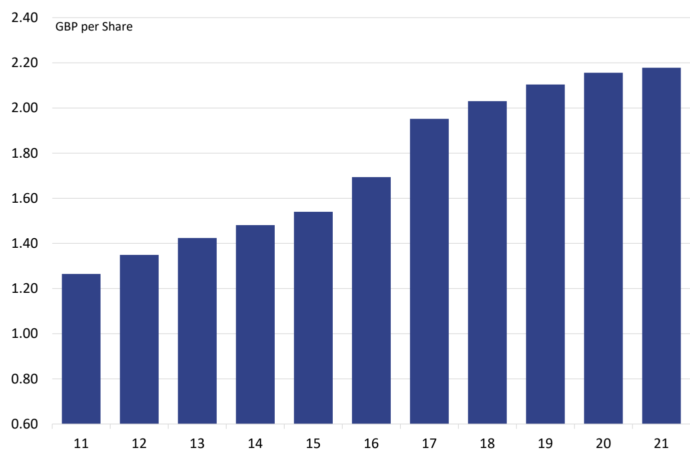
SPEED READ

- **The US is the largest nicotine market in the world (outside of China), so the acquisition of Reynolds American made sense – on paper.**
- **But the US is also one of the most regulated markets and regulatory uncertainty has been rising steadily over the past five years.**
- **At the same time, consumers have been switching to New Generation Products (NGPs, such as heated tobacco, vapour, and modern oral products) as a substitute for traditional combustible cigarettes. Tobacco companies have had to invest hugely to stay relevant.**
- **5 years post the acquisition, debt is under control, NGPS are gaining traction, and BAT is returning its focus to shareholder returns. The market has noticed.**

The acquisition of Reynolds marked "peak exuberance" for BAT. Conditions got tougher thereafter. While greater exposure to the crucial US market may have made sense, it also came with increased exposure to one of the most highly regulated markets – at a time when regulatory scrutiny was rising steadily. Furthermore, it coincided with the emergence of New Generation Products (NGPs) – alternatives to traditional combustible cigarettes that offered consumers greater choice with less health risk. That prompted a flood of new entrants into the market – notably JUUL – that offered vapour alternatives with an array of flavours that appealed to the young. Consequently, volume declines – which were always quite benign – accelerated. In addition, investors fretted over the risks associated with tighter regulation - the banning of flavours, including menthol, and a reduction in nicotine levels. To round off the toxic mix, the emergence of ESG as a force behind investing resulted in many asset managers banning tobacco from their portfolios on health considerations. Consequently, the sector derated sharply. Having traded at a PE ratio above 20x prior to 2017, the sector has traded at a PE ratio below 10x for the past few years, despite incremental annual profit growth. That is a substantial change of fortune.

We have never lost faith in BAT (and its peers listed overseas). The strong cashflows that the industry offers remain appealing, reflected in the fact that despite the challenging conditions, BAT has continued to reward shareholders with steadily rising dividends – even through the Pandemic. Despite offering investors an income yield greater than 8% over the past few years – at a time when interest rates were effectively zero – that consistency has not been rewarded as strategic issues have outweighed the income benefit. Furthermore, tobacco was boring – the last five years have been all about technology and green energy.

BAT ANNUAL DIVIDEND



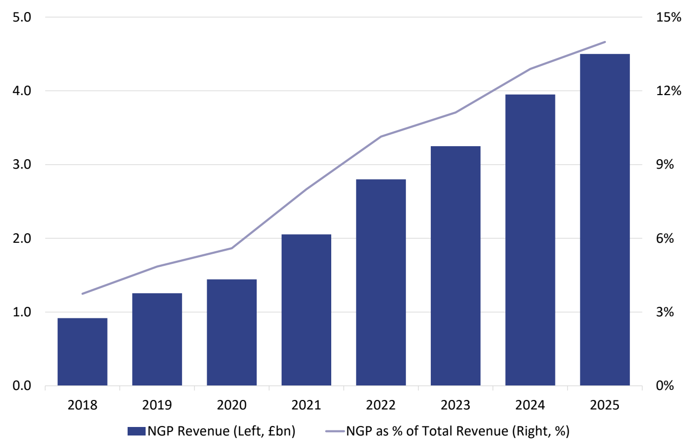
BAT could be considered the poster child for consistent dividend growth over time. Yet that consistency has not been rewarded recently due to overriding strategic risks.

But is there change in the air? Over the past seven months BAT's share price has rallied by 30%. Is this another flash in the pan? We don't think so, for 3 key reasons:

1. BAT's NGP strategy is bearing fruit. To stay relevant, BAT has been forced to invest heavily in its NGP strategy in recent years. This has consumed a lot of capital and weighed on margins. But this investment has paid off. BAT has gained market share in all categories and now dominates some of its key markets. This is manifesting in accelerating sales growth, and NGP revenue rising as a proportion of total sales. Whilst NGP products are still lossmaking, investors are getting increasingly confident that BAT will meet its medium-term goal of generating almost £5 billion of revenues from NGPs by 2025. Furthermore, accelerating revenues are reducing losses, which have stabilized (and improved) Group margins. Importantly, NGPs also carry lower excise tax rates, and hence will be more profitable as scale is achieved. This justifies BAT's strategy of investing aggressively to gain dominance.

> "BAT has gained market share in all categories and now dominates some of its key markets."

NGP REVENUES

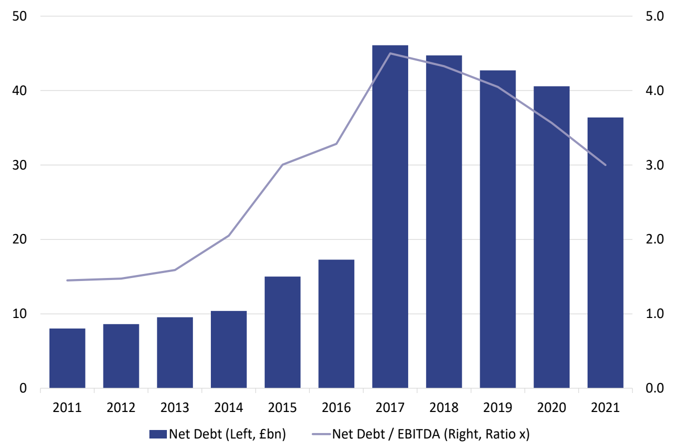


Revenue from NGPs is accelerating and becoming a larger proportion of the overall pie.

2. Regulatory risks have not gone away, but some issues are working in BAT's favour. Last month, the US FDA banned JUUL's vapour products, BAT's key competitor in the US market. JUUL epitomized American innovation. It was launched to take advantage of the growth in vapour, with dozens of new flavours that appealed to teenagers. Consequently, it is largely blamed for an exponential rise in teen smoking. Because vapour was unregulated, JUUL was not obliged to follow the normal regulatory processes for product approval. That has now come back to haunt it. On the other hand, BAT can't afford to do anything but follow the letter of law down to the last full stop. Hence growth has been slower, but BAT has a better record of new product approvals. Whilst the decision for JUUL does raise risk that all vapour products may be banned in time, this seems unlikely given the health benefits relative to normal cigarettes. Rather, it highlights the benefit of regulatory experience that incumbent operators have over new entrants and raises the barriers to entry for new disruptors in future.
3. Finally, and at long last, debt is back under control. Excessive debt has tripped up even the most competent management teams. Ultra-low interest rates encouraged many companies to expand using debt, rather than

issuing new shares. On the face of it, that decision made sense. But slowing revenue growth (for all the reasons we have discussed) meant that debt didn't fall as quickly as anticipated. That, in turn, has impacted on shareholder returns. After 4 long years, debt is finally back under control and the ratio of Net Debt/EBITDA is back to management's internal guideline of 3x. That has prompted a change in strategy and allowed the company to embark on a share buyback program, whilst still committing to its progressive dividend policy. The last time it bought back shares was in 2014. We expect the virtuous cycle of stronger revenue, falling debt and rising shareholder returns (both buybacks and dividends) to underpin BAT's recovery.

BAT'S DEBT PROFILE



Debt soared after the Reynolds acquisition, leading to serious indigestion. Finally, net debt has returned to management's internal target, allowing for a resumption of buybacks and rising shareholder returns.

Whilst we have never lost faith in BAT, the past few years have tested the resolve of even the most patient investor. BAT's share price trajectory provides a useful insight into the workings of markets. Despite improving underlying trends, companies can languish unloved for lengthy periods. Yet at some point, the market recognizes the improvement, and the share reacts accordingly. We are confident that patience will be rewarded in this case and encourage investors to stay the course.

AUDREY HEPBURN

Audrey Hepburn gave smoking a good name in the film adapation of Truman Capote's "Breakfast at Tiffany's".

Topic:	Topic to be confirmed

The next topic for our Insight seminars will be announced in due course.

Natal Midlands	
Date:	15th September 2022
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	20 September 2022
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

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CONTACT DETAILS:

For more information on the range of products and services offered by Harvard House Investment Management and its associated companies (including Harvard House, Chartered Accountants), or for any financial advice, please contact the Company at:

HARVARD HOUSE GROUP

3 Harvard Street, Howick, 3290, South Africa

P.O. Box 235, Howick, 3290, South Africa

+27 (0) 33 330 2164

+27 (0) 33 330 2617

@ admin@hhgroup.co.za

W www.hhgroup.co.za