INTUITION

10 NOVEMBER 2023

British American Tobacco: Where there's smoke there's (less) fire

"For after-action satisfaction, Lexington ... that's the one!" will resonate with many South Africans as will Peter Stuyvesant's 1990s adverts, shot across millionaire playgrounds from the ski-slopes of St Moritz to sun-kissed beaches of Saint Tropez, ending with the catchphrase, "Your international passport to smoking pleasure." Cigarettes have long been associated with having a good time, but as modern science caught up to the harsh reality of smoking-related health complications, the industry has had to adapt or die. Ironically, the strategic decision to increase its ownership of Reynolds American to 100% to gain exposure to its suite of new-generation products (NGPs) to diversify away from traditional combustible cigarettes, has seen British American Tobacco (BAT) come under increased pressure. This includes heightened debt levels and greater exposure to an increasingly hostile regulatory environment. According to the World Health Organisation (WHO), there are 1.1 billion smokers worldwide but in just 15 years there are already c100 million NGP users. This article will look at the current risks and opportunities facing the company as it navigates a new world where every competitor is targeting NGPs as the next growth lever.

Nick Rogers

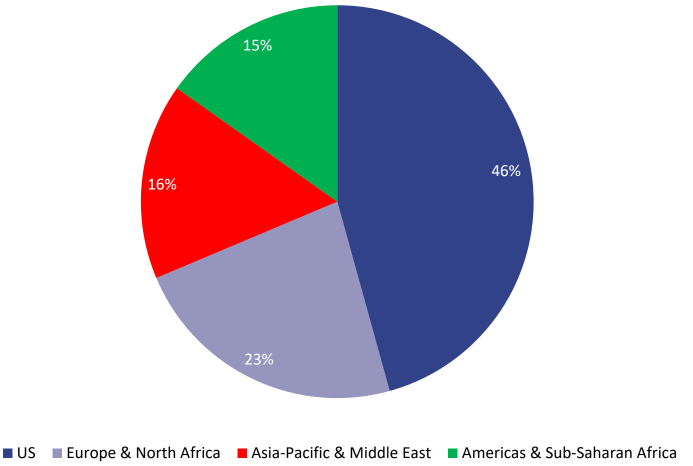
At the beginning of the 20th century, the giant monopoly American Tobacco Company controlled nearly all of the US tobacco market and was one of the original 12 members of the Dow Jones Industrial Average when it was created in 1896. Monopolies have never been popular with governments as they can manipulate the market. Sin taxes (tax from alcohol, gambling, cigarettes etc.) also form a substantial portion of government revenue. Consequently, in 1911, the US government broke up the monopoly resulting in the formation of American tobacco giant RJ Reynolds & British American Tobacco, amongst others. Mergers and acquisitions have always been a feature of the tobacco industry, as competitors jostled for brand leadership and geographic reach. Fast forward to 2017. BAT was missing two crucial weapons to compete effectively against its peers, namely a dominant presence in the most profitable market, the US, and a portfolio of NGPs to diversify away from combustible cigarettes. (Inhaling tobacco smoke is where the real damage to one's health originates.) One simple transaction would solve both issues. Despite already owning 42% of Reynolds American, BAT agreed to buy the remainder in a deal worth $49.4 billion. Whilst strategically sound, this move would have unintended consequences from a debt and regulatory point of view. Why?

SPEED READ

- **BAT's cigarette revenue only grew by a measly 0.2% over the 6 months to June '23, due to volume decline of 5.8%. In stark contrast, NGPs revenue grew 27% and now account for 17% of total revenue.**
- **NGPs have recorded a compound annual growth rate of 33% since 2019 and the company expects them to reach £5 billion in revenues by 2025. This is a strategic goal and one that needs to be met to improve investor sentiment.**
- **Last month, the US FDA instructed BAT to halt sales of its menthol flavoured Vuse Alto vape, the most popular e-cigarette in the US (Vuse has a c42% market share).**
- **BAT's 29.2% stake in India Tobacco Company Ltd (ITC) is worth £16.1 billion, an exciting opportunity given that India is on target to become the most populous country on earth.**
- **BAT currently pays a 9.2% dividend and is undervalued versus peers due to pressure from its US operations.**

Readers will recall that interest rates were at record lows at the time, a hangover from the GFC. Before the acquisition,

REVENUE BY GEOGRAPHY



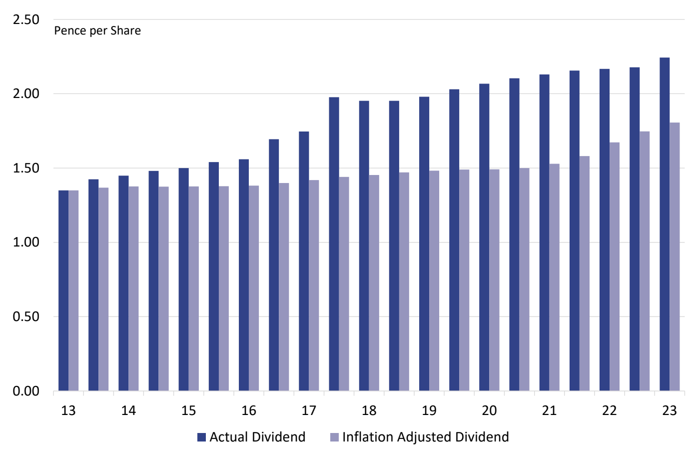
The US became BATS biggest market post the Reynolds American acquisition and catapulted BATs much-needed NGP exposure in a world where traditional cigarettes are in decline.

BAT's total debt sat at a very manageable £20 billion but it soared to £50 billion immediately after the deal. Consequently, BAT's Net Debt/EBITDA ratio moved to an uncomfortable 4x. Despite this, low interest rates meant that refinancing this debt was not a problem. It was simply rolled forward, backed up the strong free cashflows generated. Since nicotine is addictive, tobacco companies can simply raise prices even in the face of declining volumes, allowing them to pay handsome dividends whilst simultaneously paying down debt. A smoker is always willing to pay up for that next fix! That has all changed. Over the past 18 months, interest rates have accelerated to over 5% in both the UK and US. Although BAT's average cost of debt is only 4.3%, it issued a $600 million 10-year bond at a 7.75% coupon in October 2022, illustrating how quickly higher interest rates can feed through to funding costs. The company had debt of £43.1 billion in FY22, 43% of which needs to be re-financed by FY27. Anyone who has a mortgage knows the pain of higher rates on bond repayments.

A combination of higher funding costs and interest rates that are expected to stay higher for longer forced BAT to suspend its share buyback program earlier this year. That combination has not been well received – the share price has been punished. This also comes at a time when the average global consumer has less disposable income. I asked a UK-based friend if the past few weekends' RWC Springbok matches had driven him to take up smoking again. "Not at £14 a pack!" (cR320) was his response. The same applies in the US. Pressure on disposable incomes has encouraged US smokers to switch allegiance, moving away from BAT's suite of premium brands into cheaper alternatives. Newly appointed BAT CEO, Mr Tadeu Marroco stated at the recent results, "We will leverage our global portfolio to continue to grow profits and cash, deliver £1 billion of efficiencies over the next three years to further fund our transformation and reduce debt to strengthen our balance sheet." Given the conditions, that may be easier said than done, although BAT has delivered on its strategic priorities in the past.

Perhaps in a sign of things to come, on the same day as the Reynolds merger vote, the WHO released a report on tobacco companies' push against anti-smoking laws, stating "governments around the world must waste no time in enacting the laws." Post the merger, the US now accounts for 54% of group revenue but this is from an increasingly hostile regulatory market. It culminated 10 days ago when the US Food & Drug Administration (FDA) ordered BAT to halt sales of its menthol-flavoured Vuse Alto vape, the most popular e-cigarette in the US. That is material. Approximately 45% of global Vuse revenue is associated with the menthol variants sold in the US. The European Commission also plans to ban flavoured e-cigarettes while simultaneously introducing a more onerous industry tax policy later this year. Similar to New Zealand, the UK is also looking to impose a generational ban which will see anyone born after 2008 never being legally allowed to purchase a traditional cigarette. To add salt into the wound, there is also a pending c£17 billion court judgment against Quebec's tobacco industry. BAT and its peers will no doubt fight these challenges in court but the negative sentiment towards the sector has caused a slump in share prices with BAT one of the worst performers (down 27% YTD in London or 15% in SA thanks to a weaker currency). Whilst NGPs now account for 16.6% of total group revenue, the category achieves higher margins than combustible cigarettes. BAT has been very confident that it will reach its £5 billion revenue target by 2025 but the regulatory pressure is a definite set-back.

ACTUAL DIVI' VS INFLATION-ADJUSTED DIVI'



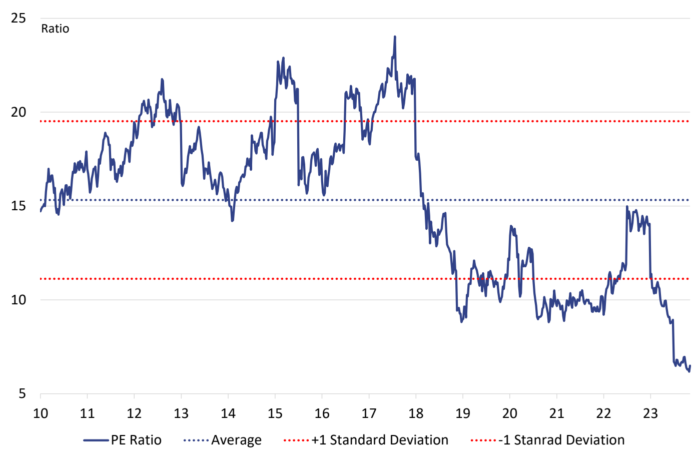
BAT has delivered inflation-beating dividends over the past decade thanks to its strong free cash flow generation.

Looking for a ray of sunshine from this dark cloud led me to investigate sources of future value for BAT. Little is published about its 29.2% stake in India Tobacco Company (ITC) which is worth £16.1 billion. From a strategic point of view, Oral Tobacco consumption is larger in India than all other oral markets combined and helps BAT's "Tobacco Harm Reduction" ambitions to appease regulators. The Group's share of ITC's post-tax results grew 22.7% to £514 million (2021: £419 million) which contributes meaningfully towards BAT's attractive 9% dividend yield. Unfortunately, India has a ban on foreign entry into the tobacco industry thus BAT cannot sell down its stake to reduce debt and no Indian company can afford to buy it out. That said, India, with a current population of 1.39 billion people, is on target to soon overtake China as the world's most populous country. BAT stands to benefit through first-mover advantage over the next decade where it will expand its product range. This should boost cashflow, which will help it to achieve its other strategic ambitions of growing shareholder returns and reducing debt.

Like so many SA companies that we cover, BAT's share price is reflecting a doomsday scenario, and one that will not necessarily come to pass. There are numerous opportunities that could easily sway sentiment for the better, including:

1. JP Morgan believe the US courts will grant a stay of enforcement of the FDA denial ruling, thus the menthol products could remain on the market for quite some time until the issue is finally decided in the courts. Menthol is a huge category in the US, so banning it has raised fears of smokers turning to the illicit trade. We know the implications of that from our own experience during lockdown! Furthermore, there is no evidence that menthol is any more harmful than ordinary cigarettes, and hence why it is being challenged.
2. Regulators may look to legalise Snus (Oral tobacco) in all European countries after Switzerland recently legalised the product amid evidence it was less harmful than cigarettes. BAT has oral brands in Sweden, Norway and the US thus supply could be turned on quickly across the EU.
3. Changes in US regulations present BAT with strong profit potential as the FDA implements new rules, particularly in the $7.2 billion electronic nicotine-device market. BAT has just had 3 vapor brands approved whilst its main competitor, Juul, could be banned along with illicit sellers.
4. BAT, which controlled just under 25% of the Russian tobacco market, has now formally agreed to sell the business. It has taken 18 months, but cash should be received shortly.
5. Cigarette volume declines should improve from over 5% in 1H to near its 3% guidance for the year as pricing has largely been absorbed by the markets. There is evidence that volumes are now stabilizing in the US, but this bears watching in relation to a broader slowdown in that country's growth rate.

PE RATIO



BAT has suffered two significant periods of valuation pressure – the first after it acquired the balance of Reynolds American and the second more recently due to economic headwinds, higher interest rates and regulatory pressure. The company is now trading at a deep discount to its historic valuation.

In conclusion, the latest results saw cigarette revenue grow marginally at 0.2% whilst NGP revenue grew 26.6% highlighting the opportunity within newer categories. There is, however, a long way to go before the proportion of revenue from NGPs becomes dominant. Despite the severe market reaction to recent events, it is difficult to see any share price catalysts in the near term, other than steady delivery on key pillars of their strategy. Management remains optimistic that they are on track to generate £40 billion of free cash flow before dividends and that leverage will trend towards the middle of their 2x to 3x Net Debt/EBITDA range. Delivery on those goals, as well as a return to share buybacks would go a long way to improving investor sentiment. We trimmed overweight positions earlier in the year in reaction to weaker fundamentals and remain in a wait-and-see mode. That said, one cannot ignore the fact that British American Tobacco is currently extremely undervalued (granted, for a reason) and offers a sustainable and substantial 9% dividend yield (in Pounds) which has boosted cashflow to SA-based shareholders given Rand weakness. As long as interest rates remain high, the share price may well continue to languish but it remains on our radar, as do its peers like Imperial Tobacco and Philip Morris.

Name	Mkt Cap ($ Billion)	PE Ratio (x)	Dividend Yield (%)
BAT	66.8	6.3	9.3
Philip Morris	143.7	16.7	5.5
Japan Tobacco	45.7	13.1	6.0
Imperial Brands	18.8	9.7	8.2
Altria Group	75.8	8.4	8.9
India Tobacco Co (BAT owns 29%)	65.4	28.1	3.6

Our next Insight seminar will take place in December in Cape Town, Johannesburg and Howick. After an eventful 2023 which has delivered its fair share of surprises, our next seminar will take stock of the year and focus on the outlook for 2024.

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Topic:	Outlook for 2024
Natal Midlands	
Date:	7th of December
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm
Johannesburg	
Date:	6th of December
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am
Cape Town	
Date:	4th of December
Venue:	ABRU Motor Studio, Lourensford Wine Estate, Somerset West
Time:	5.30pm for 6pm

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