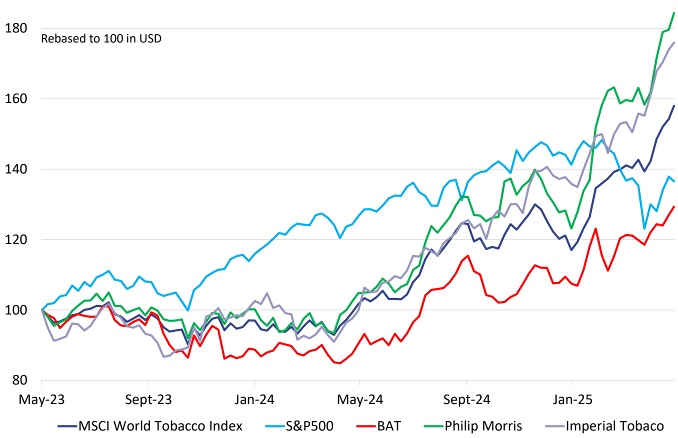
British American Tobacco: Time to 'Quit'?

British American Tobacco (BAT), the 2nd-largest tobacco company in the world, has been a core holding across Harvard House portfolios for over a decade thanks in part to its high dividend yield (6-8% in British Pounds). In 2017, BAT spent $49 billion acquiring Reynolds American to take advantage of the superior growth in the region and its leading brand portfolio. The US became BAT's largest market overnight, but the resultant high debt burden has seen BAT's balance sheet remain under pressure ever since. The US consumer is also under pressure. More importantly, the health risks of smoking are well understood, so the tobacco industry is experiencing increased regulation and scrutiny as the global focus on ESG influences investor behavior and funding. We feel that this structural risk poses the greatest threat to BAT's long-term returns. This article will highlight our main concerns, focusing mainly on the US to illustrate why we are gradually reducing our holdings given the current opportunity to lock in recent gains.

Nick Rogers

Over the past two years, global tobacco companies have enjoyed spectacular returns. In fact, the MSCI World Tobacco Index (+56%) has outperformed the S&P 500 (+37%), which includes tech shares like Apple, Microsoft, Nvidia, Tesla and Amazon. The main drivers behind this rally include undemanding PE multiples and investors switching into more defensive sectors such as tobacco, with its strong cashflows and high yields. Given the

PERFORMANCE OF THE TOBACCO SECTOR



In July 2024, the MSCI Tobacco Index traded at a 39% discount to the MSCI Consumer Staples Index. Since then, the valuation gap has closed as the tobacco sector found favour with investors looking to diversify away from the over-valued tech sector.

SPEED READ

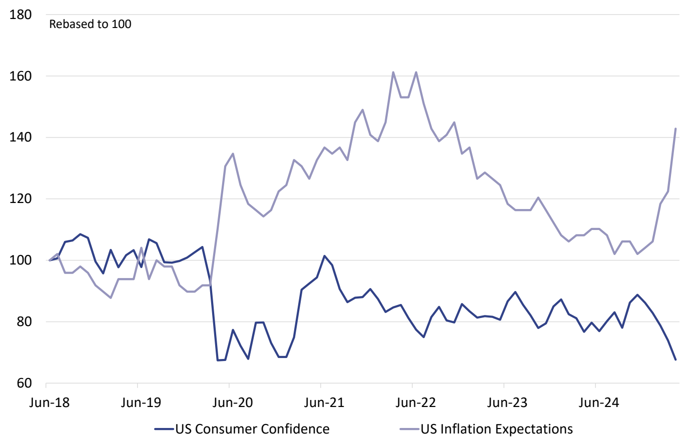
- **The MSCI World Tobacco Index (+56%) has outperformed the S&P 500 (+37%) over the past two years. BAT has surged over this period but has lagged its major peers due to high debt levels and a reliance on the US, where regulation risks are high.**
- **US consumer confidence is currently touching Covid-19 lows, forcing consumers to trade down to cheaper cigarette brands where BAT is under-exposed.**
- **Young American adults (18-24 years old) may pose the biggest threat to the US tobacco industry. Their heightened health awareness has resulted in a decline in smoking of 9% per year since 2002, far exceeding the 3.4% average annual decrease across all ages.**
- **New Generation Products (NGPs), deemed far healthier than combustible cigarettes, broke even last year but we don't believe BAT will re-rate much further until NGPs contribute more significantly to group revenues and operating profits. This is a long way off.**
- **Having watched the share slump to R529 in December 2023, we have waited patiently for a recovery - currently around R800 (+50% off the lows). This provides an ideal opportunity to lock in recent gains, especially given the structural headwinds.**

increasingly unpredictable outlook, tobacco counters have provided a "harbour in the tempest." BAT has risen strongly too but has lagged peers Philip Morris and Imperial Tobacco.

BAT's primary listing is on the London Stock Exchange. Consequently, with the Rand at near-record lows against the Pound, BAT has provided steady protection against a weakening local currency. Geographically, BAT relies heavily on the United States which accounts for 44% of sales and 50% of operating profits. Here we have several concerns:

1. The strong dollar over the past ten years has boosted earnings reported in Pounds. However, current economic forecasts suggest that the Dollar may weaken in the years ahead, which will turn a tailwind into a headwind.
2. US consumer confidence is currently touching Covid-19 lows. This likely reflects short-term economic uncertainty over tariffs and their potential to boost inflation. Both are negative for consumer spending. Tariffs will lead to a rise in global inflation, hurting BAT's sales both in the US and the c180 other countries in which they operate.

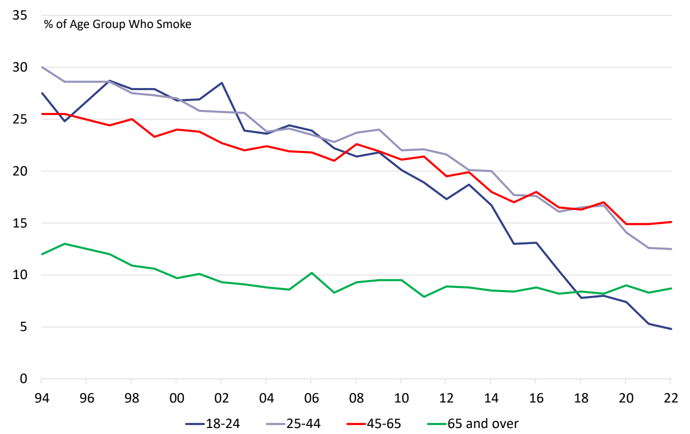
US CONSUMER CONFIDENCE



Weakening consumer confidence likely reflects short-term economic uncertainty over tariffs and their potential to boost inflation - which will impact sales across all industries, including tobacco.

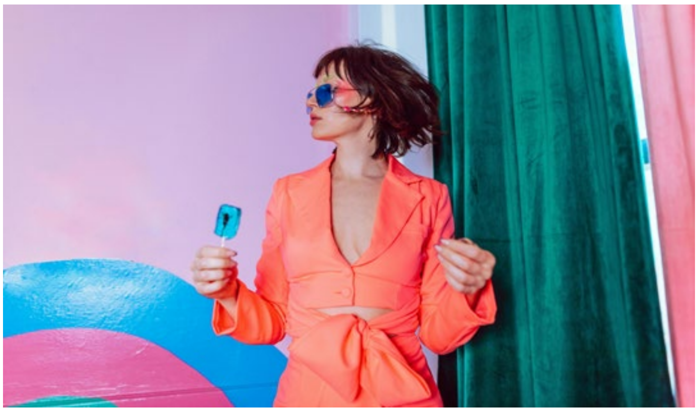
3. Pricing is key to maintaining market share during an economic downturn. Although tobacco is addictive, there is a point at which constrained consumers will trade down to cheaper alternatives. BAT has a higher exposure to the premium segment in the US through brands like Camel and Dunhill, so it has lost market share to competitors like Philip Morris, Altria and Imperial Brands. The US discount category has grown market share from 25% (Q1 2020) to 30.4% (Q4 2024) highlighting BAT's lost opportunity.
4. Young American adults (18-24 years old) may pose the biggest threat to the US tobacco industry. This age group's smoking prevalence rate contracted to 4.8% in 2022 or 9% per year since 2002, far exceeding the 3.4% annual decrease for all ages (according to US Centre for Disease Control and Prevention). Why? Firstly, young people are better informed on health risks and secondly, access to new products such as smoke-free vapes, nicotine pouches, and even legal cannabis products.

SMOKERS BY AGE GROUP



There has been a dramatic decline in Smoking-Prevalence Rates by Age Group in the US, especially in the 18-24 age group, thanks to recent health awareness trends and alternative products like NGPs.

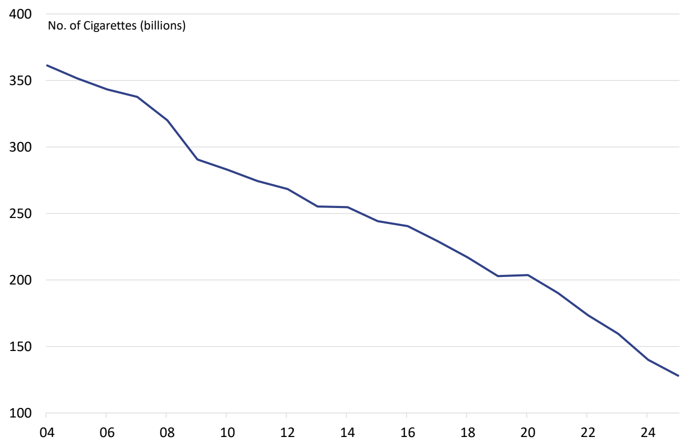
5. The growing awareness of the health risks associated with smoking has resulted in the number of cigarettes sold in the US declining significantly over the years. BAT's US combustible volumes declined 10.1% versus in 2024, relative to a decline of 8.4% for the industry. The company remains far too reliant on cigarette volumes to recover, especially in in the US.
6. In January, the Food and Drug Administration (under pressure from the new administration) withdrew its



Young people are enjoying themselves in many ways, but seldom with a cigarette in their hands.

proposed ban on menthol cigarettes. This was positive news given that menthol cigarettes account for more than half of BAT's cigarette sales in the U.S. This may, however, prove temporary given that the chemical compound in menthol makes cigarettes easier to smoke and thus harder to quit.

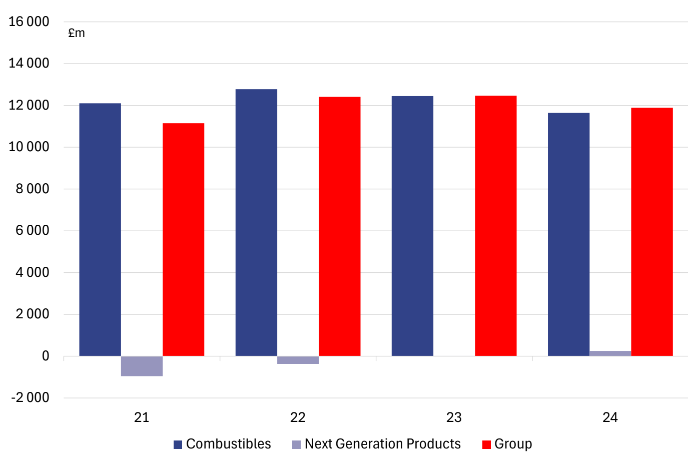
US CIGARETTE VOLUMES



The number of cigarettes sold in the US has been in a structural decline for over 2 decades. Tobacco companies have mitigated this by raising prices and expanding into new markets and new products. But you can only push the envelope so far.

7. Finally, BAT has responded to declining cigarette volumes by introducing a range of Next Generation Products (NGPs). Despite breaking even two years ahead of schedule, in 2023, BAT's NGPs generated revenues well below expectations in 2024, causing concern. Much work needs to be done, especially given the threat of illicit tobacco products, which continue to steal market share. National enforcement of illicit products may take the FDA years to implement. Despite a focused effort to diversify its products away from combustibles, NGPs do not contribute materially to BAT's operating profit.

BAT: OPERATING PROFIT



Despite BAT having the 2nd largest exposure to NGPs, the contribution remains immaterial, placing huge reliance on combustible tobacco.

BAT's attractive dividend yield relies on strong cashflows and a healthy balance sheet. Only now, seven and a half years after the acquisition of Reynolds American, has the Net Debt/EBITDA ratio (2.4x) fallen within management guidelines of 2.0-2.5x. On the positive side, the monetisation of a portion of BAT's Indian Tobacco Co. stake, enabled the company to announce a share buyback program worth £1.6 billion over the course of 2025. However, a legal challenge over the compatibility of the UK's corporation tax regime with EU law and potential settlement payments in connection with outstanding litigation in Canada remain threats to cashflow.

In conclusion, BAT may well continue to attract global investors during the current volatility. However, as GDP growth recovers, the same investors will once again seek higher returns elsewhere. Bloomberg consensus earnings forecasts have moved lower over the past 12 months, not surprising given that NGP revenues have fallen back below 10% and currency movements are turning into a headwind. With valuations largely corrected, the recovery seems to have played out. In terms of portfolio management, we will steadily diversify into companies with stronger growth potential, whilst offshore, Imperial Tobacco is the preferred choice due to its stronger balance sheet and its focus on the cheaper end of the market.

Electronic cigarettes have not yet replaced the revenues generated by traditional smoking tobacco - and may not do so any time soon.

Our next Insight seminar will be held in June. As usual, we will take stock of how our economy and markets are faring six months into the year."

Topic:	Mid-Year Update
Natal Midlands	
Date:	12th of June 2025
Venue:	Christ Church Howick, 23 Mare Street, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	3rd of June 2025
Venue:	Rosebank Union Church, Cnr Winne Mandela Drive and St Andrews Road, Hurlingham
Time:	7am for 7.30am

Cape Town	
Date:	5th of June 2025
Venue:	SSISA Conference Centre, Boundary Road, Newlands, Morne du Plessis Boardroom, 4th floor
Time:	7.30am
Venue:	ABRU Motor Studio, Lourensford Wine Estate, Somerset West
Time:	5.30pm for 6pm

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