

British American Tobacco

WARNING: Returns may be Addictive



British American Tobacco is the world's second largest publicly traded tobacco company by market share. The company rolls more than 700 billion cigarettes a year, sold in 200 markets in across 60 plus countries. BTI offers the rare opportunity to invest in a superior quality business, in an industry which is highly regulated and stable, at a discount to fair value.

WHAT WE LIKE

BTI have been able to provide shareholders with an annualized return of almost 14%, over the last ten years, ahead of the JSE all share index at around 11%. The business is extremely cash generative, and this is due to the business model being capital-light, so it does not require much new capital investment every year, as well as the high operating margins it achieves. The business has also managed to achieve returns on capital well ahead of their costs, creating shareholder wealth in the process. A very underrated aspect of the business model is the ability to pay out most of the earnings to shareholders (BTI have consistently paid out around 65% of earnings as dividends), whilst still being able to grow the business.

INDUSTRY STRUCTURE

Much has been made about the decline in tobacco volumes, as volumes are expected to decline by 2%-3% per year, and yet BTI and other major players in the industry have still been able to grow their revenues by low to mid-single digit revenues each year due to their significant pricing power. The business can pass through pricing ahead of inflation due mainly to the addictiveness of the product and the brand loyalty of customers.

The industry has highly favourable economics for the major produces. There has been consolidation in the

industry as the main five producers supply over 80% of the cigarettes worldwide. The market share in the industry has been very stable as there are strict marketing controls as tobacco advertising is severely restricted in most markets, with bans on most forms of mass marketing. This not only makes it difficult for new entrants to gain the attention of smokers, but also serves to lessen the competition between the current manufacturers.

In addition to the high barriers to entry for potential newcomers to the industry as discussed above, BTI also has considerable advantages due to economies of scale and intangible brand assets.

Economies of scale – Cigarette manufacturing is a highly scalable business due to the homogeneity of the product and significant economies of scale are generated throughout the supply chain in the production of combustibles. It would also be extremely challenging to develop a distribution network of sufficient scale to compete with the current tobacco giants.

Intangible brand assets – Tobacco contains nicotine which is addictive and habit forming. There is strong brand loyalty in the tobacco space as the average user changes brands less often than once every ten years and brand equity tend to be higher in tobacco than other consumer product categories. This is also the effect of the absence of new brands due to the high barriers to entry as well as the restriction on marketing to tempt users to switch brands.

SHAREHOLDER RETURNS

The most compelling feature of the BTI business case is the current dividend yield available to shareholders. The company has consistently raised its dividend and is almost three times what it was going into the financial crisis. The current yield is 8% in pounds and the dividend seems to be secure, as the operating cash flows have not been largely affected from the COVID-19 pandemic. »

CONCERNS

High debt levels – While a debt of around £45 billion pounds at a Net debt to EBITDA of 3.6x seems high, it is a company which is highly cash generative with strong and stable cash flows and assets. The debt of the company is well managed, and liquidity is also not a concern.

Regulation – Government intervention is the biggest risk to the investment case. In the US the FDA had started a process to regulate the amount of nicotine in cigarettes to below addictive levels, as well as a ban on menthol cigarettes. While we do take these risks into consideration in our valuation and monitor them carefully, we view these risks as low probability non near-term risks.

CONCLUSION

We are happy to be invested in BTI across all our portfolios at current levels. The counter provides us with the asymmetric risk return profile which we look for in our investments. •