

British American Tobacco

Consumer Staples



Hold

Company Update Report

Trump administration supports share price gain as tariffs and menthol ban revocation supports American sale expectations

Analyst recommendation

Table 1: Analyst recommendation

Counter	Share price	Intrinsic value	Difference
British American Tobacco	£33.90	£34.08	0.5% Upside

10 February 2024

Executive summary

1. After two years of declining cigarette volumes, the revocation of the menthol ban should mitigate declining volumes, although negative volumes are still expected.
2. Key points in the investment thesis are:
 - a. Management states that illicit vapour in the US account for 60% of sales. The FDA is moving too slowly at the frustration of management. Aim for 50% smoke-free products by 2035.
 - b. US cigarette sales surprised on the downside with volumes down in the low teens single digits in the past 18 months. This was against the expectation of 3-5%. Going forward it is expected at low single digits, and the revocation of the menthol ban should help.
 - c. £900m in share buybacks expected in FY25. Net Debt/EBITDA expected to be below 2.5x upon results on 13 February which should prompt additional buyback plans.
 - d. NGPs still growing strongly and have turned to a profit, and BATS has the highest market share in both vapour and Tobacco Heated Products.
 - e. Company sitting on a dividend yield of 7% and forward PE of 9.3, 50% lower than Philip Morris.
3. Have an intrinsic value of £34.08 per share (upside of 0.5%) and recommend Hold position.
 - a. Conservative revenue growth estimate of 2% for 2024-2026 negative growth in 2023 and negative growth expected in FY24 results. EBIT margins remain strong at 46% and we forecast a 2026 EBITDA of £13.4 billion
 - b. Assumption of no growth in the cigarette business with company falling slightly short of its 2025 NGP target of GBP5 billion.
 - c. Share price has run hard in the last year and particularly the last three months (25%). This has resulted in the share price reaching our intrinsic value and is trading three standard deviations above the mean.
4. What would make us change our minds?
 - a. Loss of market share to Philip Morris in the US in the NGP segment.
 - b. Above expected decline in US cigarette sales.



- c. Continued derating to lower levels. Net Debt/EBITDA target has been reached and management has guided at returning money to shareholders.

Table 2: Qualitative summary

Factor review	Rating	Description
Valuation		
Growth		Cigarette growth expected to be relatively flat with price increases offsetting volume declines whilst high growth in NGP business however it is still a small part of revenue. Revenue is expected to be slightly down in 2024 and then low single digits growth in 2025 and 2026.
Valuation		Value the company on a EV/EBITDA valuation with a 0.5% upside.
Dividend yield		Dividend yield of 7%
Issuance		No significant changes in shares outstanding. Management has been buying back shares in FY24 and expected to continue in 2025.
Catalyst	<ul style="list-style-type: none"> Continued market share appreciation in Next Generation Products and FDA regulation on illicit vapes Share buybacks Slower than expected decline in the cigarette business. 	
Quality		
Quality of earnings		Consistent, reliable and industry leading margins. Very few adjustments and non-IFRS reporting.
Moat		High brand power and loyalty in the cigarette business with competitive pricing power, however the threat of new market entrants in the NGP category could pose future threats to market share appreciation.
Management and governance		Long tenured management team with inside ownership of 12.5%.
Balance sheet		Neutral balance sheet with higher than usual debt levels, however management is focused on reducing this debt which is due to their acquisition of Reynolds American in 2017. Targeting Net Debt/EBITDA of sub 2.5x and it is currently 2.57x, and should be closer to 2.3x in the results on 13 February 2025.
Macro and quantitative sensitivities		
Risks	Upside risk <ul style="list-style-type: none"> Continued market share growth in Next Generation Products in the USA. Price increases to offset decline in volumes in the cigarette business and a slowdown in the volume decline. 	
	Downside risk: <ul style="list-style-type: none"> Higher than expected decline in the cigarette business. Philip Morris's drive to gain market share in the USA. Regulatory bans on the vaping products could slow growth. Expect to hear the outcome in early 2024. 	
Regulation		Highly regulated industry. BATS is facing regulatory issues with its menthol vapes in the USA which is set to be a prolonged process. Management is frustrated with the lack of action from the FDA.



ESG		Neutral rating on FactSet with a core 52/100. Neutral rating on the business model and above average rating on environment.
Momentum price		Price momentum is positive, share price is above the 50 day and the 200-day moving average.
Momentum earnings		Neutral earnings momentum. In the last 3 months the earnings have been revised up by 1% for the next financial year.
Piotroski Score		Piotroski score of 4 out of 9.

Source: PSG Wealth



Most recent results

On 25 July 2024, British American Tobacco released half year results for FY24.

1. Total revenue declined 8.2% to £12.3 billion, but down 0.8% when adjusted for currency movements due to the exit of the Russia/Belarus segment and weaker than expected risk reducing products segment. DEPS was up 13.8% due to lower interest and tax costs as well as lower shares due to the buyback program.
2. The US combustibles segment is a concern. The expected volume decline of 3%-5% a year seems low as the half year number was down 13.7% relating to a number of factors.
3. Modern Oral was the highlight with revenue up 122% albeit off a low base.
4. NGPs have started contributing to profits following loss making periods previously.
5. Operating margins to remain steady at just under 45%.
6. Total new categories (Vapour, THP & Modern Oral) to continue to be impacted by illicit vapour in the US. Could see a surprise following the announcement of a retraction of the menthol cigarette ban in the US. This will be a continuing theme going forward.
7. Net Debt/EBITDA of 2.5x with closer to 2.2x expected by the end of FY24.
8. Guidance remained unchanged and share buybacks continue. Management has guided £700m in FY24 and a further £900 million in FY25.

Expected results 13 February 2025

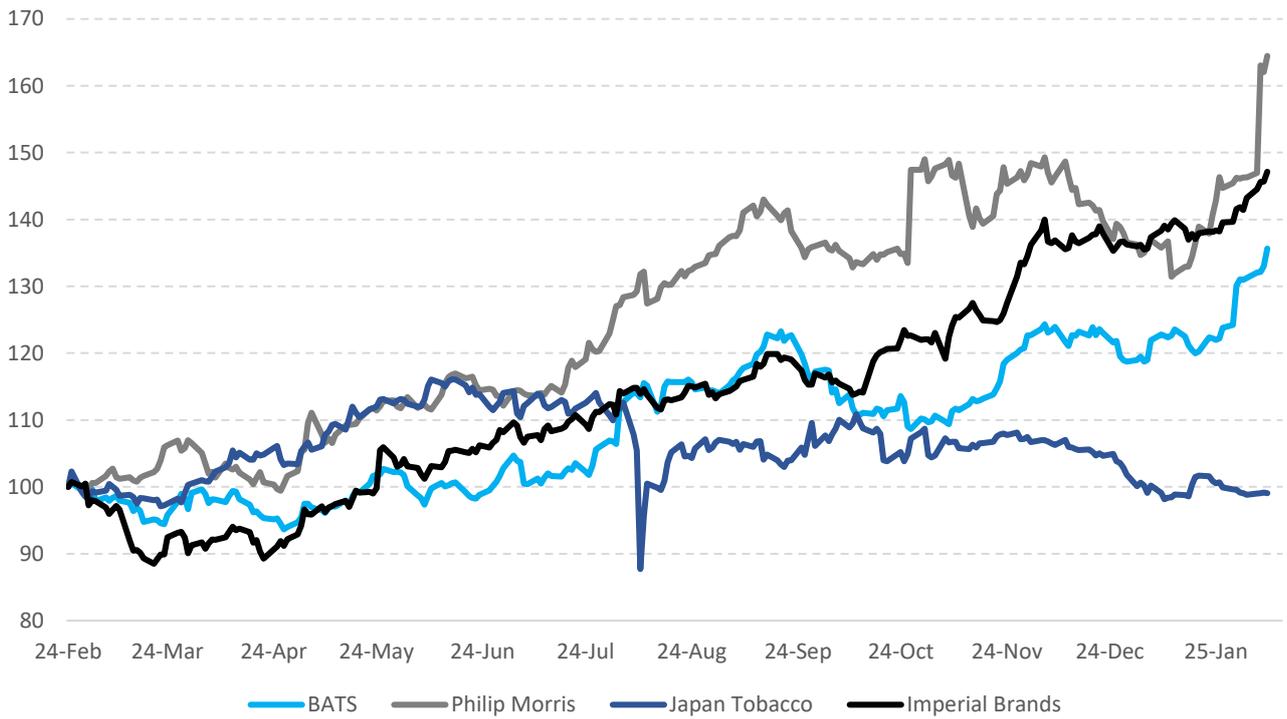
1. Sales are expected to come in at £26.03 billion a 5.3% decline which reflects the struggling cigarette category.
2. Whilst there is no guidance in the Next Generation Products division, we expect just under £4 billion in sales in this division,
3. EPS is expected at £3.64, a decline of 3%.
4. Any surprise on the upside for US cigarette volumes will only be seen in 1H25 results in July.
5. Net Debt/EBITDA will be of key importance as management slightly missed on this figure for FY23. The target range of 2.0x-2.5x should finally be met around the midpoint at which point we expect further announcement of additional share buybacks which could buoy the share price.

Past 12 months performance

Tobacco stocks have been on a strong run in the last 12 months with the exception of Japan Tobacco. BATS is up 35% in the last year whilst Philip Morris is up 64% and Imperial Brands is up 47%. These stocks are also high dividend payers in the price performance doesn't reflect this. BATS yields 7% whilst Philip Morris yields 4%. After a strong performance from the tech sector in 2024 it is good to see that there has still been a place for the more defensive stocks in a portfolio.



Graph 1: Relative performance



Source: PSG Wealth

Table 3: Total Return performance

Total Return	YTD	1M	3M	6M	1Y	2Y	3Y	5Y	10Y
British American Tobacco p.l.c.	17.7%	14.3%	24.0%	21.0%	40.0%	11.3%	3.7%	-1.7%	-7.1%
MSCi World Index	3.8%	4.4%	2.4%	13.1%	18.5%	40.4%	29.6%	64.3%	133.9%
Out / (Underperformance)	13.9%	9.9%	21.6%	8.0%	21.5%	-29.1%	-25.9%	-66.0%	-141.0%

Source: FactSet

10 February 2025

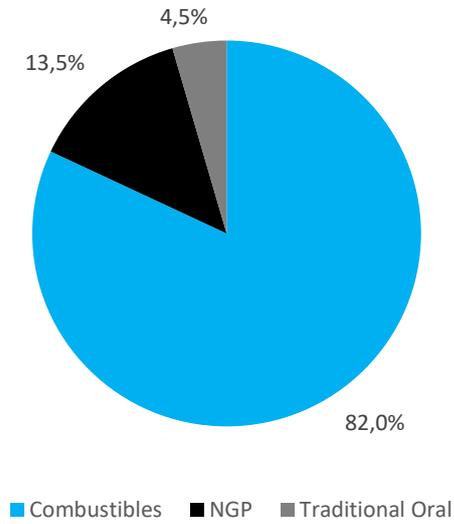
Overview

The company consists of three operating segments namely:

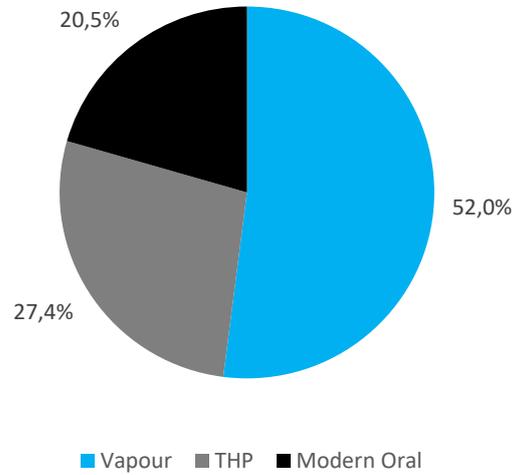
1. Combustibles & Other
2. Next Generation Products
3. Traditional Oral



Graph 2: Revenue Split 1H24



Graph 3: NGP Split 1H24

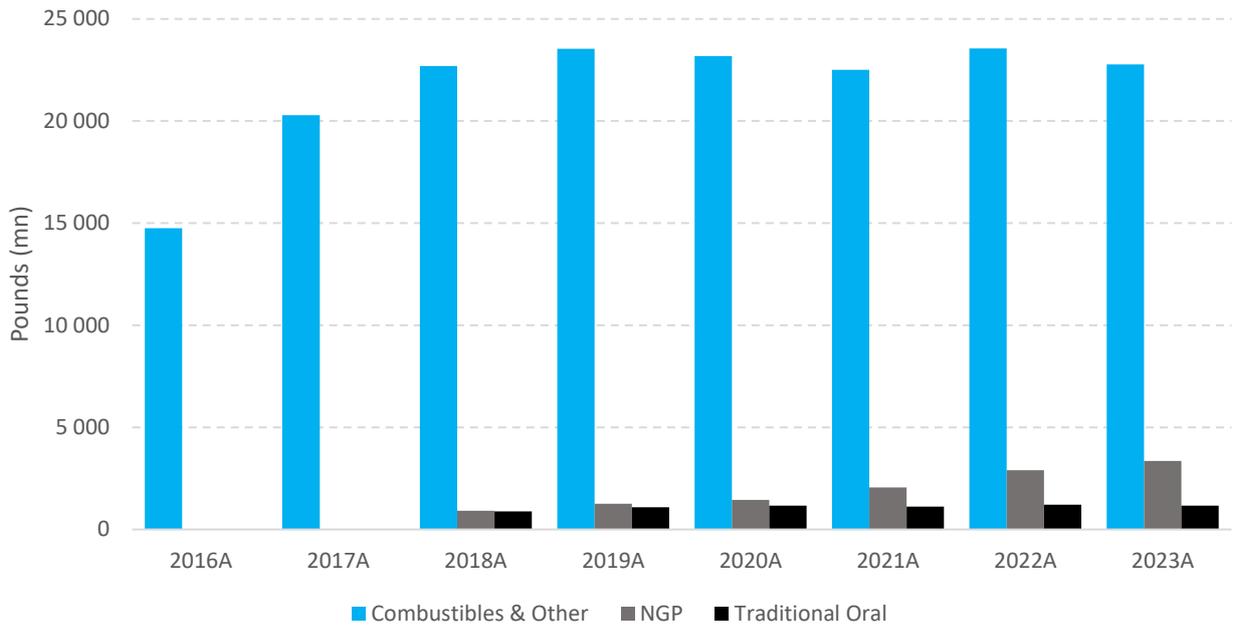


The company's strategy is set out clearly:

1. To continue transitioning away from cigarettes to NGPs – “Building a Smokeless World”:
 - a. The goal is to be 50% NGP by 2035.
 - b. Their US Vapour market share has grown from 15.5% in 2019 to 45.6% in 2023 but saw a small contraction in 1H24.
 - c. Tobacco Heating Products market share has grown from 12.9% in 2019 to 18.2% in 2023, however, this segment seems to be stagnating. Further marketing and sales initiatives are expected in 2H24.
 - d. Total NGPs have grown from £917 million in 2018 to £3.34 billion in 2023 and are expected closer to £4.6 billion by FY25.



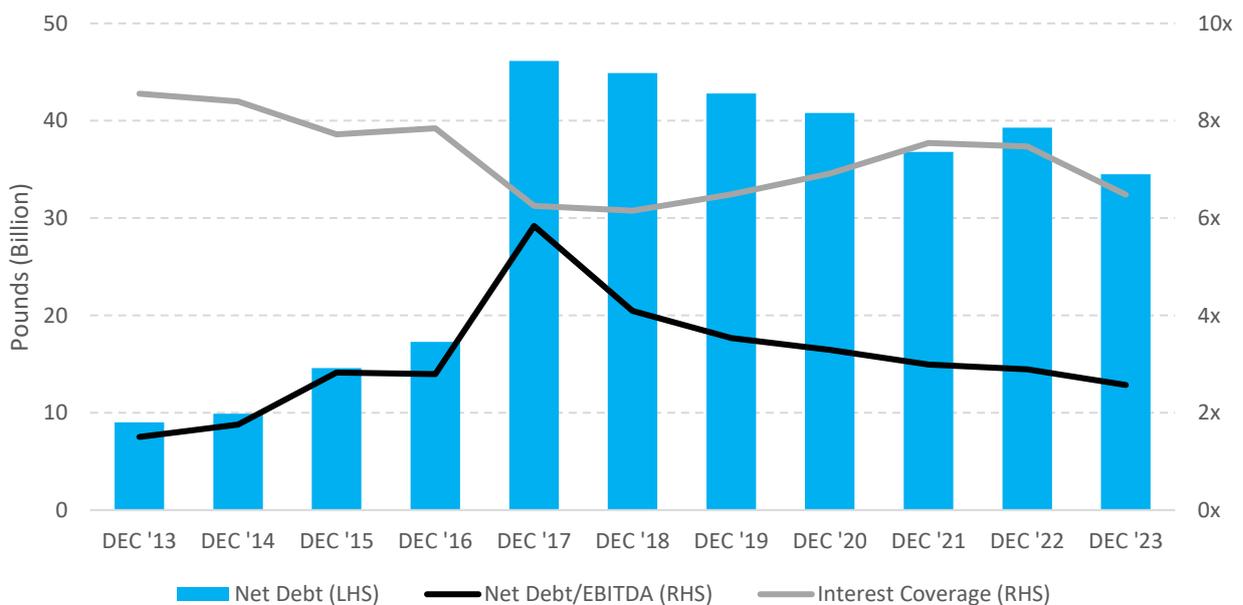
Graph 4: Revenue Analysis



2. Continue debt reduction.

- a. Reduce Net Debt/ EBITDA to 2.5x. This was expected by FY23 but came in at 2.57x and should be closer to 2.3x by the end of FY24.
- b. Net Debt/EBITDA peaked at 5.2x in 2017 following the purchase of Reynolds American for \$49.4 billion. There was a slight miss on the target for FY23, but the potential partial sale of the ITC stake will bring it under the target.

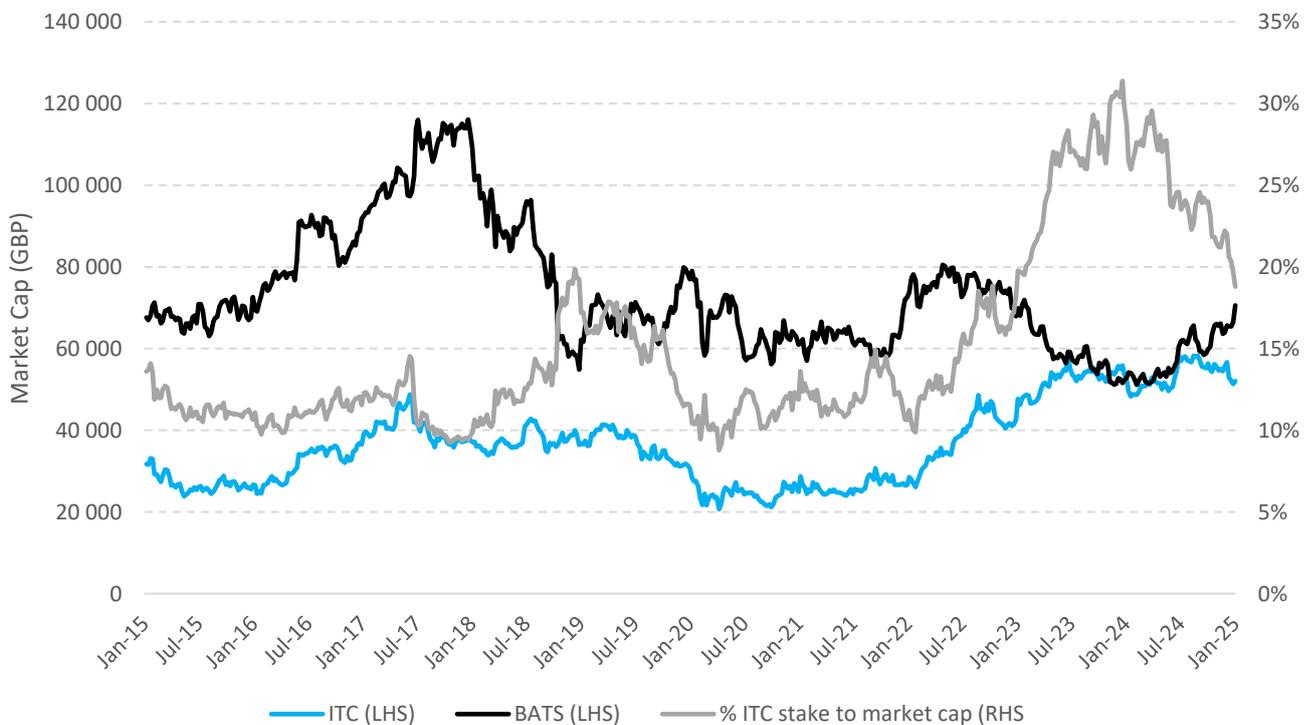
Graph 5: Debt Profile





3. Continue to protect margins.
 - a. BATS has an industry leading EBIT margin of 46% at the end of FY23. Margins having been consistently increasing since 2013, however, declined slightly to 44.9% in 1H24.
 - b. Net margin sits at approximately 24%.
 - c. NGPs are expected to contribute to margins in the future, however, they are currently undergoing extensive investment in products and marketing. This segment has just turned profitable, two years ahead of the initial expectation,
4. Continue to offset cigarette volume decline with price increases.
 - a. The business currently has a global market share of 22% excluding China, however, global cigarette volumes have been declining between 3% and 5% for the last decade, however, they saw a “high double-digit decline” in the US in 2023 and saw a 13.7% decline in volume for 1H24 which is concerning.
 - b. The company’s discount cigarette brands trade at a price discount of approximately 40% to Marlboro.
5. BATS has been a long-term shareholding in ITC (previously Indian Tobacco Company).
 - a. BATS held a 29% stake in ITC and since ITC has moved away from tobacco and become a conglomerate of various companies.
 - b. Indian regulation does not allow for foreign investment in tobacco companies. BATS legacy shareholding allowed them to keep their stake but makes any future sale difficult due to the restrictions.
 - c. BATS has no intention of a full sale of their stake, however, in March of last year they reduced the stake to 25.5% which generated about £2.5 billion and allowed the company to retain voting control.
 - d. It is unlikely that we will see any further sales.

Graph 6: ITC Stake





Valuation

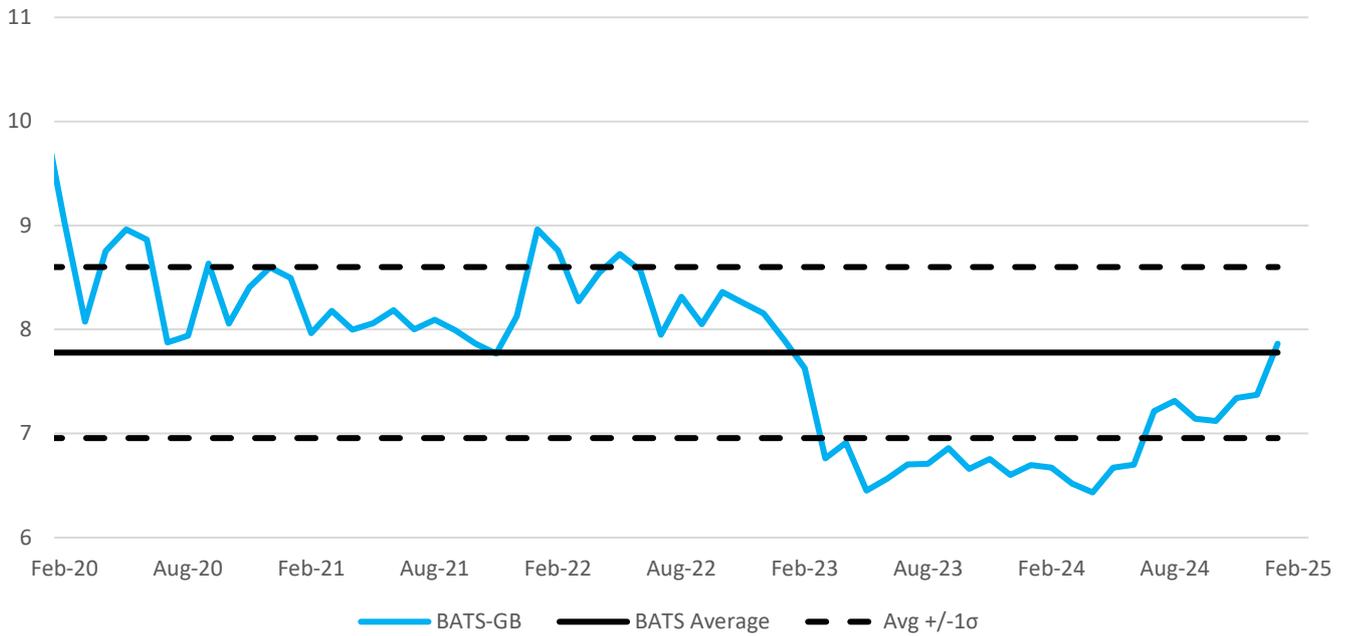
We value BATS shares using a EV/EBITDA valuation. The current two year forward EV/EBITDA is 7.9x, in line with its five year average post the 2017 acquisition of Reynolds American. We assign a probability of 10%, 60% and 30% for the bear, base and bull case respectively. We do not believe that the company will trade closer to the 10x multiple as cigarette volumes have declined faster than expected and the issues surrounding the illicit vapes will cause headwinds. A 7x multiple (bear case) is a conservative estimate and any mean reversion towards 8x five year average is reasonable and as they reduce debt and buyback shares it could trade closer to 9x EV/EBITDA and possibly get closer to the 10x ten year average, although we believe that the industry has changed enough that this is unlikely.

Table 4: Valuation

	Bear	Base	Bull
2026 EBITDA (£)	13,373	13,373	13,373
Consensus EBITDA (£)	13,761	13,761	13,761
EV/EBITDA Multiple assumptions (x)	7	8	9
Enterprise Value (£)	93,611	106,984	120,357
Net Debt/(Cash) (£)	34,470	34,470	34,470
Equity Value (£)	59,141	72,514	85,887
Shares in Issue	2206	2206	2206
Intrinsic Value per case (£)	26.81	32.87	38.93
Upside/downside per case	-20.9%	-3.0%	14.8%
Case Weight	10%	60%	30%
Intrinsic Value (£)		£ 34.08	
Current share price		£ 33.90	
Upside/(downside)		0.5%	

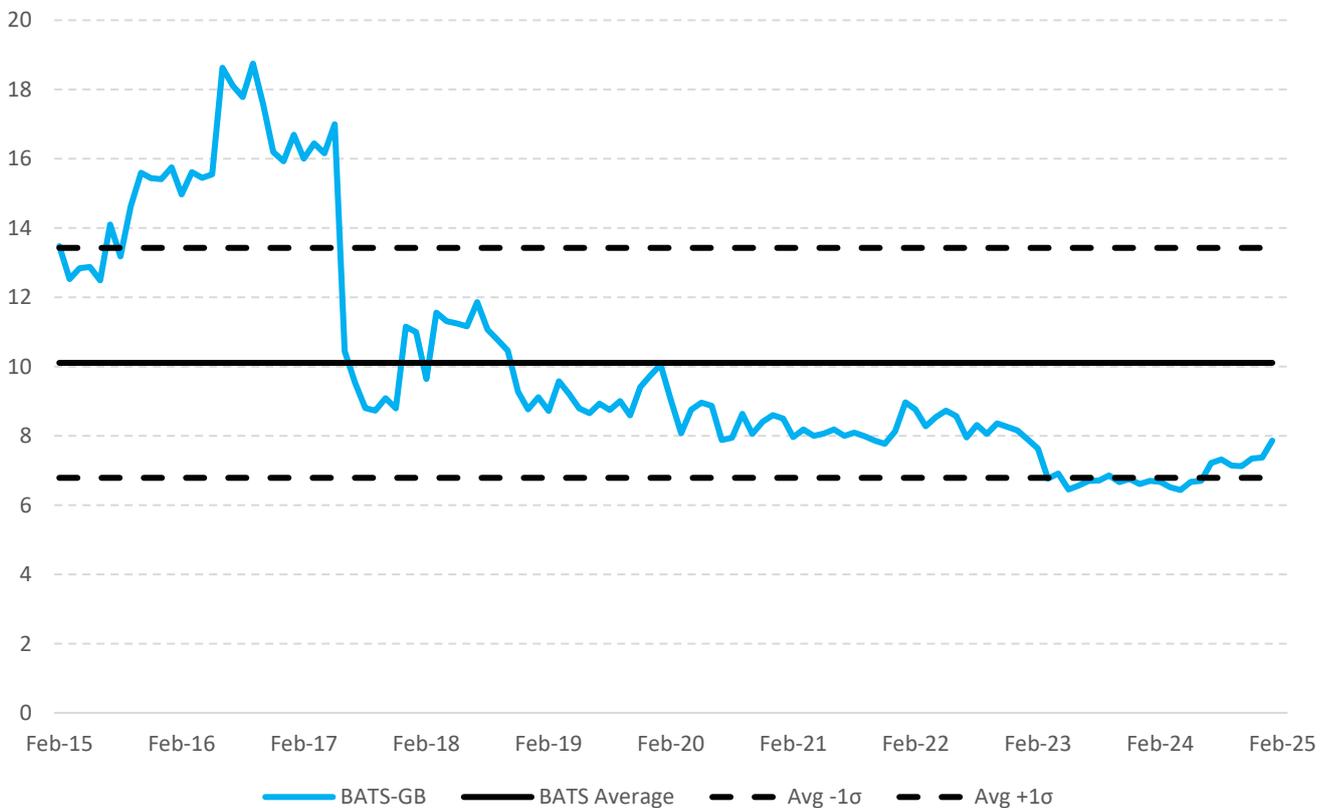


Graph7: EV/EBITDA five year average



Source: FactSet

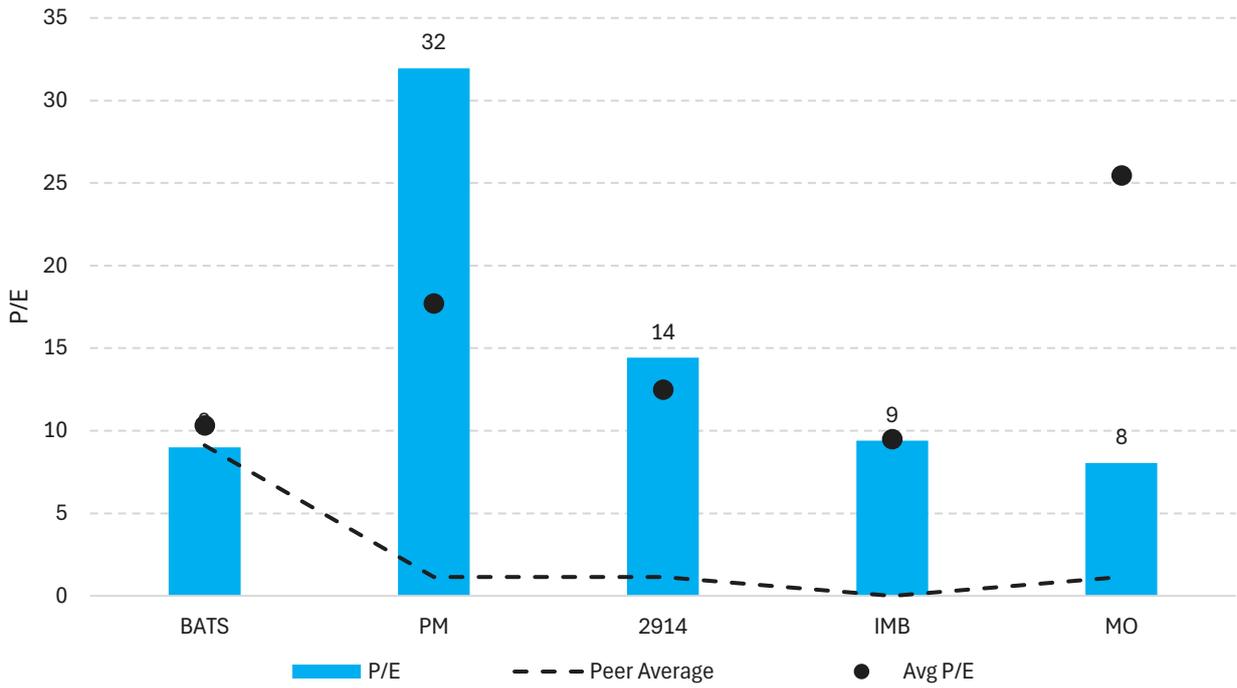
Graph 8: EV/EBITDA 10 year average



Source: FactSet



Graph 9: P:E peer comparison



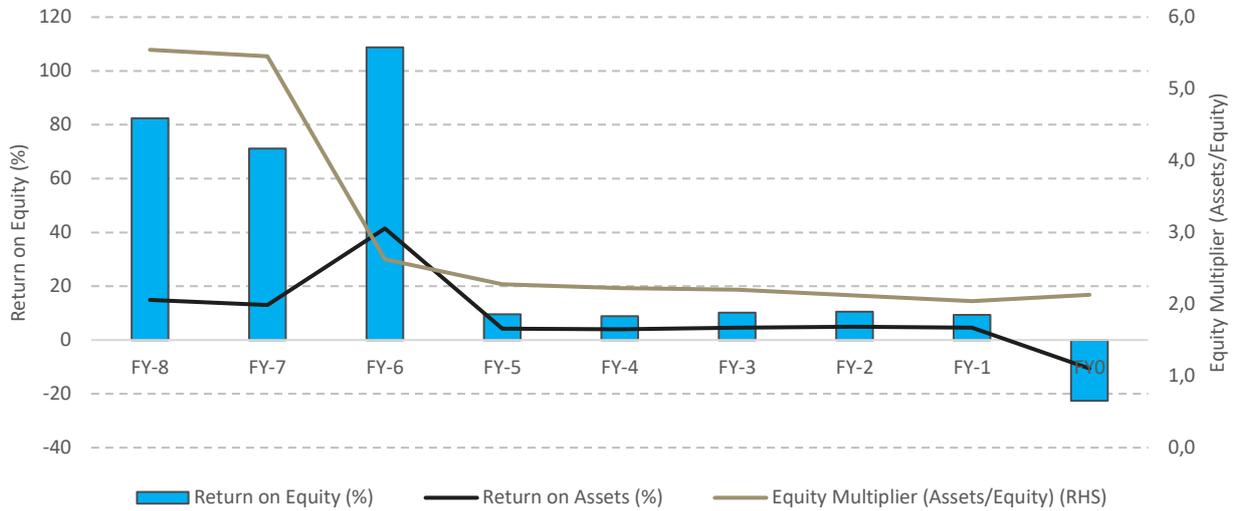
Graph 10: Price to earnings relationship





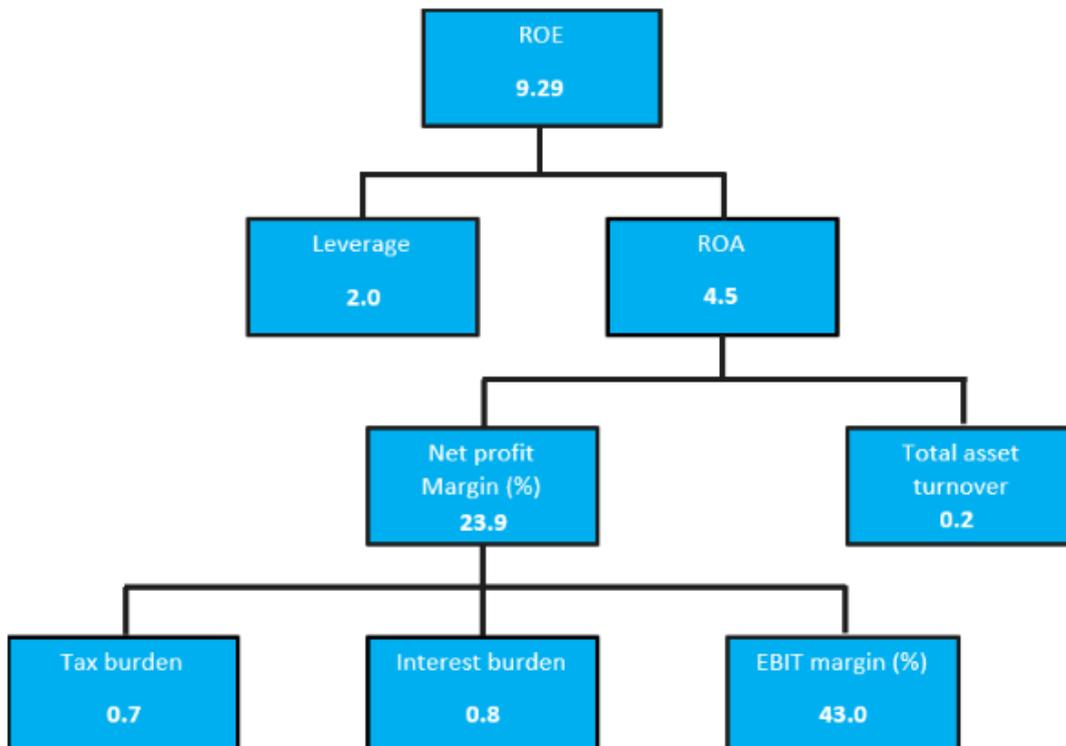
DuPont

Graph 11: Return on equity



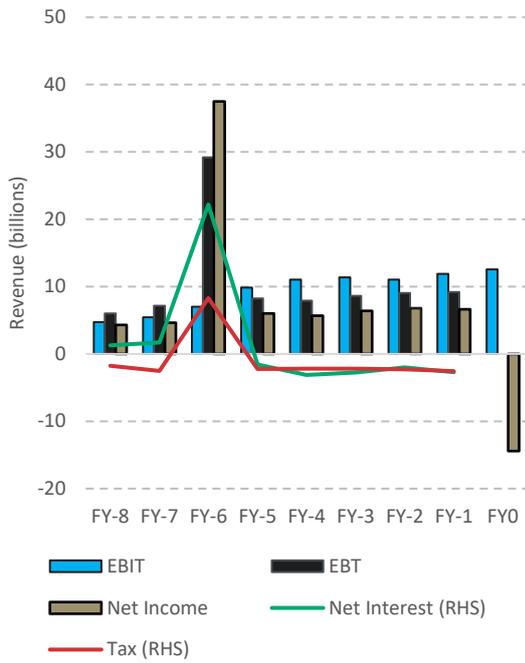
Source: FactSet

Graph 12: Dupont analysis summary

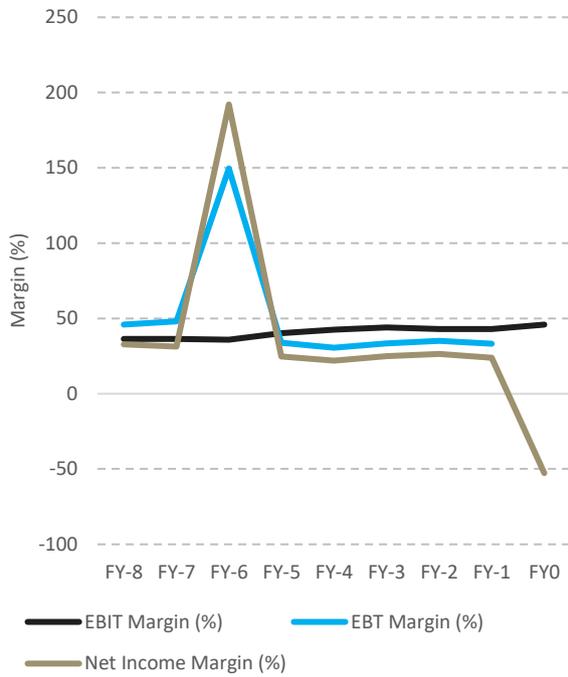




Graph 13: EBIT, EBT and Net Income



Graph 14: Margins



Source: FactSet

Financial analysis

Table 4: Share price summary

52-week high	£33.56
52-week low	£22.52
Market value (bn)	£74.4
Price momentum	Positive
3m earnings revision	0.7%
Fiscal year end	2024/12/31
Beta (3Y, daily)	0.67

Source: FactSet



Graph 15: EBIT, EBT and Net Income

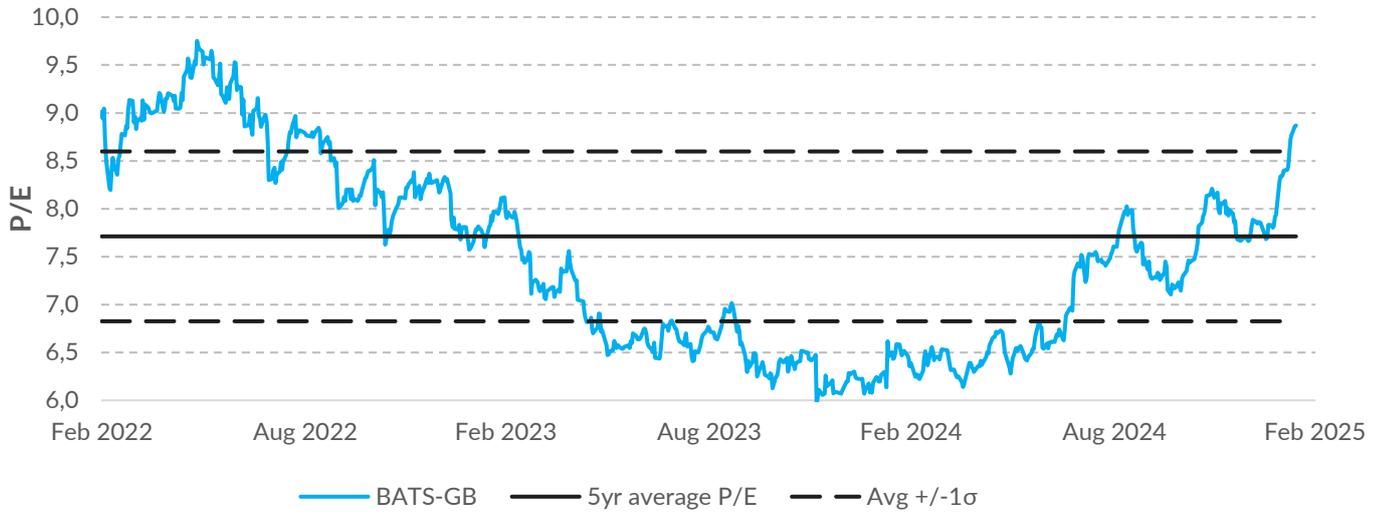
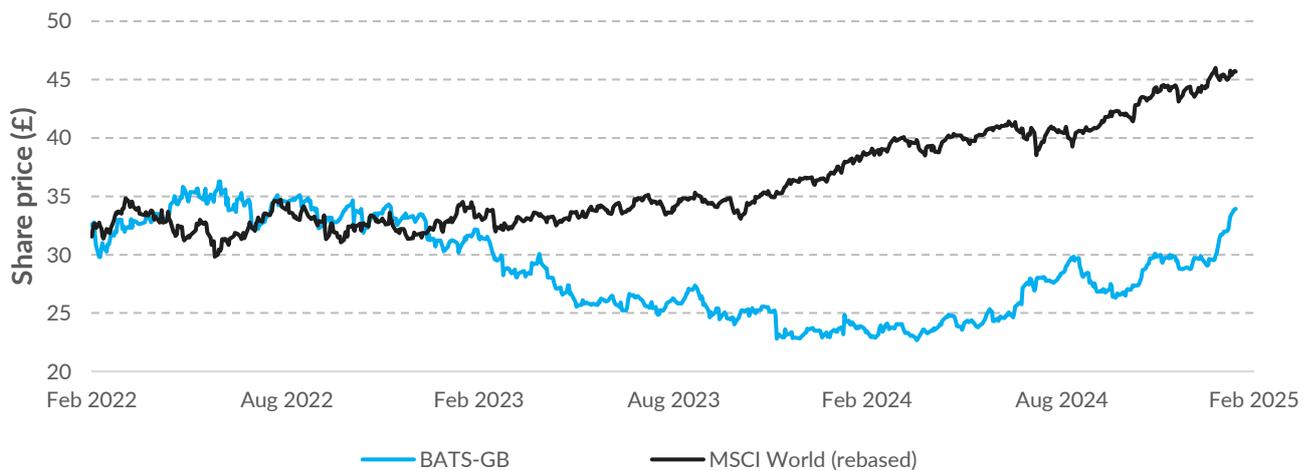


Table 5: Valuation multiples

Multiple	Latest:	Last note:
	Feb-2025	Oct-2024
P:E	8.8x	7.3x
P/S	2.8x	2.3x
P/B	1.4x	1.1x
P/CF	8.7x	6.5x
EV/EBITDA	8.1x	7.1x
EV/EBIT	8.9x	7.9x
EV/SALES	4.0x	3.6x
Dividend yield	7.3%	9.0%
FCF yield	8.6%	14.8%

Graph 16: Share price history vs benchmark



Source: FactSet



Table 6: Performance versus benchmark

Period	YTD	MTD	3M	6M	1Y	2Y	3Y	5Y	10Y
British American Tobacco p.l.c.	16.3%	4.7%	22.5%	19.5%	38.3%	10.9%	2.9%	-2.8%	-7.1%
MSCI World	4.3%	0.0%	5.3%	14.3%	18.8%	34.6%	33.8%	66.1%	174.4%

Source: FactSet

Table 7: Key competitors

Code	Price (local)	Market Cap (£bn)	Sales FY (£bn)	EBIT FY (£bn)	Net Income FY (£bn)	EV/EBIT	P:E	Price % (3mo)	Price % (1YR)
BATS-GB	33.5	74	27	12	8	8.9x	8.8x	22.5%	38.3%
PM-US	144.4	181	31	12	8	16.9x	20.2x	19.2%	64.9%
2914-TKS	3921.0	42	15	4	3	9.4x	13.0x	-2.1%	-0.1%
IMB-LON	28.3	24	32	4	3	8.1x	8.5x	19.5%	50.2%

Source: FactSet



Factset Consensus

Table 8: Financial statement summary

Income statement (£bn)	2018	2019	2020	2021	2022	2023	5Yr CAGR	2024E	2025E
Sales	24.3	25.8	25.8	25.7	27.7	27.3	2.33%	26.0	26.4
Y/Y growth (%)	-	6.2	-0.2	-0.4	7.7	-1.3		-4.7	1.4
Gross income	19.8	21.4	21.6	21.1	22.6	22.2	2.71%	26.3	27.3
Y/Y growth (%)	-	7.7	1.3	-2.3	6.9	-1.9		16.1	3.7
EBITDA	11.0	12.0	12.1	11.9	13.2	13.3	3.73%	13.0	13.2
Y/Y growth (%)	-	9.1	1.0	-1.8	10.9	0.4		-1.8	1.4
EBIT	10.3	11.1	11.4	11.2	12.4	12.5	3.79%	11.8	11.9
Y/Y growth (%)	-	7.6	2.1	-1.9	11.3	0.5		-5.5	1.4
Net income	6.8	7.4	7.6	7.6	8.4	8.4	4.32%	8.0	8.1
Y/Y growth (%)	-	9.1	2.6	-0.7	11.4	-0.2		-5.0	2.1
EPS	3.0	3.2	3.3	3.3	3.7	3.8	4.83%	3.6	3.7
Y/Y growth (%)	-	9.1	2.4	-0.8	12.9	1.1		-3.9	2.7

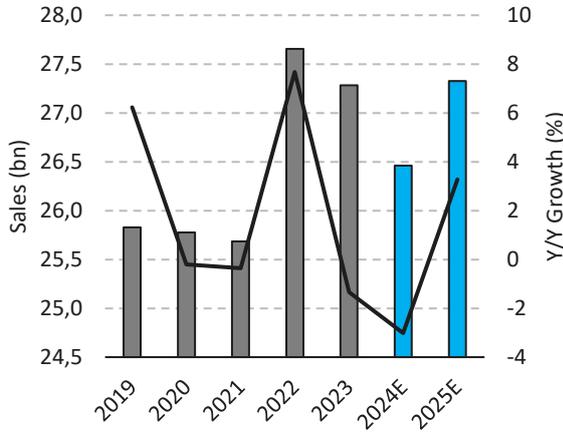
Balance sheet and cash flow (£bn)	2018	2019	2020	2021	2022	2023	5Yr CAGR	2024E	2025E
Capex	0.9025	0.781	0.711	0.714	0.6405	0.487	-11.61%	0.6	0.7
Cash from operations	8.8	7.6	10.2	8.3	9.0	12.3	4.30%	10.4	11.0
Free cash flow	7.9	6.6	7.5	7.5	8.2	8.5	1.54%	8.6	9.1
Y/Y growth (%)	-	-16.1	13.4	-0.3	9.9	3.5		0.7	6.1
Cash and ST investments	2.6	2.5	3.4	2.8	3.4	4.7	12.36%	6.3	7.8
Total assets	146.3	141.0	137.7	137.4	153.5	118.7	-4.10%	118.4	118.5
ST debt	3.8	7.1	3.5	3.5	0.1	4.3	2.86%	4.3	4.3
LT debt	43.3	37.8	39.9	35.7	38.7	35.4	-3.94%	33.9	32.9

Ratios (£bn)	2018	2019	2020	2021	2022	2023	5Yr CAGR	2024E	2025E
Gross margin (%)	81.6	82.7	83.9	82.3	81.8	81.3	82.8	82.8	82.8
EBIT margin (%)	42.6	43.1	44.1	43.4	44.9	45.7	44.2	45.3	45.3
Net income margin (%)	28.0	28.7	29.5	29.4	30.4	30.8	29.8	30.7	30.9
Current ratio	0.8	0.7	0.9	0.8	0.9	0.9	0.8	-	-
Total debt to equity	71.9	70.3	69.4	58.4	51.6	75.6	65.0	-	-
Total debt to assets	32.1	31.8	31.6	28.5	25.3	33.5	30.1	-	-
ROA (%)	4.2	4.0	4.6	4.9	4.5	-10.6	1.5	-	-
ROE (%)	9.6	8.8	10.1	10.5	9.3	-22.5	3.2	-	-

Source: FactSet

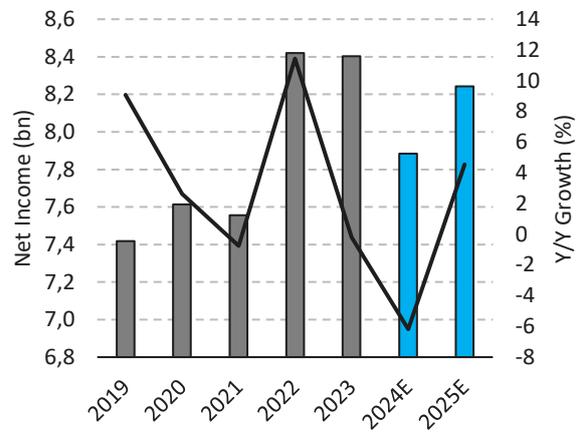


Graph 17: Annual Sales

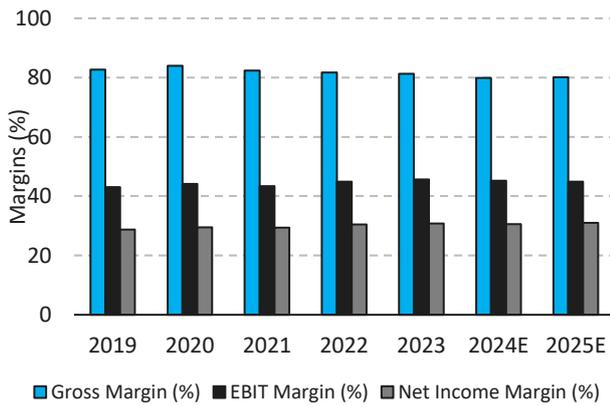


Source: FactSet

Graph 18: Annual net income

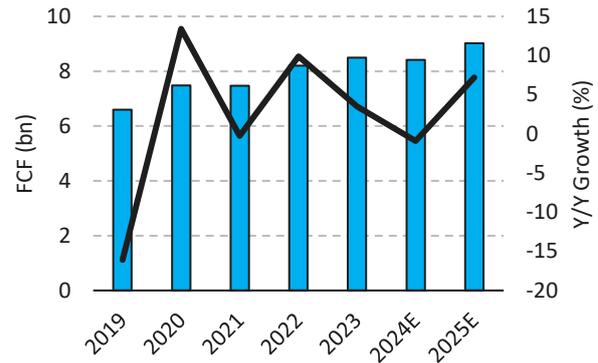


Graph 19: Gross, EBIT, Net Margins

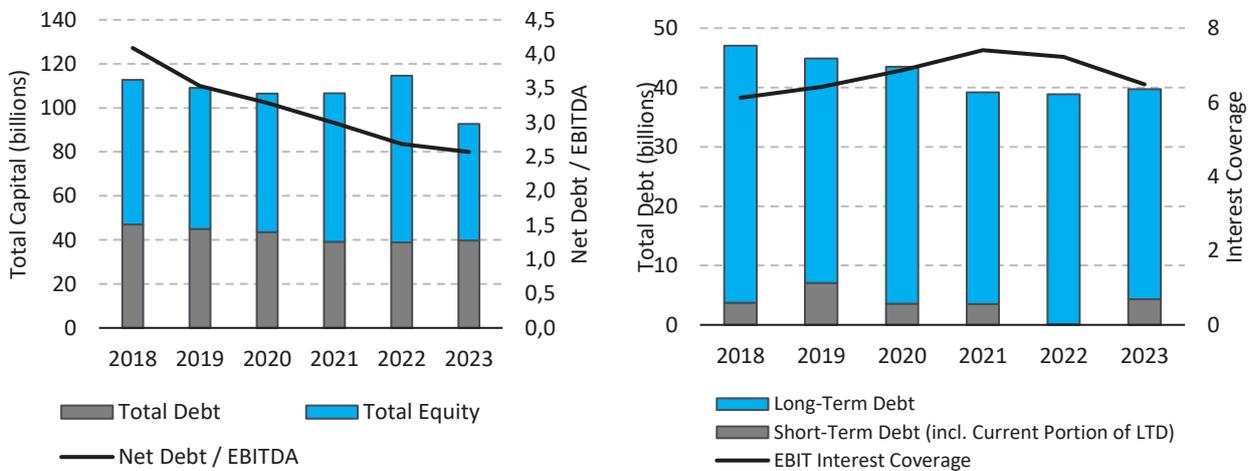


Source: FactSet

Graph 20: Free Cash Flow



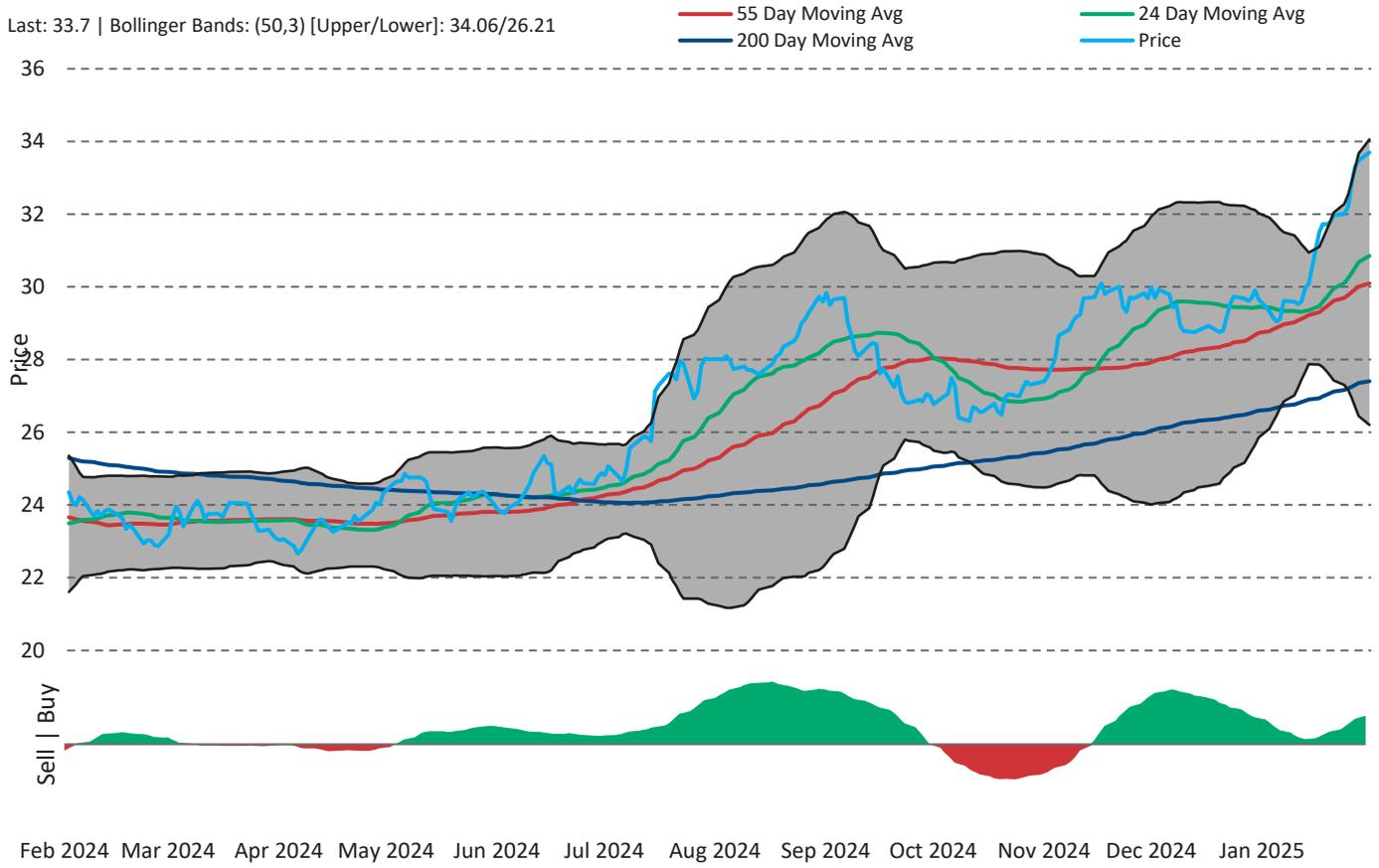
Graph 21: Capital Structure and Net Debt/EBITDA



Source: FactSet Source: PSG Wealth Research



Graph 22: Price Momentum





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