



Company Background



Description

British American Tobacco (“BAT”) was founded in 1902 as a joint venture between the UK’s Imperial Tobacco Company and the American Tobacco Company. It is the world’s second largest quoted tobacco group by global market share.

History

Tobacco

Surely ranking as one of mankind’s most curious inventions (rolling a leaf into a roll and smoking it), tobacco has been smoked for at least three thousand years. Christopher Columbus found it when he landed in the Americas in 1492, but ancient temple carvings show tobacco being smoked in Central America as long ago as 1,000 BC.

Ever since it arrived in Europe in the late 15th century, tobacco has divided opinion, sparked controversy and generated substantial revenue through tax. Not long after it reached Europe, it was being described in terms ranging from “vile custom of manifold abuses” and “feast for the fiend” to “the divine herb” and “cornucopia of all earthly pleasure”.

“We found a man in a canoe going from Santa Maria to Fernandia. He had with him...some dried leaves which are in high value among them, for a quantity of it was brought to me at San Salvador”

- Christopher Columbus’ Journal, 15th October 1492

“There is a herb which is sowed apart by itself and is called by the inhabitants Uppowoc. In the West Indies it hath diverse names, according to the several places and countries where it groweth and is used: the Spaniards generally call it Tobacco”

-Thomas Hariot ‘A Brief and True Account of the New Found Land of Virginia’, 1588

British American Tobacco

On 29th September 1902 the UK’s Imperial Tobacco Company and the American Tobacco Company of the US (founded by James “Buck” Duke) formed a joint venture, the British American Tobacco Company, in a bid to end an intense trade war.

Under the agreement, the two companies would not trade in each other’s domestic markets and acquired the right to use each other’s brands and trade marks in their own territory. Imperial Tobacco’s and American Tobacco’s businesses outside the “home” markets of the UK and US were transferred to BAT, giving the new company operations in countries as diverse as Canada, Japan, Germany, Australia, South Africa and China.

By 1911, the American Tobacco Company had divested its shares in the joint venture and BAT had listed on the London Stock Exchange with British investors acquiring most of its American parent’s shares. The company was then free to conduct its business independently throughout the world, except in the UK where territorial agreements remained with Imperial Tobacco.

Products

BAT focuses on producing high-quality brands that are now chosen by one in eight of the world's smokers. Of the 300 plus brands sold worldwide, 27% of global volumes are accounted for by its four so-called "Global Drive" brands:



Kent

Introduced in America in 1952 and sold in more than 75 countries, Kent is BAT's largest premium brand.

Lucky Strike

Launched in 1871, Lucky Strike is one of the oldest and most iconic trademarks in the world, sold in more than 65 countries.

Dunhill

First sold in 1907, Dunhill offers a range of premium and super premium cigars and cigarettes sold in more than 100 countries.

Pall Mall

Introduced in 1899 and sold in more than 100 countries, Pall Mall is BAT's leading global value-for-money brand.

These premium brands continue to generate steady growth as smokers defect from rival brands and are the most profitable arm of the business. They also benefit from up-trading in countries such as Russia, Africa and China.

Other famous international brands include:



John Player Gold Leaf

Dating back to the 1890's, BAT owns the international rights outside of the UK, US & Europe.

Vogue

A super premium brand sold in more than 55 countries.

Rothmans

Launched in 1890 and sold in some 60 countries.

Benson & Hedges

Created for the Prince of Wales in 1873, BAT acquired the rights to the brand in a large number of overseas markets in 1956.

Viceroy

Introduced in 1936, Viceroy is sold in more than 40 countries.

Peter Stuyvesant

First launched in South Africa in 1954 and then internationally in 1957. Now sold in around 30 countries.

State Express 555

Launched in 1895 and now sold in more than 20 countries, the brand is particularly popular with smokers in China, Taiwan, Cambodia and Vietnam.

In summary, BAT's product portfolio is broadly balanced between premium, mid-price and low-price. Though the premium brands are the most profitable, it is still important for the company to have strong low-priced brands for those trading down, particularly in Western Europe and the US.

Organisation

Though headquartered in London, BAT was “born international” and its business spans Africa, the Americas, Asia and Europe and employs more than 60,000 people worldwide.



BAT's London Headquarters

Strategy

Emerging Markets

BAT relies pretty much exclusively on the emerging markets for its growth as the number of smokers in the developed world continues to decline. Indeed the majority of its profits stem from outside the UK with emerging markets accounting for 75% of volumes, 66% of revenue and 60% of profit. And smoking rates in developing countries remain high. The World Health Organisation (“WHO”) says tobacco use in emerging markets is rising 3.4% per year, with the Western Pacific region having the world’s highest smoking rate at nearly two thirds of the male population. With smoking rates still rising sharply in highly populous countries such as China, India and Indonesia, BAT is well placed for balanced, defensive growth and to successfully switch customers towards its premium brands.

Historically, smoking controls in many of the emerging markets have been far less stringent than in the West. In Hong Kong, for example, duty represents only 60% of the retail price of cigarettes, lower than the 75% recommended by the WHO. In many markets, the proportion is lower still.

BAT has also started producing cigarettes in China. 62% of Chinese men and 3.8% of Chinese women smoke. That’s a total of 350m people and rising. Less than 5% of the 1.7trn cigarettes sold each year in China are currently made by foreign companies, suggesting there is huge growth potential.

Developed Markets

Because it deals in relatively price inelastic and addictive products, BAT also offers defensive growth in developed markets that doesn’t require a crystal ball to forecast. Despite a continual battle against stiffening government regulations around the marketing of cigarettes, and the effects of tax increases on demand, people continue to smoke. And, in an ironic twist, the effect of government’s attempts to stifle the supply of smuggled cigarettes seems to be boosting sales volumes of the duty-paid ones.

Takeovers

Whilst the era of mega-mergers is winding down, there is much scope for merger & acquisition activity in the form of smaller bolt-on acquisitions, such as niche product or state-owned companies.

One example is the 2008 takeover of ST which gave the company a bigger foothold in the £1bn plus market for snus. Snus is a moist powder tobacco which is consumed by placing it under the lip. Traditionally used in the Scandinavian market, it has been a highly effective way for Swedes to quit smoking, and thus reduce the health risks of tobacco use. The WHO acknowledges that Swedish men have the lowest rate of lung cancer in Europe. Though still harmful it does eliminate exposure to second-hand smoke and thereby evade smoking

bans. Though banned in Europe, recent actions by many European governments to limit the use of cigarettes has led to calls to lift the ban on snus, as it is generally considered to be less harmful than cigarette smoke. It is being trialed in South Africa and the US.

Another example is the 2008 purchase of Turkey's state-owned cigarette company Tekel, which transformed the company's position by giving it a 36% share in the world's eighth largest cigarette market.

Tobacco Regulation

Tax increases

Tobacco duty increases in themselves have not proved entirely problematic for BAT -due to the low starting point and price inelasticity of cigarettes in many countries price rises have historically had a relatively limited impact on volumes. In fact, duty increases often present tobacco companies with a useful opportunity to push through their own price rises. The tobacco industry relies on price inflation much more than volume inflation and BAT has been particularly successful at raising prices.

Smoking Bans

BAT has been fighting the likes of smoking bans for most of its 100+ year existence and has responded by introducing new product lines of "light" cigarettes that have lower levels of nicotine and tar. And new products, such as chewing tobacco, are able to circumvent smoking bans.

Prohibition

Although the products pose risks to health and the industry can be seen as controversial, their products are legal and calls for prohibition are rare and about a billion adults globally choose to smoke.

Summary

Trading on a p/e ratio substantially less than the overall market, BAT is a classic "boring defensive" share that more than matches the growth stocks. The beauty of a mature business such as BAT is that capital spending can be low, so most of the masses of cash generated can be paid straight to shareholders as dividends. This makes BAT one of the best dividend payers as well as price performers in the FTSE.

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