Simon Raubenheimer

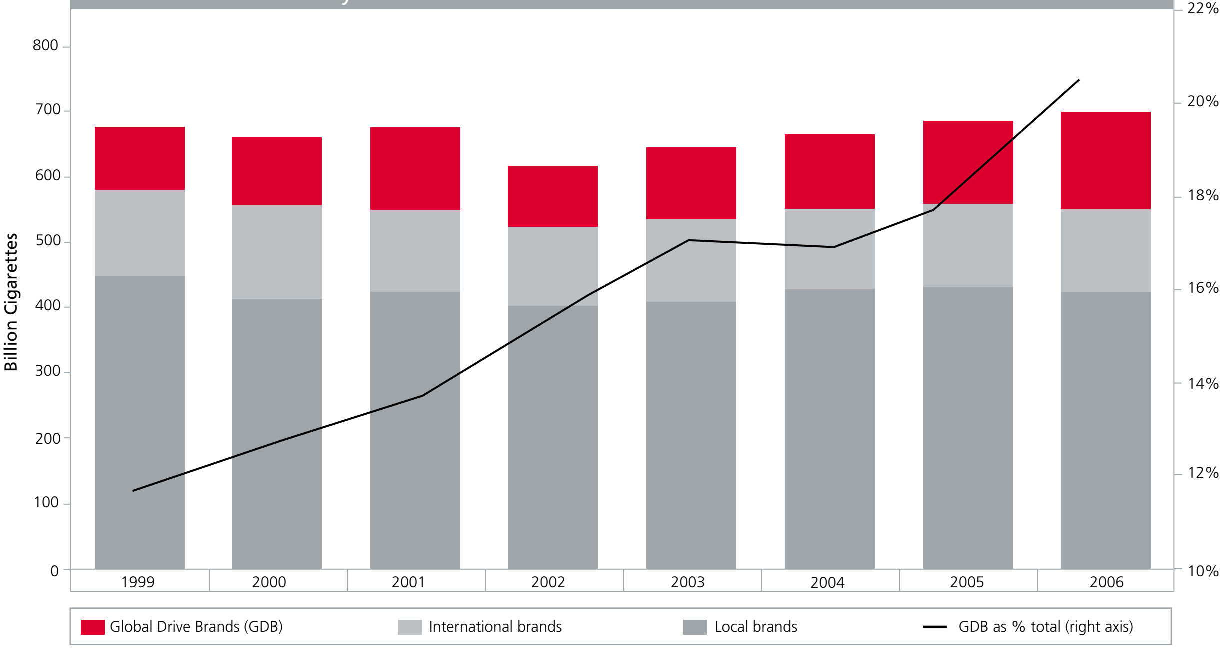
BRITISH AMERICAN TOBACCO: A LONG CONSISTENT HISTORY OF GENERATING RETURNS

EXECUTIVE SUMMARY: The constancy of demand for tobacco over many decades makes it a particularly attractive investment especially for South African investors, given the unsustainably high levels of profitability currently enjoyed by many local companies. Investors can tap into British American Tobacco (BAT), which has produced phenomenal returns over 95 years, through Remgro and Richemont, who own 11% and 19% of BAT respectively. Simon Raubenheimer outlines the investment case for BAT, based on three factors: volume growth, successful brand management and cost savings.

British American Tobacco (BAT) has been a phenomenal investment over the very long-term: £1000 invested in BAT in 1912 would have generated a total return of £93m vs. £25m for the FTSE, an outperformance of 1.3% p.a. for 95 years. A distinguishing feature of the tobacco industry has been the constancy of demand for its products over many decades. This defensiveness is particularly attractive in our market, given what we believe to be the unsustainably high levels of profitability currently enjoyed by many South African companies.

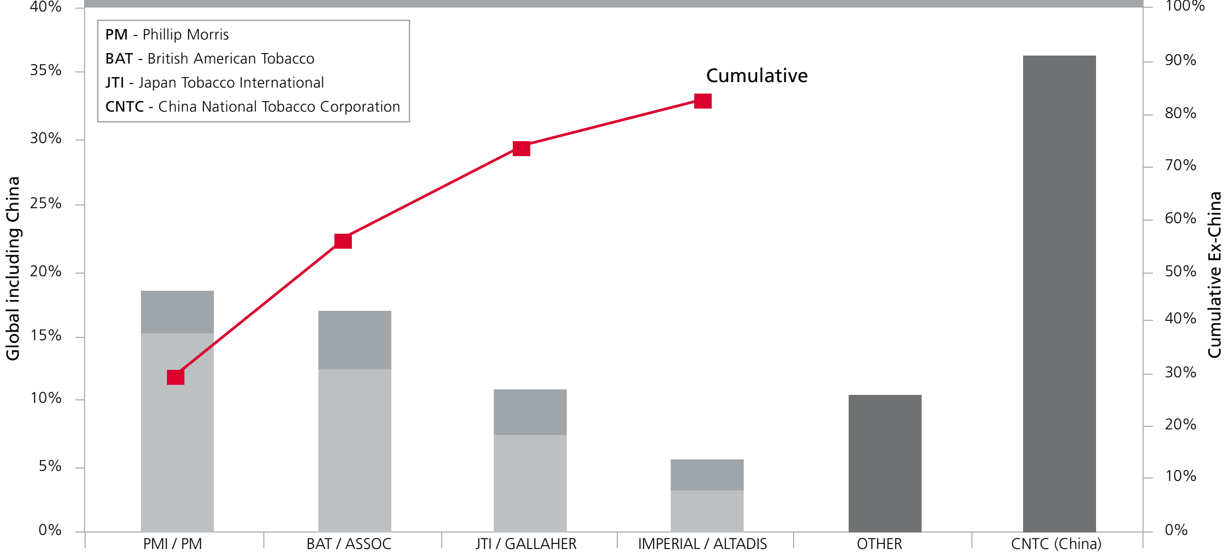
BAT is not listed directly on the JSE, but remains one of our clients' biggest holdings through Remgro and Richemont, who own 11% and 19% of BAT respectively. At the current share price, BAT accounts for 50% of Remgro and 40% of Richemont's value. Remgro and Richemont recently announced their intention to explore the possibility of splitting their tobacco assets from their remaining operations, which may entail providing their shareholders with the option of becoming direct shareholders in BAT. Depending on the mechanics of the unbundling, this transaction could be significant for our domestic stockmarket as BAT's market capitalisation, at £39bn, is similar to that of Anglo American.

GRAPH 1 BAT volume by brands



Source: Allan Gray research

GRAPH 2 World market share



Source: Allan Gray research

The investment case for BAT: volume growth, successful brand management and cost savings

The investment case is substantiated by:

- Volume growth in emerging markets: accounting for 80% of BAT's volumes and offsetting the decline experienced by developed markets, resulting in flat to moderate growth overall;

- Favourable mix effects and real price increases: largely due to consumer up-trading to BAT's Global Drive Brands (Kent, Lucky Strike, Pall Mall and Dunhill) that generate significantly higher margins. Global Drive Brand volumes have grown by over 9% p.a. since 1999 and almost doubled as a percentage of overall volumes (to 22%). This can be attributed to successful brand management, product and packaging innovation. Examples of these include flavour threads, Superslims, 'Top Leaf' and 'Fine Cut' tobacco; wallet, moisture-proof and resealable packs. Marlboro, the world's best-selling premium cigarette and competitor to BAT's Global Drive Brands, experienced marginally declining volumes over the same period;

- Significant cost savings and efficiency gains: in 2006, BAT operated from 52 factories in 51 countries. A century of bolt-on acquisitions has resulted in BAT's current unwieldy manufacturing setup. Despite having initiated a restructuring programme in 2003, BAT retains the highest cost base in global tobacco but management is confident that much can be done to align BAT's costs further with its global peers.

Regulatory changes moderately soften demand but adds barriers to new entrants

First world tobacco usage has been in moderate decline since the publicity in the early 60s of tobacco's harmful effects, and undoubtedly will continue to decline in the face of quickening regulatory changes and excise increases. Despite a proliferation of increasingly antagonistic regulatory changes over the past decade, BAT has managed to grow its earnings by over 10% annually. Regulatory threats remain, but are largely in the base: global tax incidence (the portion of the retail cigarette price that accrues to government) is now at 65% (from 58% in 2003), and numerous countries have instituted advertising and public smoking bans. Empirical evidence (UK, Ireland, Italy) has shown that consumer behaviour adjusts swiftly to new regulation and historical trends usually prevail after an initial short-lived knee-jerk reaction. Where, on the one hand, higher tobacco taxes have served to soften demand, they have, on the other hand, also raised the barriers to entry by making it more difficult for new brands to compete on price.

Following the Master Settlement Agreement in the US in 1998, global tobacco litigation has been in secular decline. The curtain seems to be falling on global tobacco consolidation with the recent corporate activity likely to result in four companies (Philip Morris, BAT, JTI-Gallaher and Imperial-Altadis) controlling over 80% of global tobacco ex-China. Competition is expected to remain fierce but rational.

> "... BAT will remain undergeared, with one of the strongest balance sheets in global tobacco."

Not currently cheap, but inherent stability gives us confidence

On over 17x earnings, BAT is not outstandingly cheap. However, its economics should enable the company to grow earnings in real terms despite paying out all its earnings. This is a hypothesis management will test over the next few years by raising the dividend payout ratio (as a percentage of earnings) from 50% to 65% and raising the share buybacks to £750m p.a., effectively returning almost all of its earnings to shareholders. Despite this BAT will remain undergeared, with one of the strongest balance sheets in global tobacco. BAT is globally diversified with no single country accounting for more than 8% of operating profits. The inherent stability that characterises tobacco consumption gives us additional confidence in BAT's ability to sustain and grow profits irrespective of global conditions. It is difficult to claim this of many other companies that have enjoyed record profitability amidst boom times.