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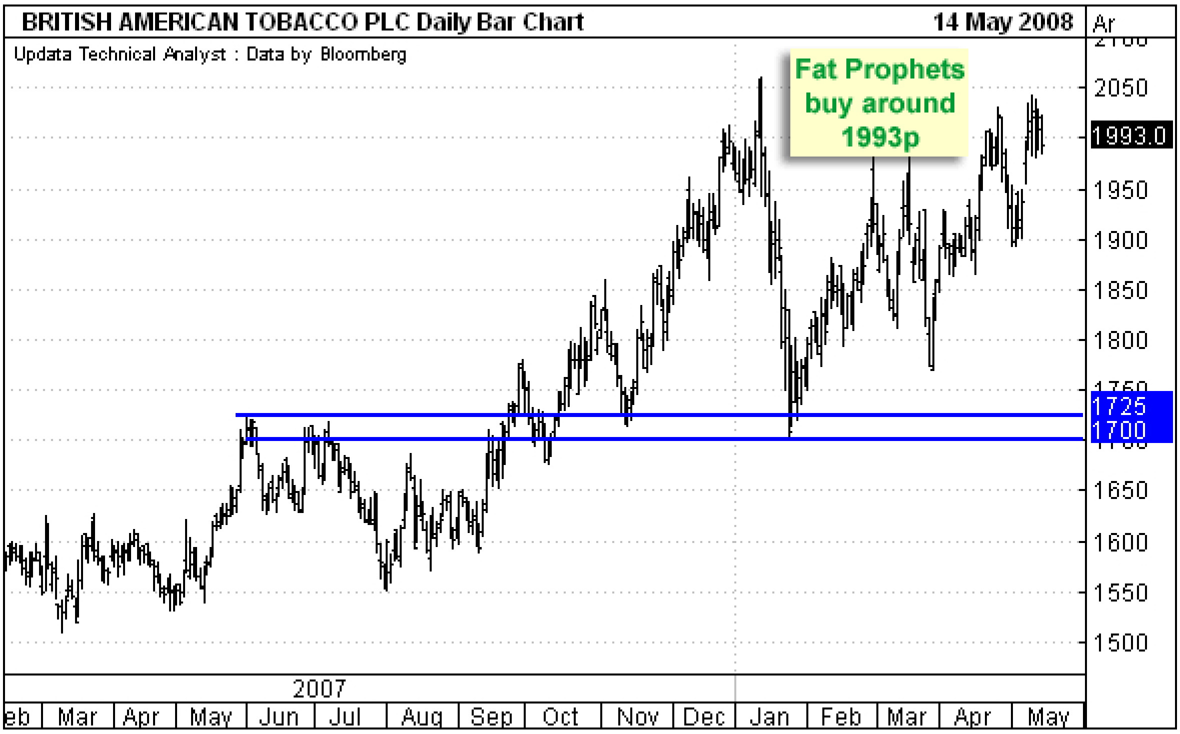
British American Tobacco 15/05/2008 FAT-UK-233

BATS GBP £19.93 Core MED. B

Still smokin'

As we have remarked frequently this year, we expect the broader market will face significant headwinds in 2008. As such stock and sector selections will be more paramount than ever. Given an environment of increasing market volatility, rising inflation, and ongoing consumer belt tightening in the West, we believe defensive opportunities will find ever-increasing favour.

And one such is the tobacco sector. Although in theory a discretionary sector, the reality is much different. The need of smokers for a 'fix' tends to prove resilient, even during tougher economic times.



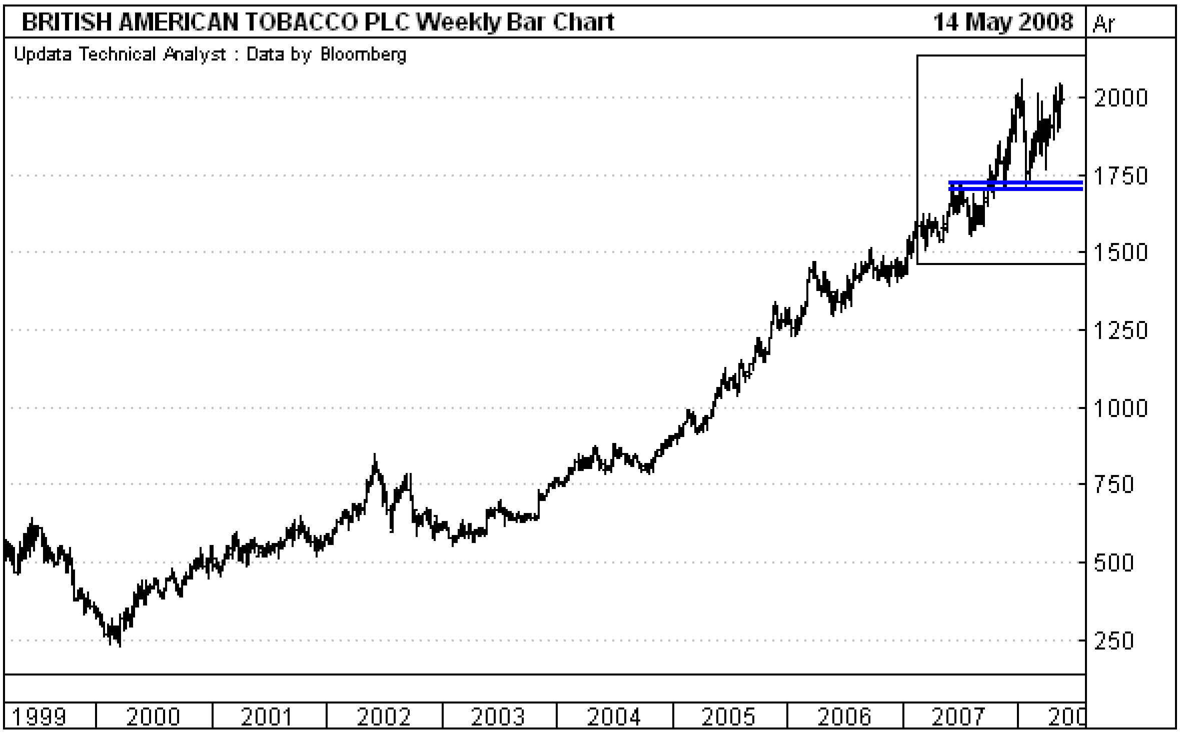
In London there are just two tobacco companies on the main board, British American Tobacco, and Imperial Tobacco. We have been following both closely for some time now, and believe both offer excellent exposure to ongoing out-performance in the sector. However, with the prospect of a rights issue hanging over Imperial we believe British American Tobacco (BATS) rates as the standout choice.

The tobacco company is the world's second largest (behind Phillip Morris), with over 300 brands sold in more than 180 markets. British American operates in around 50 cigarette factories and sells more than 680 billion cigarettes per annum. Premium brands comprise Dunhill, Kent, Lucky Strike and Pall Mall.

Such a position of dominance has of course has taken time to evolve, and there has been a fair share of pain along the way. British American Tobacco was founded in 1902 as a joint venture between the UK's Imperial Tobacco and the American Tobacco companies.

The ensuing 100 years have seen the company grow rapidly, both organically and through acquistion. Mind it hasn't all been smooth sailing, with wars and decolonisation putting paid to key markets in Egypt, Indonesia and China.

Today the company is a true multi-national, another key attraction in our view. Revenues are well diversified globally across Europe (38 percent), Asia Pacific (19 percent), Latin America (26 percent), and Africa/Middle East/American Pacific (17 percent). Exposure to the US is through 42 percent owned Reynolds American.



And being an international, well branded, maker of (let's be honest) a highly addictive product, against the backdrop of a burgeoning global population, has unsurprisingly reaped rewards.

As the charts would suggest.

A strong upward trend has been the dominant feature of the shares for more than eight years. In this time, there has been a greater than nine-fold increase in prices.

Although the long-term upward trend has paused for consolidation since reaching an all-time high of 2060p in January, underlying momentum remains firm. Over the past four months, the stock has staged a solid rebound, climbing more than 20 percent to touch 2043p.

On inspecting the charts, one might suggest that the story is 'done' with upside capped. Not so in our view. The ever increasing number of potential customers, a proven ability to pass on price increases, and defensive nature of the product mean that the growth story is far from over in our view.

This week's first quarter results bear this out.

Earnings for the three months to March rose 18 percent to £807 million on revenues that were up 14 percent to £2.5 billion.

Yes a weaker pound offered some assistance, however underlying turnover growth was a still solid 6 percent. Group volumes ticked up 1 percent to 158 billion on the back of robust performances by the four “Global Drive” Brands (which now account for 33 percent of total volume).

Sales of Kent and Pall Mall were up 30 percent while Lucky Strike and Dunhill rose 16 and 8 percent respectively. This equated to overall premium brand sales growth of 23 percent.

Notably, a third of the revenue rise in premium brands came from migrations, with customers ‘trading up’ from lower price brands. Given the margin benefits we view this as a highly encouraging trend. And one which we expect to continue, particularly in emerging markets as consumers become more affluent and upgrade product choices.

From the company’s viewpoint, we expect this may also result in some brand ‘consolidation’ at the lower end at some point (and further cost savings).

Regionally, it appears the much hyped smoking bans across Europe are barely causing a blip on the revenue line. Underlying earnings in the region (excluding positive currency impacts) were up 16 percent to £210 million. In addition to stability of the customer base, price increases have also bolstered profitability. In our view this further reinforces the demand inelasticity of the company’s products.

Similar trends of improved product mix, increased pricing, and unwavering demand were just as prevalent in most other regions.

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The only real blot on the copybook was at US subsidiary, Reynolds American. Underlying profits at the maker of Camel and Kool cigarettes dropped 10 percent as smoking continues (unlike everywhere else) to fall out of favour across the Atlantic. We expect management to monitor the performance of the subsidiary closely and to ponder divestment at some point. An additional incentive to do so may be, despite the industry’s successful track record in defending lawsuits, the highly litigious nature of the US.

Much better to focus on faster growth markets in any case in our view.

And this is exactly what BATS is doing.

In February the company won the auction for Turkish state-owned tobacco group Tekel with a bid of US$1.72 billion. The deal elevated BAT’s local market share from 7 to 36 percent.

The purchase is a canny one in our view. Although taxes are being raised and a ban on smoking in public places implemented, it is unlikely to reduce consumption significantly in the world's eighth biggest tobacco market.

And management was not finished deal making. A week later BATS bought Skandinavisk Tobakskompagni, the Danish owner of Prinz cigarettes, for £2 billion. The transaction gives BAT the number one market position in Denmark and Norway, and takes it from fourth to second on the grid in Poland.

In addition to market share gains, management are also conscious of costs savings to be made. The Turkish deal is expected to produce annual synergies of around £30 million within 3 years, while the Swedish acquisition could deliver double that.

And indeed cost savings are something that management is vehemently comitted too. This has gained increasing focus with the shift of manufacturing to low cost locations in recent years. The company successfully saved US$1 billion last year and is targeting savings of US$800 million annually from now till 2012. We view this as an achievable target, particularly as CEO Paul Adams points out the company has "colossal purchasing scale."

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Moreover, we have every expectation that this scale will continue to be added to. The company has earmarked a US$1 -2 billion war chest for acquisitions. Already on the radar are pending nationalisations in Algeria, Tunisia, and Egypt.

With management clearly not resting on their laurels, we therefore have every confidence that a long term underling earnings growth target of 6 percent can be met.

And the balance sheet can indeed support these ambitions. Whilst gearing is around 100 percent, robust cash flows (US$1.9 billion in free cash last year) are ensuring debt levels are in decline (gearing was 150 percent 6 years ago). Interest cover is meanwhile extremely strong at 8 times. Cash totals around US$1.2 billion.

As such, we believe the current price earnings valuation of 16 times is reasonable. Complement this with a dividend yield of around 4 percent and we believe the case for recommending British American Tobacco is compelling.

"The company has world-class brand names, is geographically diversified and has an ever increasing position in some of the fastest growing tobacco markets on the planet."

Of course a key fundamental industry risk is that slowing economic growth, advertising restrictions, growing health awareness, and price inflation see tobacco consumption decline globally. We do not expect this to happen. America aside, the evidence suggests that price rises, government clampdowns, product warnings, etc are having minimal impact on overall demand from existing, and (the number of) new, consumers.

Meanwhile industry margins are actually expanding in fast growing emerging markets as their populations become more affluent.

On the charts while we cannot rule out further minor corrective dips in the near-term, we believe that such moves will be relatively shallow and short-lived. Below 1980p, support between 1950p and 1930p protects the important near-term low of 1893p.

Given the strong gains since January and the resilience of the longer-term trend, the outlook for British American Tobacco remains positive. In the months ahead, we anticipate a continuation above 2060p with considerably higher levels achievable in due course.

Overall we believe that British American Tobacco is a (excuse the pun) sterling exposure to the ongoing out-performance of the tobacco sector. The company has world-class brand names, is geographically diversified and has an ever increasing position in some of the fastest growing tobacco markets on the planet. We also believe that defensive positions such as BATS will be vital in the year(s) ahead.

Accordingly, we recommend British American Tobacco as a long term buy around 1993p.

Snapshot BATS

British American Tobacco

British American Tobacco plc is a holding company that owns, directly or indirectly, investments in the numerous companies constituting the British American Tobacco Group of companies. The Company is an international tobacco company, with its brands sold in over 180 markets.

Market Capitalisation:£40b