British American Tobacco

15/11/2018 **FAT-UK-758**

BATS

GBP £28.18 Core **MED.** **S**

Fat Prophets take profits

Shares in **British American Tobacco** (LSE.BATS) were under pressure this past week when US regulators sought to broaden their crackdown by including the highly valuable menthol cigarette category in a potential banning measure. That aside, the 'alternatives' like e-cigarettes are also seeing strict regulatory involvement in the early stages of the product's lifecycle putting a cap to its potential. Thus, we believe that it's the best time to 'kick the habit' and bank further profits before things go downhill further.

All in all, this caps a successful stint for BATS in the portfolio, with the stock first recommended at 1993p and profits taken a number of times, including at 4800p in September 2016. Dividends have also been 'healthy'.

What's New?

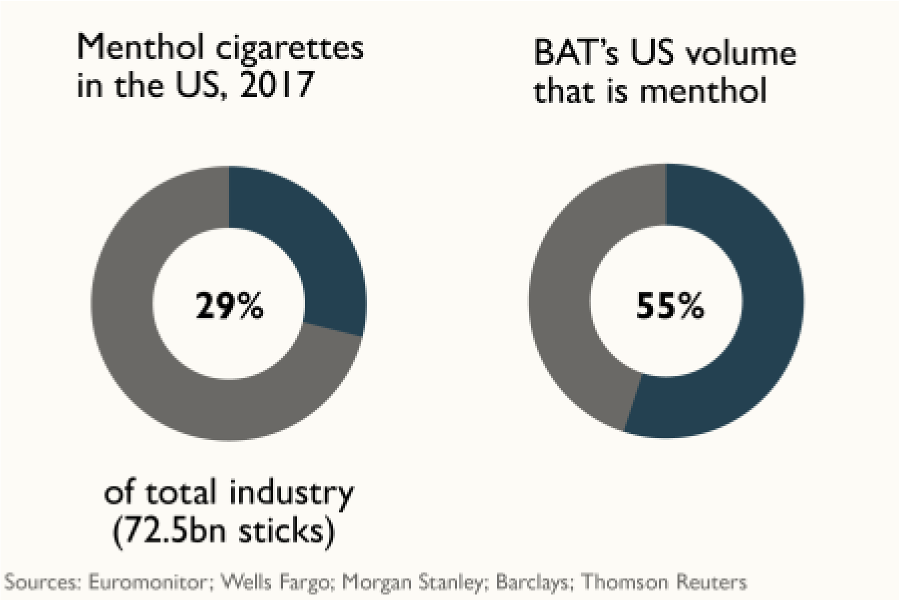
Last month (FAT-UK-753) we covered the company's first half 2018 (1H18) results which were fairly decent with operating profit continuing to climb due to pricing power as well as cost savings. We also noted the accretive impact of the Reynolds American (RAI) acquisition which has led to a surge in both top and bottom-lines.

Though we note that the timing of the acquisition looked suspect as the US regulators began taking increasingly aggressive measures on nicotine content and the flavours found in e-cigarettes (e-cigs).

Since then, it seems that the US Food and Drug Administration (FDA) has become even more aggressive with FDA commissioner Scott Gottlieb commenting this week about the expected ban on the flavoured e-cigs but also broadened the scope to include traditional cigarettes with menthol flavouring.

Consequently, BATS shares took a deep slide, to their lowest level since 2014, down some 18% since our last coverage. The market reaction is not surprising considering that a crackdown on menthol cigarettes would be particularly damaging to BATS as it has a sizeable exposure to the category thanks to its market leading (15.6% share) menthol brand Newport (acquired with RAI).

Menthol cigarettes account for at least 55% of BATS' US sales volumes, and possibly as high as 60%, while providing around a quarter of profits in the region. At the group level, menthol cigarettes account for a more modest, but not negligible 18% to 20% overall cigarette volumes and about 15% to 17% of operating profits.

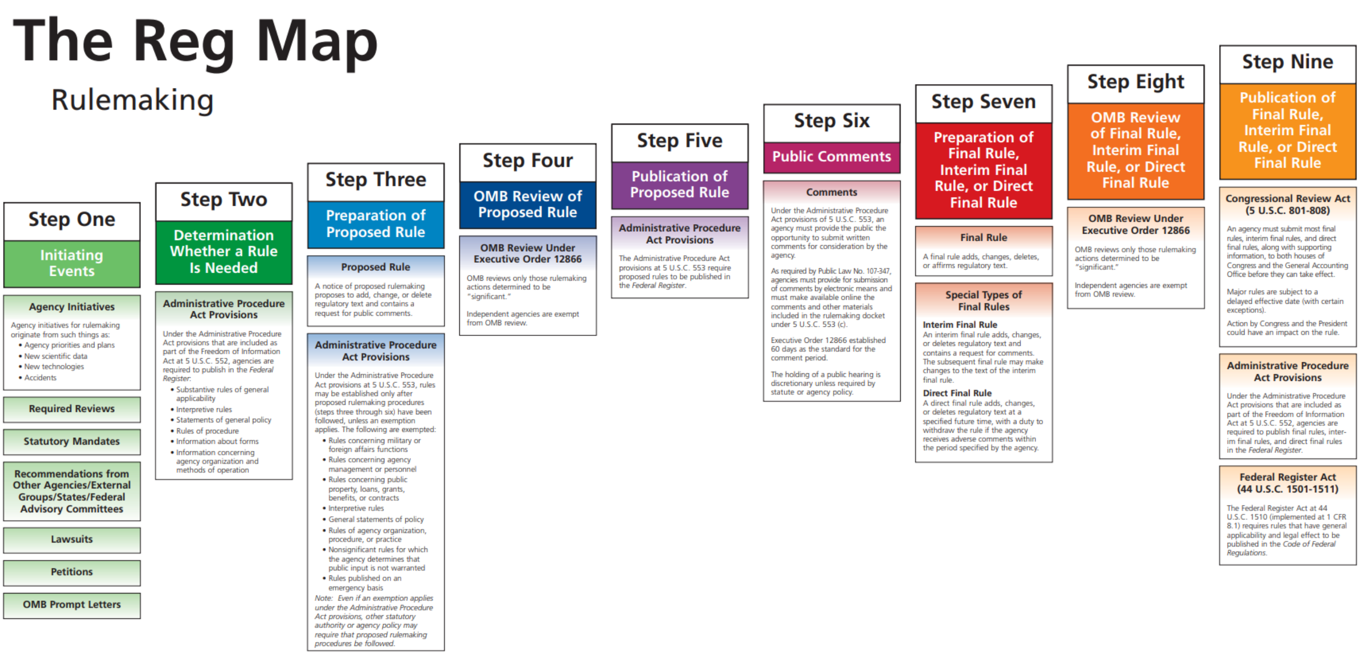


Source: The Times

This regulatory 'attack' isn't exactly a surprise considering that it has been long in the making as the FSA has been considering introducing tougher restrictions on menthol since 2013. This was when studies showed the flavour carries greater risk because it makes it easier to ignore the health effects as it hides the harsh taste of tobacco and doesn't irritate the throat.

That feature has also made it much harder to quit and makes it a gateway for new smokers to get hooked – many of which are young or underage. A concerning fact is that over 19 million Americans smoke menthol with a sizeable proportion of it being teenagers. It has become so big that it has drawn attention by regulators as that single flavour has grown to a large proportion covering over US$25 billion and 29% of all cigarettes sold in the US.

Thinking about this deeper, at present we believe this development mostly as a 'headline risk' with both media and the market largely sensationalising the event. Looking closely at the regulatory process, the path to implementation would be a long and gruelling one. The graphic below illustrates the multiple steps to implementing bans:



Source: US Food and Drug Administration

As such, we believe the near-term implementation remains suspect as it should still take years before a full ban takes place, as it would require a couple of years for a rule to be finalised and then another year or so for the ban to enforceable in the market. Furthermore, we also don't expect the Tobacco industry to just take the hit and expect significant blowback, especially with their lobbyists which would apply pressure on lawmakers and regulators.

Outside of just using legal tactics, tobacco companies can also tweak their products. A case in point is what the industry did with the fruit and candy flavour ban by putting such in cigars which has seen a rise in use since cigars and cigarillos weren't included.

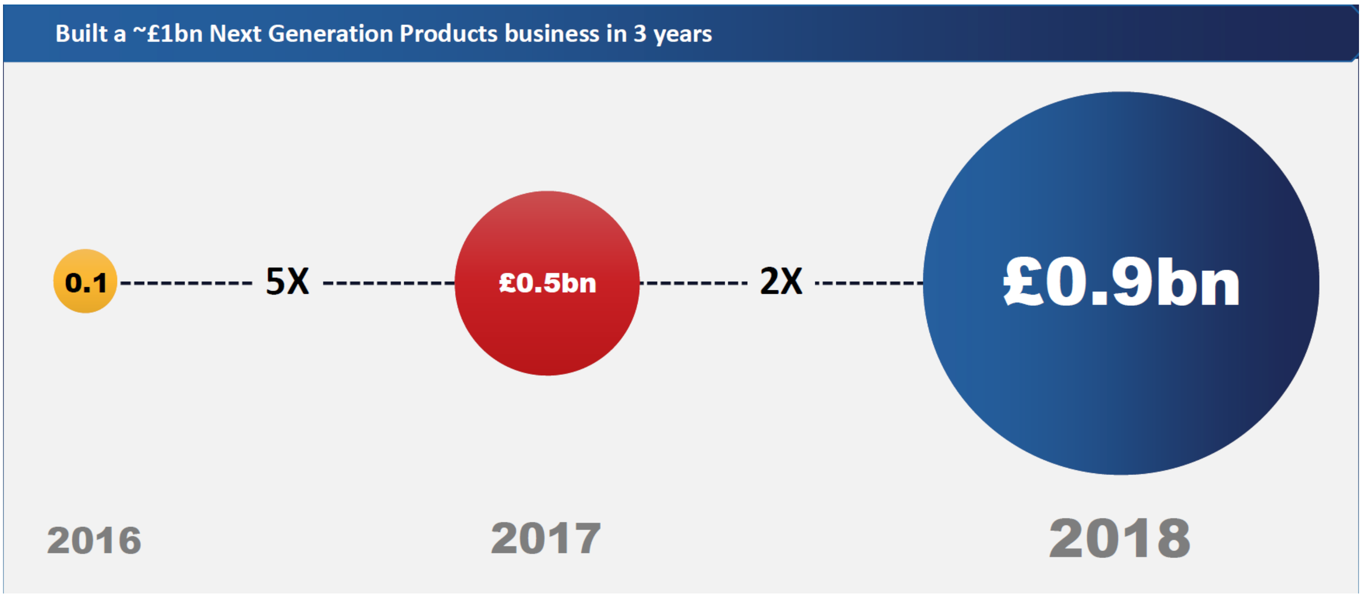
Though to be fair, it's not a matter of "if" but "when" a ban will take place as other regions like the European Union has already planned a ban soon to take effect in 2020 while Canada has already implemented one. Thus, we believe that it's more prudent to make the call to exit before things go further downhill.

Outside of regulatory headwinds, it also doesn't help that BATS' recent trading update last month showed some weakness in its Next Generation Products (NGP):

Trading Update

In an analyst call last month, CEO Nicandro Durante was quoted that the company "remains on track for a strong performance in 2018." However, he also provided an indication that the company's full year revenue targets are likely to undershoot previous expectations as NGPs are coming in 10% lower due to a flat market in Japan and a product recall in the United States.

The graphic below attempts to hide that fact by making comparisons with a much smaller base of previous years when it was just launched:



Source: 16 October 2018 Presentation

Given these mix of headwinds, we believe it's the best time to 'kick the habit' and fully exit from the stock.

On the daily chart, the bearish moving average crossover present since early September 2017 is suggestive of momentum to favour the downside. This is when the 50-day moving average (red line) crosses below the

200-day moving average (green line). Various support levels have given way, including that at the April low of 3553p, and this week the 127.2% Fibonacci retracement at 3130p. In order for the short-term technical outlook to improve, a decisive break back above both these levels is required.

With reference to the monthly chart, prices have entered a corrective phase of the overall technical cycle after printing an all-time high of 5643.60p in June 2017. Dynamic support at the long-term uptrend line has been broken. Support around the 161.8% Fibonacci extension at 3682p has given way as has the 200% Fib at 3339p. The 2013 low of 2871p could now be coming under threat.

British American Tobacco Plc - BATS (LSE) - 1 Month CandleStick Chart - GBP

Summary

This week has been a trying one for British American Tobacco which was hard hit by recent developments in the regulatory space when the US FDA announced that it's intensifying its crackdown on the industry by including menthol flavours – responsible for over half of US volumes – in the anticipated measure.

We ultimately see this ban as inevitable seeing the regulatory trends in other regions like the EU and Canada which will eventually limit inflows of new smokers – menthol is the gateway flavour after all. Though, to be fair, the proposed menthol ban would take years to implement from rulemaking to enforcing allowing the sector to gradually shift customers to other products.

There are other concerning matters as well since next generation products like e-cigarettes and thermal heating products are also seeing growing regulatory threat facing like the FDA plotting to ban fruity or sweet flavoured e-cigs. This regulatory involvement in the early stages of the product's lifecycle can put a cap to its potential.

Thus, we believe that it's the best time to 'kick the habit' and bank further profits before things go downhill further. All in all, this caps a successful stint for BATS in the portfolio, with the stock first recommended at 1993p and profits taken a number of times, including at 4800p in September 2016. Dividends have also been 'healthy'.

Accordingly, we recommend Members SELL their holdings in British American Tobacco (LSE.BATS), and coverage of the stock will cease immediately.

DISCLAIMER

Snapshot BATS

British American Tobacco

Latest Closing Price: £28.18

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:£64.9b

	FY1	FY2
Price to Earnings	3.7	9.7
Dividend Yield (%)	2.0	7.0
Price to Book	1.9	1.0
Return on Equity (%)	80.9	10.7
EV/EBITDA	16.3	10.0