

A better tomorrow

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In the old days, so-called “cancer sticks” were considered to be cool. Few from generation X can forget the pre-cinema action adverts of “Winston man” – he who didn’t give a damn and could do anything if he tried. Sports were “in play” for sponsors too. Parties in the 80s and 90s were incomplete without gorgeous women handing out free cigarette samples to impressionable young men.

Nowadays, Virginia Slims are verboten. In most civilised countries, big tobacco companies cannot even advertise their wares. As investments, big tobacco stocks are shunned, despite immense profitability and having generated some of the strongest returns over the longer term.

We first bought British American Tobacco (BATS) roughly three years ago, when the P/E ratio seemed priced for perpetual decline. Though global combustible cigarette volumes are collapsing, pricing remains robust and there is rapid replacement from growing reduced-risk products (RRP) including vapour, modern oral pouches and heat-not-burn (HNB), such that overall nicotine volumes are roughly flat (on a unit equivalent basis). Meanwhile, nicotine revenue remains growing, at a mid-single digit pace.

Our view was that, as BATS replaced reducing combustible revenue with growing RRP, the stock could rerate to a higher multiple, as growth and ESG concerns started to evaporate. Studies show that RRP, contain roughly 90-95% less harmful chemicals and carcinogens, which should steadily assuage concerns about killing customers. Though RRP have not been around long enough to determine the empirical risk reduction, there is already long-term evidence for snus (oral tobacco pouches) in Sweden, where adoption has significantly reduced cancer incidence.

Indeed, the rerating road has been run by Phillip Morris – the number one player globally – with approximately 36% of revenue coming from RRP and now sporting a P/E ratio near 19. The scintillating success of the IQOS brand in HNB products was driven by first mover advantage, scale and technological leadership. Its business model is akin to Gillette razors or Oral-B electric toothbrushes, where upfront device sales are heavily subsidised and outsized profit is made on the consumable “heat sticks”. Once IQOS had a bridgehead in any market, it became an uphill battle for competitors.

BATS is well-positioned as the number two player globally in RRP, with approximately 17% of revenue coming from RRP (well above the global average of 10%). Whereas BATS lags in HNB products (its Glo brand has the number two share globally), the company has the number one product in both pod-based vapes (Vuse) and modern oral (Velo), thus is well placed to lead the transition in these categories. Pod-based vapes generate money off profitable replacement pods. Meanwhile, G7 governments are increasingly banning dodgier disposables due to litter and recycling concerns. Rather befuddlingly, BATS’s P/E ratio remains down in the doldrums at just above 7, well below big tobacco cohorts with lesser RRP mixes.

So, what gives? BATS does bear some idiosyncratic factors:

- Last year, the Biden administration floated a federal ban on menthol to “protect minorities”, who apparently love mint. As BATS had over-indexed towards menthol, they risk being most impacted. Ultimately though, the proposal was dropped prior to the US presidential election for fear of alienating core constituents.
- BATS’s UK listing carries a higher cost of capital (lower P/E ratio) compared to its US peers. Moreover, investors in the UK are more enthused by ESG. We see this in other sectors such as energy, where UK companies trade at steep discounts to their US equivalents. Indeed, this is one of the reasons why Flutter Entertainment recently shifted its primary listing across the pond.
- In the US, over the past two years, there has been an explosion in the adoption of illegal, favoured, disposable vapes (Elf Bar, Lost Mary, etc.) imported from China. Whereas BATS’s Vuse brand can and does compete “toe-to-toe” with these upstarts outside of the US, they cannot do so in the US as they await regulatory clarity and enforcement.
- Velo is the number one modern oral product globally outside of the US. However, in the US, BATS is only approved to sell a first generation, inferior product, whilst awaiting regulatory approval for their latest, superior product, which was submitted over two years ago.

In the US, the Food and Drug Administration (FDA) requires that all legal RRP be approved. Only if an application was submitted before 9 September 2020, can it stay on the market (pending approval). The process involves expensive, time-consuming study and approval processes, akin to drug trials. The big prize for BATS (and other applicants) is a regulated oligopoly, with big barriers to entry, in a huge market comprising approximately a third of global nicotine revenue (ex-China). In granting approvals, the FDA has balanced harm reduction to existing smokers against encouraging new usage of RRP, particularly amongst the youth. To date, only a handful of vape products have been approved (of which Vuse is one) and only tobacco and menthol flavours. As things stand, disposables are precluded from the FDA process, since the form factor didn’t exist at the expiry in 2020. BATS has an application pending for flavours, using Bluetooth age verification which will prevent underage use. However, as with all things regulatory, the FDA pace seems glacial.

Meanwhile, we have witnessed a flood of illegal flavoured, disposable vapes, mostly from China, which have no possible path to FDA approval, but which BATS estimates today comprises some 60% of the market. Indeed, in US convenience stores today, one would see assorted flavours of disposable vapes and no-one will have any inkling that FDA regulations even existed. For a regulated market to work, there needs to be effective enforcement against the illegal market. The FDA under President Biden seems either unwilling or unable (or both) to clamp down. Whatever the cause, BATS is currently competing with both hands tied behind its back, lacking legal flavours and form factors (disposables) in the US.

The incoming Trump administration should add impetus to FDA approvals and enforcement. Indeed, big tobacco backed Trump’s campaign, and their lobbying machine is well connected in conservative circles. Some of Trump’s most famous supporters, including Tucker Carlson and Joe Rogan are “Zynfluencers” (well-known modern oral users and promoters).

BATS is playing the “long game”. The company motto is “a better tomorrow”, which is something investors alike, would light up for.



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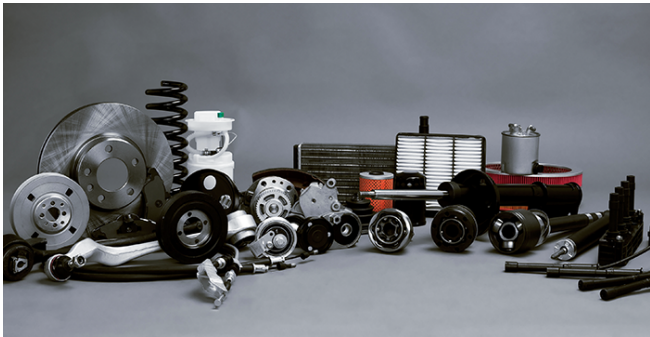


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