OPINION

British American Tobacco may lack the Magnificent Seven's cheery consensus, but it has a lot to offer

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The London offices of British American Tobacco, in England, on Jan. 15, 2021.

TOBY MELVILLE/REUTERS

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One of Warren Buffett's most notable quotes is that investors "pay a very high price in the stock market for a cheery consensus." This lesson was from a 1979 Forbes article where Mr. Buffett correctly highlighted that despite a lack of enthusiasm for equities, stocks were extremely attractive, with the S&P 500 trading at just eight times earnings.

Presently, the S&P trades at 25 times trailing earnings, an elevated multiple, but more interesting is the record high 87-per-cent premium that the S&P trades at to the rest of the world's stock markets; more than two standard deviations beyond its 20-year history.

Unquestionably, this divergence is being driven by the Magnificent Seven technology stocks, which trade at a historically rich median 50 times trailing earnings. Thankfully, there are still stocks with undemanding valuations, if investors are willing to look abroad.

British American Tobacco (BAT), whose ADR in New York is traded as BTI-N (/investing/markets/stocks/BTI-N/) +1.99% ▲ , is a global tobacco company with its primary share listing and headquarters in London, even though the majority of its profit comes from the U.S.

Despite increasingly moving away from traditional cigarettes to innovative reduced-harm offerings, the company has been abandoned by most active managers and passive funds because of an assumed terminal decline and ESG mandates.

However, even under a backdrop of falling cigarette volumes, profits have steadily increased owing to higher prices as customers have limited price sensitivity. For example, from 2018 to 2022, cigarette volumes at BAT declined to 605 billion units from 701 billion units, yet adjusted earnings per share increased to 371 pence from 297 pence (even with the majority of profits being paid out as dividends).

With a pack of cigarettes costing an average of just $9 in the U.S. versus $16 in Britain or $26 in Australia, countries that have similar smoking rates to the U.S., there still appears to be further pricing power in BAT's most important market as it transitions into its next generation of products.

The future of the tobacco sector began in 2015 with the first successful commercial vaporizer from Juul Labs. Vaping, which uses battery power to heat up a nicotine liquid into an aerosol, is not only seen by health experts as less harmful than smoking because of the lack of combustion but it allows for consumption in locations where traditional smoking would have typically left strong odours or easily set off fire alarms.

Although vaporizers were officially positioned as smoking-cessation devices, Juul's viral growth was actually fuelled by first-time users who found the sweet-smelling fruity flavours particularly appealing. This enticement of new nicotine users put pressure on regulators to force Juul and other U.S. vape manufacturers to withdraw their enticing flavours.

The product gap left vape users searching for a replacement. Nearly all users transitioned to illegal Chinese disposables that are now widely available at the 10,000 independent cigarette and vape shops across the U.S. These illegal devices come in a myriad of flavours, have zero oversight on safety from the FDA, and are intentionally mislabelled to avoid paying high duty and excise taxes. The imported shipping containers are sold to distributors, who service the independent stores via an underground network of vans and trucks.

At present, it is estimated by BAT that at least 60 per cent of the U.S. vape industry is illegal (compared with estimates as low as 7 per cent for illicit cigarette sales). These difficult conditions combined with an ill-timed massive purchase of tobacco company Reynolds in 2017 pushed BAT's shares down to today's 14-year lows and a historic low of six times earnings.

We believe that investors are missing the potential for the removal of illegal vape devices in BAT's key U.S. market. There was a blistering expert report in 2022 that described the FDA's failed efforts on the vape market as "reactive and ineffective." But it was not until later in 2023 that a number of exceptionally well-written articles succinctly highlighted that the FDA "has confiscated more heads of romaine lettuce than it has illegal e-cigarettes in the last five years."

This finally kick-started Washington into addressing the problem. In December, the new congressional committee on U.S.-China relations sent a request to the Justice Department and the FDA calling attention to "the extreme proliferation of illicit vaping products." The U.S. International Trade Commission also voted to institute an investigation of "disposable vaporizer devices."

Shortly thereafter, federal agents seized 1.4 million illegal Chinese vapes at the Los Angeles International Airport that had intentionally been mislabelled as toys and shoes. Big Tobacco is also going directly after the problem with both BAT and Altria recently launching separate court cases against illegal manufacturers and retailers.

With the Biden administration set to implement a menthol ban and with illegal disposables running wild, we believe we are near peak pessimism in the tobacco market. Any sustained enforcement success against illicit vapes would immediately turn a major headwind into a tailwind and potentially rerate BAT's PE multiple.

BAT is especially interesting because of its ownership of Vuse, the number one legal vape brand in the U.S. with a stunning 47-per-cent market share in tracked channels. Even with illegal competitors, BAT's next generation division has already turned from a £1.1-billion loss in 2020 to break-even a full two years ahead of schedule.

The company expects 50 per cent of its revenues to be from these less harmful, non-combustibles by 2035, up from 17 per cent today. Leverage is also coming down with net debt to EBITDA having declined to 2.7 times in 2023 from 5.3 times in 2017, making additional stock buybacks and/or a dividend hike increasingly likely. BAT's largest individual shareholder Ken Dart seems to agree on the opportunity, having recently increased his position to 10.5 per cent from 8 per cent of the company.

Finally, BAT has 29-per-cent ownership in the India Tobacco Company, which is equal to a third of BAT's market capitalization, despite contributing just 4 per cent of company profits. Although there are no plans to spin off this investment presently, if ever approved and at today's prices, it would further lower the PE ratio to just four times from six times.

British American Tobacco might not have the cheery consensus of the Magnificent Seven, but it does have a rock-bottom valuation, improving fundamentals and a 10-per-cent dividend yield, which strikes us as a far better risk/reward.

Full disclosure: The author and his clients have a position in British American Tobacco shares.