

26 July 2012 | 20 pages

Tobacco (GICS) | Tobacco (Citi)
Europe | United Kingdom

British American Tobacco PLC (BATS.L)

1H12 Detail: BATS a Bit Below

- **EPS in-line but EBIT was about 1% below consensus** – 1H12 organic EBIT growth was 5.7%, about 2% below our forecasts, but this was made up for by a lower-than-expected finance charge. It is rare for BAT to miss, but nonetheless in absolute terms the result was still quite good: Constant currency EPS growth was about 10%, and excluding the Japan hurdle, organic EBIT growth was about 8%.
- **Still plenty of growth in EMs, led by Brazil and Russia** – BAT dominates both Brazil and the premium sector in Russia, and in both we expect price rises in mid-2012, combined with uptrading, to deliver teens profit growth. And although BAT had a small miss on group EBIT, it still looks solid in the context of other defensive sectors: there have been bigger downgrades in pharma and telecoms, in both cases due to weak demand in Europe. By contrast about 55% of BAT's profit comes from EMs.
- **But tobacco pricing mechanism not working in some markets** – Tobacco companies have struggled to grow profits above inflation in many developed markets in 1H12, perhaps because pack prices have got too high. In Western Europe cigarette volumes dropped 6% according to PM, and even BAT, which is gaining share and has the best cost cutting potential, couldn't post more than 2% profit growth. Underlying profit in both Australia and Canada (together about 14% of profit) fell slightly for BAT in constant terms as consumers continued to trade down.
- **EPS estimates trimmed** – We have lowered our organic EBIT growth forecasts for 2H12 and 2013 slightly but this has been mostly offset by a cut to our interest charge. Overall we've cut EPS by between 0.2% and 1%, which is hardly material.
- **Retain Buy** – We expect BAT to post about 10% constant currency EPS growth in the next few years. This means that if the multiple remains unchanged, investors should see 10% annual capital returns. But our strategists believe companies like BAT that can post steady EPS and DPS growth even in the current environment will see a bit more multiple expansion. We have therefore assumed that BAT's forward P/E expands a bit to 15x, so we have lifted our price target to 3785p from 3400p. We retain our Buy rating. BAT is part of Citi Focus List Europe.

- Company Update
- Target Price Change
- Estimate Change

Buy	1
Price (25 Jul 12)	£32.81
Target price	£37.85
	from £34.00
Expected share price return	15.4%
Expected dividend yield	4.1%
Expected total return	19.5%
Market Cap	£63,908M
	US\$99,041M

Price Performance (RIC: BATS.L, BB: BATS LN)



British American Tobacco PLC (GBP)

Year to 31 Dec	2010A	2011A	2012E	2013E	2014E
Sales (£M)	14,883.0	15,399.0	15,459.7	16,153.1	16,959.8
Profit Before Tax (£M)	5,126.0	5,718.0	5,971.4	6,434.4	6,988.4
Diluted EPS (p)	175.8	194.6	207.2	227.6	252.3
Diluted EPS (Old) (p)	175.8	194.6	207.9	229.9	252.7
PE (x)	18.7	16.9	15.8	14.4	13.0
EV/EBITDA (x)	12.2	10.9	10.5	9.7	9.0
DPS (p)	114.2	126.5	134.6	147.9	164.0
Net Div Yield (%)	3.5	3.9	4.1	4.5	5.0

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

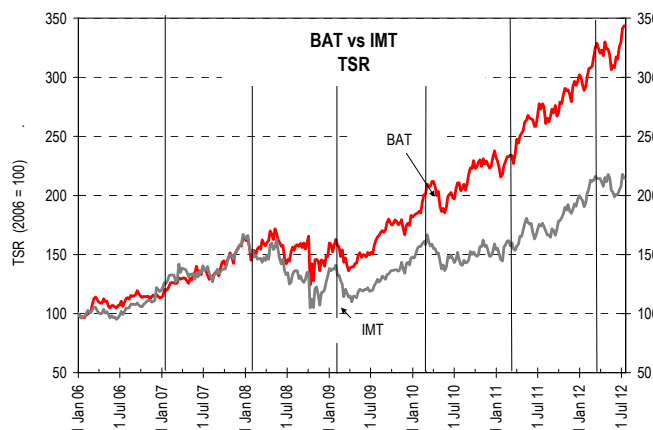
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BATS.L: Fiscal year end 31-Dec						Price: £32.81; TP: £37.85; Market Cap: £63,917m; Recomm: Buy					
Profit & Loss (£m)	2010	2011	2012E	2013E	2014E	Valuation ratios	2010	2011	2012E	2013E	2014E
Sales revenue	14,883	15,399	15,460	16,153	16,960	PE (x)	18.7	16.9	15.8	14.4	13.0
Cost of sales	-6,518	-6,504	-6,424	-6,604	-6,822	PB (x)	7.1	7.8	9.1	10.9	14.5
Gross profit	8,365	8,895	9,036	9,549	10,138	EV/EBITDA (x)	12.2	10.9	10.5	9.7	9.0
Gross Margin (%)	56.2	57.8	58.4	59.1	59.8	FCF yield (%)	5.0	5.1	5.7	6.7	7.6
EBITDA (Adj)	5,426	5,966	6,153	6,585	7,074	Dividend yield (%)	3.5	3.9	4.1	4.5	5.0
EBITDA Margin (Adj) (%)	36.5	38.7	39.8	40.8	41.7	Payout ratio (%)	65	65	65	65	65
Depreciation	-469	-394	-430	-439	-423	ROE (%)	34.2	35.6	51.9	67.2	94.5
Amortisation	-428	-423	-155	-159	-165	Cashflow (£m)	2010	2011	2012E	2013E	2014E
EBIT (Adj)	4,984	5,519	5,701	6,120	6,595	EBITDA	5,881	6,336	6,286	6,718	7,182
EBIT Margin (Adj) (%)	33.5	35.8	36.9	37.9	38.9	Working capital	107	144	-50	20	20
Net interest	-480	-460	-441	-464	-460	Other	-1,500	-1,844	-1,174	-1,081	-1,152
Associates	550	670	708	778	853	Operating cashflow	4,488	4,636	5,062	5,657	6,050
Non-op/Except	-666	-798	-150	-150	-100	Capex	-523	-566	-650	-670	-550
Pre-tax profit	4,388	4,931	5,818	6,284	6,888	Net acq/disposals	0	0	0	0	0
Tax	-1,248	-1,556	-1,588	-1,713	-1,870	Other	-77	-404	-112	-50	-50
Extraord./Min.Int./Pref.div.	-261	-280	-314	-343	-374	Investing cashflow	-600	-970	-762	-720	-600
Reported net profit	2,879	3,095	3,916	4,229	4,645	Dividends paid	-2,327	-2,633	-2,904	-3,130	-3,398
Net Margin (%)	19.3	20.1	25.3	26.2	27.4	Financing cashflow	-2,818	-3,857	-4,618	-4,844	-5,357
Core NPAT	3,505	3,857	4,036	4,349	4,725	Net change in cash	1,001	-87	-117	94	93
Per share data	2010	2011	2012E	2013E	2014E	Free cashflow to s/holders	3,240	3,326	3,652	4,203	4,694
Reported EPS (p)	144.4	156.1	201.0	221.3	248.0	Sales by Region (£ m)	2010	2011	2012E	2013E	2014E
Core EPS (p)	175.8	194.6	207.2	227.6	252.3	Asia-Pacific	3,759	4,251	4,403	4,818	5,083
DPS (p)	114.2	126.5	134.6	147.9	164.0	Americas	3,498	3,558	3,471	3,478	3,645
CFPS (p)	225.1	233.9	259.8	296.0	323.1	West Europe	3,695	3,600	3,344	3,314	3,357
FCFPS (p)	162.5	167.8	187.4	219.9	250.7	EEMEA	3,931	3,990	4,242	4,544	4,875
BVPS (p)	464.9	418.4	361.6	301.9	226.9	Sales - total segments	14,883	15,399	15,460	16,153	16,960
Wtd avg ord shares (m)	1,983	1,970	1,936	1,899	1,861	Adj EBIT by Region (£ m)	2010	2011	2012E	2013E	2014E
Wtd avg diluted shares (m)	1,994	1,982	1,948	1,911	1,873	Asia-Pacific	1,332	1,539	1,680	1,864	1,990
Growth rates	2010	2011	2012E	2013E	2014E	Americas	1,382	1,441	1,447	1,486	1,582
Sales revenue (%)	4.8	3.5	0.4	4.5	5.0	West Europe	1,103	1,228	1,132	1,124	1,168
EBIT (Adj) (%)	11.7	10.7	3.3	7.3	7.8	EEMEA	1,167	1,311	1,442	1,646	1,854
Core NPAT (%)	15.1	10.1	4.6	7.7	8.6	EBIT - total segments	4,984	5,519	5,701	6,120	6,595
Core EPS (%)	14.9	10.7	6.4	9.9	10.8	Organic EBIT Growth (%)	2010	2011	2012E	2013E	2014E
Balance Sheet (£m)	2010	2011	2012E	2013E	2014E	Asia-Pacific	2.4	11.1	7.5	10.2	6.6
Cash & cash equiv.	2,329	2,194	2,194	2,194	2,194	Americas	5.5	4.5	6.4	5.0	6.5
Accounts receivables	2,409	2,423	2,468	2,450	2,432	West Europe	10.3	9.8	-0.4	2.0	3.7
Inventory	3,608	3,498	3,563	3,537	3,511	EEMEA	na	16.7	15.7	15.9	12.6
Net fixed & other tangibles	3,389	3,352	4,659	3,498	3,625	Total EBIT	6.4	10.3	7.4	8.7	7.7
Goodwill & intangibles	12,458	11,992	11,977	11,918	11,842						
Financial & other assets	3,256	3,317	3,171	3,317	3,317						
Total assets	27,449	26,776	28,178	26,914	26,921						
Accounts payable	808	808	3,280	3,256	3,232						
Short-term debt	1,254	1,612	1,612	1,612	1,612						
Long-term debt	8,916	8,510	8,627	8,534	8,441						
Provisions & other liab	6,923	7,372	7,372	7,407	8,956						
Total liabilities	17,901	18,302	20,891	20,808	22,241						
Shareholders' equity	9,206	8,167	6,917	5,667	4,167						
Minority interests	342	307	370	438	513						
Total equity	9,548	8,474	7,287	6,105	4,680						
Net debt	7,841	7,928	8,046	7,952	7,859						
Net debt to equity (%)	82.1	93.6	110.4	130.2	167.9						

For further data queries on Citi's full coverage universe please contact Citi Research Data Services at CitiRsch.DataServices.Global@citi.com
For definitions of the items in this table, please click [here](#).

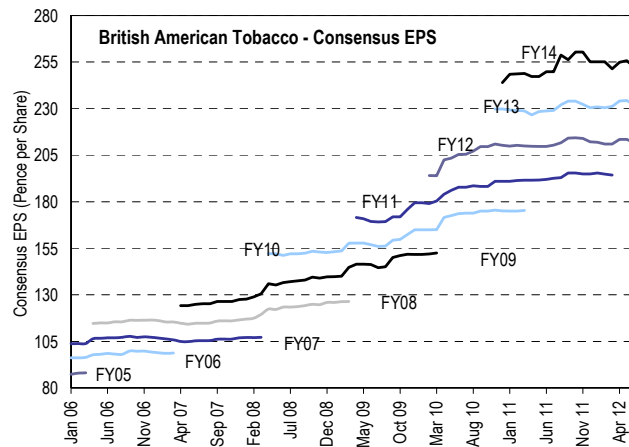
BAT – The Key Charts

Figure 1. British American Tobacco vs. IMT, 2006 to Present (GBP)



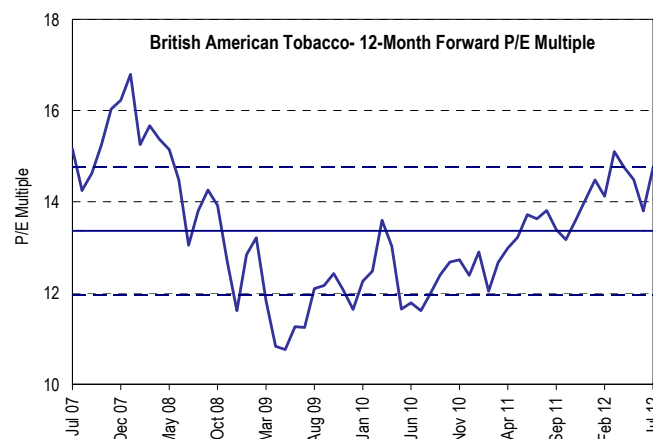
Source: DataStream, Citi Research

Figure 2. British American Tobacco – Consensus EPS



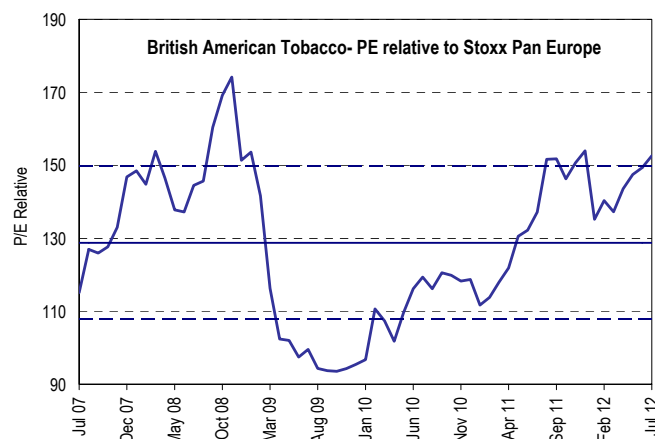
Source: DataStream, Citi Research

Figure 3. British American Tobacco – 12 Month Forward P/E Multiple



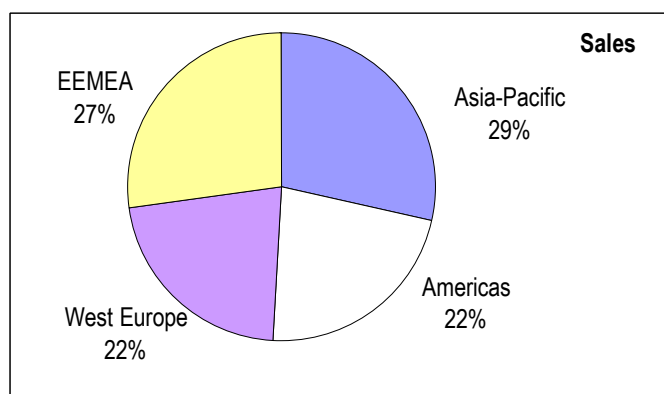
Source: DataStream, Citi Research

Figure 4. British American Tobacco – P/E Relative to Stoxx Pan Europe



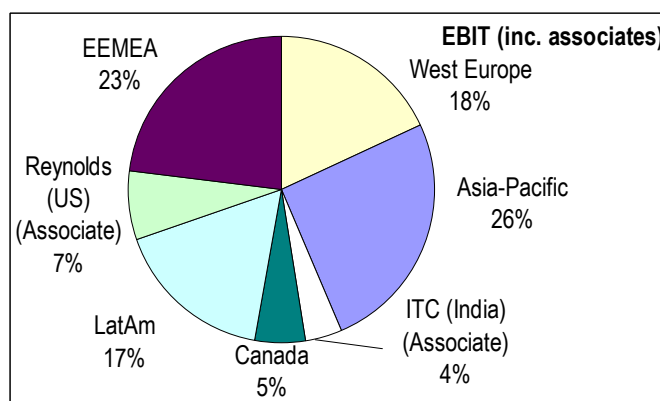
Source: DataStream, Citi Research

Figure 5. British American Tobacco – Split of Sales, FY12E



Source: Citi Research Estimates

Figure 6. British American Tobacco – Split of EBIT, FY12E



Source: Citi Research Estimates

BAT – 1H12 Results At A Glance

Reported Numbers

EPS essentially in line but organic EBIT growth disappoints – Adjusted EPS of 102.4p was essentially in-line with consensus (102.5p) and Citi (102.0p), although the adjusted operating result was 1% light at £2,839m (vs consensus at £2,868m and Citi at £2,876m.) EPS was in-line because of small beats on associates and a bigger one on the finance charge.

Figure 7. British American Tobacco — 1H12 Income Statement vs. Citi and Consensus Expectations (£ in millions)

		Actual	Estimates for 1H12		1H12	Variance	Comments
	1H11	1H12	Citi	Cons	Growth	Vs. Citi	
Net sales							
Asia-Pacific	2,025	2,050	2,169		+1.2%	-5.5%	1H11 boosted by forestalling in Mex
Americas	1,744	1,706	1,781		-2.2%	-4.2%	
Western Europe	1,719	1,649	1,687		-4.1%	-2.3%	
EEMEA	1,950	2,047	1,967		+5.0%	+4.1%	
Total Sales	7,438	7,452	7,604	7,609	+0.2%	-2.0%	Vols were v close
EBIT							
Asia-Pacific	766	815	808		+6.4%	+0.9%	Growth in hi-margin mkts: Malay, Jpn, NZ
Americas	768	754	796		-1.8%	-5.3%	
Western Europe	572	558	580		-2.4%	-3.7%	
EEMEA	654	712	693		+8.9%	+2.7%	
Total EBIT, pre exceptionals (ex Associates)	2,760	2,839	2,876	2,868	+2.9%	-1.3%	Unusual to see a miss
Associates (exc exceptionals)	315	347	339		+10.2%	+2.4%	ITC outperformed again
Exceptionals	(55)	(102)	(50)		+85.5%	+104.0%	
Net finance costs	(233)	(211)	(250)		-9.4%	-15.6%	Saved by the bell
Pretax Profit	2,787	2,873	2,915		+3.1%	-1.5%	In-line
Adjusted Pretax Profit	2,842	2,975	2,965		+4.7%	+0.3%	
Tax	(781)	(787)	(804)		+0.8%	-2.1%	Down due to geographic mix Due to profit growth in Malaysia
~ Tax on ordinary activities	(794)	(810)	(814)		+2.0%	-0.5%	
<i>Tax rate on ordinary activities</i>	<i>31.4%</i>	<i>30.8%</i>	<i>31.0%</i>				
Minorities	(136)	(157)	(150)		+15.4%	+4.9%	
Net Profit	1,870	1,929	1,962	1,962	+3.2%	-1.7%	In line
Adjusted Net Profit	1,912	2,008	2,002		+5.0%	+0.3%	
Per Share							
Adjusted Diluted EPS	96.1	102.4	102.0	103.0	+6.6%	+0.4%	In –line
DPS	38.1	42.2	42.2		+10.7%	+0.0%	Mechanical calculation

Source: Company Reports and Citi Research Estimates. Consensus is compiled by Dow Jones Newswire.

Volumes were almost identical to our forecasts, but the sales line missed due to worse-than-forecast price-mix. In Asia growth in the margin made up for this, thanks to BAT's growth in the high margin markets, but in Europe and Americas profit missed our forecasts.

The miss to EBIT was driven by Americas and W Europe – Group organic EBIT was 2.3 points below our forecast (Figure 8); of this miss, 1.7 points came from the Americas.

- In the **Americas** the price-mix was disappointing (3.5% vs our forecast of 10%). We think this occurred because we weren't aware that a large forestalling gain in Mexico had benefitted 1H11 possibly by as much as £45m¹. In addition it is possible that the Brazilian price rise was less effective than we had hoped.

¹ This would explain why Americas had 9% organic EBIT growth in 1H11 but close to zero in 2H11. In the absence of any other explanation, we had assumed at the time of the 2H12 results that a severe decline in Canada was to blame for the slowdown. The Mexico forestalling explanation is much less worrying.

- In **W Europe**, margins were disappointing (-70bps vs Citi +30bps), presumably due to adverse geographic mix, and in particular the large volume declines in Italy, which more than offset the cost cutting programmes.
- In **EEMEA**, growth was better than forecast at 15% (vs Citi at 12%), driven by Russia and the Persian Gulf countries (GCC). EEMEA profit would have been even better if there hadn't been unrest in Nigeria and sanctions applied to Syria. On the other hand there was a bit of overshipping in GCC, which will (presumably) unwind in 2H12.
- In **Asia**, profit beat despite the weak sales as BAT did particularly well in high margin markets like Malaysia and New Zealand. In Japan it has gained share and in Australia profit went slightly backwards, but both of these had been factored into our thinking ahead of the results.

The dividend (42.2p/share) was in-line with expectations because BAT has a policy of mechanically paying 1H dividends that are one-third of the prior year's full year dividend.

2. Organic Growth

The organic EBIT growth was also a little disappointing at 5.7% vs our forecast of 7.8%. Excluding the hurdle from the unusual gains in Japan in 2Q11, the organic EBIT growth was about 8%.

Figure 8. British American Tobacco — Organic Growth Rates by Division vs. Citi Forecasts

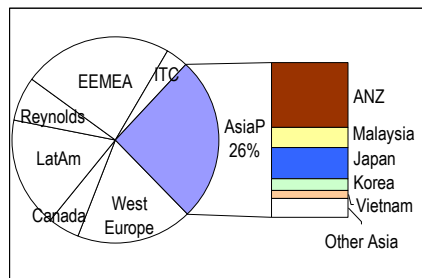
	1H11	2H11	2011	Actual 1H12	Citi Estimates	
					1H12	2012E
BAT						
Volume	-1.0%	+0.2%	-0.2%	-0.6%	-0.7%	-1.0%
Price/Mix	+7.2%	+6.8%	+6.8%	+4.8%	+6.4%	+5.9%
Sales	+6.2%	+7.0%	+6.6%	+4.2%	+5.7%	+4.9%
EBIT	+11.1%	+9.5%	+10.3%	+5.7%	+7.8%	+7.7%
Margin (bps)	155	76	115	55	74	96
Asia Pacific						
Volume	+1.0%	+3.2%	+2.0%	+0.0%	+0.0%	-0.4%
Price/Mix	+8.9%	+7.7%	+8.4%	-0.5%	+5.4%	+3.4%
Sales	+9.9%	+10.9%	+10.4%	-0.5%	+5.4%	+3.0%
EBIT	+13.7%	+8.7%	+11.1%	+3.4%	+3.6%	+5.7%
Margin (bps)	124	(70)	23	148	(65)	95
Americas						
Volume	-5.0%	-5.8%	-5.0%	-2.0%	-3.1%	-4.0%
Price/Mix	+14.0%	+9.1%	+11.0%	+3.5%	+10.0%	+6.4%
Sales	+9.0%	+3.3%	+6.0%	+1.5%	+6.9%	+2.3%
EBIT	+8.7%	+0.3%	+4.5%	+3.1%	+9.3%	+5.1%
Margin (bps)	(13)	(113)	(57)	68	100	108
Western Europe						
Volume	-0.1%	+0.3%	+0.0%	-4.0%	-3.7%	-2.9%
Price/Mix	+0.4%	+6.4%	+3.5%	+6.8%	+7.1%	+5.1%
Sales	+0.3%	+6.6%	+3.5%	+2.8%	+3.4%	+2.2%
EBIT	+1.8%	+18.0%	+9.8%	+1.9%	+6.5%	+1.5%
Margin (bps)	49	334	195	(28)	100	(23)
EEMEA						
Volume	+0.1%	+1.6%	+1.0%	+1.8%	+1.8%	+1.4%
Price/Mix	+6.7%	+5.6%	+6.0%	+10.9%	+5.0%	+10.4%
Sales	+6.8%	+7.2%	+7.0%	+12.7%	+6.8%	+11.8%
EBIT	+20.7%	+13.1%	+16.7%	+14.8%	+11.9%	+19.0%
Margin (bps)	380	167	270	64	160	210

Source: Company Reports and Citi Research Estimates

1H12 Results Commentary by Division

Asia-Pacific

Figure 9. AsiaPac as % of FY12E EBIT



Source: Citi Research Estimates

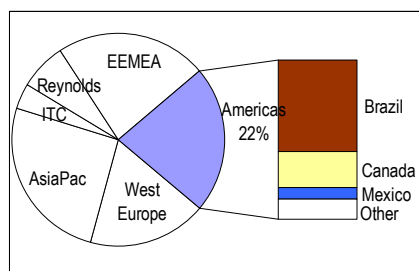
Org growth:	1H12
Volume	0%
Sales	-0.5%
EBIT	+3.4%
Margin	+150bps

Asia-Pacific results were distorted by Japan, where BAT was able to make large extra shipments in 2Q11 because Japan Tobacco's supply system was temporarily crippled by the earthquake.

In Australia, which has the most expensive cigarettes in the world, profit fell slightly in AUD as consumers continued to trade down.

However, in the other markets, BAT did well. In Malaysia BAT continues to grow share but intense anti-tobacco regulation makes it a tough market to grow profit in. In Japan its spot share is 12.1%, which compares with its 2010 share of 10.6%. This 14% increase ($=12.1\%/10.6\%-1$) is about the same as PM has achieved. Elsewhere BAT is performing well, although in Korea and Indonesia it has lost some share, but for reasons we think are temporary.

Figure 10. Americas as % of FY12E EBIT



Source: Citi Research Estimates

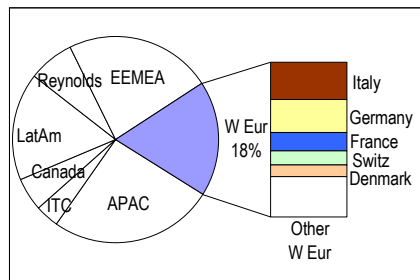
Americas

Org growth:	1H12
Volume	-2.0%
Sales	+1.5%
EBIT	+3.1%
Margin	+70bps

We had hoped to see a large profit increase as BAT increased prices in Brazil ahead of the tax increase there, and we think this probably came through, because excluding the forestalling gain in Mexico, organic profit rose 9%, despite a slight decline in Canada, where downtrading continues. It appears the new minimum price has been quite well enforced in Brazil, because there hasn't been a big increase in ultra-cheap volumes (at least through the legitimate channels) following the price increase there. (For more details on Brazil and on Russia, please see [British American Tobacco PLC \(BATS.L\) - Smoking Prices in Emerging Markets.](#))

BAT said its market share in Mexico is now effectively flat sequentially, but it measures market share differently from the way PM measures it. BAT is doing very well in its smaller markets in LatAm – Chile, Venezuela and Colombia.

Figure 11. W Europe as % of FY12E EBIT



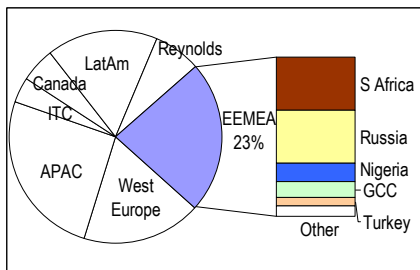
Source: Citi Research Estimates

Western Europe

Org growth:	1H12
Volume	-4.0%
Sales	+2.8%
EBIT	+1.9%
Margin	-30 bps

In Western Europe, i.e. the EU, market volumes fell severely in 1H12, with an 8% decline² in BAT's most important market, Italy. BAT is gaining share in Europe as a whole, with particularly strong growth from Lucky Strike (due to a combination of its new positioning as a mid-price brand, and innovation). There had been a surge in profit in 2H11 to +18% growth (visible in Figure 8), due to price rises in some key markets, cost cutting, and the clampdown on illicit trade in Romania. However the volume declines in 1H12 meant the growth rate has been slowed significantly, even if profit is growing faster for BAT in this region than for some of its rivals. BAT seems to be turning around the STK businesses too, after a couple of years of decline. Profit and share increased in Poland and Sweden, and we believe the situation in Denmark is more stable now. (There had been bad downtrading triggered by tax hikes there.)

Figure 12. EEMEA as % of FY12E EBIT



Source: Citi Research Estimates

E Europe/ Mid East/ Africa

Org growth:	1H12
Volume	+1.8%
Sales	+12.7%
EBIT	+14.8%
Margin	+60 bps

For us the main surprise in this region was the profit growth in Turkey, which has been a source of persistent problems for BAT, even if the local brands continue to shrink fast. However, the most important markets in EEMEA are S Africa and Russia, and here the news is better.

- In S Africa, profit returned to growth, with market share gains in the premium brands. This is a reversal from 2H11, when profit fell due to downtrading and illicit trade.
- In Russia, we estimate profit is growing in the mid-teens, thanks to strong industry price increases and uptrading. BAT says it is gaining share in premium, and now has a 50% share of that sector, thanks to the strength of Kent.

In GCC (=Gulf Cooperation Council, in other words Saudi, UAE, Kuwait and some others), BAT is performing strongly, but profit was further flattered by some overshipping, and this will unwind in 2H12. BAT is also doing well in Nigeria, but the 1Q12 civil unrest held back profits (we expect temporarily.) BAT has stopped shipping to Syria, but we believe this will have a much more minor effect on BAT than it has had on Imperial.

² Source: PM.

Changes to Estimates

1. Changes to Organic Forecasts

Overall we have lowered our forecast for organic EBIT growth this year by 1.4% (which implies a cut to 2H growth rates on top of the disappointments in 1H) but we continue to forecast operating profit growth of 7% or better for each year, and like-for-like sales of about 5%, entirely due to pricing.

- **Our volume forecasts** are effectively unchanged, with lower figures in Europe offset by slight increases in Asia and Americas. It's hard to be optimistic about the EU currently.
- **Sales and EBIT growth** – We have cut our estimates both for price-mix (mainly in Americas) and margins (mainly Europe). We are also assuming less margin growth in Europe in 2013E, even from the reduced base of a lower 2012E.

Figure 13. British American Tobacco — Changes to Organic Growth Estimates Following 1H12 Results

Organic Growth Rates	2012E			2013E			2014E		
	New	Old	Change	New	Old	Change	New	Old	Change
Volume by Region									
Asia-Pacific	+0.8%	-0.4%	+1.2%	+0.8%	+0.8%	+0.0%	+0.5%	+0.5%	+0.0%
Americas	-4.0%	-4.6%	+0.5%	-3.5%	-3.5%	+0.0%	-2.2%	-2.2%	+0.0%
West Europe	-3.6%	-2.7%	-0.9%	-2.0%	-2.0%	+0.0%	-2.2%	-2.2%	+0.0%
EEMEA	+1.4%	+1.4%	-0.0%	+0.0%	+0.0%	+0.0%	-0.5%	-0.5%	+0.0%
Total Volume	-0.8%	-1.1%	+0.3%	-0.9%	-0.9%	+0.0%	-0.9%	-0.9%	+0.0%
Sales by Region									
Asia-Pacific	+2.6%	+5.8%	-3.1%	+8.8%	+8.8%	+0.0%	+5.5%	+5.5%	+0.0%
Americas	+2.3%	+5.0%	-2.6%	+2.5%	+2.5%	+0.0%	+4.8%	+4.8%	+0.0%
West Europe	+0.8%	+2.7%	-1.9%	+2.0%	+2.0%	+0.0%	+1.3%	+1.3%	+0.0%
EEMEA	+12.8%	+8.9%	+3.9%	+8.9%	+8.9%	+0.0%	+7.3%	+7.3%	+0.0%
Total Sales	+4.8%	+5.7%	-0.9%	+5.9%	+5.9%	+0.0%	+5.0%	+4.9%	+0.1%
EBIT by Region									
Asia-Pacific	+7.5%	+5.8%	+1.7%	+10.2%	+10.3%	-0.1%	+6.6%	+6.6%	-0.1%
Americas	+6.4%	+8.4%	-2.0%	+5.0%	+4.2%	+0.7%	+6.5%	+6.5%	-0.0%
West Europe	-0.4%	+3.8%	-4.2%	+2.0%	+4.4%	-2.4%	+3.7%	+3.6%	+0.1%
EEMEA	+15.7%	+17.5%	-1.8%	+15.9%	+15.6%	+0.3%	+12.6%	+12.4%	+0.2%
Total EBIT	+7.4%	+8.8%	-1.4%	+8.7%	+8.9%	-0.2%	+7.7%	+7.6%	+0.1%

Source: Citi Research Estimates

2. Changes to absolute sterling forecasts

We have cut our EPS estimates only modestly because our cut to organic growth is offset by a cut to the interest charge we're expecting, even though we have lowered our cashflow forecast to reflect higher capex and a worse working capital performance than we had previously factored in.

Our models assume ongoing buybacks of £1.25bn this year and next, and mild increases thereafter. We are assuming the average price for buybacks this year is about £32, rising to £34.50 next year.

Figure 14. British American Tobacco — Changes to Citi Estimates Following 1H12 Results (£ in Millions)

	2012E			2013E			2014E		
	New	Old	Change	New	Old	Change	New	Old	Change
Net sales									
Asia-Pacific	4,403	4,505	-2.3%	4,818	4,891	-1.5%	5,083	5,160	-1.5%
Americas	3,471	3,512	-1.2%	3,478	3,508	-0.9%	3,645	3,676	-0.9%
West Europe	3,344	3,476	-3.8%	3,314	3,511	-5.6%	3,357	3,557	-5.6%
EEMEA	4,242	4,128	+2.7%	4,544	4,436	+2.4%	4,875	4,760	+2.4%
Total Sales	15,460	15,622	-1.0%	16,153	16,346	-1.2%	16,960	17,153	-1.1%
EBIT									
Asia-Pacific	1,680	1,634	+2.8%	1,864	1,800	+3.6%	1,990	1,923	+3.5%
Americas	1,447	1,466	-1.3%	1,486	1,489	-0.2%	1,582	1,586	-0.2%
West Europe	1,132	1,200	-5.7%	1,124	1,243	-9.6%	1,168	1,290	-9.5%
EEMEA	1,442	1,468	-1.8%	1,646	1,677	-1.8%	1,854	1,885	-1.6%
Total EBIT, pre exceptionals (ex Associates)	5,701	5,768	-1.2%	6,120	6,209	-1.4%	6,595	6,684	-1.3%
Associates (exc exceptionals)	711	706	+0.7%	778	763	+2.0%	853	799	+6.7%
Exceptionals	-153	-100	+53.0%	-150	-100	+50.0%	-100	-100	+0.0%
Net finance costs	-441	-477	-7.5%	-464	-464	-0.0%	-460	-456	+0.8%
Pretax Profit	5,818	5,898	-1.3%	6,284	6,408	-1.9%	6,888	6,928	-0.6%
Adjusted Pretax Profit	5,971	5,998	-0.4%	6,434	6,508	-1.1%	6,988	7,028	-0.6%
Tax	-1,588	-1,620	-2.0%	-1,713	-1,761	-2.7%	-1,870	-1,911	-2.1%
~ Tax on ordinary activities	-1,621	-1,640	-1.2%	-1,743	-1,781	-2.1%	-1,890	-1,931	-2.1%
<i>Tax rate on ordinary activities</i>	<i>30.8%</i>	<i>31.0%</i>		<i>30.8%</i>	<i>31.0%</i>		<i>30.8%</i>	<i>31.0%</i>	
Minorities	-314	-307	+2.4%	-343	-335	+2.4%	-374	-365	+2.4%
Net Profit	3,916	3,970	-1.4%	4,229	4,313	-1.9%	4,645	4,652	-0.2%
Adjusted Net Profit	4,036	4,050	-0.3%	4,349	4,393	-1.0%	4,725	4,732	-0.2%
Per Share									
Adjusted Diluted EPS	207.2	207.9	-0.3%	227.6	229.9	-1.0%	252.3	252.7	-0.2%
DPS	134.6	135.1	-0.3%	147.9	149.4	-1.0%	164.0	164.2	-0.2%
Diluted Shares Outstanding	1,948	1,948	+0.0%	1,911	1,911	+0.0%	1,873	1,873	+0.0%

Source: Citi Research Estimates

BAT – Financial Summary

Figure 15. British American Tobacco - Financial Summary, FY07-FY16E (£ in Millions)

Profit and Loss / Year to Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E	2015E	2016E 5-yr CAGR
Net Sales	10,018	12,122	14,208	14,883	15,399	15,460	16,153	16,960	17,809	18,684 3.9%
EBITDA	3,339	4,147	4,907	5,426	5,966	6,153	6,585	7,074	7,584	8,123 6.4%
Margin	33.3%	34.2%	34.5%	36.5%	38.7%	39.8%	40.8%	41.7%	42.6%	43.5%
Operating Profit (Adj EBIT)	3,003	3,717	4,461	4,984	5,519	5,701	6,120	6,595	7,090	7,614 6.6%
Margin	30.0%	30.7%	31.4%	33.5%	35.84%	36.88%	37.9%	38.9%	39.8%	40.7%
Associates	533	477	541	622	659	711	778	853	908	963 7.9%
Trading Profit including Assoc	3,536	4,194	5,002	5,606	6,178	6,412	6,898	7,448	7,998	8,577 6.8%
Net Finance	(269)	(391)	(504)	(480)	(460)	(441)	(464)	(460)	(456)	(448)
Adj Pretax Profit	3,267	3,792	4,484	5,126	5,718	5,971	6,434	6,988	7,543	8,129 7.3%
Exceptionals (Pretax)	(98)	(119)	(418)	(738)	(787)	(153)	(150)	(100)	(100)	(100)
Tax	(791)	(1,025)	(1,124)	(1,248)	(1,556)	(1,588)	(1,713)	(1,870)	(2,024)	(2,188)
Underlying Tax Rate	29.6%	30.8%	30.3%	30.2%	31.2%	30.8%	30.8%	30.8%	30.8%	30.8%
Minorities	(157)	(202)	(243)	(261)	(280)	(314)	(343)	(374)	(407)	(444) 9.6%
Net Profit (Pre Amort/Ex)	2,296	2,582	3,046	3,505	3,857	4,036	4,349	4,725	5,091	5,477 7.3%
Per-Share Data										
EPS (Adjusted)	112.6	128.8	153.0	175.8	194.6	207.2	227.6	252.3	277.8	305.2 9.4%
DPS	66.2	83.7	99.5	114.2	126.5	134.6	147.9	164.0	180.6	198.4 9.4%
Number of Dil. Shares Out	2,039	2,005	1,991	1,994	1,982	1,948	1,911	1,873	1,833	1,795 -2.0%
Buyback (% of Shares)	2.2%	1.1%	0.0%	0.0%	1.4%	2.0%	1.9%	2.1%	2.2%	2.0%
Growth Rates (%)										
Sales	2.6%	21.0%	17.2%	4.8%	3.5%	0.4%	4.5%	5.0%	5.0%	4.9% 3.9%
EBITDA	4.4%	24.2%	18.3%	10.6%	10.0%	3.1%	7.0%	7.4%	7.2%	7.1% 6.4%
EBIT	7.4%	23.8%	20.0%	11.7%	10.7%	3.3%	7.3%	7.8%	7.5%	7.4% 6.6%
Profit before Tax	11.3%	16.1%	18.2%	14.3%	11.5%	4.4%	7.8%	8.6%	7.9%	7.8% 7.3%
Net Profit	12.7%	12.4%	18.0%	15.1%	10.1%	4.6%	7.7%	8.6%	7.8%	7.6% 7.3%
EPS	14.8%	14.4%	18.8%	14.9%	10.7%	6.4%	9.9%	10.8%	10.1%	9.9% 9.4%
Cash Flow										
Operating Cash Flow	3,181	4,156	4,645	5,207	5,537	6,086	6,588	7,102	7,612	8,151 8.0%
Interest	(280)	(280)	(499)	(491)	(469)	(463)	(464)	(460)	(456)	(448)
Tax	(866)	(943)	(1,095)	(1,178)	(1,447)	(1,588)	(1,713)	(1,870)	(2,024)	(2,188)
Capex	(436)	(482)	(515)	(523)	(566)	(650)	(670)	(550)	(567)	(583) 0.6%
Other (Divs to/from minorities/associates)	112	153	94	225	271	267	461	472	474	475
Free Cash Flow	1,711	2,604	2,630	3,240	3,326	3,652	4,203	4,694	5,040	5,406 10.2%
Margin	17.1%	21.5%	18.5%	21.8%	21.6%	23.6%	26.0%	27.7%	28.3%	28.9% 6.0%
M&A	152	(2,343)	(399)	(77)	(404)	(112)	(50)	(50)	(50)	(50)
New Equity	(750)	(400)	0	0	(755)	(1,250)	(1,250)	(1,500)	(1,600)	(1,600)
Change in Cash Items	(85)	(1,532)	433	1,070	(191)	(317)	94	93	102	220
Non-Cash Items	(500)	(2,778)	616	(69)	104	200	0	0	0	0
Change in Net Debt	(585)	(4,310)	1,049	1,001	(87)	(117)	94	93	102	220
End of Year Net Cash/(Debt)	(5,581)	(9,891)	(8,842)	(7,841)	(7,928)	(8,046)	(7,952)	(7,859)	(7,757)	(7,537) -1.0%
Ratios										
Interest Cover	11.2	9.5	8.9	10.4	12.0	12.9	13.2	14.3	15.6	17.0
Cash Interest Cover	11.4	14.8	9.3	10.6	11.8	13.1	14.2	15.5	16.7	18.2
Dividend Payout Ratio	59%	65%	65%	65%	65%	65%	65%	65%	65%	65%
Net Debt/EBITDA	1.7	2.4	1.8	1.45	1.3	1.3	1.2	1.1	1.0	0.9
ROIC	13.9%	13.7%	14.5%	16.7%	18.0%	19.0%	21.4%	23.0%	24.6%	26.4%
Historical Multiples										
Historical Average Share Price	1,659	1,820	1,807	2,242	2,678	3,218	3,280	3,280	3,280	3,280
P/E	14.7	14.1	11.8	12.8	13.8	15.5	14.4	13.0	11.8	10.7
FCF Yield	5.1%	7.2%	7.3%	7.3%	6.3%	5.9%	6.7%	7.7%	8.4%	9.2%
Historic EV	33,676	39,723	41,882	46,916	53,744	62,884	62,443	61,098	59,692	58,278
EV/EBITDA	10.1	9.6	8.5	8.6	9.0	10.2	9.5	8.6	7.9	7.2

Source: Company Reports and Citi Research Estimates

Figure 16. . British American Tobacco - Organic Growth Rates by Division, FY07-FY16E

Volume / Year to Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E	2015E	2016E 5-yr CAGR
Asia-Pacific					+2.0%	+0.8%	+0.8%	+0.5%	+0.5%	+0.5%
Americas					-5.0%	-4.0%	-3.5%	-2.2%	-2.0%	-2.0%
Western Europe					+0.0%	-3.6%	-2.0%	-2.2%	-2.5%	-2.5%
EEMEA					+1.0%	+1.4%	+0.0%	-0.5%	+1.0%	+1.0%
Total Volume	-1.0%	+1.0%	-3.0%	-3.0%	-0.2%	-0.8%	-0.9%	-0.9%	-0.4%	-0.7%
Net Sales / Year to Dec			2009	2010	2011	2012E	2013E	2014E	2015E	2016E 5-yr CAGR
Asia-Pacific				+2.0%	+10.4%	+2.6%	+8.8%	+5.5%	+5.5%	+5.5%
Americas				+3.3%	+6.0%	+2.3%	+2.5%	+4.8%	+4.0%	+4.0%
Western Europe				-0.7%	+3.5%	+0.8%	+2.0%	+1.3%	+1.0%	+1.0%
EEMEA					+7.0%	+12.8%	+8.9%	+7.3%	+8.0%	+7.5%
Total Sales			+5%	+2.8%	+6.6%	+4.8%	+5.9%	+5.0%	+5.0%	+4.9%
EBIT / Year to Dec			2009	2010	2011	2012E	2013E	2014E	2015E	2016E 5-yr CAGR
Asia-Pacific				+2.4%	+11.1%	+7.5%	+10.2%	+6.6%	+7.0%	+7.0%
Americas				+5.5%	+4.5%	+6.4%	+5.0%	+6.5%	+5.2%	+5.2%
Western Europe				+10.3%	+9.8%	-0.4%	+2.0%	+3.7%	+3.3%	+3.3%
EEMEA					+16.7%	+15.7%	+15.9%	+12.6%	+12.3%	+11.6%
Total EBIT			+7%	+6.4%	+10.3%	+7.4%	+8.7%	+7.7%	+7.4%	+7.3%

Source: Company Reports and Citi Research Estimates

Figure 17. British American Tobacco - Divisional Summary, FY07-FY16E (£ in Millions)

Net Sales / Year to Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E	2015E	2016E 5-yr CAGR
Asia-Pacific		2,717	3,270	3,759	4,251	4,403	4,818	5,083	5,362	5,657
Americas		2,863	3,156	3,498	3,558	3,471	3,478	3,645	3,790	3,942
West Europe		3,218	3,884	3,695	3,600	3,344	3,314	3,357	3,391	3,425
EEMEA				3,931	3,990	4,242	4,544	4,875	5,265	5,660
TOTAL Sales	10,018	12,122	14,208	14,883	15,399	15,460	16,153	16,960	17,809	18,684
Operating profit / Year to Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E	2015E	2016E 5-yr CAGR
Asia-Pacific		924	1,148	1,332	1,539	1,680	1,864	1,990	2,133	2,286
Americas		1,052	1,186	1,382	1,441	1,447	1,486	1,582	1,665	1,751
West Europe		760	994	1,103	1,228	1,132	1,124	1,168	1,211	1,255
EEMEA				1,167	1,311	1,442	1,646	1,854	2,081	2,322
TOTAL Operating Profit	3,003	3,717	4,461	4,984	5,519	5,701	6,120	6,595	7,090	7,614
Operating Margins / Year to Dec	2007	2008	2009	2010	2011	2012E	2013E	2014E	2015E	2016E 5 yr. chg
Asia-Pacific		34.0%	35.1%	35.4%	36.2%	38.2%	38.7%	39.2%	39.8%	40.4%
Americas		36.7%	37.6%	39.5%	40.5%	41.7%	42.7%	43.4%	43.9%	44.4%
West Europe		23.6%	25.6%	29.9%	34.1%	33.9%	33.9%	34.8%	35.7%	36.6%
EEMEA				29.7%	32.9%	34.0%	36.2%	38.0%	39.5%	41.0%
TOTAL Operating Margins	30.0%	30.7%	31.4%	33.5%	35.8%	36.9%	37.9%	38.9%	39.8%	40.7%

Source: Company Reports and Citi Research Estimates

British American Tobacco PLC

Company description

BAT is a global tobacco company, with more than half its profit coming from emerging markets. Its most valuable assets are its 32% stake in ITC and its 42% stake in Reynolds American. In many markets (e.g. Canada, Brazil, South Africa, Australia) it is the dominant company. It owns many brands, with its top four accounting for one-fifth of volume. It is centralising management, marketing and production, thereby cutting costs.

Investment strategy

We have a Buy rating on BAT. We expect BAT will continue to post strong, predictable EPS growth, and an attractive dividend. The tax system is changing in two of its most important markets, Brazil and Russia, and we think this will accelerate the uptrading in those markets. In addition, it is continuing to drive costs lower, adding about 3 points to EBIT growth each year. In this economic environment we think investors will continue to value BAT's defensive growth, self help and emerging market exposure. BAT has a strong balance sheet and effectively it has an exclusive option to buy the 58% it doesn't already own of Reynolds.

Valuation

Our 12-month price target is 3785p. This represents our view of fair value, based on P/Es. Our fair value estimate assumes that in 12 months' time the shares will be trading at c.15x next year's EPS. However, in 12 months this will be based on calendar 2014E earnings, not 2013E earnings. Given our estimate for 2014 EPS, this implies fair value is 3785p. Currently BAT is trading at a slightly lower forward P/E but we think this may rise as the market comes to appreciate the beneficial structural changes to the tax systems in Russia and Brazil. Our strategists believe that growth companies such as BAT - in other words those with self-help stories - will continue to appreciate relative to the market. In the past five years, BAT has traded at an average of about 13.4x forward P/E based on the next 12 months consensus earnings, but that included a period during 2008-09 when multiples of almost all companies were depressed.

Risks

Positive risks to our target price include the fact that tobacco is a fairly steady and predictable industry. Furthermore, BAT has by far the greatest geographical diversification of any tobacco company. We would highlight in particular the following negative risks that may affect the achievement of our target price:

BAT shares are likely to rise or fall, depending on sector rotation. If the market rotates away from defensives, tobacco will underperform.

Foreign-exchange risk is significant for BAT. If some of its emerging market currencies fall, it may be subject to a worse-than-expected transactional squeeze.

One or more of BAT's major markets could suffer from a **price war**, like the one we saw in Spain in 2011.

Of all the European tobacco companies, BAT has the biggest risk from **litigation**, via its exposure to Canada and Brazil as well as the US. Several Canadian provinces have passed legislation designed to help the provinces sue BAT for billions of dollars using reduced levels of proof.

BAT could suffer from **more large excise tax rises**.

The Australian government says it intends to **ban the use of all trademarks** related to tobacco. We think this ban is likely to go ahead, and it could hurt profit more than we expect.

The trend to **discount products** could invade more of BAT's markets, hurting profits globally.

Conversely, if any of these factors proves to have less of an effect than we anticipate, the stock could materially outperform our target.

Notes

Notes

Appendix A-1

Analyst Certification

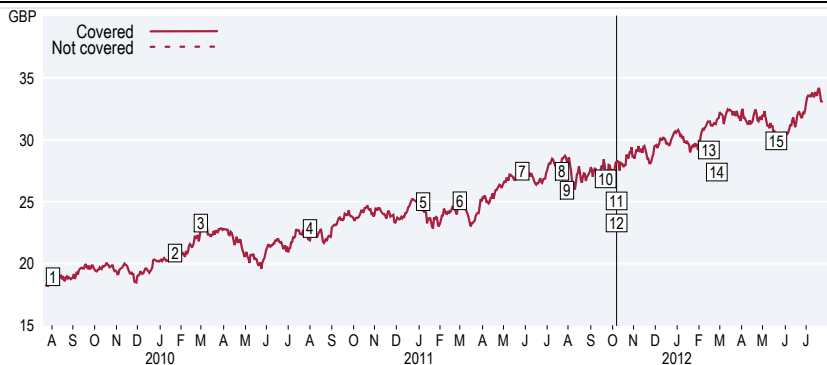
The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

British American Tobacco PLC (BATS.L)

Ratings and Target Price History Fundamental Research

Analyst: Adam Spielman



	Date	Rating	Target Price	Closing Price
1	4-Aug-09	1L	*21.00	18.52
2	22-Jan-10	1L	*23.30	20.54
3	1-Mar-10	1L	*24.60	22.89
4	2-Aug-10	1L	*25.70	21.88
5	7-Jan-11	*2L	*25.00	24.27

* Indicates change

	Date	Rating	Target Price	Closing Price
6	1-Mar-11	2L	*24.50	24.71
7	27-May-11	2L	*28.00	27.20
8	22-Jul-11	2L	*28.90	28.48
9	29-Jul-11	2L	*29.90	28.21
10	22-Sep-11	2L	*28.75	26.92

	Date	Rating	Target Price	Closing Price
11	7-Oct-11	Stock rating system changed		
12	7-Oct-11	*2	28.75	28.24
13	15-Feb-12	2	*32.50	31.45
14	27-Feb-12	2	*33.30	31.59
15	21-May-12	*1	*34.00	30.21

Rating/target price changes above reflect Eastern Standard Time

British American Tobacco PLC (BATS.L)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Adam Spielman



	Date	Rating	Target Price	Closing Price
1	11-Feb-11	*ADD LP	-	24.24

* Indicates change

	Date	Rating	Target Price	Closing Price
2	1-Aug-11	*REM LP	-	28.28

	Date	Rating	Target Price	Closing Price
3	30-May-12	*ADD MP	-	30.03

Rating/target price changes above reflect Eastern Standard Time

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% of companies in each rating category that are investment banking clients	44%	43%	40%	48%	43%	45%

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