

Financial analysis of british american tobacco plc finance essay



Introduction

The purpose of this report is to provide information & Interpretation of British American Tobacco plc (BAT) in terms of historical record, comparative financial indicators, and position in the market along with key value drivers for the company and performance indicators. This is done by analysing the information provided in the historical and present financial statements.

About British American Tobacco & Revenue Analysis

British American Tobacco is a public company listed on the London Stock Exchange, which has direct and indirect stakes in several companies together constituting to be the British American Tobacco Group of companies. The group achieved gross turnover of GBP 40, 713 million with revenues amounting to GBP 14, 208 Million in the year 2009. There are more than 250 brands in their portfolio with Dunhill, Kent, Lucky Strike & Paul Mall being their flagship cigarette brands which are together sold in more than 120 countries with total sales constituting 196 Billion cigarette units (Annual Report, 2009). The company follows the accounting cycle starting 1st January of the calendar year & ending on 31st December of the same calendar year. The company currently has 95, 710 employees on its payrolls. It sold 724 Billion cigarette units in the same year and has production capabilities in 50 cigarette factories based in 41 countries.

British American Tobacco is the second largest tobacco company in the world (Excluding China), while it has 6. 4% share of the UK market, dominant players being Imperial Tobacco & Japan Tobacco International (Nielsen Data,

Feb 2010). 74% of BAT's sales come from the developing countries & emerging economies (Annual Report, 2009).

Revenue by Geography

BAT's largest market lies in Western Europe which accounted for 27.3% of its total revenues in FY 2009. BAT saw an increase of 20.7% from the revenues it had registered in the FY 2008.

Asia Pacific accounted for 23% of its total revenues while Americas accounted for 22.2%. Eastern Europe accounted for 11.5% of the total revenues while the highest performed for BAT turns out to be Africa and Middle east which accounted for 22.2% but it saw an increase of 31.2% in terms of revenue over last year.

Historical Performance & Analysis

British American Tobacco was established as a joint venture between the Imperial tobacco group of the United Kingdom & the American Tobacco Group of the United States in the year 1902. Subsequently, In the year 1911 the company was listed on the London Stock Exchange. In 1913, the company looked overseas for expansion and entered the Argentinean markets. In the 1920s, British American Tobacco's capitalization had quadrupled since 1902 and sales grew by nearly a factor of 40. In 1923, The Company's worldwide sales had grown to 50 billion cigarettes per year. By 1962, British American Tobacco's capitalization allowed it to move towards diversification. It grew consistently, however, and was achieving turnover at the rate of 15% per annum by 1970. Diversifying and expanding at a rapid pace, British American Tobacco became a well known brand globally. With <https://assignbuster.com/financial-analysis-of-british-american-tobacco-plc-finance-essay/>

uncertainty about a long term market in tobacco, steps were taken to reduce BAT's dependence on the tobacco industry. In 1986, only half of its total pre tax profit came from tobacco group which was down from 57% pre tax profit BAT achieved in the year 1985. The 1990s were not a good time of the decade for tobacco sales as companies in the industry faced several lawsuits and litigations. The U. S. courts awarded verdicts which cost the tobacco companies millions of dollars as the consumer claimed tobacco related illness and relatives of smokers who claimed heavy compensation. The company continued with its strategy to take over small to midsized companies as it acquired Canada's dominant tobacco company, Imasco in the year 2000. The company has been consistently achieving Year on Year growth in the range of 8-12% in terms of revenue since 2005. While it has consistently maintained the operating margin percentage in the range of 26%-29% from 2005 to 2009, the Adjusted Diluted earnings per share has been rising from 56. 9p in 2000 to 153p in the year 2009 (Annual Report, 2005-2009).

Annual Report Analysis

“ The goal of accounting information is to provide economic decision makers with useful information,” according to Williams, Haka, Bettne & Carcello (2006, p. 670). Financial statements analysis is not just important for the shareholders but various stakeholders as well.

The Group has prepared its annual consolidated financial statements in accordance with International Financial Reporting Standards (IFRS), as endorsed by the European Union. Some of the highlights of the Annual

Report include revenue increase of 10% at constant rates of exchange & <https://assignbuster.com/financial-analysis-of-british-american-tobacco-plc-finance-essay/>

17% at current rate, when compared to the financials for the year 2008.

Adjusted profits from operations too increased by 10% at constant rates and 20% at current rates. The total benefit of the result amounted to GBP 355 Million, which resulted in adjusted diluted earnings per share grow by 19% to 153 pence. Over the past 5 years, BAT has achieved a compounded annual growth rate of 15% in earnings per share and 19 % in dividends per share. The total shareholder returns over the same 5 year has been 175% compared to the FTSE 100 index which gave 35% returns to the investors.

The financial analysis views the group as a strong player in the global tobacco industry. The resilience in achieving profits & wealth generation along with geographical diversification has positioned the group as a multi national company with strong fundamentals which makes it more susceptible to face risks and unforeseen events in the future. In the first half of the financial year 2009, Sales volumes had increased by 4% or declined by 2% when the benefit derived from acquisition was excluded. BAT's free cash flow remained strong and resilient during the year 2009 and looks set to remain the same in the year 2010 despite volume pressures. Price increases & sales improvements continue to offset the volume pressure faced by the company in the broad range of other markets. In the financial year 2009, FFO was 31% of fully adjusted debt which was 3% points higher than the FFO in the year 2008. The reason for the same was marginal decrease in debt along with the increase in earnings due to acquisitions. The absorption of operating cash flow in to discretionary spending has slowed due to the company suspending the offer to buy back shares until further notice given. BAT is likely to generate free cash flows despite various expenses like restructuring &

dividend payments to the shareholders as it has ample internal liquidity, cash flow characteristics & access to capital markets. The liquidity of BAT was supported by a) USD 1.75 Billion revolving credit facility for a five year period which along with the cash balance of USD 1.3 billion exceeded gross debt maturing on June 2010; b) Bond maturities; Bond worth USD 2.5 billion were issued to extend the groups debt portfolio c) Finance accessibilities; It has ready access to credit facilities on offer by the financial institutions; d) Significant cash position in excess of USD 1 billion.

Based on analysis, BAT's profitability margins are on par with its global peers. BAT intends to improve its sales by 2% year on year by price increases and product mixes. Market share reached by BAT in specific markets determined its profitability. Operating margin in developing countries can be compared with the margins achieved in matured markets as shown by the margin achieved in excess of 30% in regions like Latin America, Africa and Middle East. EBITDA margins for BAT in the year 2009 figured 36%, has had a significant rise of 2.5% percentage point from 33.5% margin it achieved in 2008 and 32.5% in 2007.

One widely accepted method of assessing financial statements is ratio analysis which uses data from balance sheet and income statement to produce interpretation which have financial meaning to it. Assessment of the financial health of a business is quick and relatively simple when information is derived using the relevant financial ratios.

Ratio Analysis

“ A ratio is a simple mathematical expression of the relationship of one item to another,” according to Williams, Haka, Bettner, and Carcello (2005, p. 674). Ratios can provide diverse information to diverse financial information users.

The analysis of annual report suggests the following ratio analysis of the group. The relevant ratios have been grouped and presented in this paper under various heads.

Profitability Assessment:

Operating Margin: BAT achieved an operating margin of 31. 12% in the year 2009 mainly due to savings it achieved in supply chain, general overheads and indirect costs. The impact of higher leaf prices and input costs were offset due to these savings. It allowed the overall operating margin to increase from 30. 7% to 31. 4% in the year which was much greater than the industry and sector average of 22. 01% and 10. 10% respectively. BAT also, had much better margins when compared to Japan tobacco which could achieve operating margin of 4. 76%.

Return on Equity: BAT has been a fundamentally sound company demonstrating consistency in giving return on equity to its shareholders. In the FY 2009, BAT's Return on Equity was standing at 37. 05% which was considerably higher than the industry and sector average of 11. 57% and 8. 01% respectively. While Japan Tobacco could manage to achieve little less than 10% Return on Equity, BAT has been since the past able to maintain consistent returns. In the past four years starting 2005 – 2008, BAT gave returns of 26. 12%, 27. 70%, 28. 95% & 30. 44% respectively. These

numbers give confidence to investors and allow BAT to be looked upon as a good company to place one's bet on.

Return on Capital Employed (ROCE): Corporate Profitability can be determined by assessing the trading profit that the company has achieved over the capital employed by it to achieve the same. BAT achieved an ROCE of 20.82% in the FY 2009 which is slightly better than the Industry average and sector average. BAT fared approximately twice as better when compared to Japan Tobacco.

Asset Utilisation:

Asset Turnover: BAT was able to maintain asset utilisation which was on par with the industry average. The industry average for the FY 2009 was 0.58, while BAT registered an asset utilisation ratio of 0.73. The company is expected to register even better numbers in the near future as FY 2009 saw some acquisitions which resulted in BAT's performance on par with the market in terms of making its asset sweat. Closure of the Soeborg factory in Denmark, Downsizing of manufacturing plant in Australia and impairment charges for certain software assets resulted in these assets having minimum and limited future economic benefit. But with consolidation resulting in greater savings and better utilisation of the assets of the companies acquired in the emerging markets, the asset turnover ratio is expected to fare better in the next financial year.

Interest Cover:

BAT's interest cover remains steady at 8.6x in the FY 2009 compared to 8.5x which was reported in the FY 2008. It was offset as a result of the

financial arrangements carried out for the acquisitions. Pre-Tax impact on adjusting item distorts the interest cover.

Risk Tolerance

By analysing the financial statements, BAT's policy seems to be moderate as it focuses on maintaining EBIDTA coverage of gross interest payments between 5x and 9x at the same time maintaining cash balance exceeding USD 1 billion and five year maturity on its debt profile. BAT needs to strike a fine balance between acquisitions and share buy backs to avoid over stretching its debt capacity over a short time frame due its commitments to a 65% annual dividend payout ratio. In the year 2008, BAT reduced its annual buy back commitment from USD 750 Million to USD 400 Million to accommodate acquisitions. BAT also suspended its buy back program in 2009 until further notice.

Cash Flow Adequacy

Growing profitability would benefit the companies' debt protection metrics to a greater extent. Strong conversion of profits into cash supports BAT's financial metrics. The groups' future working capital requirements will remain stable in proportion to its annual sales unless there are any significant large scale acquisitions. BAT's capital expenditure of its net operating cash flows is very low when compared with the averages in food, beverage & tobacco industries. In the year 2009, BAT's capital expenditure accounted for 15%-20% of net operating cash flows. BAT's future capital expenditure is most likely to grow giving the compounded annual growth rate of the company along with the industry.

<https://assignbuster.com/financial-analysis-of-british-american-tobacco-plc-finance-essay/>

Key Performance Indicators

The key performance indicators for BAT has been its consistent ability to maintain growth in its core competency. Revenue for the FY 2009 grew by 17% which is 3 - 4 per annum greater than the target growing revenue for the medium and long term. This was possible due to acquisitions it made and favourable exchange rate movements.

One of the key strengths of the company in terms of its performance is its diversified global drive brands which constitute majority of the sales for the company. Though growth of 16% was achieved in the FY 2008 in this segment, FY 2009 volumes grew by 4% which is coherent with the company's strategy to achieved single digit growth over the long run.

The adjust profit from operations achieved by the firm was well above the company target to achieve 6% profit from operations. BAT registered a growth of 20%.

The net cash from operating activities in the FY 2009 was up by £26 million to £ 2630 million. Free cash flow per share increased by 2%, the ratio of free cash flow to adjusted diluted earnings was 86%.

Adjusted Earnings Per Share (EPS) had grown at an average of 11% over the last ten years. This exceeds the company's target of growing at a single digit figure per annum on an average. Adjusted diluted EPS grew by 19% in the year 2009.

S. W. O. T. Analysis

Strengths:

Diversified Global Brand Drive (GBD) portfolio

One of the keys strength's of the group is its diversified portfolio of cigarette brands. In the FY 2009, overall volume of the GBD grew by 4%.

Emerging Economies

Currently, 74% of BAT's revenues come from the emerging economies.

Enhanced Internal Operations

BAT saved GBP 239 Million in the FY 2009 by improving its supply chain, overheads and indirect costs.

Weaknesses:

Legal Issues

Recoupment actions and Class actions are filed against the company and its subsidiaries which in turn impacts not only the brand image but also its cost structure.

Poor Asset Utilization

The company's Return on Assets (ROA) and Return on Equity (ROE) has been poor when compared to its competitors. Philip Morris International and Altria Group recorded an ROA of 29.7% and 20% respectively with BAT recorded an ROA of 15.1% only. Similarly, ROE for BAT was lower than Philip Morris International which recorded 99.2% while BAT could achieve 40.6% only.

Opportunities

Acquisitions

BAT completed an acquisition of a Turkish state owned tobacco company in the year 2008 which elevated its market share from 7% to 36%. In the same year, BAT Bought Skandinavisk Tobakskompagni (ST) which allowed it to increase annual sales of approximately 30, 000 million cigarettes.

Recently BAT acquired PT Bentoel Internasional Investama, Indonesia's fourth largest cigarette maker which had sales of around 250 million cigarettes a year.

These acquisitions would increase the global presence of BAT across the globe and in turn enhance its topline and profitability.

Growth of Tobacco Industry

The tobacco industry is forecasted to witness growth. It is estimated that there would be 1. 3 billion smokers in the world by 2020 up from 1. 3 billion currently. According to the Datamonitor estimates, the global tobacco market generated total revenues of \$429. 3 billion in 2009, representing a compound annual growth rate (CAGR) of 3. 1% for the period spanning 2005-2009. Cigarette sales generated total revenues of \$394. 2 billion in the FY 2009, equivalent to 91. 8% of the market's overall value. The global tobacco market is forecasted to have a value of \$490. 2 billion, an increase of 14. 2% since 2009. BAT is the second-largest global cigarette player. It tends to benefit from this positive outlook.

Threats

Illicit Trade

Illicit trade is estimated up to 660 million cigarettes a year which represents 12% of world cigarette consumption. This results in losses upto GBP 4 Billion to GBP 7 billion a year. Increase in illicit trade would reduce revenues of the company.

Advertising restrictions

Brand Building, advertising and promotion are facing hindrances globally. The absence of marketing would effect introduction and promotion of new products in the markets. It could have a negative impact on BAT's sales.

Consumer focus and awareness on health issues

Increasing health consciousness and introduction of substitutes to cigarettes into the market has led to decline of sales for the company. Pharma products and nicotine - replacement patches along with chewing gums are the new source of harmless alternatives.

What makes British American Tobacco work?

The year 2009 was a challenging year for the Fast Moving Consumer Goods (FMCG) segment. Total market volumes declined by 2% for the BAT products. The overall performance for BAT was firm . It continued to invest in its marketing initiatives which resulted in it maintaining its market share in key markets. The Global Drive brands (GDB) grew by combined 4% in terms of

volume. These accounted for 27% of the global volume sales for BAT. The overall brand mix for BAT is balanced between premium, mid-price & low-price.

Managing business to business relationships makes up for a large part of BAT's trade marketing activities. BAT co-ordinate its business with its trading partners to ensure that it is able to meet the demands of the customer at the right place and at the right time. This has worked out well for the company as it helps it maintain the market share in a highly competitive tobacco industry.

Understanding customer and their needs is of the core non financial activities of BAT. BAT regularly surveys their customer base internationally against its peers in the FMCG industry and particularly against its competitors in the tobacco industry. Their efforts made them be recognised as the leading business in the tobacco category for customer relationship management by Dow Jones sustainability index for the third successive year in 2009.

Apart from its own marketing initiatives, BAT makes efforts to develop marketing programmes jointly with its retail partners, who engage with consumers in market channels like Global Travel Retail and Global Convenience Retail.

For BAT, the Direct Store Sales is the most preferred way of selling cigarettes to customers. It facilitates greater access to consumer information and market. It has also helped them with a direct commercial link to their

most strategic retail accounts. In the FY 2009, total sales volumes distributed through DSS reached 50%.

Integrated Global Enterprise

Apart from the key revenue generators for the company, BAT has been able to achieve growth by savings. BAT was successful in turning a multinational business operations in over 180 markets into an integrated global enterprise which take better advantage of its scale. It led to savings in supply chain, overheads and indirect costs amounting to £239 million. The company has a target achieve £800 million savings by 2012.