FLASH NOTE – IMPERIAL BRANDS

NOVEMBER 29TH, 2019

Imperial Brands	
Ticker Site BiG	IMB
Ticker BiGlobal Trade	IMB
Ticker BT24	IMB
Ticker BiG Power Trade	IMB
P/E Ratio 2019E	6,22
P/BV Ratio	3,28
EV/EBITDA	8,35

Source: Big Research;

Price and Performance (Values in GBP)	
Price	1708,60
52 week high	2713,50
52 week low	1655,00
YTD	-28,1%
Average daily volume (un)	2.477.683
Market Capitalization (mn)	16.173
Beta	0,94
Dividend	2,07
EPS	1,06

Source: BiG Research;

Analysts Consensus (last 3 months)	
Buy	11
Hold	6
Sell	4

Source: BiG Research;

Financial Data	
Sales (USD mn)	16.200
EBITDA (USD mn)	3.513
Number of Employees	33.300
ROA	3,1%
ROE	18,9%
D/E	2,44
Dividend Yield	11,71%

Source: BiG Research;

Notes:

All quotes were updated in Bloomberg at 11h00 of November 29th, 2019.

Relevant Information:

Use the following link to view our most recent publications: https://www.big.pt/InformacaoMercados/TradingIdeas/Index/-1

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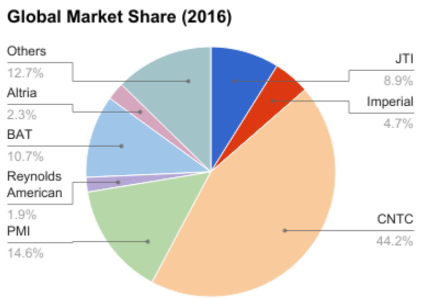
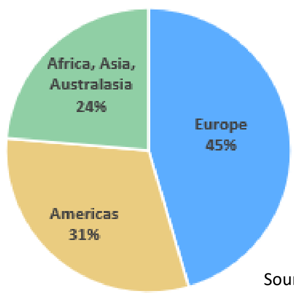
Imperial Brands (Ticker: IMB LN)

Description

Formerly known as Imperial Tobacco, Imperial Brands is one of the world's largest tobacco producers and distributors in the world. It was founded in 1901 and it is headquartered in the United Kingdom. Worldwide, it employs more than 30 thousand people and it produces more than 300 billion cigarettes per year. Its products are sold in more than 100 countries. Its main markets are developed countries such as the USA, UK, France, Spain, Italy, Russia and Germany as well as others such as Japan and Australia. The company has grown a lot through acquisitions. In 2003 it acquired Reemtsma Cigarettenfabriken (a German tobacco producer which, at the time, was one of the world's largest tobacco companies) and, in 2007, it entered the US market by acquiring Commonwealth Brands (which, at the time, was the 4th largest US producer). The company has already announced that its current CEO, Alison Cooper, which has been with the company since 2010, will step down in January 2020. The new CEO will be Thérèse Esperdy (an internal director) and her main mission will be to head a GBP 2 billion asset divestment program (of its cigar business) and to focus on the development of the new smoking technologies.



Revenue by region (2019)



Source: Company's data

Investment Points

The main question in regards to Imperial Tobacco is if, in the long-term, it can fight the volume loss in tobacco sold and the declines in revenues from its main markets (as consumers, in the developed world, are slowly decreasing their tobacco habits). For now, it has been able to offset volume decreases of, for example, -4.4% in 2019 with increases in pricing so that, overall, its revenue increased 2.2% in constant currency. Investors used to be more confident that tobacco's decreases could be counterbalanced by the increases in vaping or e-cigarette use. However, with the new controversies of vaping related lung disease and youth use and addiction, there is concern among investors as to what regulations may be implemented in the future. Imperial Brands is not too exposed to this situation as the causing agent behind these diseases has been determined to be Vitamin E acetate which the company uses in none of its products. The case was also, as typical, blown out of proportion as the disease was mostly linked to street produced THC pods and not to retail brands. Also, this situation is for now only in the USA which is not Imperial Brand's single market.

Dividend Sustainability: A dividend per share growth cut (which has been growing at a yearly rate of 10% since the recession) is very likely due to the high interest rates (around 4.5%) and the low growth (<2%) that the company is experiencing. The company has already signaled this when they announced that they will now only increase dividends depending on the underlying business performance and that it will focus on growth opportunities and debt repayment. Nonetheless, there is a strong possibility for, at the very least, dividend maintenance if we presume there is no further major pressures and/or a quick business downturn. With this, an equity investor would receive a dividend yield above 10% and have its investment payback in less than 10 years.

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Even at a 2% yearly decline in cash flow from operations, there is still sufficient room (assuming debt refinancing is possible) to maintain dividends, increase capex by about GBP 200 million and repay a small amount of debt.

Lagging behind in the e-cig and vaping business: Its main brand in this business segment is Blu and myBlu (an e-cigarette and a vaping product brand respectively). The company acquired Blu in 2015 and paid USD 7.1 billion for the brand (and others). Unfortunately, while Blu was one of the early movers in this segment (being the second most popular brand in the US in 2015 and dominating the market in 2012) it started lagging behind in both the e-cig and vaping segments as more and more competition entered the business and consumers grew more refined tastes. It is now focused on being a widely available, low to medium quality and cheap brand (with some of its devices selling for as low as USD 1) which often is the first product that consumers use when they switch from tobacco. Unfortunately, this means that its margins are severely compressed. More problematic is the fact that the market appears to be one with a large degree of consumer power and that, contrary to tobacco, it will not transform into a strong profit margin oligopoly. Mostly, because consumers have a lot of competing choices (from different brands, tastes, etc.) and there is a need for large amounts of technology investments and product research. We, for now, do not see any decent returns on investment from it.

Regulation: Government intervention, especially in the USA, can be a curse and a blessing. On one side, it may limit the marketing of these products or add heavy taxation. On the other hand, it may limit sale to only products it can reliably guarantee safety (which means a focus on the main brands effectively creating an oligopoly). This may, indirectly, create some upside for the e-cig and vaping business. The US government is to take a decision on this issue in this month of November.

Resilience to recessions: The company did a major acquisition during the 2008 years so a lot of its accounting is distorted for that year. Nonetheless, organically, the company still grew revenues at a 7% rate in that year and increased operating profits (excluding acquisitions) from GBP 1.47 bi to 1.57 bi. Tobacco companies, in general, prosper during bad times as consumers cut spending in more discretionary items and use cash on essentials and products that can lift up their mood. Especially items, such as cigarettes, that can easily be bought in a service station.

Strategic acquisition: The tobacco industry is prone to consolidation since there are a lot of incentives to cut costs in what is a declining industry in the western/developed countries. There were already rumors, in 2017, that Japan Tobacco might have been interested in acquiring Imperial Brands. The call off of the Philip Morris and Altria merger may also push Philip Morris to buy Imperial Brands and consolidate its business in Europe. The same can be argued for British American Tobacco. If this were to happen, an outright acquisition would be the most likely scenario, and the investor could pocket a nice premium.

China Monopoly: The Chinese market is a massive “golden egg” (that accounts for 40% of the world’s tobacco consumption) that is, for now, monopolized by the Chinese National Tobacco Company (CNTC) but where there could be some opportunities, especially in the e-cig business. However, China has already banned the online sale of these products and may move to implement more restrictions. Furthermore, there is already plenty of Chinese companies (such as RELX) with established market shares so entry is very difficult without heavy spending.

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Income Statement (GBP millions)	2018	2019
Revenues	30,066	31,594
COGS	(24,056)	(25,354)
Gross Profit	6,010	6,240
Distribution & advertising	(2,001)	(2,295)
Administrative and other expenses	(1,602)	(1,748)
Operating Profit	2,407	2,197
Net finance costs	(626)	(562)
EBT	1,823	1,690
Taxes	(609)	(396)
Net Income	1,427	1,081
Earnings per share	143.6	106.0

Source: Company Data

Balance Sheet (GBP millions)	2018	2019
Assets	30,848	33,730
Cash & Equivalents	775	2,286
Intangibles	19,117	18,596
Receivables	2,585	2,993
Inventories	3,692	4,082
Property Plant & Equipment	1,891	1,979
Other Assets	2,788	3,794
Liabilities	24,403	28,146
Short term Debt	2,397	1,937
Long term Debt	9,598	11,697
Trade and other Payables	8,270	9,536
Deferred tax	1,113	1,156
Retirement benefit	1,249	1,061
Other liabilities	1,776	2,759
Total Shareowner's Equity	6,445	5,584
Total Equity and Liabilities	30,848	33,730

Source: Company Data

Free Cash Flow (GBP millions)	2018	2019
Operational Cash Flow	3,087	3,236
Operating Profit	2,407	2,197
D&A, impairments	1,266	1,316
Taxes	(407)	(522)
Inventories	(112)	(560)
Increase receivables	(35)	(267)
Increase in payables	136	877
Others	(168)	195
Investment Cash Flow	(230)	(425)
Capex	(327)	(409)
Interest received	10	15
Acquisitions	(75)	(17)
Disposals	134	57
Others	28	(71)
Financial Cash Flow	(2,654)	(1,271)
Interest paid	(501)	(488)
Increase in borrowings	1,619	3,699
Repayment of borrowings	(2,261)	(2,330)
Share buyback	(41)	(108)
Dividends	(1,676)	(1,844)
Others	206	(200)
Change in free cash flow	203	1,540
Cash and equivalents at end	775	2,286

Source: Company Data

Financial performance and guidance

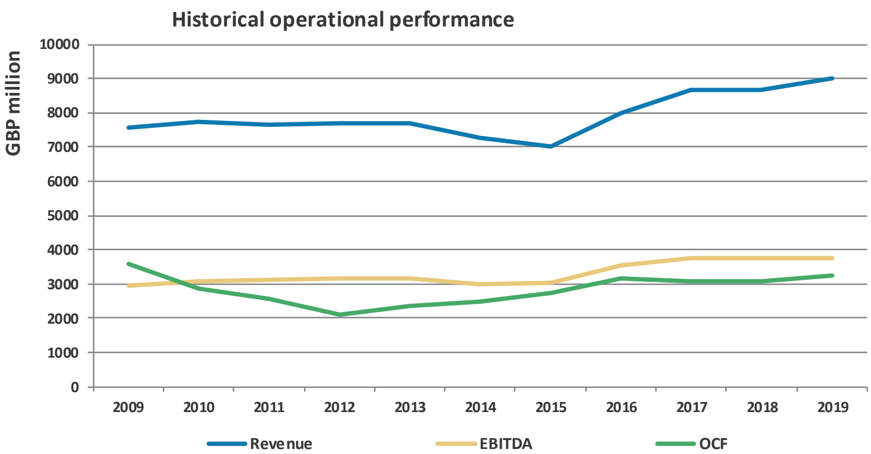
This was a challenging year for the company with mixed results. The company lost market share in the UK and Germany (around 1.4% and 0.7% respectively) and had low gains in other markets (such as the US where it grew 0.1% market share). If we consider adjusted net revenues, the company increased revenues by 2.2%, in constant currency, to close to USD 8 billion. This translated into an operating profit decrease of 0.7% to GBP 3.5 billion. As for earnings per share, the year ended at GBp 273 (which represents a decrease of 2.4% vs. last year).

In non-adjusted terms, revenue increased 5.1% while operating profit declined by about 8.7%. The major difference in this decline, in non-adjusted operating profits vs. adjusted, came from an amortization charge of approximately 1 billion (due to a goodwill impairment in the cigar premium cigar division, due to the divestment sale preparations), an excise tax provision of GBP 140 million and restructuring costs of GBP 144 million.

The European business had a flat net revenue growth of 0.4%, in constant currencies, with the company saying that the volume decreases (of -4.4%) reflect major market decline trends. It decreased in market share in all its major European countries (although always less than 1.5%) except for Italy. The European vapour category while growing more than 100%, had a lower than expected growth in the second half of the year, as adoption of closed systems (such as the ones from the Blu brand, which do not allow for refillable cartridges) were slower than expected. The company is pushing regulators to force this standard. This led to lower operational profits due to spending in support of myBlu market launches and provisions for slow-moving inventories and supply contract terminations.

In the Americas, the USA cigarette market share grew by 0.1% and is now at 8.8%. On a constant currency basis, net revenues here increased by 6.8%. In Africa, Asia and Australasia the situation was different as net revenues decline by 4.8% due to tobacco declines in Russia, Australia and the Middle East.

The company says that its outlook for 2020 is more cautious as low single digit growth is expected. Regulation uncertainty adds to this and management has highlighted that it will decrease NGP investment, in 2020, until it can get a clearer horizon. Tobacco should continue to be resilient and deliver modest revenue growth.



Source: BiG Research

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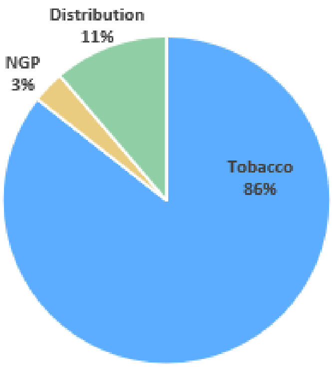
Net Revenue by segment (2019):



Source: Company Data

Major tobacco brands for IMB:

JPS West Winston Davidoff P&S KOOL FINE News GAULOISES L&B

Source: Company Data

Major NGP brands for IMB:

blu skruf

Source: Company Data

Blu products:

Source: Company Data

Segments and Products

Tobacco: This is Imperial's brands main business segment and what it considers to be its mature and high return area. Products here are mostly cigarettes, fine cut tobacco (for rolling), papers, cigars and snus. This segment decreased, in volume, by about -4.4% in 2019, however a pricing increase of 5.5% netted an overall 1.1% increase in net revenue (in constant currency). Asset brands accounted for 66% of net revenues. Adjusted operating profits decreased close to 1%, for the year.

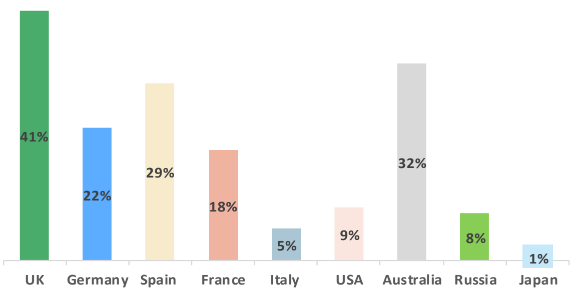
The major brands are JPS (premium cigarettes with major markets in UK, Germany and Australia), West (cigarettes mostly popular in Germany), Winston (in the USA), Davidoff (in the premium cigars category), Parker & Simpson and Gauloises (popular in France). The company says the USA premium segment market has been impacted by the growth in the deep discount market. However, the Winston brand still showed resilience. In the UK, Germany and Australia, however, the JPS brand was more pressured.

Next Generation Products (NGP): This segment is supposed to be the big disruptor within the industry. As millions of consumers shift from smoking the more harmful tobacco sticks into alternatives that are more varied and less harmful. Imperial Brands has products focused on the vapour (which uses liquids to replace tobacco), heated tobacco and oral nicotine products markets. Blu, which is a vape and e-cigarette producer that is mostly present in the United States and various European countries, is its major brand. Pulze, which is a recently released heated tobacco product only available in Japan (which banned the sale of e-cigarettes) will have nationwide expansion in 2020. In July 2019, the company also started a partnership with Auxly Cannabis to profit from the opening of commercialization of cannabis derivative products in Canada. Imperial Brands is preparing a Premarket Tobacco Product (PMTA) to submit for FDA approval in May 2020. This will allow it to market further Blu products (containing tobacco) in the USA.

The segment generated net revenues of EUR 285 million in 2019. It grew, as a whole, net revenues by 48%, in constant currencies, in 2019. However, growth still came below expectations. America was the big disruptor as revenues decreased 26.5% from the impact of the vaping controversy (when a significant increase was expected). While the growth for the year was below expectations, NGP still grew above 100%, in net revenue, in both the European and African, Asia and Australasia regions. In France, for example, myBlu was the number 2 vapour brand. It is, however, still not generating profits.

Distribution: comprises the distribution of tobacco & NGP products for product manufacturers, including Imperial Brands, as well as a wide range of non-Tobacco & NGP products and services. The net fees coming from the distribution segment were GBP 1015 million which translated into an operating profit of GBP 232 million. This represented an increase of 2.7% and 9.9% respectively.

Market Share per country (2019):



Source: Company's data; BiG Research

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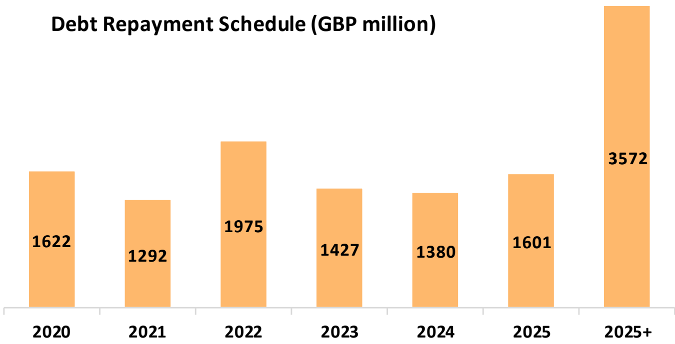
Debt Structure

The debt structure of the company is quite relevant due to its high leverage. The company currently has around GBP 13.4 billion in net debt and GBP 15.6 billion in total debt (by company's definitions) and a rating of BBB. The company has, currently, 18 outstanding bonds with a total principal value of GBP 12.8 billion. The average weighted coupon rate of these bonds is close to 4%. Most of these bonds have covenant clauses with a coupon step-up that increases interest by 1.25% (if a rating downgrade is to happen) and put provisions in the case of the company dropping below investment grade.

The bonds are, approximately, 74% in EUR and 26% in USD (excluding the ones in GBP). All-in cost of debt is currently at 3.6%. The company has around GBP 3 billion in unused revolving credit facilities. Most of its debt is reasonably spread with an average yearly repayment between GBP 1.5 to 2 billion.



Relative Valuation

Imperial Brands main advantages, over its peers, are its high dividend yield and undervaluation vs. the average (EV/EBITDA of 8 vs. peer average of 10 and a P/E of 6). However, this is offset by its higher amount of leverage, at a net debt to EBITDA of 3.1, and its lower margins and lower growth.

Name	Country	Market Cap (mn)	P/E 2020E	Div. Yield (%)	Repurchase Yield (%)	YTD (%)	EV/EBITDA	Organic Growth 1y	Op. mg. Y
BRITISH AMERICAN TOBACCO PLC	BRITAIN	84,220.6	8.3	7.0%	0.0%	14%	10.6	25%	37%
JAPAN TOBACCO INC	JAPAN	45,205.1	12.7	6.2%	0.2%	-6%	7.2	4%	24%
PHILIP MORRIS INTERNATIONAL	UNITED STATES	130,024.4	15.0	5.5%	0.8%	25%	12.2	3%	36%
ALTRIA GROUP INC	UNITED STATES	86,699.8	10.4	7.0%	0.0%	-6%	10.4	1%	49%
IMPERIAL BRANDS PLC	BRITAIN	21,350.3	6.2	11.0%	0.0%	-26%	8.4	5%	14%
Average exc. Imperial Brands	-	86,537.5	11.6	6.4%	0.2%	7%	10.1	8%	37%

Name	Prof mg. Y	ROE	ND/EBITDA	FCF Yield (%)	FCFE/EV	CFO/Capex	CFO/Price	CDS Yield	Rating
BRITISH AMERICAN TOBACCO PLC	25%	10%	1.1	9.9%	6.6%	11.6	11.0%	91.0	BBB+
JAPAN TOBACCO INC	17%	14%	1.2	3.3%	0.1%	3.3	5.9%	17.0	AA-
PHILIP MORRIS INTERNATIONAL	25%	n.a.	2.2	6.3%	5.6%	6.6	7.1%	65.0	A
ALTRIA GROUP INC	9%	14%	2.7	7.9%	18.6%	35.3	8.2%	67.0	BBB
IMPERIAL BRANDS PLC	6%	19%	3.1	14.1%	16.8%	6.8	16.5%	91.0	BBB
Average exc. Imperial Brands	19%	12%	1.8	6.8%	7.7%	14.2	8.0%	60.0	-

Source: Bloomberg; BiG Research

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Recent M&A:

Worldwide premium cigar business (to be sold in 2020): The company is aiming to sell its cigar business in 2020 and use the proceeds for debt repayment and investments.

Oxford Cannabinoid Technologies Ltd (2018, bought for undisclosed amount): A United Kingdom biopharma company focused on cannabinoid medicine.

VON ERL GmbH (2017, bought for undisclosed amount): Austrian vaping manufacturer which Imperial acquired and rebuilt its "My Von Erl" products brand into the myBlu.

Nerudia Ltd (2017, bought for undisclosed amount): United Kingdom business focused on nicotine containing e-liquid production.

KOOL/Salem/Winston/Maverick/Blu brands (2014, bought for USD 7.1 billion): Bought these brands as a third party to Reynold's acquisition of Lorillard.

Risks

Brexit: In the case of a hard Brexit there is a possibility of an increase in import duties and the risk of an increase in tobacco contraband smuggling. The company estimates a more immediate impact of GBP 100 million from restructuring due to tax purposes. Further complications could appear; however, it appears the risk of a non-deal Brexit is now significantly lower.

Ban and European legislation: Europe, which is still Imperial Brand's main market is very prone on combating tobacco and smoking in general. The trend, in Europe, is for a decline in the number of consumers. Government agencies could decide to further help this decline by promoting the use of alternatives or by banning or increasing taxation in tobacco products. As an example, in 2016, France briefly considered banning the sale of premium or "stylish" brands such as Gitanes or Gauloises because of a European directive that specified that tobacco products could not include elements of promotion. The measures of plain packaging (which have been introduced in Australia, UK, France and Belgium) could also be further extended.

USA ruling on e-cig and vaping products: While less relevant in the short-term (due to it still being a small segment) the USA is yet to decide on how it will handle the situation regarding these products. This can be both a risk and a good prospect for the company as a higher level of scrutiny could impact the foreigner and smaller local competitors and benefit the big brands. However, a general tighter control in sales or marketing can definitely harm the company's growth prospects and the sector as a whole.

Graph

Source: Company's data; BiG Research

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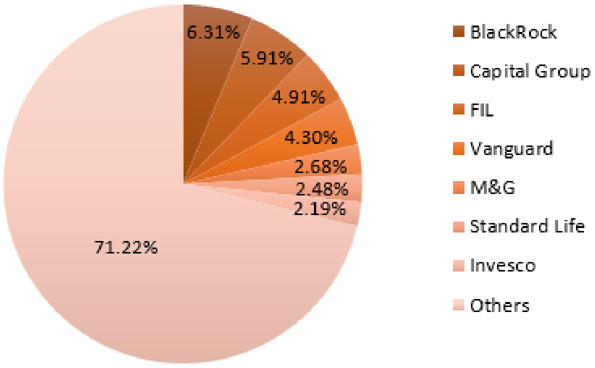
Calendar

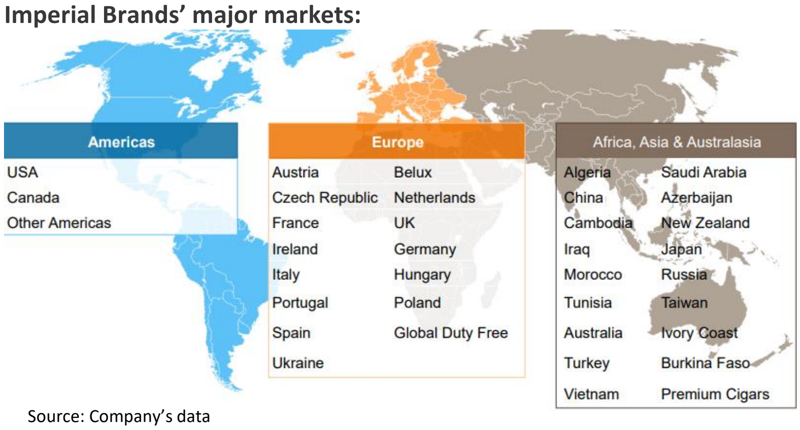
Dividend ex-date: 21 November 2019
Dividend payment: 31 December 2019

Shareholders



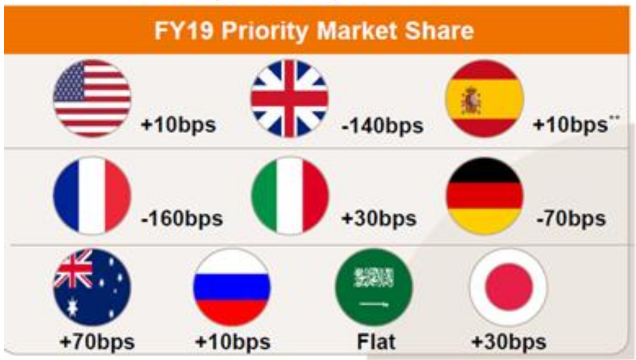
Others

Imperial Brands' major markets:



Source: Company's data

Market share changes, for major markets, in 2019:



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  - Buy, expected absolute return above 15%;
  - Accumulate, expected absolute return between +5% and +15%;
  - Keep/Neutral, expected absolute return between -5% and +5%;
  - Reduce, expected absolute return between -5% and -15%;
  - Sell, expected absolute return below -15%;

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