The Compromised Compounder

A Forensic Audit of British American Tobacco's Cash Yield vs. Structural Headwinds

£7.9bn FCF	41x
12x P/E	-1.9% g
Net Debt	£35bn
EBITDA Margin	42%
Div. Yield	$1.2bn
Vol. Decline	-4%
NGP Rev	+15%
Tax Rate	23%
CapEx	£1.5bn
FCF Conversion	90%
Adj. EPS	320p
Leverage	3.1x

April 2026 Assessment

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The Franchise / Durable Cash

Metrics:

~£7.9bn	Free Cash Flow (2024)
~46%	Adjusted Operating Margin
~£26bn	Revenue

Insight: The underlying business converts cash at ~100% and yields ~10–11% FCF on equity.

The Valuation / Distressed Pricing

Metrics:

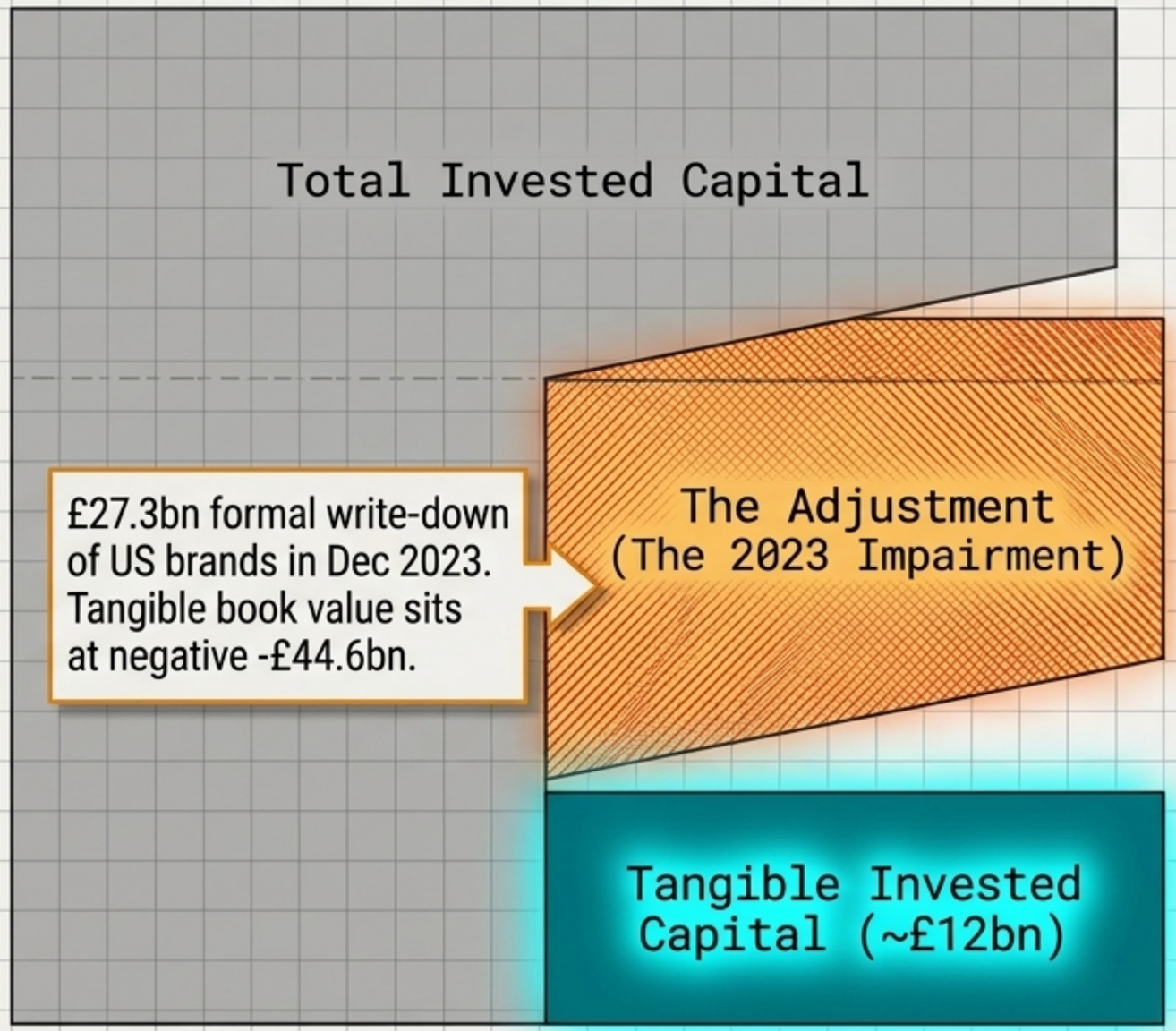
12.1x	Forward P/E
45%	Valuation Discount to PMI
5.7%	Dividend Yield

Insight: The stock prices in a run-off thesis—projecting terminal decline.

The analytical question: Does the 12x multiple accurately reflect the decline of combustibles, or does it over-penalize accounting noise and past capital misallocation?

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BAT's Capital Base Deconstructed



The Accounting Reality:

~11% Reported ROIC

Depressed by ~£80bn+ in initial goodwill and acquired intangibles from the 2017 Reynolds buy-in.

The Economic Engine:

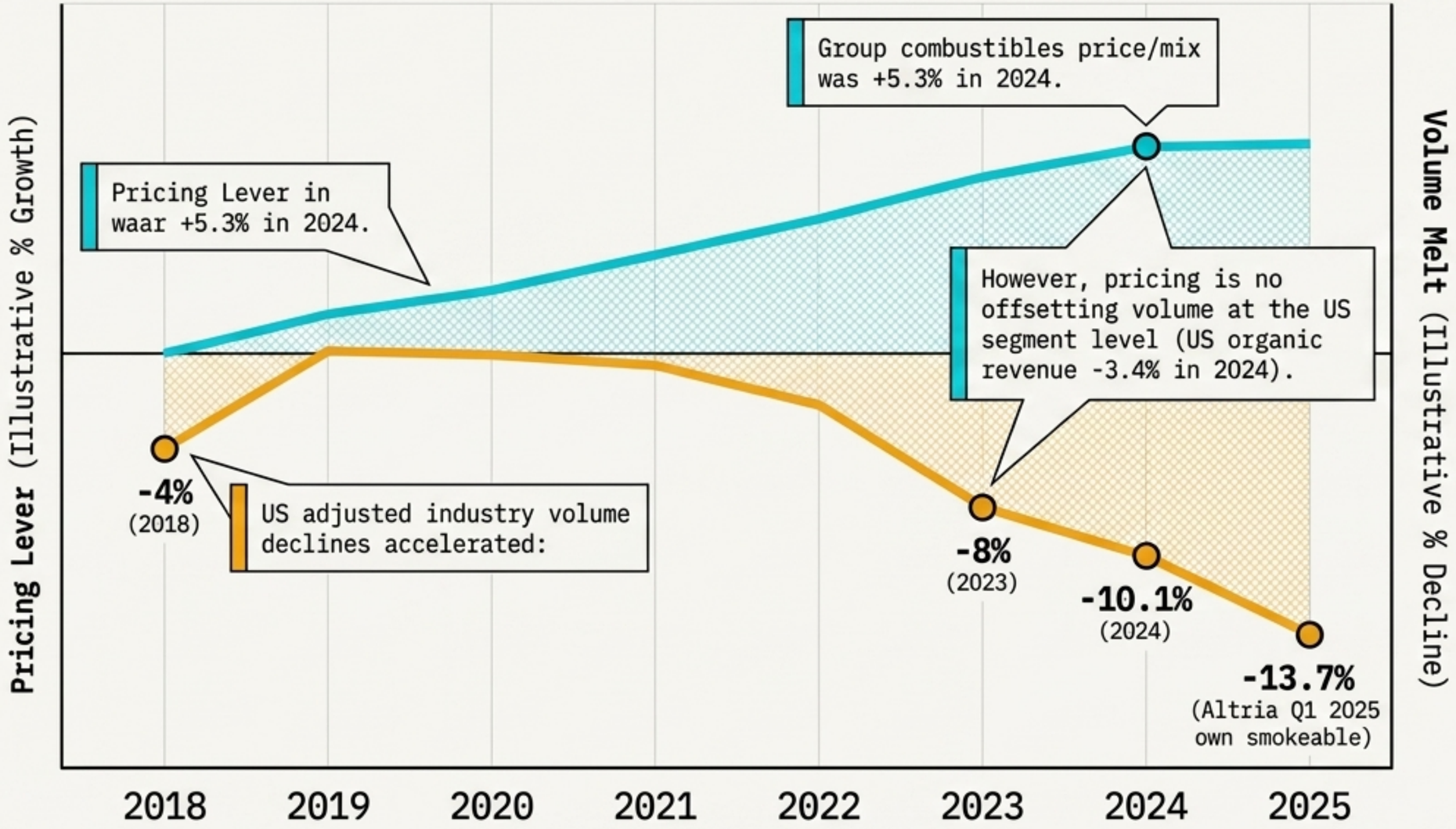
~70-75% Tangible ROIC

Calculation: £9bn NOPAT resting on just ~£12bn of tangible invested capital.

Insight: Classic tobacco economics remain intact. Cigarette manufacturing requires minimal capital.

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Closing Scissors



The End of the Old Algorithm.

The terminal value assumptions of a decade ago (pricing +5%, volume -3%) are no longer arithmetically supported in developed markets.

The melt is accelerating.

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Financial Ledger: Global Tobacco Players Comparison Matrix

Player	Revenue	Smoke-Free % Rev	Anchor Assets	Forward P/E
PMI	~$37.9bn Rev	~40% Smoke-Free	Marlboro ex-US, IQOS, ZYN	~22x P/E
BAT	**£25.9bn Rev**	**17.5% Smoke-Free**	**Newport, Camel, Vuse, Velo**	**12.1x P/E**
Altria	~$24bn Rev	~12% Smoke-Free	Marlboro US, on!	11.5x P/E
Imperial Brands	£32.4bn Rev	LSD% Smoke-Free	JPS, West, blu	~8x P/E

Synthesis Takeaway:

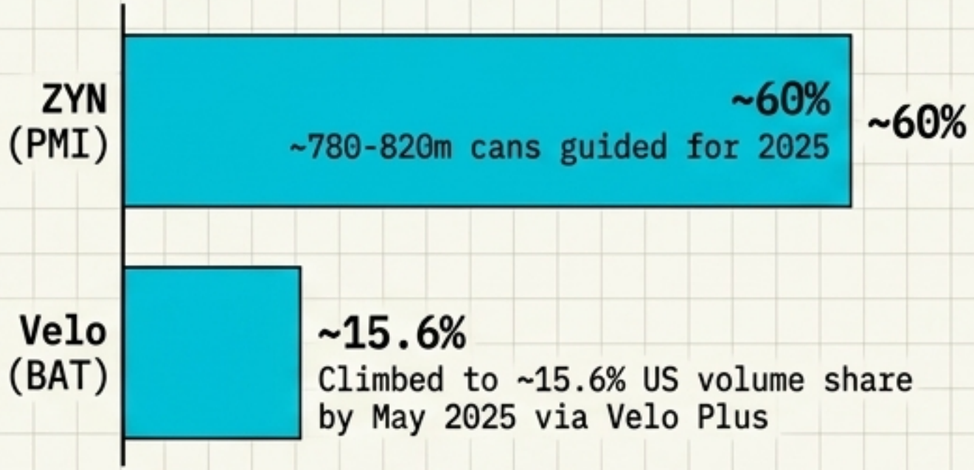
The durable valuation gap between BAT and PMI is anchored in NGP scale (17.5% vs 40%) and quality of transition, not current margins.

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Forensic Ledger: Battlegrounds & Disclosure Gaps

The Pouch War (Modern Oral)

US Volume Share (Forecast 2025)

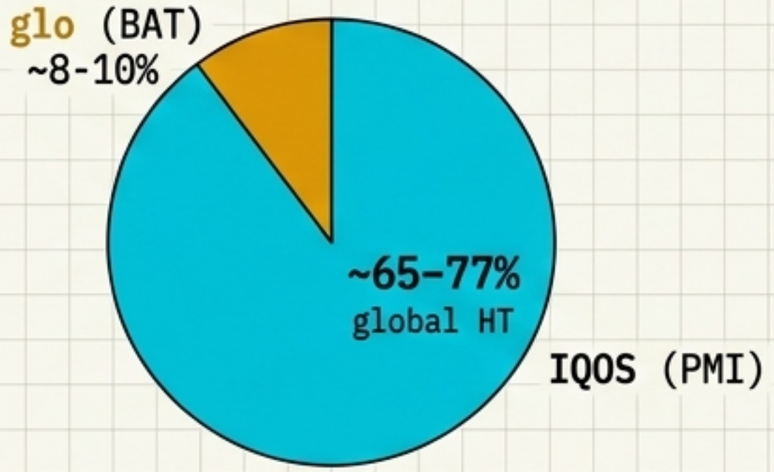


ZYN (PMI) is the structural US winner: ~780-820m cans guided for 2025 (~60% share).

Velo (BAT) is growing fast but remains a distant #2: climbed to ~15.6% US volume share by May 2025 via Velo Plus.

Heated Tobacco

Global HT Volume Share



IQOS (PMI) dominates with ~65–77% global HT volume.

glo (BAT) is a clear #2 globally but losing share (~8-10%).

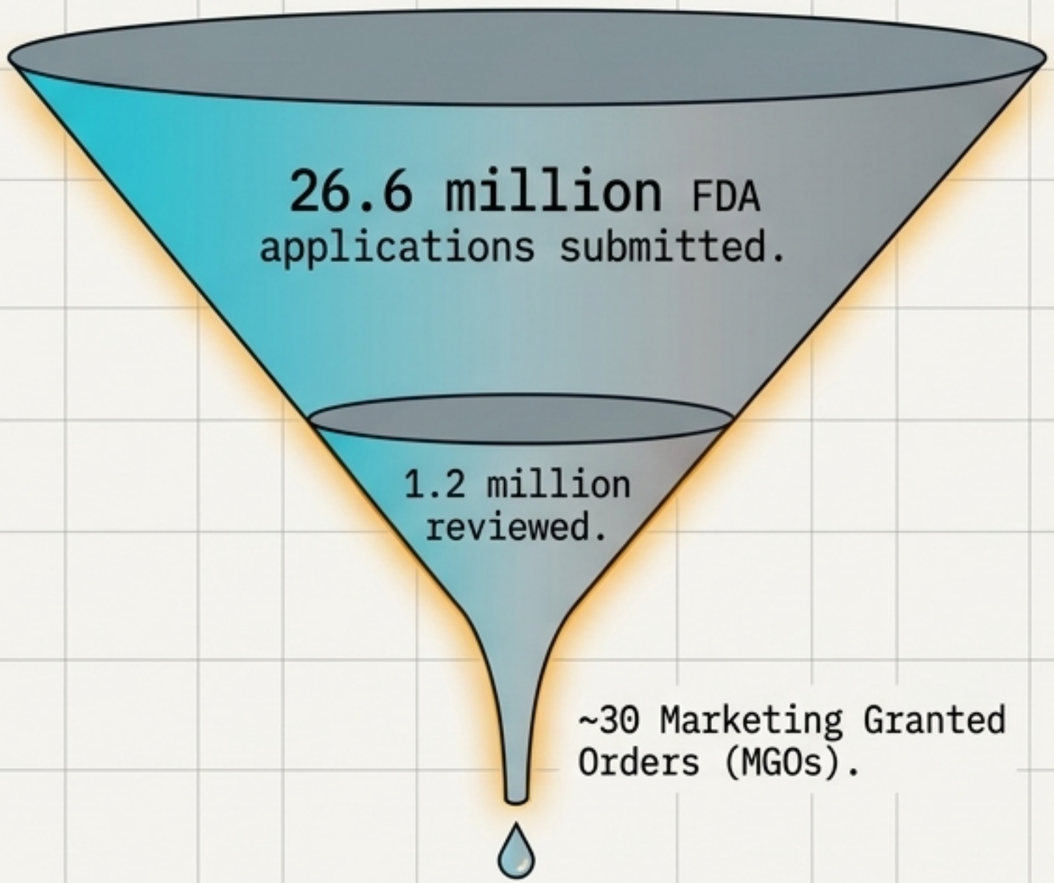
The Disclosure Gap: NGP Profitability Transparency

- PMI reports >$5bn in true smoke-free operating income.
- BAT claims NGP profitability (+11.8% contribution margin in 2025) but measures on category contribution before central overhead. Standalone NGP operating profit is not verifiable under IFRS 8.

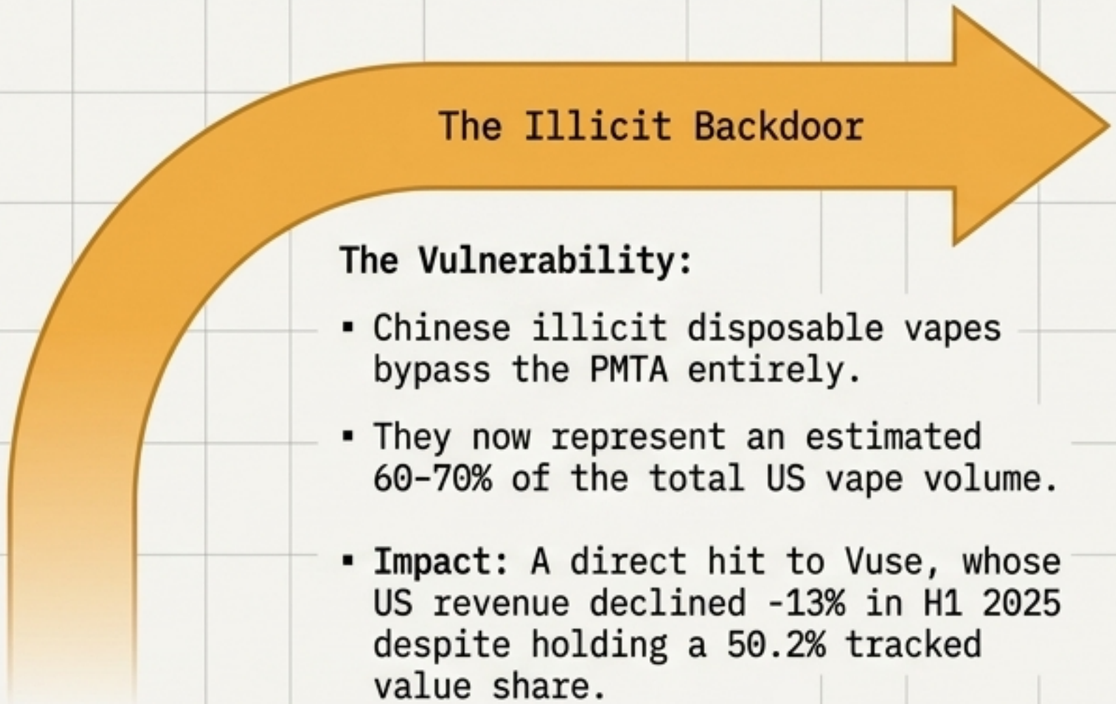
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Forensic Ledger: The Regulatory Bypass & Market Distortion (US Vape)

The Moat (PMTA Funnel): Regulatory Stranglehold



The Illicit Backdoor: Massive Market Bypass



The Vulnerability:

- Chinese illicit disposable vapes bypass the PMTA entirely.
- They now represent an estimated 60-70% of the total US vape volume.
- **Impact:** A direct hit to Vuse, whose US revenue declined -13% in H1 2025 despite holding a 50.2% tracked value share.

Synthesis Takeaway: The PMTA process acts as an effective barrier to entry for legitimate players, but its extreme restrictiveness has created a massive illicit market opportunity exploited by foreign disposable vape products, severely impacting compliant market leaders like BAT's Vuse.

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Forensic Ledger: Risk Ledger – Mitigated vs. Active Risks

Mitigated Risks

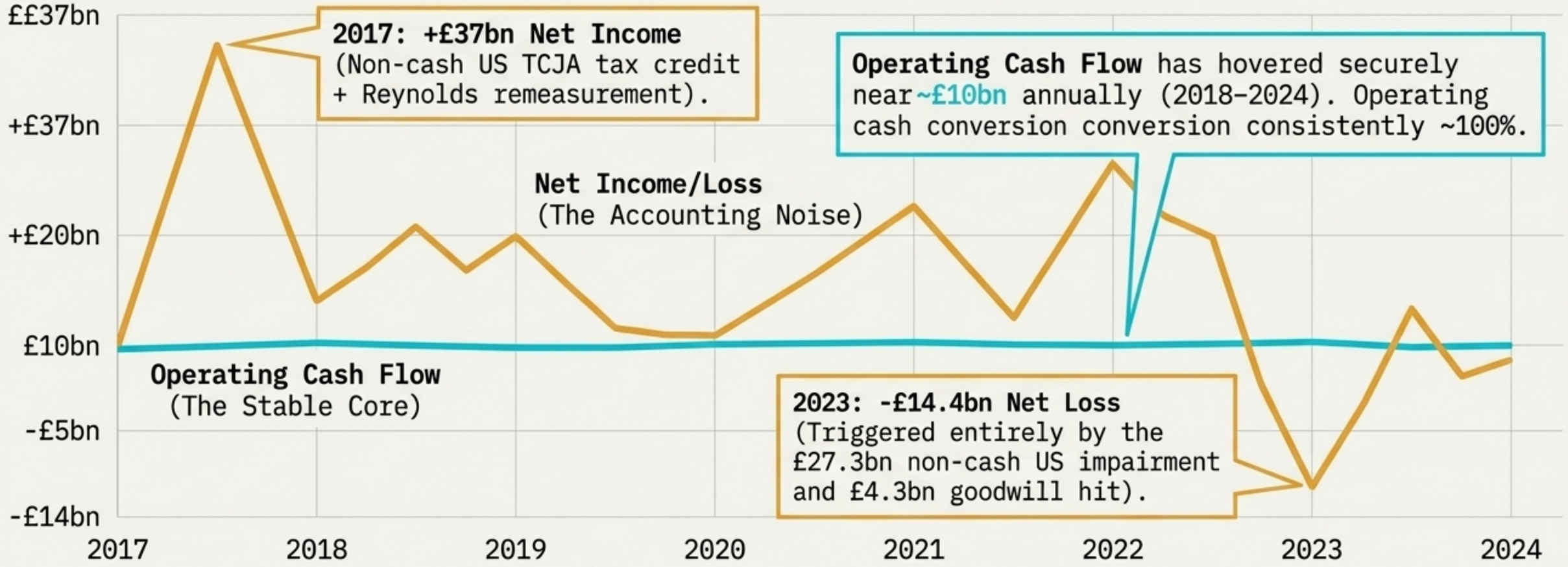
- **US Menthol Ban:** Formally withdrawn by Trump FDA on Jan 21, 2025. Materially positive for Newport (~$8bn annual US retail value).
- **Canada CCAA Settlement:** Sanctioned March 2025. BAT provisioned £6.2bn and has already paid down ~£2.6bn. Structural release from all Canadian claims.

Active Risks

- **UK Generational Ban:** Prohibiting sales to anyone born on/after Jan 1, 2009 (targeted Jan 2027).
- **Velo Mini PMTA:** Decision pending as of end-2025 pilot; material overhang.
- **EM Currency Drag:** Persistent ~3% translational headwind on reported EPS expected into 2026.

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Forensic Ledger: Cash Flow Reality vs. Accounting Volatility (2017–2024)

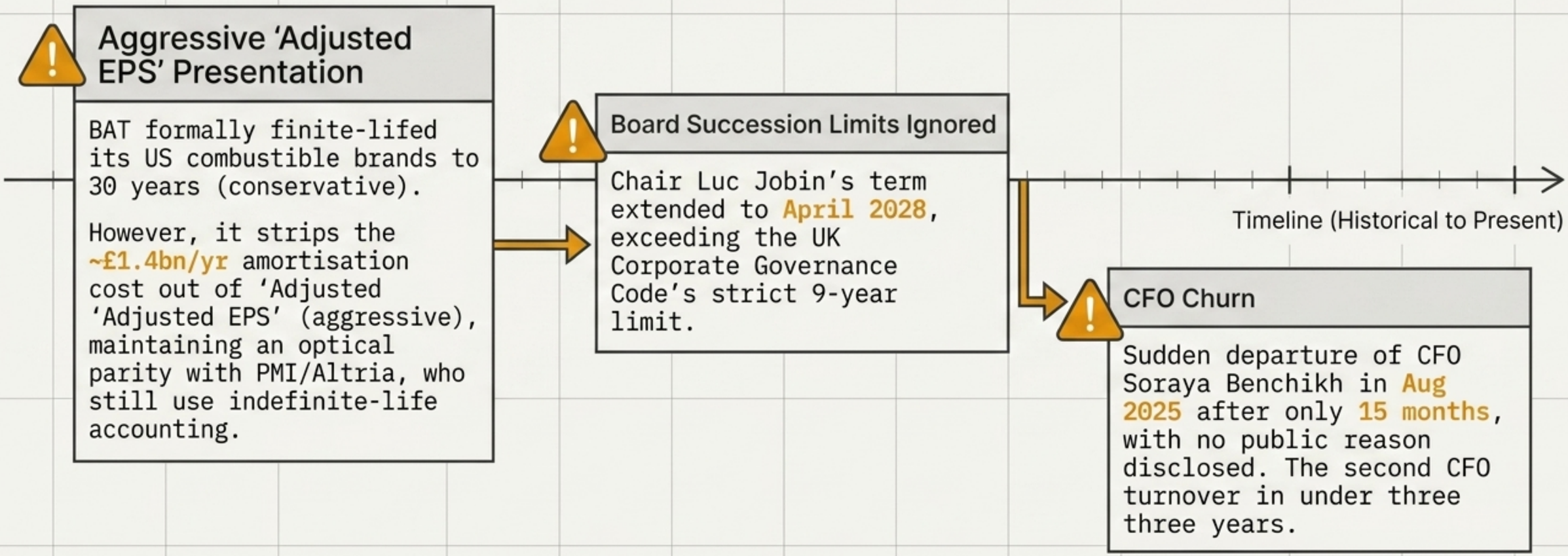


FORENSIC INSIGHT

Key Insight: A reader relying purely on the IFRS P&L misses the indestructible **~£10bn cash floor** that funds the dividend and debt service.

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Forensic Ledger: Governance Radar – Red Flags



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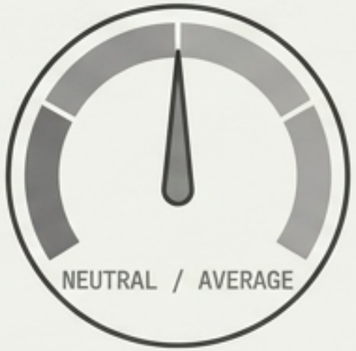
Forensic Ledger: Capital Allocation Scorecard

The Reynolds Buy-in (Value Destructive)



- Paid $49.4bn at 16.9x EV/EBITDA at peak multiples (2017).
- Implied IRR: ~3-5% vs BAT's ~7-8% WACC. Culminated in a £27.3bn impairment.

Buybacks & Capital Returns (Delayed/Forced)



- Buybacks paused from 2017-2022 to digest Reynolds debt.
- Restarted mechanically in 2024–2026 (£1.3bn for 2026), but missed the opportunity to retire massive equity at the £22 trough.

Portfolio Cleanup (Positive Remediation)



- Partial ITC monetization: Block trades in 2024/2025 unlocked ~£2.6bn to fund the buyback.
- Russia exit (2023) and honest write-downs signal a Marroco-era 'remediation,' though not a value-creation renaissance.

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Forensic Ledger: Valuation Implication – The Equation

The Math

£7.9bn FCF / £130bn EV = 6.08% yield

At an 8.0% WACC, the market is pricing in a perpetual FCF trajectory of -1.9%.

What is Priced In?

- To reach a -1.9% perpetual FCF decline, combustible volume must decline roughly 6–8% per year in perpetuity.
- Crucially, this math assigns exactly $0 of terminal value to New Category products.

The Verdict

BAT equity offers only ~70bps of FCF-yield pickup over BBB credit. It is priced as levered credit in terminal decline, offering free optionality on any future NGP success.

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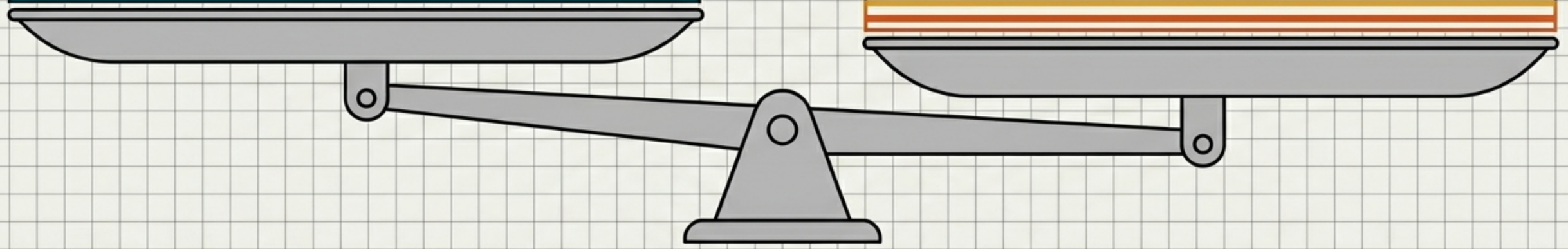
Forensic Ledger: Upside Optionality vs. Downside Risks

Market is Too Bearish If…

- FDA/Customs enacts meaningful structural enforcement against illicit Chinese disposables.
- Velo Plus execution drives modern oral category contribution toward £1bn+ by 2027–28.
- Menthol ban remains permanently dead.

Market is Too Bullish If…

- Group combustible volume declines permanently accelerate past -8%, breaking the pricing-offset math.
- ZYN capacity entirely crowds out Velo in the US.
- A second Reynolds impairment becomes necessary if US volume declines exceed -12% perpetually.



The central question is not whether BAT is a pristine business, but whether above-industry cash flows will persist longer than the market's aggressive run-off assumptions imply.

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