

Our Investment in BAT

April 2025

Dear investors,

In our June 2024 letter, we explained why we decided to start investing outside Brazil. We had already invested in two British companies, one of which was British American Tobacco (BAT). We recently sold that position with a return of ~31% in British pounds (~49% in Brazilian reais) in just under a year.

It was a small investment, part of a proof of concept that it would be possible to apply our investment philosophy to other geographies with similar success to what we have achieved on the Brazilian stock exchange. With the benefit of hindsight — always an unfair vantage point — we should have invested more.

Whether for its value as a proof of concept for how interesting it was to study the tobacco industry — which is full of controversy and has evolved in a rather atypical way over the past few decades — we thought it would be worthwhile to share with you the story behind this investment thesis.

A Brief History of the Tobacco Industry

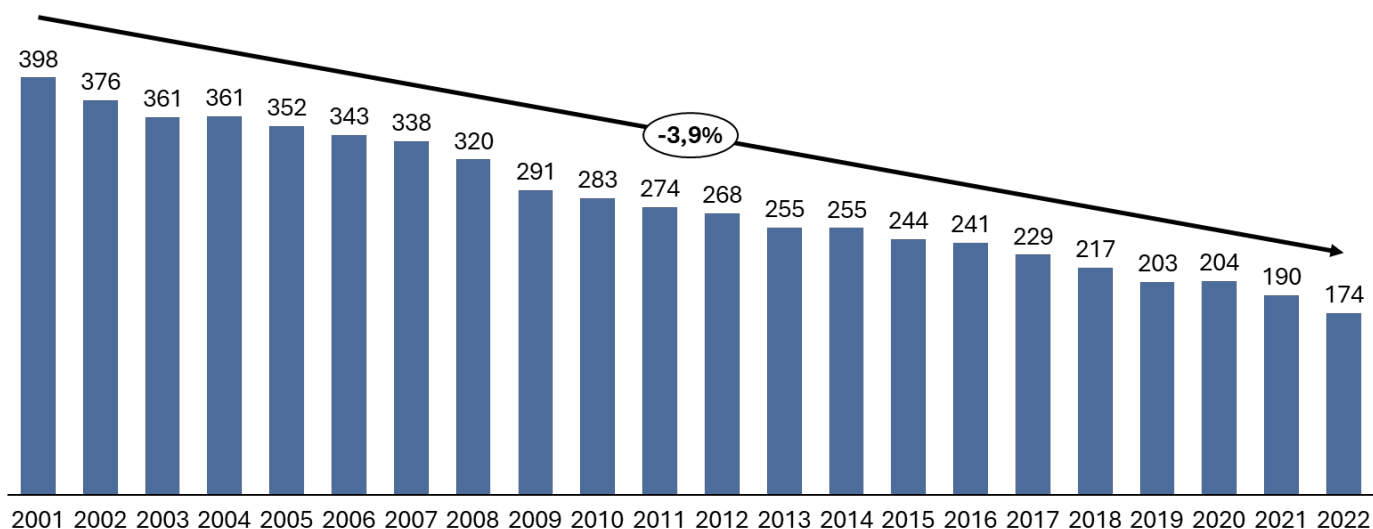
Tobacco is native to the Americas and was brought to Europe in the 15th century by Christopher Columbus. Over the following centuries, it grew in popularity and became one of the most valuable products in global trade, rivaling sugar and cotton. Until the end of the 19th century, tobacco products were handcrafted: pipe tobacco, cigars, and snuff. It was the Industrial Revolution that enabled the mass production of the cigarettes we know today, and British American Tobacco, founded in 1902, was one of the first tobacco companies to achieve global reach.

The peak of tobacco consumption came in the 1960s, when early indications began to emerge of a correlation between smoking and lung cancer. At the time, the tobacco industry responded by denying that its products caused any adverse effects and publicly fighting back against its accusers. Later, internal documents from the major companies were discovered, revealing that they not only knew about the health risks but were also studying ways to make cigarettes deliver more nicotine, thereby increasing smokers' dependency. The ethical failures of the tobacco industry during this period generated a strong reaction from regulators and created a reputational stain that persists to this day.

From the 1970s onward, anti-tobacco public policies were implemented around the world. One of the first measures was banning cigarette advertising. This made it virtually impossible for new companies to enter the sector. How do you launch a mass-market product or expand your market share without advertising? The move ended up benefiting the major tobacco companies, which sharply reduced their advertising expenses while still maintaining their sales volumes nearly unchanged. The growth limitations and stigma surrounding the industry triggered a major consolidation wave, and today the 5 largest tobacco companies in the world account for 93% of global sales volume.

More than 50 years of anti-tobacco campaigns have been effective from a public health standpoint. Today, only 10-15% of the population in developed countries consumes tobacco-derived products, compared to more than 40% in the 1960s. As a result, sales volumes have been declining, and the traditional cigarette business is destined to disappear or become a small niche market.

Cigarette Sales Volume in the United States (billions of units)



Fonte: Source: Federal Trade Commission – Cigarettes Report

New Generation of Tobacco Products

The tobacco industry's evolution has been to pursue new products that preserve the aspects consumers enjoy while reducing or, ideally, eliminating the health harms. The result of this effort has been three new product classes: e-cigarettes (vapes), heated tobacco, and nicotine pouches. Together, these are known as NGPs (New Generation Products). The general concept is to deliver nicotine — which produces the effect smokers enjoy — without emitting the products generated by burning tobacco, which are carcinogenic. There is still widespread debate around how harmful these new products are to health. The prevailing view is that they are less harmful than traditional cigarettes, but that nicotine itself is not healthy to consume, so use remains not recommended.

Curiously, regulators have taken a more restrictive stance toward new products — especially vapes — than toward traditional cigarettes. The apparent rationale is the view that cigarette smokers are already dependent on the product and cannot be stopped from consuming it. If cigarettes were banned, consumption would shift to the black market and continue to exist illegally. However, regulators are determined to prevent young people from becoming new smokers and have acted against vapes in an attempt to curb the growth of this market.

Regulation varies considerably from country to country. In the United States, the sale of vapes is permitted, but the range of flavors is restricted to tobacco and menthol, on the grounds that other flavors (e.g., fruits and sweets) are more appealing to young people. In Brazil, the sale of vapes is entirely prohibited. However, in both markets the bans have not been successful in curbing use. In the United States, 60-70% of vapes consumed are illegal products. In Brazil, 100% is contraband. In both countries, illegal vapes are easily accessible — they can be purchased at local shops and even in online stores.

The great harm of contraband is the complete lack of control over what is being sold. While legalized vapes comply with regulatory requirements (in the US, the FDA), illegal products follow no standards whatsoever. There have been cases of contamination by heavy metals and nicotine concentrations far higher than what is declared on the packaging of illegal products. The dilemma is: continue trying to fight vapes and stop contraband, or ease the restrictions to shift consumption toward legalized products, where quality control is greater? So far, the illegal market has only continued to grow.

The Possible Future of NGPs

An undeniable fact is that people enjoy nicotine. Before the harms of smoking became common knowledge, practically half the population smoked. In underdeveloped countries, the smoking rate still approaches that level. It is very likely that cigarette consumption will never return to what it once was, for good reason: the habit of smoking over decades reduces life expectancy between 5 and 15 years (depending on daily consumption volume). But the question that NGPs now raise is: what is the harm of consuming pure nicotine through methods not associated with burning tobacco?

There is still limited research separating nicotine consumption from traditional cigarettes, but there is evidence that the health risk of pure nicotine is considerably lower than the risk associated with burning tobacco. A study published by Public Health England (the UK's health agency) states that vapes are 95% less harmful than cigarettes. If this assessment were to become an academic consensus, would it still make sense to continue investing in anti-vape campaigns?

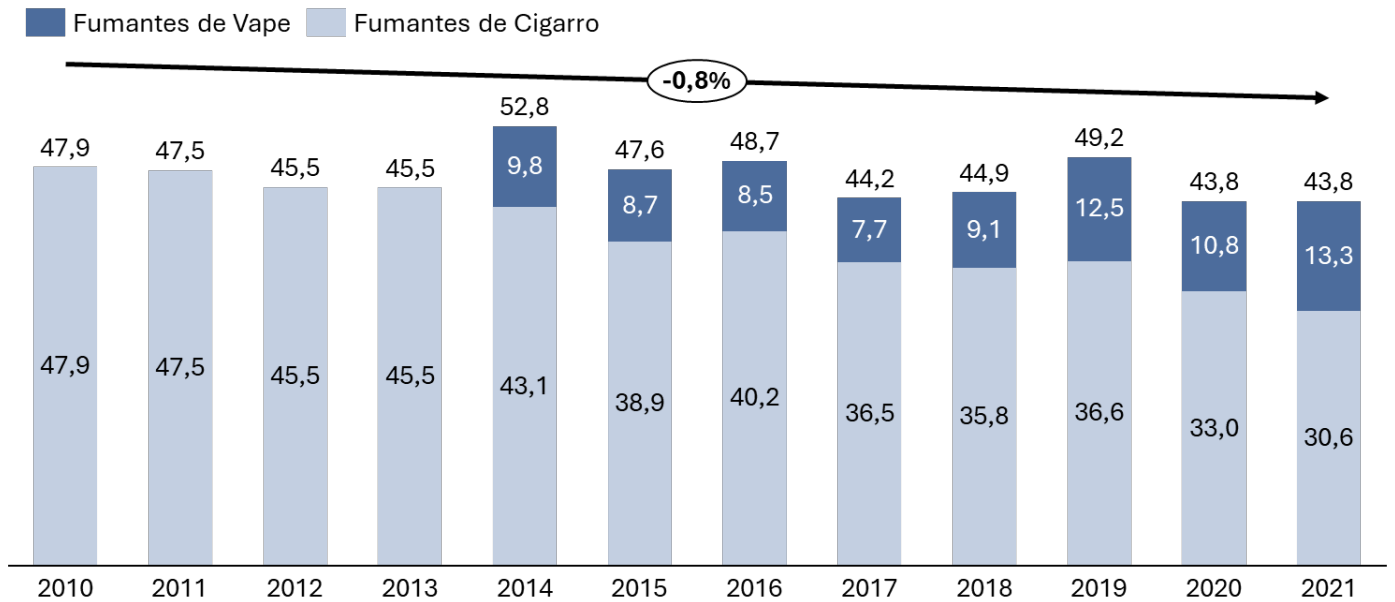
The debate is a sensitive one, but it is clear that people commonly do not follow best practices to maintain good health. For example, the consumption of alcoholic beverages is well known to be harmful, yet widely accepted in most countries. Even more common is the consumption of foods high in fat and sugar. Even with full awareness of the harms these products cause, most people do not want the state supervising their personal habits and imposing restrictions in the name of public health. In which cases regulatory intervention is appropriate will always be the product of a debate shaped by cultural factors, the degree of harm in question, and whether third-party harm results from the activity or not. In the case of cigarettes, the considerable harm and the health impact on non-smokers exposed to cigarette smoke (known as passive smokers) were the main arguments for regulatory action. With NGPs, this logic does not necessarily hold.

Today, there is strong regulatory action against NGPs, especially against vapes, in several countries. It seems to us that the main driver is the association with traditional cigarettes and the distrust of the major tobacco companies. However, we believe that what will ultimately define the fate of the NGP industry will be the scientific evidence and popular opinion about the habit — not the regulator's original intent. A case that reinforces this view is the history of Prohibition in the United States.

In 1920, the manufacture and sale of alcoholic beverages was banned across the entire United States. The motivation was not health-related, but rather the argument that excessive alcohol consumption caused social problems, domestic violence, and crime. Initially, alcohol consumption fell, but the black market quickly developed and organized crime came to dominate the production and sale of alcoholic beverages. After 13 years, the US government admitted the law had failed and repealed it.

What we ask ourselves is whether the story of vapes will not be an echo of Prohibition. As with alcohol, regulatory pressure has not been sufficient to curb nicotine consumption. The number of cigarette smokers has been falling, but new vape users offset the decline, and the total number of nicotine consumers has remained practically stable.

Number of Cigarette and Vape Smokers in the United States (millions)



Source: US Census, lung.org statistics

If anti-vape regulation were abolished in the future, the growth potential for NGPs in the market would likely reach the level of cigarette consumption seen in the 1960s, when more than 40% of the population smoked. In this scenario, the major tobacco companies could expand rapidly, since they are the ones that today possess the products and distribution channels to dominate that market.

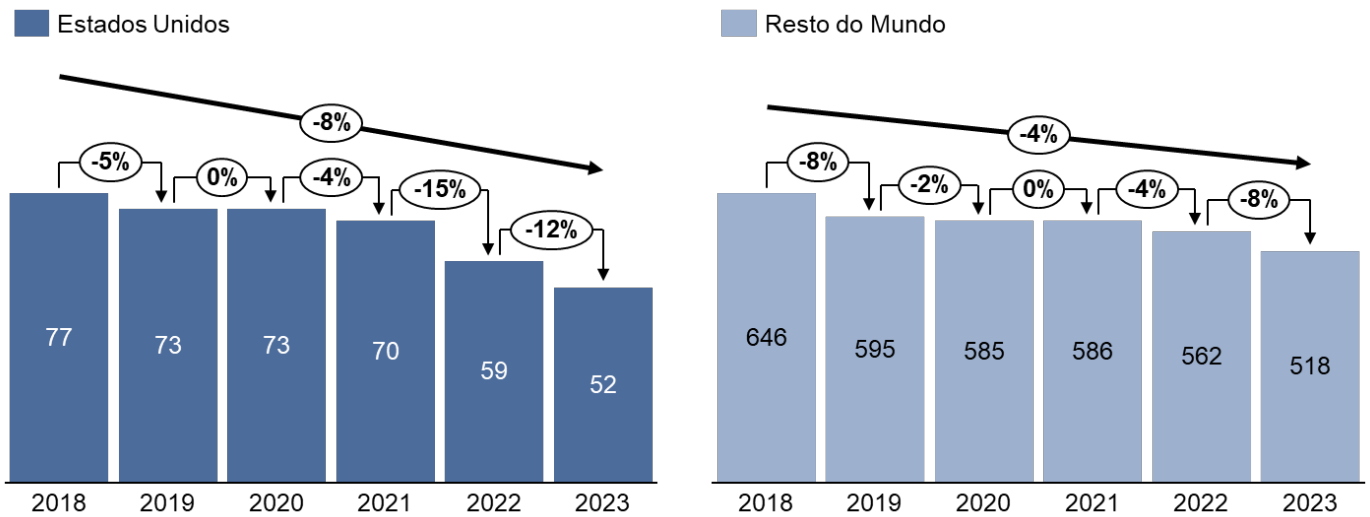
Why We Bought BAT

BAT is the world's largest tobacco company, with ~30% of the global market for traditional tobacco products (cigarettes, cigars, and pipe tobacco) and a similar share in the legal NGP market. The company operates in 180 countries with widely recognized traditional product brands (e.g., Lucky Strike, Dunhill, Pall Mall, Kent, Camel) and in more than 60 countries with major NGP brands (Vuse, Glo, and Velo). It generates GBP 26 billion in annual revenue, has an EBITDA margin of ~45% (~GBP 12 billion), generates substantial cash flow (~GBP 8 billion), and pays generous dividends (~GBP 5 billion).

The financial results are excellent, but the future of the business is not straightforward. There are two product segments with quite different dynamics within the company. Traditional products, mainly cigarettes, currently represent ~87% of revenue but are in clear decline. New generation products, primarily vapes, account for the remaining 13% and have significant expansion potential when considering public acceptance, but there is strong regulatory resistance preventing that growth from materializing. It was necessary to analyze each segment separately.

The history of cigarette consumption confirms what we already know from direct observation: few smokers quit the habit. What has been causing the smoking population to shrink is that the number of new smokers is increasingly smaller. In other words, sales volumes decline as the smoking population ages, dies, and is not replaced by equally numerous new generations of smokers. This demographic dynamic is inevitable, but slow. As a result, the pace of decline in cigarette consumption has followed a more or less predictable trajectory.

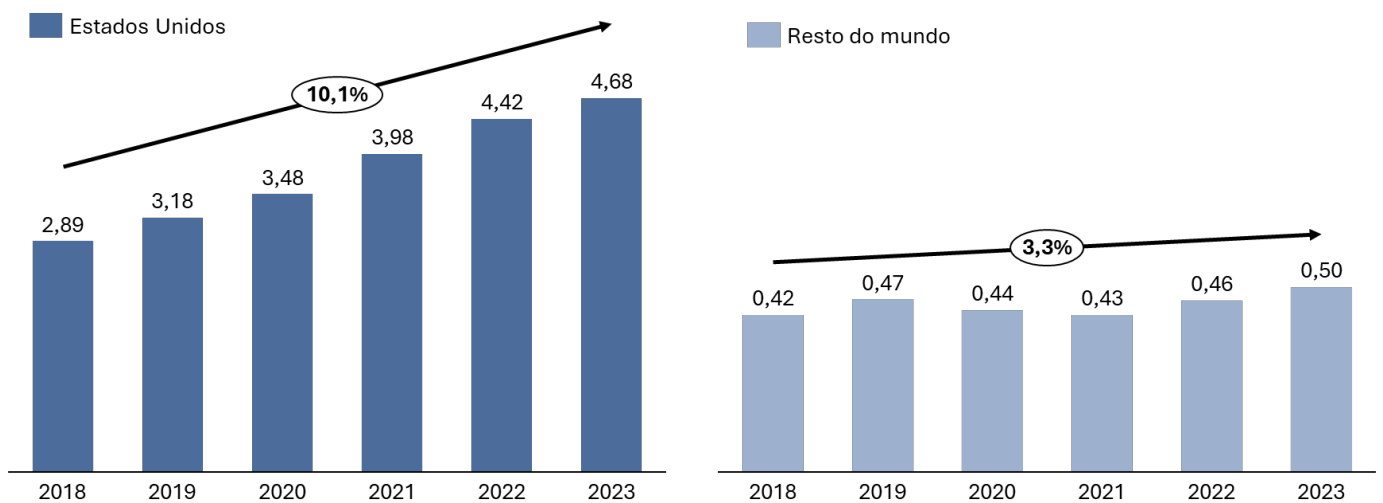
Number of Cigarettes Sold by Geography (billions of units)



Source: BAT

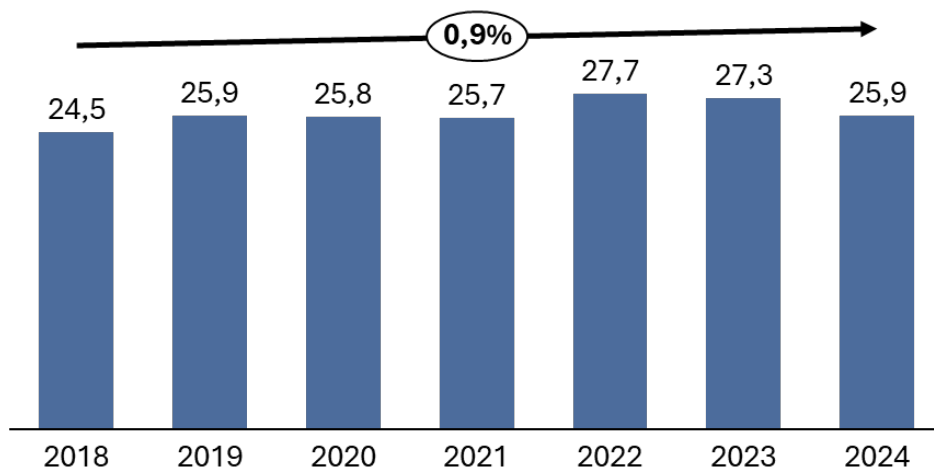
Interestingly, BAT's revenue and EBITDA from cigarette sales has remained at the same level despite the volume decline, thanks to a very simple strategy: raising cigarette prices to offset the reduction in volume. It is counterintuitive that this works, but smokers have proven to be relatively price-insensitive, and the major tobacco companies have been applying annual price increases above inflation for several years. The effect has been to continuously increase the profitability of the tobacco industry, which would normally attract new competitors, but regulatory restrictions prevent that from happening.

BAT's Average Price per Pack of Cigarettes (USD per unit)



Source: BAT

BAT's Net Revenue (GBP billions)



Source: BAT

The vape question is more delicate, largely because it depends on the regulatory stance. Even if the end scenario is the lifting of restrictions — as was the case with Prohibition — the time required for that to happen could follow the historical precedent and exceed a decade. Assuming deregulation does occur, there is still uncertainty about the profitability level of this new product segment, since in a more permissive regulatory environment new competitors could emerge and price wars could ensue. The possible scenarios are so varied that no clear conclusion emerges: the NGP segment could be worth very little, or more than all of BAT is worth today. Fortunately, at the time we decided to buy shares, it was not necessary to have a more precise view of this segment.

We added BAT shares to our portfolio in April 2024. The company's market value on the London Stock Exchange was ~GBP 52 billion, and our estimates indicated that even with traditional cigarette revenue in accelerated decline and NGP revenue stagnant forever, the likely return was in the order of 10% per year in British pounds — a currency with a historical inflation rate of 1-3% per year. Nothing phenomenal, but quite satisfactory for a rather pessimistic scenario. The stock was clearly mispriced. At that price, we were getting for free the options that cigarette sales decline more slowly and that the NGP segment grows. Not having to pay for the unpredictable part of the business made the purchase decision considerably easier.

Why We Sold BAT

A year after becoming BAT shareholders, the picture has not changed much compared to what we analyzed at the time of purchase. Traditional cigarettes continue to decline in major markets, NGPs continue to face growth barriers from regulation, and illegal products continue to serve most of the demand. The regulatory evolution around the world has been extremely slow and is still trending toward being more restrictive on vapes, not less.

During this period, the share price rose to a level we consider closer to fair value, and the logic that we were getting the vape business option for free is no longer true. Meanwhile, several Brazilian stocks remain deeply discounted and we have virtually all of our fund's capital deployed. So, why not sell BAT to buy more shares in companies with greater return potential? That is exactly what we did.