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| **Company: Reynolds American Inc.** | Ticker: RAI Current Price: $45.91 | Sector: Consumer Staples | Sub Industry: Tobacco |
| Target Price: $50Stop Loss: $4052 Week High/ Low: $31.35-49.56 | TTM P/E: 14.92Forward P/E (2015E): 22.8TTM EPS: 1.38 | Beta: 0.86Credit Rating: BBB- (S&P)Rating Outlook: Positive | Market Cap: 65.61BAvg. Vol (30 Day): 6.7MDividend Yield: 3.12% |

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| **Company Background:**  |
| Reynolds American, Inc. ([NYSE](https://en.wikipedia.org/wiki/New_York_Stock_Exchange): RAI) is an American tobacco company and is the second-largest tobacco company in the US. Its holdings include R. J. Reynolds Tobacco Company, American Snuff Company (formerly Conwood Company), Santa Fe Natural Tobacco Company and Niconovum AB. Reynolds American's subsidiaries manufacture and market a variety of tobacco products, including cigarettes (Newport, Camel, Pall Mall, Kent, Doral, Misty, Capri and Natural American Spirit brands) and moist snuff (Grizzly and Kodiak brands). In 2010, Reynolds American's operating companies sold about 28% of all cigarettes sold in the U.S. In July 2014, Reynolds American announced the purchase of Lorillard Tobacco Company in a deal valued at $27 billion. |
| **Industry Outlook:**  |
| The fundamental outlook of S&P NetAdvantage for the tobacco sub-industry for the next 12 months is positive, reflecting by the favorable pricing trends, healthy free cash flow growth and a relatively benign litigation environment. Year to date through August 21st, the S&P Tobacco Index increased 7.4%, versus an 4.0% decline for the S&P 1500 Index. In 2014, the Tobacco Index rose 8.5%, compared to the S&P 1500's 10.9% gain.  |
| **Investment Thesis:**  |
| * The company raised its earnings outlook for the year, reflecting strong sales from the recently acquired Newport brand and an uptick in preference for menthol cigarettes.
* Revenue is expected to rise 25% in 2015, reflecting net benefits from the acquisition of Lorillard in June 2015. Operating (EBITDA) margins will likely widen in 2015 to about 44%, up from 38% in 2014, on an improved product mix following the completion of the acquisition of Lorillard.
* EPS is estimated of $2.00 in 2015, up 17% from operating EPS of $1.71 in 2014, excluding one-time items.
* Japan Tobacco has agreed to purchase the rights to one of Reynolds' cigarette brands. RAI is selling the international rights to its Natural American Spirit name and associated trademarks to Japan Tobacco Group for $5 billion in cash. The deal, which does not include the rights to the U.S. market, allows Reynolds to retain its share of domestic revenue. The funds received from the transaction will probably go toward paying off debt and/or buying back stock.
* A federal assessment that forced cigarette manufacturers to make annual payments of approximately $1 billion to farmers has ended. Altria, Reynolds American, and Lorillard mostly paid the payments. The expiration of the payment will estimate to provide a 10% boost to Reynolds' 2016 earnings.
* Higher disposable incomes due to lower gas prices and e-cigarette customers that have moved back to combustibles will at least benefit the traditional cigarettes industry in the short term.
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| **Investment Risks:**  |
| * Increasing regulation and taxation could have an adverse effect on the results of operations, cash flows and financial position
* RAI’s operating subsidiaries are subject to significant limitations on advertising and marketing of tobacco products, which could harm the value of their existing brands and their ability to launch new brands
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| **3-5 Takeaways From Last Quarter’s Investor Call Transcripts:**  |
| * Net sales, earnings and margins were all significantly higher in the third quarter driven by excellent performance at the operating companies and the impact of Newport's addition to the R.J. Reynolds portfolio.
* RJR Vapor's VUSE Digital Vapor Cigarette continued to perform well in the third quarter.
* In September, the company announced the proposed sale of the Natural American Spirit business outside the U.S. to the JT Group for $5 billion.
* A signing of a technology sharing term sheet between R.J. Reynolds and British American Tobacco provides a framework for collaboration and mutual cross licensing of vapor product technologies through 2022.
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| **Financial Performance:** | **Discounted Cash Flow**  |
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|  | 2012 | 2013 | 2014 | Q1-2015 | Q2-2015 | Q3-2015 |
| Revenue | 8,304.00 | 8,236.00 | 8,471.00 | 2,057.00 | 2,403.00 | 3,161.00 |
| Operating Profit | 2,214.00 | 3,132.00 | 2,531.00 | 693.00 | 4,364.00 | 1,206.00 |
| Net Income | 1,272.00 | 1,718.00 | 1,470.00 | 389.00 | 1,928.00 | 657.00 |
| Revenue Growth % | (2.77) | (0.82) | 2.85 | 6.30 | 11.15 | 41.12 |
| EBITDA% | 28.24% | 39.28% | 31.13% | 35.05% | 182.77% | 39.26% |
| Operating Profit % | 26.66 | 38.03 | 29.88 | 33.69 | 181.61 | 38.15 |
| Net Income Margin | 15.32 | 20.86 | 17.35 | 18.91 | 80.23 | 20.78 |
| D/E | 96.92 | 98.68 | 112.41 | 112.39 | 98.22 | 97.04 |
| Interest Coverage | 9.60 | 11.79 | 9.13 | 7.89 | 41.37 | 6.46 |
| EPS | 1.13 | 1.58 | 1.38 | 0.37 | 1.70 | 0.46 |
| PE Ratio | 7.29 | 9.35 | 22.41 | 12.04 | 12.55 | 14.39 |
| Current Ratio | 1.28 | 1.19 | 0.94 | 0.94 | 1.16 | 1.13 |
| ROE | 22.11 | 32.96 | 30.34 | 31.39 | 25.25 | 26.60 |
| ROA | 7.75 | 10.75 | 9.61 | 9.45 | 8.39 | 9.04 |
| Dividend Per share | 1.17 | 1.24 | 1.34 | 0.34 | 0.34 | 0.36 |

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|  | 2001-14 | 2015-20 |
| Avg. Revenue Growth  | -0.19% | 8.29% |
| Avg. EBITDA Margin  | 60.72% | 50.19% |
| Avg. NOPAT Margin | 34.75% | 24.99% |
| Cost of Debt | 1.66% (after tax) |
| Tax Rate | 42% |
| Cost of Equity  | 7.47% |
| WACC | 6.2% |
| Perpetuity Growth Rate (Terminal) | 4.4% |

**Analyst Opinion**

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| Buy: 8 | Hold: 2 | Sell: 0 |

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|  | Rating  | Target |
| S&P NetAdvantage  | Strong Buy (5 Star) | $55.00 |
| Morningstar | 3 star | N/A |
| Value Line  | Timeliness 1Safety 2Financial Strength A | $40-$55 |

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| **Relative Valuation** | **Total Return** |
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|  | BATS | VGR | PM | MO | Ind. Average  | **RAI** |
| P/E | 17.62 | 61.82 | 18.36 | 61.82 | 21.81 | 14.92 |
| P/B | 11.86 | - | - | 38.75 | 21.93 | 3.55 |
| Dividend Yield  | 3.94 | 6.25 | 4.71 | 3.72 | 3.76 | 2.97 |
| PEG Ratio  | 2.56 | - | 3.16 | 2.67 | 3.85 | 3.55 |
| EPS (Last FY) | 2.75 | 0.33 | 4.76 | 2.56 | 2.69 | 1.38 |
| Rev Growth (Last FY) | 3.47 | 10.56 | 14.29 | -1.62 | 0.1 | -0.3 |
| NI Growth (Last FY)  | 22.17 | -17.97 | -9.88 | 9.38 | 27.44 | 40.69 |
| Operating Margin  | 32.43 | 20.64 | 42.72 | 46.34 | 25.03 | 38.15 |
| Debt / Equity  | 247.63% | - | - | 443.11% | 229.37% | 97.04% |
| Market Cap | 108.02B | 2.99B | 132.3B | 111.88B | 26.8B | 65.61B |

**Prepared By: Yun Xie****Sources: Bloomberg, S&P NetAdvantage, VLIS, Morningstar** |

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|  | RAI | Sector  | S&P 500 |
| YTD | 46.82% | 17.26% | 12.04% |
| TTM |  |  | 0.686% |
| Last 3 Years  | 34.55% | 66.05% | 63.45% |
| Last 5 Years  | 33.77% | 56.51% | 84.44% |

**CSR Characteristics**

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|  | Company  | Industry  |
| ESG Disclosure | 40.91 | 25.57 |
| Governance Disclosure Score | 66.07 | 50.00 |
| Social Disclosure Score | 17.54 | 34.39 |
| Environmental Disclosure Score | 40.31 |  33.08  |

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