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Service

## Rating Tobacco Companies



DBRS Rating Approach



## DBRS Rating Approaches

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The following is an addition to the base DBRS rating methodology for industrial companies (see General Overview), which details some factors that are important considerations for DBRS in deriving credit ratings for the tobacco industry. For a full understanding of the rating methodology that DBRS uses for the tobacco industry, the reader should refer to this document [and](#) the General Overview.

#### Industry Factors

Tobacco company ratings are generally constrained by potential and current litigation issues, including those brought by the government and individuals and governmental regulation of tobacco sales and marketing, which varies from country to country. The stability and free cash flow and low debt levels generally support the ratings.

#### Regulation

The degree of regulation of a domestic tobacco industry varies widely from country to country, with most Western nations having strictly regulated industries at both the Federal and regional governmental level. In some cases, this type of environment can be costly for tobacco producers, makes it more difficult to establish new brands and facilitates the ability of taxation issues to play a large part in the industry. Hence, the constantly evolving regulatory and tariff environment of various countries can have a significant impact on volumes and profitability. The Canadian tobacco industry is highly regulated at both the Federal and Provincial level, and even as this has allowed for highly profitable and sizeable annual price increases, the constantly changing government legislation and regulation in Canada has also created an uncertain business environment. For example, regulations regarding sponsorship programs will become stricter in the near future, and some of the recent initiatives proposed by the B.C. government could raise future costs. Other Canadian initiatives have affected volumes, and smuggling issues can rise as provinces and regions impose different tax structures on similar products.

#### Litigation

Tobacco litigation from both governments and individuals is the largest area of concern for the tobacco industry. The concern over litigation is an evolving risk for the entire tobacco industry. While the validity of these claims and the long-term financial implications are uncertain and difficult to quantify, these do place an implicit ceiling on the tobacco credit ratings as potential payoffs would likely be substantial. Tobacco litigation is expected to remain a long-term issue limiting the ratings, and even though DBRS tobacco ratings allow for some negative impact from these issues, final resolution may represent an event risk if actual results differ significantly from the levels allowed for in the ratings. The United States has witnessed the largest number of litigation events, and while it continues to be the most potentially dangerous area for the tobacco industry, the trend of increasing legal issues is spreading throughout the world. Substantial and influential settlements have been reached recently, including federal actions, individual claims and class action lawsuits, and international lawsuits by foreign governments are also a concern. Despite the most recent positive legal event of the U.S. industry whereby the F.D.A. declined jurisdiction over tobacco, numerous claims present future difficulties, including healthcare cases, union lawsuits, private class action suits, and further actions brought by various levels of government. The industry has managed to decertify most class action cases but these situations have affected the U.S. operating environment. The Canadian tobacco industry has also experienced an increase in legal issues recently, including: (a) The B.C. government has taken an aggressive stance against the tobacco industry with the passage of several new laws and regulatory requirements. B.C. has introduced legislation which has increased tax and regulatory costs and could permanently weaken profitability for the industry in B.C. All are being challenged by industry, but of greater concern is the risk that other provinces will follow B.C.'s initiatives. (i) The 1998 Tobacco Fee Act is a \$20 million licensing fee based on market share, with the future cost of this fee yet to be established. (ii) The 1998 Tobacco Sales Amendment Act requires the disclosure of all additives and ingredients in cigarettes. (iii) The 1997 Tobacco Damages Recovery Act allowing the recovery of health care benefits by an individual

or government was recently struck down by the Supreme Court as unconstitutional. (b) Although not to the same degree as witnessed in the U.S.A., the risk of private lawsuits against Canadian tobacco companies is becoming a greater industry concern. (c) Smuggling concerns have surfaced and any future settlement or regulations stemming from these initiatives could prove difficult.

#### Declining Per Capita Consumption

The long-term trend towards declining tobacco consumption in developed markets due to increased public awareness of health risks, declining social acceptability and demographics is a major challenge. Volumes are declining annually by 1-3% in most western markets but are rising in less developed markets. The 5-6% decline in global industry volumes in 1999 was due to several unusual events including the substantial price increases in the U.S. and is not likely to be repeated. Canadian consumption peaked in the early 1980s at about 75 billion cigarettes and declined at an annual rate of approximately 2% until the early 1990s when consumption levels stabilized somewhat at around 53 billion cigarettes. Since then, consumption has once again begun to fall and this is expected to continue at about 1-2% annually. The rate of decline in tobacco consumption in Canada has followed a similar pattern to that of the United States despite a substantially different regulatory environment. Various governments have been utilizing higher excise taxes and duties, which has also negatively impacted industry volumes. Since the industry is facing declining volumes in most markets, it must rely on market share growth or acquisitions to increase volumes. There is a risk that margins will suffer as tobacco companies strive to increase their share. Brand counterfeiting is also having a negative impact on volumes in certain markets.

#### Stability

Both earnings and cash flow are highly stable for the industry and largely dependent on market share, which is generally relatively stable over the short- and long-term.

#### Balance Sheet Strength

Due to the ability to produce high levels of cash flow and low capital expenditure and working capital requirements, the balance sheet and related coverage ratios of the industry players are generally considered strong. Liquidity is usually not a concern as the companies have low debt levels. Tobacco companies have low fixed costs and capital needs as the initial large investments for production capacity have been depreciated over a number of years and still have useful life due to the low technological demands on equipment. Although most companies have a strong financial profile, dividend payout ratios are generally high at over 50%. However, an offsetting factor to balance sheet strength is the possibility and method of financing any currently indeterminable litigation obligations.

#### High levels of profitability

Overall industry profitability is very high, with a net after-tax margin in the 20% range and ROC in the upper 40% ranges, which should not diminish meaningfully in the near term. The tobacco industry in Canada has been highly profitable due in part to the high degree of regulation, with annual price increases allowing profit levels to rise over the past several years.

#### Competition

The international industry is dominated by a few large players, namely British American Tobacco and Philip Morris, with a number of smaller firms holding significant market share. The industry is disciplined in regards to competition, which has resulted in an atmosphere conducive to good profitability. Many governments have recently been privatising their state-owned tobacco agencies, and this represents an opportunity for the larger players to gain share and increase international operations relatively easily.

## Company Specific Factors

### Diversification

The degree to which a company diversifies its operations will lend more stability to results and can be an important factor in increasing profitability and volumes away from the mature markets of the world. The larger tobacco firms are well-diversified by product line and geography and this is expected to increase in the future as more of the smaller, regional or one-country players are consolidated. The more geographically diverse companies are exposed to greater litigation risks, which offset the benefits of market diversification to a large degree.

### Brand Portfolio

The size and relative degree of strength of the individual companies' brand portfolios are important considerations to the rating. Strong U.S. brand names generally perform well when introduced internationally.

### Market Share & Demographics

It is important to examine a company's performance over a longer period of time as market share swings are gradual, and, in turn, dependent on long-term marketing effectiveness. It is difficult to gain share due to marketing restrictions, and as most consumers are brand loyal and do not generally change brands once in their 20s. However, it is important that companies maintain effective advertising and brand loyalty programs within the allowed regulations as market share is difficult to regain once lost. The company's market share of the young adult smokers market and that of the older "quitters" market must also be examined. The regulatory environment in Canada makes it difficult to gain share due to marketing restrictions, and to introduce new brands.

### Strong parent

Companies with a strong parent have an advantage due to the potential alternative source of capital.