Don’t Stub This Butt!
Newsletter for May 2018

We are no advocates of smoking. We also don’t stand in moral judgement of any industry or company. We simply have an affinity for those that generate growing cash flows and which distribute them to shareholders. Tobacco is one such industry. Today, tobacco stocks trade at decadal lows in terms of their valuations, even as their profits (in most cases) continue to climb ever higher. It has been hard to resist taking a serious look at them now.

We asked ourselves several pointed questions. Is the market correct in its perennial concerns about the industry today more than at any time in history? Will the industry’s profits go into a terminal decline? Stock prices seem to believe they might. If proven otherwise, history will mark this as a multi-year trough and the proverbial buying opportunity of a lifetime.

The four most talked-about concerns regarding the industry (that have been so for some time) are:

1. It is heavily regulated and litigated
2. It is highly taxed
3. The fact that smoking is declining
4. The advent of e-cigarettes

Heavy Regulation and Litigation

There have been umpteen regulatory attempts over the past decades to rein in smoking, from outright bans on cigarette advertising to banning smoking in public places to the more recent plain paper packaging introduced in certain countries. In addition to this, legal settlements in the U.S. have cost the industry billions. Such settlements could have killed off many other industries. However, the tobacco industry has fought back each time and not just ensured its survival but also thrived thereafter. In fact, given the level of regulation and litigation, it has been amazing that tobacco has been able to produce any returns, let alone the highest in American history.

High taxes

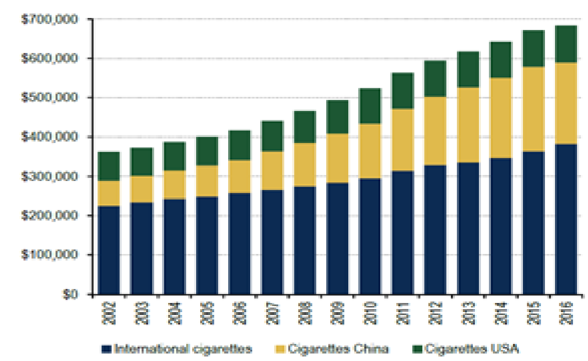
Taxation has been driven up over the years in a bid to make smoking more expensive and thus deter smokers. It has helped in reducing the quantity of sticks smoked. It has also, perversely, filled the coffers of governments. Despite this, companies’ profits have been unscathed and have grown throughout history. This is because tobacco product inflation has been almost five times higher than overall inflation since 1950, though a lot of the price increases have been to offset rising tobacco taxes, which in some U.S. states make up more than one-third of the sales price.

Governments earn billions of dollars from tobacco taxes each year, a golden goose they can ill-afford to kill. Governments which have recently gone overboard in their zeal to tax the industry have realised how easily this can backfire. Countries such as the Philippines in 2013, South Korea in 2015, Malaysia in 2016 and Saudi Arabia in 2017 have all found to their chagrin that they have willy-nilly ‘handed-over’ their industry to smugglers who have deprived these very governments of their tax revenues. For example, in Malaysia, smuggled cigarettes accounted for nearly 40% of the cigarettes sold in 2015. Today nearly 60% of the market rests with the smugglers.

Decline in Smoking

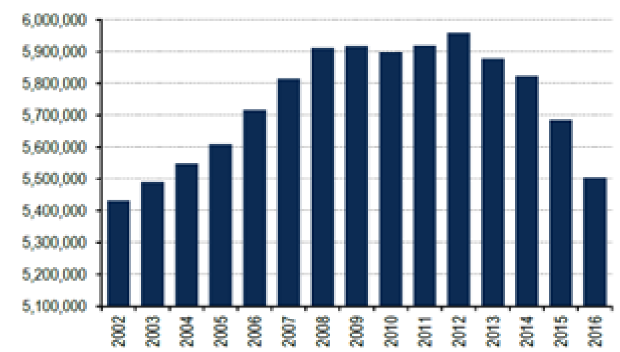
Smoking rates have been falling for half a century. Half the percentage of U.S. adults smokes today than did in the 1950s. Even though there has been population growth during that period, it has not been enough to offset the decline in smoking rates. The number of cigarettes sold in the U.S. from the start of this century until 2016 declined 37%. However, this has been more than made up by the greater than 70% increase in cigarette prices. Governments have achieved their objective of curbing smoking but the industry has stayed ahead, generating ever higher profits and cash for its shareholders through this period.

Retail sales of traditional combustible cigarettes (US$bns)



Source: Euromonitor

Cigarette volume (sticks)



Source: Euromonitor, BofA Merrill Lynch Global Research

During the period 2011-2016, while cigarette volumes have declined by 2.1% globally ex-China, sales value has risen by 3.3% through price increases. Through this period the top five companies have grown their net dividends at a CAGR of 10.9%.

Moat

When one wishes to describe a 'moat' in investing, there is no better example than the tobacco industry. Not surprisingly then, there are perhaps few other industries that have generated the kind of shareholder returns over long periods of time as tobacco has.

Years of consolidation have left the world with just six large global companies that own the lion's share of the brands, revenues and the global profit pool today, excluding China. These are Altria, British American Tobacco (BAT), Phillip Morris International (PMI), Japan Tobacco Co (JTC), Imperial Brands and Swedish Match. The banning of tobacco advertising in mainstream media has effectively meant that new brand creation would be almost impossible in future and that existing brands can enjoy practically no new competition. In fact, we cannot fathom anybody entering this business at a regional level, leave alone globally. In no other industry can one think of a structure with just six global companies and 15-20 brands which share the spoils of a global profit pool that runs into tens of billions of dollars every year in perpetuity.

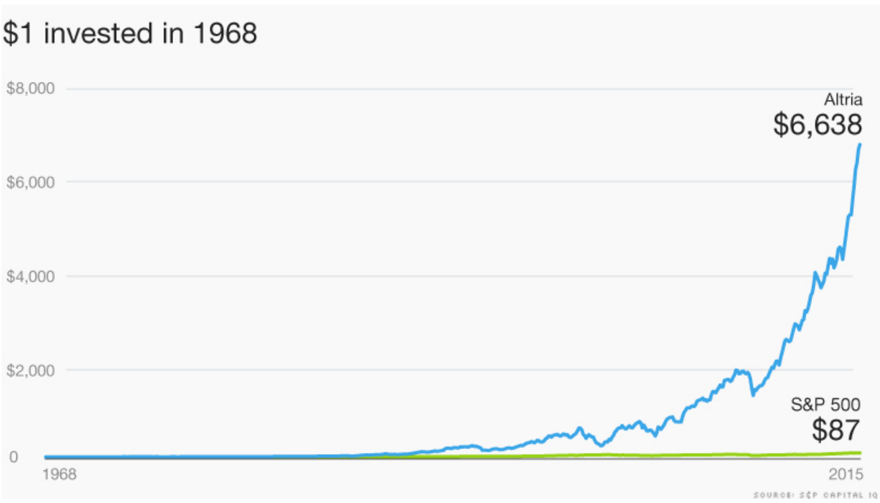
The second factor is very high consumer loyalty to brands. Hardened smokers seldom shift away from the brands they have been smoking for long, regardless of price. This brand loyalty lasts through a lifetime and price inducements are not known to make them jump from brand to brand, as is the wont in other consumer staples or discretionary products. This brings a huge stickiness to the revenues and profits of the companies. Market share swings across brands are so glacial and minute in magnitude that often leading companies crow when they eke out a 10 or 20 basis point gain in market share.

Finally, tobacco has largely had no substitutes globally. This is unlike say beer which has been recently challenged by craft beer or a shift away from drinking beer to wine or hard liquor in some countries. What big tobacco has had to worry about is someone rolling out sticks illegally and not paying their fair share of taxes, often actively in connivance with some governments. It has been such an age old problem that the industry has found a way to compete and battle this scourge, with some success.

Stock performance and shareholder returns – the longest puffs in history

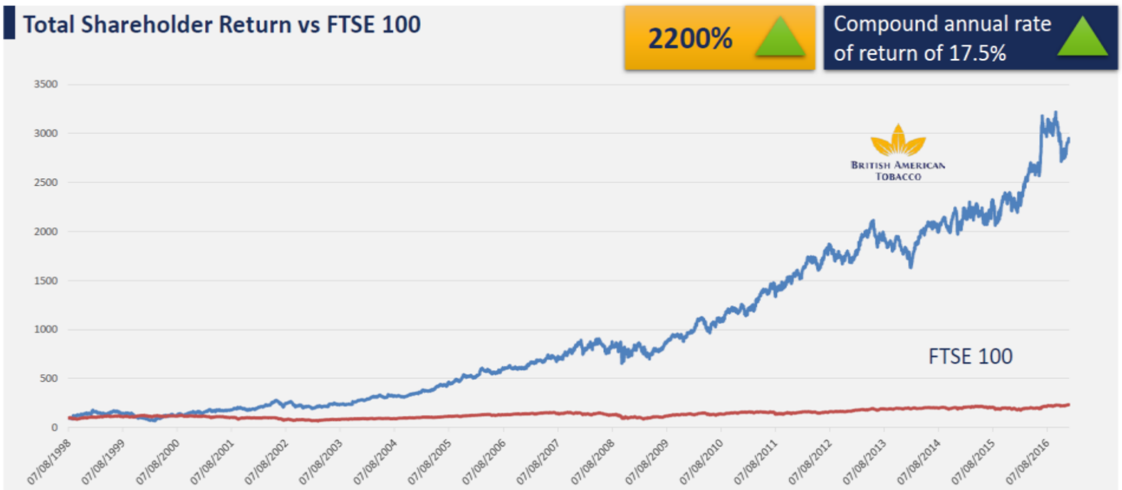
Observe the stock returns delivered by Altria and BAT over long periods of time.

The returns that Altria has delivered since 1968 are truly staggering and we would bet would be hard to beat by any company of that vintage.



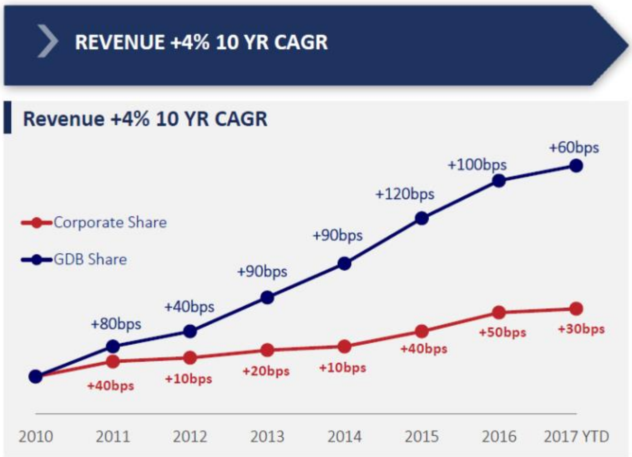
Source: S&P Capital

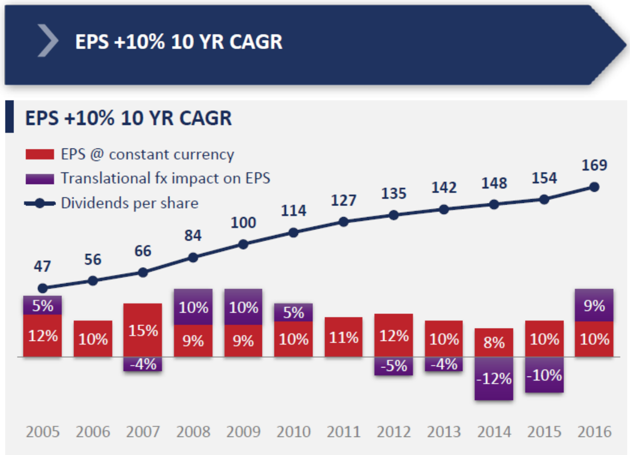
BAT has pulverised the FTSE100 index in the period 1998 – 2016.



Source: BAT

BAT provides more proof of how consistent its revenue and profit performance have been since 2010 (charts below).

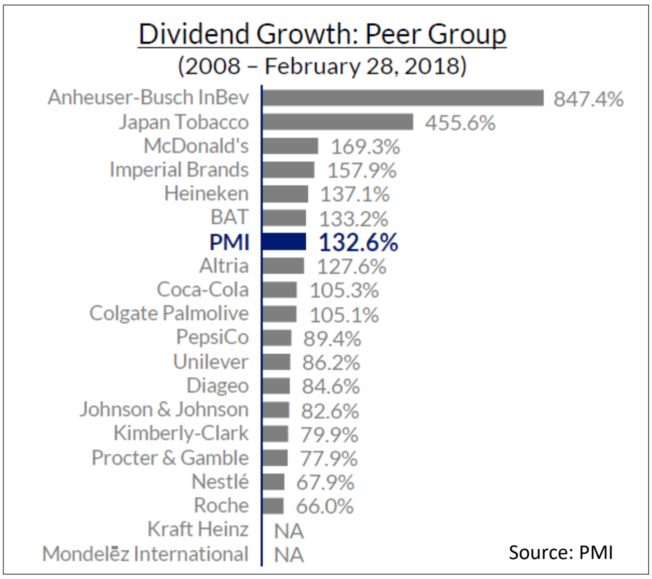


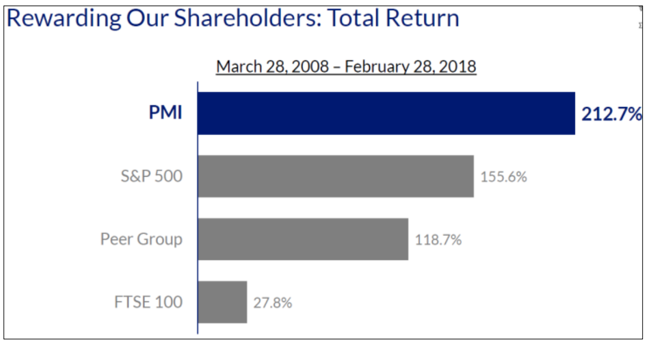


Source: BAT

Source: BAT

The table on dividends growth culled from a PMI report is even more telling. Of the top ten companies to have grown dividends in the period 2008-2017, five of them are the tobacco giants and two are liquor companies. PMI itself has beaten the indices and its peer group by some distance over a ten-year period that has seen some of the strictest regulation and steepest tax increases being affected in history. As we can see, 'sin stocks' make for great investments.





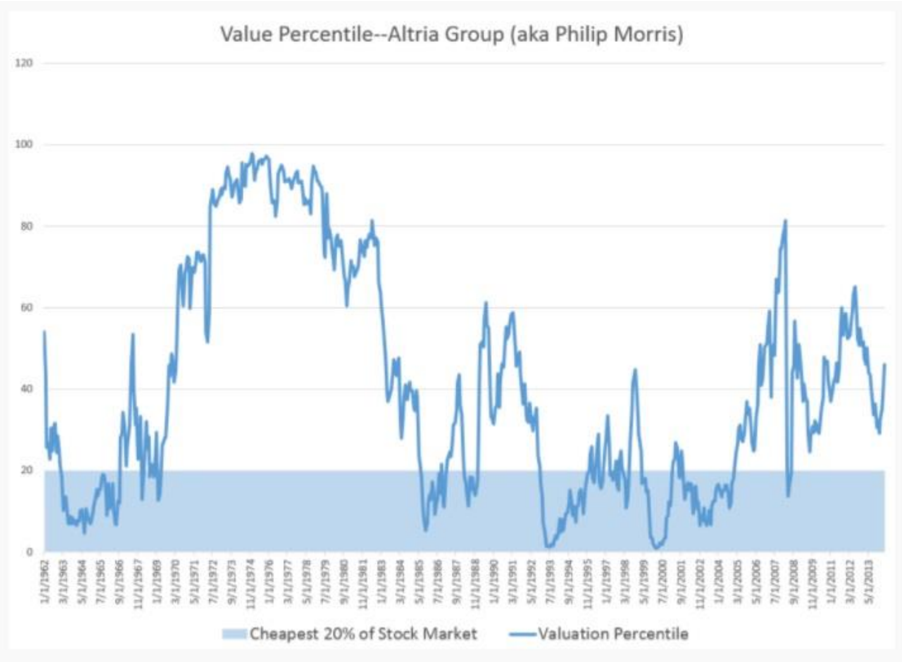
Source: PMI

So, what is it about tobacco that leads to such extraordinary returns for shareholders over the long term despite it appearing to be an average business? It comes down to two factors, both of which are paradoxical yet very relevant to investors across industries:

1. *Disgust and disdain for it*: This has proven good for investors. Several large institutional investors are barred from owning them (ESG investing). The constant threat of litigation has also hung over the industry for decades, further deterring investors. This adds up to millions of otherwise smart investors who would not buy tobacco stocks. Low investor demand keeps tobacco stock valuations lower than their peer group, consumer staples. Low valuations lead to high dividend yields and high dividend yields, compounded over years and decades, add up to

massive returns. Thus the classic contrarian view is valid here - the more hated an investment is at a point in time, the higher long term returns are likely to be. This is one of the most difficult investing concepts to come to terms with, but one of the most powerful.

Despite being one of the best-performing stocks of the last fifty years, Altria has spent a great deal of its traded history among the cheapest stocks in the market, each time rewarding shareholders handsomely in the years that follow such periods of under-valuation.



Source: Fortune Financial

2. *No innovation or low innovation will not kill them*: Tobacco companies have barely innovated and do not feel the need to (until recently with the advent of e-cigarettes which we will discuss later). Innovation promises new products, markets, etc. but it is expensive. A company in any other industry needs to innovate constantly, reinvent its products and market them successfully year after year or risk becoming irrelevant.

   Tobacco companies, on the other hand, make the same product today that they did fifty years ago. It is a boring business but it can be beautiful for shareholders because the companies keep throwing out huge cash for shareholders. The money they save on advertising is profit for shareholders to partake in.

The Questions Being Asked

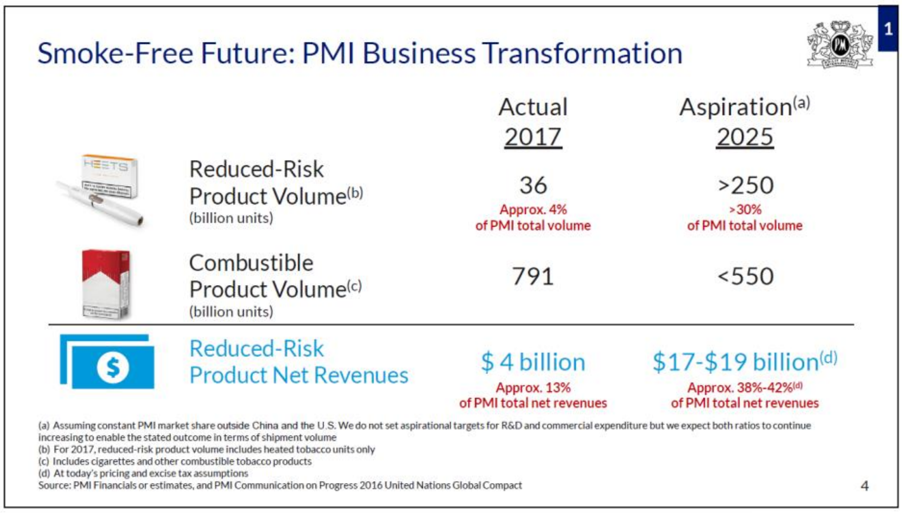
Investors have asked these questions of the industry in the past surely.

1. Will the next ten years deliver returns as rich as the past ten or twenty did?
2. Are the low future return expectations embedded in today's valuations justifiable given that the industry is on the cusp of its first technological revolution in the form of e-cigarettes?
3. Will the loss of combustible cigarette volumes and value be fully compensated by e-cigarette adoption?
4. How will the reversal of the decades-long bear market in U.S. and European bonds lead investors to adjust to the changing monetary environment? Tobacco stocks have been perceived as dividend yield plays and these are feeling the heat in the short-term.

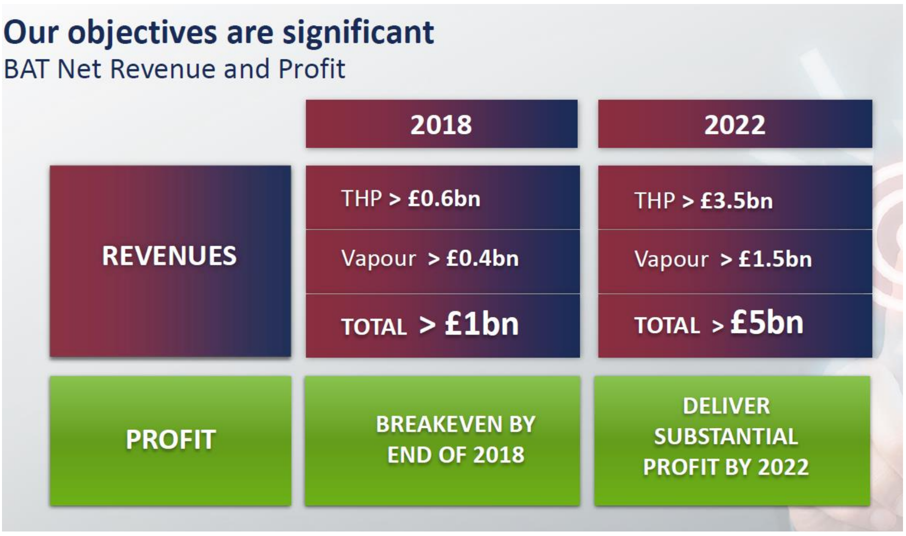
This period of transition for the industry and the global capital markets has possibly blind-sided investors temporarily from appreciating the true merits of this industry - the consistency and persistence of its ability to grow profits and dividends for its shareholders through thick and thin.

e-Cigarettes: The next frontier

The top three companies today – PMI, BAT and JTC - are committed to transforming the industry over the next ten years through e-cigarettes. This transformation has begun some years back and advanced to an extent where the financial impact on these companies has become apparent and added a new dimension to their earnings. Consider the following comments from PMI and BAT at their respective Investor Days.



Source: PMI



Source: BAT

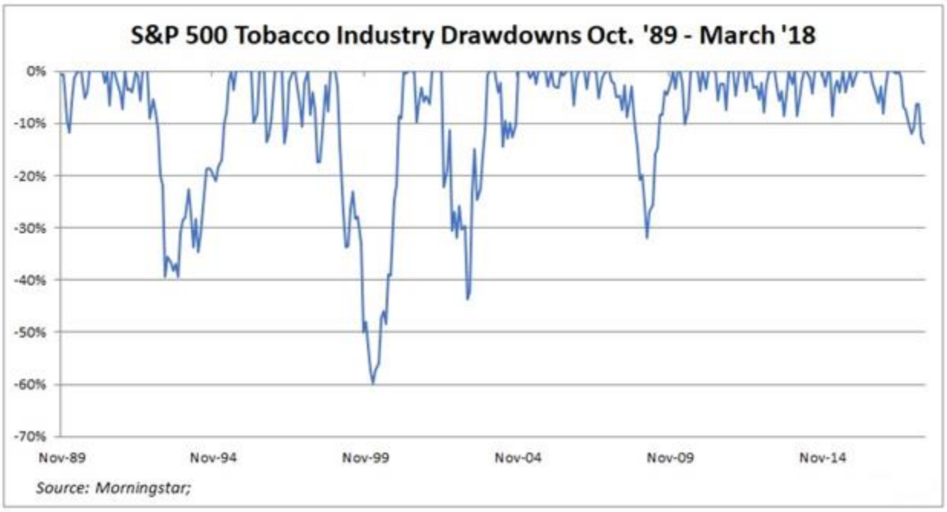
It is apparent that investors will track the progress and adoption of these products across geographies and their financial impact in the next few years. Currently, taxation levied on them is lower than that on combustible cigarettes in many countries. Also, the cost structure of these products will likely improve as volumes grow exponentially in future. This interplay of revenues, margins and profits is likely to impart some volatility to reported results. This will give additional margin uplift to companies till such time as governments see these products becoming significantly large. However, as long as the execution of their strategies is mostly on track, investors ought to travel through this period relatively unscathed as cash-flows and dividend streams would continue in the same vein on a rolling year basis.

There is also a battle between technologies, vapour and heat-not-burn being the two leading ones. Their adoption in different countries and which company succeeds where will determine the ultimate winners of market supremacy.

Some even think that if science could prove that e-cigarettes carry lower risk than combustibles, they could attract those smokers who quit smoking to return to the fold, thus reversing decades of declining smoking rates. Already schools in the U.S. are having a hard time keeping teenagers off 'vaping' away on trendy e-cigs. That would be the most powerful of stock re-rating catalysts if and when it happens, a possibility we would not discount.

How long would this pain last?

If history is any guide, tobacco stocks should not be down for too long. In the past 30 odd years, the longest drawdown was a bit less than three years, a shorter duration than the broader consumer staples sector and much shorter than the overall market.



Source: Fortune Financial

Potential catalysts for the sector could emanate from lower-than-expected volume declines as economic growth broadens and picks up. The financial impact on the profits from e-cigarettes will become tangible by the end of 2018 at BAT and PMI. The market could reconcile to living with a rising interest rate environment but one which is accompanied by economic growth.

Valuations – butt-crushing!

The bear arguments for not owning tobacco are beginning to sound like broken LP records to us. It is all in the price, as they say. It would be worth casting an eye on the valuations of tobacco stocks globally and a few regional listed entities to illustrate how significantly they have de-rated in recent times. Looking at sell-side consensus estimates too, earnings expectations of investors over the next 2-3 years are perhaps better now from what they were three years back and yet stocks trade at troughed multiples.

Robust Forward Estimates			
Company	3 Year Forward Growth Outlook (2017-2020)		
	Revenue	Net Profit	Dividend
PHILIP MORRIS INTERNATIONAL	25%	26%	16%
BRITISH AMERICAN TOBACCO PLC	41%	62%	27%
ALTRIA GROUP INC	5%	35%	41%
JAPAN TOBACCO INC	12%	28%	27%
ITC LTD	31%	41%	55%
IMPERIAL BRANDS PLC	-38%	81%	43%
HM SAMPOERNA TBK PT	23%	23%	16%
KT&G CORP	12%	3%	16%
GUDANG GARAM TBK PT	31%	30%	2%
SWEDISH MATCH AB	-20%	13%	24%
BRITISH AMERICAN TOBACCO BHD	23%	26%	8%

Source: River Valley Asset Management, Bloomberg

Crushed Valuations				
Company	1yr Fwd P/E (x)	5yr Avg P/E (x)	Difference	1yr Fwd Div. Yield
PHILIP MORRIS INTERNATIONAL	15.3	18.5	-17.3%	5.4
BRITISH AMERICAN TOBACCO PLC	12.7	14.8	-14.6%	5.3
ALTRIA GROUP INC	13.8	20.0	-31.0%	5.4
JAPAN TOBACCO INC	13.5	16.7	-19.3%	5.0
ITC LTD	30.5	33.1	-7.9%	2.0
IMPERIAL BRANDS PLC	10.1	18.0	-44.1%	7.2
HM SAMPOERNA TBK PT	29.4	34.7	-15.2%	3.2
KT&G CORP	12.2	12.7	-4.2%	4.3
GUDANG GARAM TBK PT	15.9	19.2	-17.0%	3.3
SWEDISH MATCH AB	21.5	16.6	29.7%	2.8
BRITISH AMERICAN TOBACCO BHD	12.2	20.3	-39.8%	7.8

Source: River Valley Asset Management, Bloomberg

Putting it all together, we are at an important inflection point for tobacco stocks across the world. The business is transitioning in the safe hands of large well-funded multinationals that have stood the tests of time. Their cashflows are far from being threatened by regulation or technological disruptions. The current state of flux in fixed income markets has slammed the brakes on these stocks, which we think is temporary. Truly long-term value-biased investors with a penchant for cashflows and yield ought to consider tobacco stocks here and now.

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