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Wages of sin

Fabiano Santin writes:

Tobacco stocks are, or rather used to be, the very stocks not to buy, let alone to hold. Since June 30, 2017, the S&P 500 Tobacco index has lost 32% while the S&P 500 has gained 28%, both after dividends. The cigarette-makers change hands near eight-year lows with dividend yields at record spreads to Treasurys and earnings multiples in the single digits. In preview, we're bullish on a pair of these pariahs.

ESG investors might want to skip this analysis. Widows and orphans, ditto, and Mike Bloomberg, scourge of cigarette smoke during his 12 years as New York City mayor, double-ditto. The *Grant's* view toward smoking is: Don't. Our line toward earning a living wage for the owners of the capital under your stewardship is: Do.

Accordingly, the risks and opportunities pertaining, especially, to Altria Group, Inc. and Philip Morris International, Inc. (MO and PM, respectively, on the Big Board), manufacturers of Marlboro, the world's best-selling cigarette, are the topics at hand.

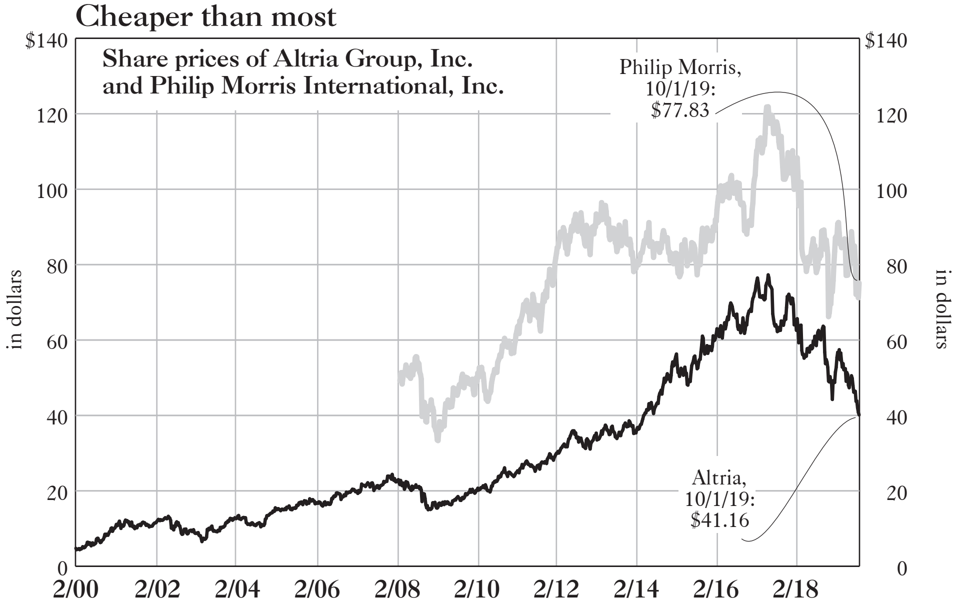
Disrupted by electronic cigarettes, social-responsibility revolutionaries and (perhaps) the march of human progress, tobacco companies have seen droves of investors selling their shares—and, to be sure, reciprocal droves buying them, albeit at lower and lower prices. Bulls and bears clash over the critical question of whether the cigarette-makers' storied pricing power can continue to compensate for accelerating declines in cigarette sales volumes.

Smoking is harmful and addictive. On this long uncontested point, the fortunes of Altria and Philip Morris International ultimately turn. It's the point that explains most everything, from corporate rebranding (doesn't "Altria" sound a little like "altruism"?) to the industry's attempts to diversify, to the immensity of tobacco earnings and the corresponding immensity of tobacco tax remittances. If not for the facts that nicotine hooks you and tar kills you, the old Philip Morris, from which sprang Altria and PM International in a 2008 corporate rejiggering, might not have expanded into cheese-making or beer-brewing—or, of more immediate relevance, into e-cigarettes.

On the one hand, those large vaping investments are now in the crosshairs of the frightened parents of the youthful vapers, as well as of the Food and Drug Administration. On the other, a crackdown on e-cigarettes may drive some smokers back to filthier and riskier habits, thus ameliorating the slump in the legacy tobacco business. In any case, Altria's investee JUUL Labs, Inc. commands a 75% market share in the domestic vapor category. Outside America, Philip Morris's innovative IQOS entry is the leader. Perhaps, then, our picks are better positioned than other tobacco investments to sustain earnings in the long run through non-traditional categories—and to continue generating strong cash flows from lit cigarettes for as long as those coffin nails give people pleasure (on which we do not pass judgment).

Time was—say, 20 years ago—when tobacco equities were as cheap as Ben Graham's figurative cigar butts

Cheaper than most



source: The Bloomberg

(*Grant's*, Nov. 5, 1999 and Feb. 4, 2000). In February 2000 the shares of Altria's corporate predecessor changed hands at 6.4 times trailing earnings compared with 28 times for the dot-com-bubbly S&P 500. In the past 19-plus years, they've delivered a compound annual return of 17.6% vs. 5.8% for the S&P 500.

Today, Altria and Philip Morris trade at 10.2 times and 14.8 times earnings, respectively. Although this is a healthy average discount to the 19 times multiple of the S&P 500, it's still only a third of what it was two decades ago. Then, again, interest rates were higher 20 years ago. Not coincidentally, value stocks were cheaper then, too (*Grant's*, Sept. 20).

The well-informed *Grant's* reader is certainly aware of the vaping epidemic that has sickened more than 800 users and caused 15 deaths. For now, the mixing of black-market substances with tetrahydrocannabinol, or THC, the main psychoactive constituent of marijuana, seems to be the main culprit.

On Nov. 15, 2018, the commissioner of the FDA, Scott Gottlieb, issued a grand plan to restrict sales of flavored e-cigarettes and cigars, curb sales of menthol products ("one of the most pernicious routes by which kids initiate on combustible cigarettes") and gradually extinguish the cigarette industry by reducing the allowable amount of nicotine per ciggy.

Walmart is now suspending the domestic sale of vaping products, and Michigan, New York and Rhode Island have enacted legislation to ban the sale of flavored e-cigarettes. On Sept. 24, Massachusetts Gov. Charlie Baker, declaring a public health emergency, implemented a four-month ban on the sale of marijuana- and tobacco-vaping products, flavored or not.

"A common refrain in our conversations with investors is that the [tobacco] stocks are 'un-investable' today," writes Callum Elliott, a sell-side analyst at Bernstein Research who rates Philip Morris as "outperform" and Altria as "market perform." "The few holders who remain commonly tell us they're looking to trim into any meaningful strength. These sentiments have been reflected in share prices that have overreacted to bad news and been slow to rally (think Imperial [Tobacco] after its disappointing 1H19 earnings) and quick to give up gains on any strength (think PMI after its knockout 2Q19 results, that has since given up all its gains)."

In the first six months, domestic cigarette sales volumes plunged by 5.5%, even worse than the long customary 4%, but you couldn't know it by the valuation of the companies' debt. Thus, Altria's 30-year, BBB/A3-rated unsecured bonds are priced to yield 4.5%, or 288 basis points over Treasurys, while the internationally diversified Philip Morris's single-A-rated, 30-year unsecured bonds change hands at a price to yield 3.8%, or 170 basis points over Treasurys; the volume of cigarette sales outside the United States and China is expected to dip by just 2.5% this year.

Marlboro's 36.3% domestic market share crowns Altria as America's top cigarette maker. Runner-up Newport, a British-American Tobacco brand, holds a 13.7% share, according to data from Euromonitor.

Look no further for evidence of the addictive power of nicotine than the price-inelasticity of cigarette demand. In the first half of the year, a 7% drop in Altria's cigarette volume translated into a 1.3% decline in consolidated corporate revenues, to $12.2 billion—and a 2.9% rise in operating income, to $4.9 billion. Credit a 7.7% price hike and cost reductions sufficient to generate a 2.7 percentage-point boost in operating margins, to 53.9% in the smokeable segment. The open question is how long smokers will continue to pay high and rising prices.

You can't deny that Altria possesses the quality of "financial flexibility" so admired by the ratings agencies. Leverage stands at 2.6 turns of adjusted earnings before interest, taxes, depreciation and amortization, but could—with the sale of roughly $18 billion of Anheuser-Busch InBev S.A./N.V. shares that Altria's balance sheet came to possess in 2016—be slashed to slightly less than one turn of Ebitda. Such a sale must await the end of a lock-up agreement in October 2021. Even so, the comfort afforded by the ownership of the asset means that Altria can continue to repurchase stock and pay dividends, absent a catastrophic downturn in the beer business, of course.

It's not easy to keep up with the corporate rebranding department, but recall that Altria was formerly the Philip Morris Companies, and that the spinoff of the overseas branch of Philip Morris (by then Altria) in 2008 gave birth to Philip Morris International. The world's second-largest cigarette manufacturer, behind only state-owned China National Tobacco Corp., PM sells Marlboro, L&M, Parliament, Chesterfield and other brands beyond the 50 states. These combustible products produced $25.5 billion in net revenues last year. A new and thriving division, selling the smoke-free IQOS e-cigarettes that heat, but don't burn, tobacco, generated $4.1 billion of net revenues in 2018, up from $3.6 billion in 2017 and $733 million in 2016.

Philip Morris's results beat expectations in the first half of 2019 with a 29.2% leap in IQOS volume, a feat that turned a 1.5% slump in cigarette volume into an 0.1% boost in overall volume. Adjusted operating income, which ex-

Altria Group, Inc.
in $ millions

	2014	2015	2016*	2017**	2018	TTM†
revenue	$24,522	$25,434	$25,744	$25,576	$25,364	$25,198
operating income	7,620	8,361	8,761	9,593	9,115	9,280
net interest expense	-808	-817	-747	-705	-665	-1,017
net income	5,070	5,241	14,239	10,222	6,963	6,309
cash from operations	4,663	5,810	3,826	4,901	8,391	6,933
capital expenditures	-163	-229	-189	-199	-238	-245
free cash flow	4,500	5,581	3,637	4,702	8,153	6,688
shares repurchased	-939	-554	-1,030	-2,917	-1,673	-1,069
dividends	-3,892	-4,179	-4,512	-4,807	-5,415	-5,831
net acquisitions	0	-102	-45	-415	-12,815	-14,647
total debt	14,693	12,919	13,881	13,894	25,746	29,240
cash and cash equivalents	3,321	2,369	4,569	1,253	1,333	1,796

* Net income includes a $9.0 billion after-tax gain from Anheuser-Busch InBev's acquisition of SABMiller.
** Net income includes $3.4 billion in net tax benefits related to the Tax Reform Act.
† For the period ended June 30, 2019.
sources: company reports, the Bloomberg

Philip Morris International, Inc.
in $ millions

	2014	2015	2016	2017*	2018	TTM**
revenue	29,767	26,794	26,685	28,748	29,625	29,453
operating income	11,702	10,623	10,903	11,581	11,377	11,095
net interest expense	1,052	1,008	891	914	665	572
net income	7,459	6,849	6,948	6,021	7,895	7,805
cash from operations	7,739	7,865	8,077	8,912	9,478	8,788
capital expenditures	-1,153	-960	-1,172	-1,548	-1,436	-1,164
free cash flow	6,586	6,905	6,905	7,364	8,042	7,624
shares repurchased	-3,833	-48	0	0	0	0
dividends	-6,035	-6,250	-6,378	-6,520	-6,885	-7,110
net acquisitions	-110	-55	-41	-111	-63	-61
total debt	29,455	28,480	29,067	34,339	31,759	30,597
cash and cash equivalents	1,682	3,417	4,239	8,447	6,593	4,008

* Net income includes $1.6 billion in net tax benefits related to the Tax Reform Act.
** For the period ended June 30, 2019.
sources: company reports, the Bloomberg

cludes currency and one-offs, jumped by 12.7%, to $6 billion. Net debt is a wieldy two times adjusted Ebitda.

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Since 1990, the average price of a pack of cigarettes in the United States has compounded at a 5.2% annual rate, to $6.96, topping the 4.5% growth rate of nominal GDP over the same span of years. At such rates of rise, volume could decline by up to 4.9% a year (1/1.052-1) before the industry suffered damage to its top line.

As it is, the average U.S. smoker spends roughly $146 a month on about 21 packs, a cost representing nearly 4% of the median income earned by a full-time wage worker, according to the Bureau of Labor Statistics. The low price-to-earnings multiples assigned to MO and PM are testament to the market's suspicion that even nicotine will encounter price resistance one day.

Because, in the words of the British psychologist Michael Russell, "people smoke for the nicotine, but they die from the tar," the industry's ambition has long been to craft a product that would hook, but not kill. Even today, with all the scary vaping news, some believe that e-cigarettes will prove that commercial salvation.

Innovation is hardly the tobacco industry's calling card, at least not since the invention of the cigarette-rolling machine in 1881. Yet hundreds of e-cigarette manufacturers began flooding the market a few years ago with various sorts of clunky vapor devices that are allegedly less harmful than cigarettes because they are not combustible. Weekly sales of e-cigarettes in the United States grew by more than 200%, to 5 million units in the middle of 2013 from 1.6 million units in January 2012. After leveling off to between 4 million and 5 million units per month through the end of 2016, they again shot higher and have averaged 6 million units for the trailing 52 weeks ended Aug. 24.

Thankfully for big tobacco, Gottlieb unexpectedly resigned from the FDA in March, but the agency has continued to sound alarms on e-cigarettes. On Sept. 15 it released preliminary figures from the latest National Youth Tobacco Survey, showing that 27.5% of high school students smoke e-cigarettes (puffed at least once in the last 30 days), up from 11.7% in 2017, and 1.5% in 2011. Final rules restricting the sale of non-tobacco-flavored e-cigarette products are on their way.

You may credit or blame the 2015 introduction of JUUL for the e-cigarette phenomenon. It wasn't the sleek, USB-like design, the mango flavoring or the reddish pods recalling the Marlboro logo that made JUUL a teenage sensation. The secret lay rather in the technology behind U.S. Patent 9215895, concerning "nicotine salt formulations for aerosol devices and methods thereof."

For whatever technical or strategic reasons, Altria saw fit to pay $12.8 billion in December for a 35% stake in JUUL Labs—the $38 billion valuation can be viewed as a hedge against innumerable terminal risks to the old business. JUUL's revenues are forecast to reach $3.4 billion this year, up from $2 billion last year when, according to Bloomberg, the startup secured 72% of the vaping market share.

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JUUL speeds the absorption of nicotine into the bloodstream. And because vapor is easier on the throat than smoke, people of all ages can indulge for longer periods. This makes JUUL more cigarette-like than other vaping products. One pod of JUUL contains as much nicotine as a pack of cigarettes, but while a smoker knows exactly how much he is consuming as his butt burns down, the JUUL user doesn't know until he's run out of juice. It's a shrewd recipe for higher nicotine consumption.

A 2017 research team led by David Levy, professor of oncology at the Georgetown Lombardi Comprehensive Cancer Center, concluded that 6.6 million lives might be prolonged if 10% of American smokers converted to e-cigarettes each year over the next decade. Such converts could live an additional cumulative 86.7 million years, Levy and his colleagues estimated.

"E-cigarettes are not harmless," David Abrams, professor at NYU's College of Global Public Health, was quoted as saying in Jia Tolentino's excellent May 7, 2018 *New Yorker* article. "But I think long-term use of nicotine, if decoupled from the toxins in cigarette smoke, would probably be much safer than heavy long-term use of alcohol and marijuana."

Philip Morris is making money with its own vape sideline. While JUUL has mostly grown at home (the European Union has limited nicotine levels in e-cigarette fluid to 20 milligrams per milliliter, about one-third the level of a JUUL pod sold in the United States), Philip Morris's IQOS is the best-selling nontraditional tobacco product in most other major markets, with sales of $1.5 billion in the second quarter alone (nearly 20% of company-wide net revenues). Launched in 2014 in Japan, IQOS commands 16.6% of that country's market share, including cigarettes. Altria holds the license to sell IQOS in America, to which product the FDA, on April 30, gave the green light for commercialization. Distribution began in Atlanta in September.

But more turns on the fate of each

company than the prosperity of its shareholders. For instance, out of Philip Morris's $79.8 billion of 2018 gross revenues, $50.2 billion reverted to various governments in the form of excise taxes. Last year Altria paid $5.6 billion in excise taxes on $27.9 billion in revenue from smokeable products. Regulatory fears aside, politicians are financially aligned with Big Tobacco.

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By now, the self-selected reader—non-ESG, non-widow, non-orphan, etc.—must decide whether the risk of the extinction of smoking is counterbalanced by the prospect of e-cigarette growth. And, of course, whether the valuations of MO and PM are low enough to provide a margin of safety.

Altria is priced to yield 8.3%, Philip Morris International, 6.1%—towering rates even if below the 9.2% that the combined company yielded in February 2000 (when the 10-year Treasury fetched 6.5% vs. 1.6% today). On Jan. 10, André Calantzopoulos, Philip Morris's CEO, reminded watchers of Bloomberg TV that the company has been raising cash distributions since its 2008 spin-off and that the dividend is "sacrosanct." Altria has consistently expanded its dividend for 40 years at a compound annual rate of nearly 11%.

The price-to-earnings multiples at which Altria and Philip Morris change hands, though not absolutely cigarette-ash cheap, are bargains compared with the above-20 times multiple the stocks traded at just three years ago. Then, too, the tobacco shares are deeply discounted in contrast to the makers of other products that will never be confused with mother's milk. Anheuser-Busch and Heineken N.V. trade at 25 and 29 times trailing earnings, respectively, Diageo plc at a 27 multiple. Casino operator Las Vegas Sands Corp. and Raytheon Co., the world's largest missile manufacturer, are both quoted at 18 times earnings.

Profitless companies with unproven business models come to market every day. Think, if you can, of Altria and Philip Morris International as cash-generative businesses with unicorns—the e-cigarette subsidiaries—of their own. The difference is that, in tobacco, the unicorns come free.

On Aug. 27, Altria and Philip Morris confirmed they were in discussions about a potential merger of equals, but talks ended only a month later. Perhaps Philip Morris balked at exposure to the American market, with its e-cigarette issues and relatively higher decline rate in cigarette volume. The agreement to disagree is arguably a good thing for potential investors, who may pick one company or another, or both, if they are comfortable with the share prices—and, of course, with the products.

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