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Up with smoke

James Robertson, Jr. writes:

Philip Morris International, Inc., the Marlboro cigarette maker, actually out-scores both Tesla, Inc. and Alphabet, Inc. in ESG ratings. It's scoring well in the stock market, too, thanks less to tobacco than to higher-margin, less harmful tobacco and nicotine products. In preview, we remain bullish.

Since we last had our say ([Grant's, Oct. 4, 2019](#)), picks-to-click Philip Morris International (PM on the Big Board) and Altria Group, Inc. (MO, also on the Big Board) have returned 16.4% and 14.7% per annum, respectively, versus a 16.3% rise in the S&P 500, all dividends reinvested. Bullish on Philip Morris, we will part company with Altria (too rich, we think) and cast an approving eye on British American Tobacco plc (BAT on the London Stock Exchange).

High dividends and addictive products explained the customary post-millennial appeal of tobacco stocks. Pricing power would offset volume declines, the bulls said, and the companies would continue to earn more cash than they'd know what to do with.

What's changed is not so much the existence but, rather, the viability of safer nicotine products—vaporizers, heat-not-burn devices and nicotine pouches. Philip Morris International earned 38% of its third-quarter revenue from these so-called new-generation products, and its leading position in that emerging market has continued to ring the register.

As Philip Morris's risk-reduced brands grew and pricing power in its ciggy business held strong over the

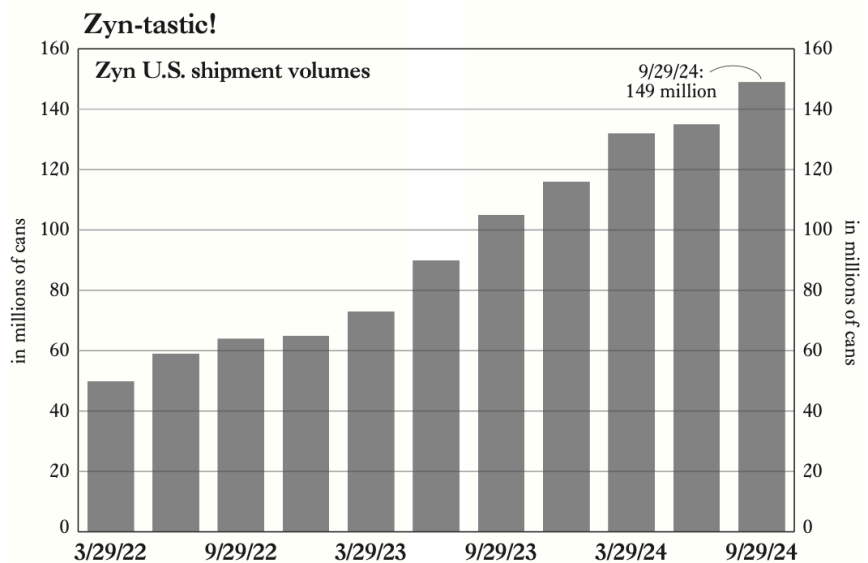
past five years, the company more than doubled its net profit margins. It was a feat similar to that of Nvidia Corp., albeit not exactly with the same revenue growth. A well-timed acquisition of Swedish Match A.B.—maker of the popular tobacco-free, oral nicotine pouch Zyn—in November 2022, for \$16 billion, provided an entry into the fastest-growing product category. PM controls nearly two-thirds of the U.S. nicotine-pouch market.

The viral sensation of Zyn, promoted by self-appointed “Zynfluencers” on TikTok and popular as a totem among younger conservatives, draws parallels to last decade's category killer, the sleek, USB-looking vape Juul. In the United States, the number of Zyn cans

shipped has soared by 133% in the past two years, bolstered by the unsolicited marketing of the product by the likes of Tucker Carlson (or “Tucker CarlZyn”), among other celebrities and podcasters, one of whom appears headed to the Trump Cabinet.

For Juul, such celebrity proved its downfall. So popular was the vape and its mango-flavored pods that they found their way not only into bars but middle-school bathrooms. The Food and Drug Administration poked around, too, and by 2022 Altria had written down its 35% stake in Juul to \$250 million from an initial 2018 investment of \$12.8 billion.

Philip Morris International runs a similar risk with Zyn. Competition,



source: company financials

too, poses a threat, as does the familiar risk of unwelcome movements in currencies and tax rates.

No deep-value stock itself, PMI trades at 18 times forward earnings and sports a dividend yield of just 4.2% (hardly towering by tobacco standards). Net debt sums to 3 times trailing Ebitda, and Ebitda covers interest expense by 13 times. The Street expects revenue growth of 7% next year, and the analytical bulls handily outnumber the analytical bears. Insiders were net sellers in the past six months, to the tune of 193,418 shares for proceeds of \$24.7 million.

The most expensive of the cigarette purveyors, Philip Morris International is the best-positioned in both incendiary and smoke-free categories. At the breakup of Philip Morris proper in 2008, PMI took the international coffin-nail operations and Altria retained the American ones. And it's in America where the old-school habit is fading fastest. In the third quarter, Altria's cigarette volume fell 8.6% year over year whereas PMI's grew by 1.3%.

Philip Morris sells several of its legacy brands, including Marlboro and Parliament cigarettes, in foreign parts. It divided its 2023 revenues among Europe (39%); Southeast Asia, the Middle East and Africa (30%); East Asia and Australia (18%); the Americas (6%) and a category called Swedish Match and Wellness (7%).

For reduced-harm products, PMI holds the pole position, drawing 38% of its revenues from the category compared with 18% from its nearest competitor, British American Tobacco. "The size of its smoke-free business has already scaled to a point where their smoke-free products are contributing both to gross margin expansion as well as operating profit expansion," Matthew Smith, who rates PM a buy for Stifel Financial Corp., tells me.

No market stands still, and PMI has proven itself an able adapter. There was no special call for adaptation in the past—stick a filter to a cancer stick and call it new—but the times and the customers have changed. Philip Morris noticed the shifting winds early.

"We've invested \$12.5 billion in smoke-free products since 2008," Philip Morris spokesman Corey Henry tells me. "I don't think any of our peers have done anything approaching that same level of investment. We put our



Trump's nominee for Secretary of Health and Human Services, Robert F. Kennedy, Jr., holding a can of Zyn, Oct. 2024.

Source: TheImageDirect

money where our mouth is in terms of developing these products, and we're delivering on that."

In Japan, vaping is banned, and the Japanese smoking population has gravitated towards heat-not-burn products (HNB), devices that essentially toast a modified-tobacco substance, producing neither ash nor smoke, only vapor. PMI's heated-tobacco offering, IQOS, commands a roughly 70% share, beating Japan Tobacco, Inc. on the latter's home turf. PMI reports an 84% share in the nascent but growing European HNB market.

It's the twin engines of Zyn and

IQOS that drive PMI's margin expansion. "Smoke-free net revenues and gross profit grew organically by plus 16.8% and plus 20.2% respectively," Chief Financial Officer Emmanuel Ba-beau announced on the third-quarter earnings call. "Smoke-free gross margins were more than 450 basis points higher than combustibles in Q3 and more than 200 basis points higher year to date."

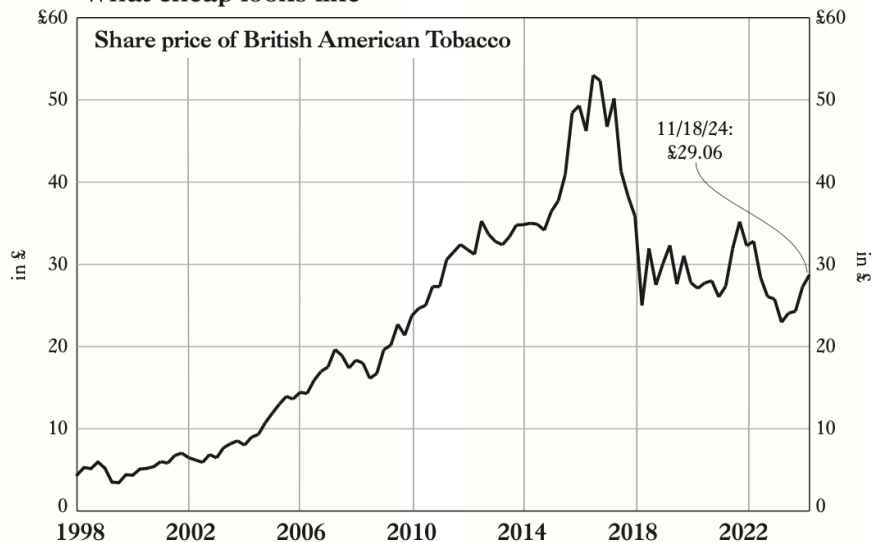
The success of Zyn in the United States is all the sweeter since Philip Morris does not sell cigarettes in this country and thereby avoids cannibalizing a legacy business. For each of the 28 million cigarette smokers it converts, PMI poaches a customer from a competitor. And that competitive advantage will only grow as IQOS debuts on American soil later this year in a pilot program; the Philip Morris front office expects full authorization from the Food and Drug Administration in 2025.

Happily, too, Zyn so far hasn't caught on where it shouldn't. Vape usage among school children has fallen by two-thirds since peaking in 2019, "a monumental public health win," the FDA crowed on Sept. 5. Nor has America's youth so far cottoned to nicotine pouches.

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The flood of black-market vapes from China is only one of the albatrosses that hang from the neck of British

What cheap looks like



source: The Bloomberg

American Tobacco. Others include dwindling U.S. cigarettes sales, stumbles in smoke-free products and a potential menthol-cigarette ban (it would hit 40% of BAT's American cigarette sales).

For all its shortcomings, the No. 2 player in cigarettes and smokeless products trades at 7.7 times forward earnings and pays a dividend of 8.1%. In that regard, BAT resembles the pariah stocks of fond memory (*Grant's, Feb. 4, 2000*). Nothing must go right, but it wouldn't take much improvement for BAT to close the 57% discount to PM or the 27% discount to MO.

British American, the London-listed maker of Lucky Strike, Kool, and Newport cigarettes, is the product of a 1902 merger of Imperial Tobacco Co. and American Tobacco Co. The international nicotine giant earned 42.9% of last year's revenue from the United States, 35.6% from Europe and the non-U.S. Americas and 21.5% from the rest of the world. Smoke-free products make up the aforementioned 18% share of revenues.

BAT has stepped in some of the gopher holes that PMI artfully (or luckily) avoided. Thus, in 2017, two years after Juul launched, British American paid \$49.4 billion for the remaining 57.8% of Reynolds American, Inc. it didn't already own, a big bet on the U.S. cigarette and vaping markets. PM's vaping business is too small to embroil its parent in the hot controversy over smuggled disposable vapes.

Following the Reynolds acquisition, BAT covers its net debt by seven times; that debt sums to 2.7 times Ebitda. Consensus expectations point to a top-line decline of 3.8% this year and a return to growth in 2025.

A menthol ban, proposed at one time or another by both the current president and his predecessor/successor but subsequently walked back by

each, seems not, as some fear, to pose a threat to the fat dividend. Duncan Fox, a senior analyst at Bloomberg Intelligence, contends that BAT would retain almost all its customers if such bans went into effect: "They're never going to cut the dividend."

BAT's Vuse e-cigarette offering may be the *legal* market leader in America, Canada and Europe, but the illegal trade is eating the law-abiding vendor's lunch. "I'll save vaping again!" Donald Trump pledged on the campaign trail. Perhaps the president-elect meant American vaping, not the illicit Chinese kind.

And maybe it helps to have friends in high places. Reynolds was the top corporate donor to the main Trump super political action committee, according to *The Washington Post*, and vice-president-elect J.D. Vance heads an office that, as he boasted in January to *Business Insider*, "probably has the highest ratio of smokers of anybody in the Senate."

A crackdown on the illegal vape market would redound to the benefit of legal products like Vuse. Since the Public Health Law Center pointed out in October 2023 that the FDA had confiscated more heads of romaine lettuce in the prior five years than it had illegal vapes, the FDA ratcheted up seizures and fines. In Louisiana, where strong enforcement has led to double-digit declines in illicit vape sales, British American Tobacco noted that its products returned to strong growth.

British American's other risk-reduced products include its nicotine pouch, Velo, and its heated-tobacco product, glo. That some Reddit users are comparing the taste of Velo to "dirty socks" does not advance the cause of BAT in America.

In Europe, BAT is the market leader in nicotine pouches. Velo controls even the Scandinavia market, where Zyn

was invented. The updated Velo Plus, due to launch in 2025 in the United States, provides British American with a more competitive, European-style product for BAT's large U.S. distribution network.

"Of all the companies that I've covered," Fox tells *Grant's*, "I'd say PMI and BAT know what they're doing. Altria is a question mark." While BAT has fallen behind PMI, "it has new products. I think what's clear is you have to come up with new iterations of your products. Otherwise you'll get overrun. And they've got three big research and development centers doing that right now." Analysts are broadly bullish, while insiders, in the past six months, have net sold 11,880 shares for proceeds of £308,044.

Another key with which to unlock value is BAT's 25.5% stake today in ITC Ltd., formerly the Imperial Tobacco Company of India, which deals in hotels, consumer products and information technology, as well as cigarettes. ITC shares trade today at 28 times earnings, almost four times the valuation of BAT. In March, to fund buybacks, BAT sold 437 million shares of ITC for proceeds of £1.5 billion.

"The margin of safety in this investment," Trevor Scott, portfolio manager of Tidefall Capital Management, L.P. and a BAT bull, tells me, "is the near-term free cash flow. The company is projecting at least £8 billion in annual free cash flow from 2026 that it expects to grow. The market cap is £62 billion, with £14bn in their ITC ownership. Back out that stake and the stock is trading for 6 times earnings. If you believe that humans will continue to consume nicotine and that the incumbent tobacco companies are the best positioned, then a growing 17% free cash yield looks too cheap to us."

And to us.

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