

THE STRAIGHT TALKING

# CURVED THINKING

QUARTERLY



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## A PHOENIX WITHOUT THE ASHES?

CAN INDUSTRY RATIONALITY  
AND REDUCED HARM PRODUCTS  
OFFSET THE THREAT OF PLAIN  
PACKAGING IN A PROFITABLE WAY?

This quarter we revisit one of the strongest performers in the Tantalum portfolios over the last year. British American Tobacco (BAT) has been a core holding in our equity basket, representing up to 10% of equity at times (in combination with the Rupert controlled investment company, Reinet).

We have written before about the merits and conflicts inherent in holding tobacco company shares (see Tantalum Curved Thinking Q3 2014 Quarterly). Tobacco is a peculiar category of consumer goods which grows its revenues and cashflows year after year despite selling less and less of its product. We shed some light on the causes of this phenomenon in our previous quarterly, and yet as appropriately sceptical investors we also shared our concerns and ongoing vigilance relating to the sustainability of this unintuitive growth story. More specifically, we articulated a bullish view on BAT's investment outcome, being underpinned by a combination of pricing power, cash-flow generation, cost-cutting potential, as well as corporate deal-making. Many of these views and themes have indeed come to fruition, but are worth revisiting as they remain vital components to this core investment.



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## DEAL-MAKING: “EVERYONE IS A WINNER”

Well executed M&A creates value for the target but can also create value for the acquirer. In the case of SAB, it was the target of ABInbev, and we enjoyed substantial returns to our funds due to an acquisition premium being paid by ABInbev. However, when holding the acquiring company, the upside may seem less certain. In the case of our holding in BAT, we have benefited greatly from the value created through corporate action undertaken by its 42% held associate, Reynolds American (RAI). During June 2015, a deal first mooted during July 2014 was finally approved by the Federal Trade Commission in the United States when \$27bln was paid to Lorillard's shareholders by RAI.

Why was this a “win-win-win” deal? By way of background, Lorillard's (the target) key attraction for RAI (the acquirer) was its premium Newport brand. Newport is the #1 Menthol brand in the US and the #2 brand overall (at 13.3% market share) behind Marlboro, the behemoth brand (44% market share, owned by Altria). RAI had to pay up a decent premium to the target shareholders, who were clearly happy to accept their windfall.

However, the story does not end there. Because RAI also owned the #3 and #4 brands, being Camel (8.2% share) and Pall Mall (7.9% share), RAI was forced to divest certain legacy brands to Imperial Tobacco (IMB), to assuage competition concerns. Under this second transaction, RAI banked \$7.1 billion by selling brands such as Kool, Salem, Winston, Maverick and blu-e Cigs to IMB. This transaction for 7% market share, together with manufacturing capacity, allowed IMB to gain critical mass in the US (c10% market share post the deal with vastly improved distribution) and was thus deemed as pro-competitive by the FTC. IMB was thus also a clear winner out of the deal.

### RAI now has the brands and the ability to attack Marlboro's market dominance

What were the benefits for RAI? As part of the transaction RAI rationalised its production footprint and guided for production cost-savings of \$800million within 18 months. RAI also gained extra volume and higher revenues through existing distribution channels, leading to immediate profit accretion. Over the long term, RAI gained the fastest growing premium brand in the American tobacco market, and one which is exceedingly well positioned in terms of America's demographic evolution. RAI now has the brands and the ability to attack Marlboro's market dominance from three unique angles. The strongest indication that this deal has been a success is the price action in the shares involved in the transaction. The two year gain in IMB's share price has been 54%, while in comparison RAI's share price has gained 84%!

## PLAIN PACKAGING

Plain packaging regulations remove the unique branding on the cigarette packet and replace it with plain colours and standardised text/font. These packages also carry graphic health warnings. On 19 May 2016, the UK High Court issued its ruling against the industry's appeal of plain packaging legislation. It both upheld the legality of the measure and dismissed the industry's claims with regards to two key issues:

- **Proportionality:** Could the small decrease in smoking prevalence be justified by the unnecessarily onerous method of taking brands away? Key to this question was evidence from Australia, where the Australian government (being the first to implement plain packaging in 2012) has acknowledged only a very modest qualitative impact on smoking prevalence from the measure.
- **Compensation:** The tobacco companies attempted to assert their rights to be compensated for having the effective value of legitimately owned and developed trademarks being expropriated.

On both of these grounds the court found that public health benefits, negligible as they may be, trumped the companies' concerns and rights. Tobacco producers in the UK are now forced to start gearing up production facilities for the formal 20 May 2017 implementation date. Similar measures are afoot in France.

From a shareholder's perspective, however, the legal matter is not completely settled. Tobacco companies will exhaust all legislative avenues of appeal, even resorting to the WTO. These appeals are not only likely to draw out the implementation of plain packaging for as long as possible, they are also possibly intended to stymie additional regulatory attacks on the next issue (which could, for example, be a ban on certain ingredients such as menthol, or a reduction in nicotine per stick).

Plain packaging regulations are undoubtedly negative but, as with other restrictions on smoking habits in the past, we believe that the industry will largely weather the storm. From a market-facing perspective, tobacco companies have seen plain packaging coming for a long time and have prepared some marketing defences. With grotesque, graphic warning labels on cigarette packages around the world, the days of flashing the brands' motto for the benefit of bystanders is long gone. Much greater focus has been placed on the product intrinsics. This starts with procuring high quality consistent tobacco leaf. Each cigarette brand has a unique taste and quality which a consumer gets attached to. To justify annual price increases, tobacco companies have realised that they need to give their clients more value and create a memorable, quality 'occasion' through a superior product. This has been further augmented in the form of innovations such as resealable packs which keep the cigarettes dry and crisp, filters that are hollow to allow better airflow, or taste capsules that alter the taste of the cigarette. Many customers have grown accustomed to these brand attributes and will keep demanding them going forward.



## GAME THEORY IN PRACTICE

Cigarettes are an extremely high margin product - this means that the producer price can fall a lot and operators can still earn a decent return. Due to the threat of exorbitant lawsuits based on the harmful effects of tobacco on consumers' health as well as bans on promotions, tobacco companies have generally not faced new competitors. Together with high excise/tax incidence, and effective 'collaboration' required by hawkish governments, the threats facing new tobacco entrants have created artificially high barriers to entry, meaning that competitive forces from new entrants are generally weak, and that super profits can be sustained in the long term. However, these super profits will come under threat should the existing competitors within the industry choose not to act rationally.

What happens when price becomes your only marketing 'lever'? Should a smaller competitor want to gain market share, it needs to lower its price relative to the market leader. If the share donor/market leader decides that its lost more revenue then it deems palatable it will drop its selling price as well and the smaller player (with the weaker brand) would have to price down again to give the market leader the appropriate price premium relative to the challenger's second tier name. In the long term both parties end up with roughly the same revenue share they had prior to the skirmish, but they've managed to shrink the pie that they are sharing!

This delicate equilibrium required to maximise industry profitability is easier to maintain between two peers who are roughly of equivalent size. However, if there is a third (or even fourth) smaller player the calculus changes. The smaller player has much more to gain through volume increases than it stands to lose through price decreases. The smallest player's payoff is asymmetric, and if they are well resourced, they can potentially pull an entire market's pricing architecture down. Big Tobacco is highly aware of this risk and has been acting in an oligopolistic fashion. The large players tend to counteract any aggressive pricing by competitors through the introduction of a value brand rather than discount on their

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existing brand portfolio or change their pricing ladder. Practically, this was seen in Australia where, on the advent of plain packaging regulations, IMB dropped pricing through the introduction of the JPM brand and subsequently gained share. Rather than fighting this action by its own round of price discounting, BAT reintroduced Rothmans into the market at the lower (value) price point, and has subsequently clawed back market share losses. Less price-sensitive and brand loyal customers thus remain and overall, the lost revenue by the industry was minimized. The industry continues to exhibit rational pricing behaviour, in the face of regulatory pressures. This action provides greater and ongoing comfort regarding tobacco margins over the long term.





## TIGHTER REGULATION: THE CATALYST FOR ANOTHER MEGA-MERGER?

As explained, plain packaging regulations do represent a heightened threat to the pricing architecture within markets. The case for rationality is a strong one, but inevitably the industry thoughts will turn to further consolidation to entrench this oligopolistic pricing mentality. Some industry players clearly recognise that low interest rates present an opportunity to sustainably protect revenue and profit pools by buying out the “challenger” in many markets. Where could the major shifts still occur?

Generally, ex China and the US, Phillip Morris International (PMI) (the owner of the Marlboro brand outside the US); and BAT are the larger players with IMB and Japan Tobacco filling challenger roles. Due to limited overlap of geographies, a deal where BAT buys IMB and spins off some units to Japan Tobacco has been mooted and speculation has progressed to a point where the highly regarded tobacco analyst from CitiBank already incorporates a 25% bid premium into his valuation of IMB. Management of all parties remain tight-lipped when questioned openly, but do acknowledge the

merits of these deals. Whilst we do not factor in a BAT/IMB transaction as our base case, we are comfortable trusting BAT's management to maximise value in the long term, as illustrated by their support for the RAI transaction, and by their well-timed takeout of minorities in Souza Cruz during 2015. This deal was done at cyclical lows of Souza Cruz's profitability and at very favourable exchange rates in Brazil. We expect further such strategies to play out within our investment horizon, and to provide upside optionality to our base case.

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## REDUCED HARM PRODUCTS

Nicotine is harmful, of that there is no doubt. It is addictive, but one could argue that so is caffeine, a far more socially accepted substance which also influences the nervous system. The major damage from cigarette smoking is caused by the fact that, during the process of combustion, carcinogens are released.

Much research and effort has been put into finding equally satisfying alternatives to smoking which lead to better public health outcomes. Tobacco companies themselves are spending significant money developing new ways of 'delivering' the nicotine, and of creating a 'similar but acceptable' social experience to smoking. If any of these products or technologies becomes successful, it begs the question whether the tobacco industry could again become a volume growth industry.

The key is obviously whether a 'reduced harm' alternative to cigarettes can be scientifically proven and consequently socially accepted. PMI has gone so far as to state that it is their goal to migrate all Marlboro consumers to IQos, their 'heat-not-burn' tobacco device. One of the interesting features of the latest set of results from BAT has been that they have removed the impact of reduced harm products from their key risk matrix. In essence, they feel that their business model can cope with the technological change, and that they have the product portfolio to profit in this nascent market. On balance, we feel that there is as yet no clear evidence of true product success, and so we factor in no value or market protection from these so-called 'reduced harm' products in our valuation. Nevertheless, it is clear that, even since our last writing on this subject, the industry has made some progress on this front, and is more confident of 'building a bridge' to these less harmful products.

## CONCLUSION

No doubt controversial, the tobacco industry continues to face many challenges, and remains under threat. Nevertheless, the focus of public health concerns is spreading to soft drinks, fast food, and a number of other product categories. The tax recovered from adult smoking at least makes a significant contribution to public coffers, and companies are acting responsibly within the rules.

From a valuation perspective BAT is still offering compelling upside. As always, due to existential concerns for tobacco's future BAT still trades at a significant discount (c25%) to global staples. On a dividend discount model, which BAT's predictable dividend and earnings growth history lends itself to, there is substantial upside from current valuation levels. BAT's rump (the global tobacco companies in BAT excluding RAI and ITC, its Indian associate) is trading at approximately 14 times forward earnings. This rating is at a record discount relative to BAT's group forward PE and we deem this multiple to represent good value. BAT's rump is trading at a discount to IMB which trades at 15.2x forward earnings, whilst BAT has significantly better growth prospects due to stronger brands and a much better demographic growth profile in its underlying markets.

Since acquisition in our balanced funds, our holding in BAT has yielded a total annualised return of more than 22.4%. This compares with an annualised return of 10.3% from the All Share index over the same period. The very high liquidity in BAT shares has also allowed us to maximise the portfolio return by tactically adding or subtracting exposure around our core weighting. Retaining a clearly defined industry perspective, adopting a long-term target price and fair value, but remaining nimble in the face of changing circumstances and volatile price action remain key strengths of our investment process.