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TOBACCO: SMOKING OUT A WINNING INVESTMENT

Historians attribute the earliest human consumption of tobacco to the Mayan civilisations of Central America between 5000 and 3000 BC. Tobacco smoking formed an important part of Mayan religious rites with ancient carvings in ruined temples showing priests smoking a tube pipe. Cannabis was common in the Middle East, and has been consumed since at least 2000BC. Today still, the water pipe called a hookah, is enjoyed widely in social settings. A Frenchman called Jean Nicot (nicotine is named in his honour) introduced tobacco to France in 1560. From there, following trade routes, tobacco usage spread around the globe.

In 1950, British scientists identified tobacco smoking as a causative factor of cancer. Rates of consumption in the developed world generally peaked during 1965, however they continue to rise in the developing world. We acknowledge the negative health effects of smoking, but in forming an investment view we do not make a value judgment on the industry.

OUR INVESTMENT IN BRITISH AMERICAN TOBACCO

Through our exposure to British American Tobacco (BATS) and Reinet, tobacco forms a cornerstone of our equity portfolios. In the 8 years to December 2013, BATS has grown earnings per share by a Compound Annual Growth Rate (CAGR) of 11.4% in British Pounds. This was off the back of modest revenue growth augmented by cost cutting initiatives and a disciplined share buy back programme. Continued cost cutting (with EBITDA margins at BATS still about 5% below peers), accretive M&A activity (eg. Reynolds American/Lorillard very recently) and the possibility of future share buy backs suggests that earnings growth should not slow down materially from the historical norm over the medium term.

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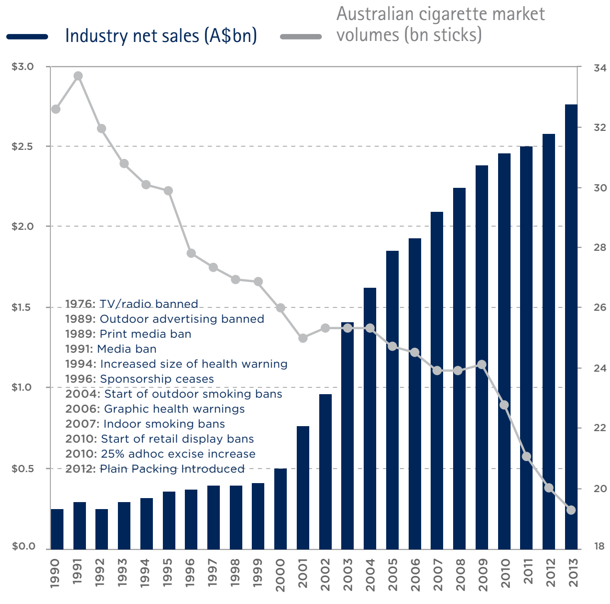
However, intuition would suggest that with near universal acceptance of the negative consequences of smoking, social stigmatisation, and a regulatory environment which aims to aggressively reduce the prevalence of smoking, our investment stance bears some scrutiny. Global (ex China) cigarette volumes have been falling at a CAGR of 1.6% since 2006 with only the Middle East and Africa bucking this trend. However, over a similar period the seven biggest listed tobacco companies managed to increase their sales by a CAGR of 3.4%, suggesting that tobacco companies have enviable pricing power. This pricing power is perhaps the single most important factor in assessing the investment case for tobacco companies. As an illustration, the chart below shows the negatively correlated relationship between Australian cigarette market volumes and the actual industry sales in A$. Industry revenues are consistently growing even when facing the most aggressive anti-smoking regulatory regime in the world.

This pricing power derives from a number of sources:

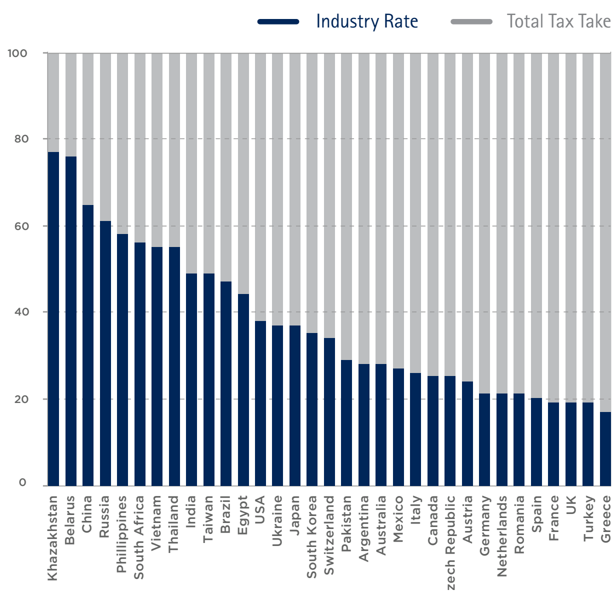
- Tobacco is an addictive substance. As such, demand from existing clients is highly price inelastic. (Elasticity is the term economists use for the phenomenon where demand for a normal good decreases relatively rapidly in relation to an increase in pricing).
- BATS tax incidence on revenue is, on average across all its territories, 68%. This means that for every rand a consumer pays for cigarettes, BATS only receives 32c. Governments tend to increase excise and taxes by at least inflation annually. Because governments receive such a large percentage of the retail consumer price, it is relatively easy for the cigarette manufacturer to add on real price increases of their own, and pass that on to their customers.
- Government revenues in many countries have become dependent on a regular 'sin tax' base. As such, they are active participants in 'managing' the annual excise increases without denuding their tax base. In the event of sudden, sharp increases in sin taxes, experience has shown that illicit (smuggled, illegal) cigarette volumes surge, often completely offsetting the intended tax gain, and stimulating criminal activity. Governments have become much more sensitive to this and prefer a steady, managed approach in most countries. Nevertheless, the rate of tax does vary from country to country (sometimes reflecting the level of border security!) The charts below illustrate this point.
- Price-led market share 'skirmishes' between the major tobacco companies have become less frequent and less severe over time, as the companies' recognise that price discipline is vital to maintain the overall profit pool for the industry in the face of government regulation.

Australian industry cigarette volumes and net sales



Source: Bank of America Merrill Lynch, August 2014

Total tax take versus industry take as a % of retail value



Source: Bank of America Merrill Lynch, August 2014

E-cigarette sales in the US have doubled every year since 2003, reaching USD1.5bln last year. If global sales of e-cigarettes were to double every year until 2018, they would represent 14% of total tobacco sales.

On balance, most tobacco companies guide for a 2-3% decline in global stick volume going forward, a slight acceleration of the past trends. However, this dynamic is not quite as pronounced in the developing world where BATS is principally positioned, as smoking prevalence is coming off a low base and cigarettes are becoming cheaper on a GDP per capita basis.

As investors we are constantly questioning the consensus around volume decline and pricing power. Most recently, we have been monitoring the growth of e-cigarettes, as well as greater regulations around cigarette presentation and packaging.

The implementation of rules allowing only "plain packaging" in Australia (and now being adopted elsewhere) seem to represent the greatest downside risk to volumes, and are being closely monitored. Plain packaging restricts the colour and font of the tobacco packaging and also includes graphic images of disease caused by smoking. The aim is to erode the appeal of the packaging and brand of the cigarette to the consumer. It has had some impact since launch, but to date, the data seems to point to greater offsetting sales of illicit cigarettes, imported/smuggled in to bypass both taxation and packaging regulation.

Stricter regulations around advertising and packaging have indeed cut some volume from global tobacco sales. Somewhat perversely, however, these regulations have also had the effect of substantially reducing the cost base of the major tobacco companies over time. In addition, these rules have meant that no new players can enter the industry, as no-one is able to launch a new brand or product without advertising. On balance, the industry has probably been a net beneficiary of these new rules and regulations, despite the negative volume impact.

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E-cigarette sales in the US have (in value) doubled every year since 2003, reaching USD1.5bln last year. If global sales of e-cigarettes were to double every year until 2018, they would represent 14% of total tobacco sales. However, the tobacco majors have acquired significant stakes in e-cigarette manufacturers and are spending considerable amounts on research and development in this field. We are thus not overly concerned that "outsiders" will participate meaningfully in the cannibalisation of existing tobacco revenues.

Following the Fed's first intimation of tapering during May 2013, emerging market currencies devalued against the dollar. Combined with excise shocks, as well as concerns relating to e-cigarettes and plain packaging, this led to a 24% fall in the value of the BATS share price in London. Following this decline, we have added significantly to our holding. BATS is currently trading at a 15.6x rolled forward earnings multiple representing a dividend yield of 4.5%. We believe that is offers an attractive yield and fair valuation for a growing stream of hard currency earnings.

Tantalum MNC Fund

Strategy	Multi-strategy, hedge					
Fund Objective	The fund is targeting above average real returns (8% to 12%) over the medium term at lower volatility than the market. Returns come from equity alpha on the long and short side, with yield enhancement from fixed interest, preference shares, hybrid instruments and listed property.					
Launch date	June-05					
AUM	R529m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	-3.69%	-0.75%	4.58%	8.29%	11.93%	186.41%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	7.71%	5.30%	7.13%			

Tantalum Resources Fund (ZAR)

Strategy	Resources, hedge					
Fund Objective	The fund is targeting 15%-25% over the medium term at lower volatility than the resources and commodity markets. The fund invests in a global portfolio of mining and energy equities, commodities and associated derivatives trading on the LSE, JSE, ASX, TSX and NYSE.					
Launch date	Mar-13					
AUM	R58m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	-0.09%	2.88%	10.22%	N/A%	8.91%	14.47%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	6.86%	N/A	12.18%			

Tantalum Global Resources Fund (USD)

Strategy	Resources, hedge					
Fund Objective	The fund is targeting 10%-20% over the medium term at lower volatility than the resources and commodity markets. The fund invests in a global portfolio of mining and energy equities, commodities and associated derivatives trading on the LSE, JSE, ASX, TSX and NYSE.					
Launch date	May-12					
AUM	$2.2m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	-5.30%	4.03%	-0.92%	N/A	1.63%	3.97%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	10.62%	N/A	6.94%			

Tantalum Fusion Fund

Strategy	Fixed Income, hedge					
Fund Objective	The fund is targeting cash + 2% returns over the medium term at lower volatility than the market. Returns come from fixed income alpha on the long and short side, with yield enhancement from preference shares, hybrid instruments and listed property.					
Launch date	Mar-06					
AUM	R92m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	-0.40%	1.83%	5.31%	7.32%	8.43%	100.27%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	2.61%	2.03%	6.15%			

Tantalum Enhanced Cash Fund

Strategy	Fixed Income, long only					
Fund Objective	The fund is targeting cash plus returns over the medium term. Returns come from fixed income alpha, with yield enhancement from preference shares, hybrid instruments and listed property.					
Launch date	Aug-10					
AUM	R1523m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	-0.76%	1.59%	5.44%	7.24%	8.23%	39.01%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	3.18%	2.14%	4.21%			

Tantalum Balanced Fund

Strategy	Multi-Asset, long only					
Fund Objective	A Reg 28 compliant fund which invests in a mix of domestic equities, bonds, property, commodities and cash where the asset allocation is tactically managed. Maximum net equity exposure is 75% and index derivatives may be used to reduce net equity exposure.					
Launch date	May-13					
AUM	R959m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	-0.36%	4.80%	10.26%	N/A	13.51%	19.66%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	8.15%	N/A	7.16%			

Tantalum Equity Fund

Strategy	Equity, long only					
Fund Objective	An equity portfolio having the primary objective to generate sustainable long term capital growth. The portfolio's investment universe consists of equity securities, preference shares, money market instruments, property shares and property related securities listed on exchanges and assets in liquid form. The portfolio's equity exposure will always exceed 80% of its net asset value.					
Launch date	Feb-14					
AUM	R1m					
Return data:	3-mth	YTD	12-mnth	3-yr (p.a.)	Incept (p.a)	Total Return
	-1.56%	11.82%	N/A	N/A	N/A	11.82%
Risk data:	12-mth Std Dev	3-yr Std Dev	Std Dev since incep			
	N/A	N/A	6.43%			