April 2021

INTRO

A Bloomberg headline noting that The Biden Administration is Considering a Rule to Cut Nicotine in Cigarettes was enough to cut shares in Altria (MO) by 14% over two days. Bottom line: We think the reaction was overdone and used the sell-off as a buying opportunity for clients that did not yet own a full position. As investments in the tobacco sector (MO and PM) constitute over 20% of our equity exposure, we are sharing the key takeaways below.

KEY TAKEAWAYS

- **First and foremost, regulation is still just a consideration at this point,** so we caution against becoming too invested in potential consequences. That said, increased tobacco regulation (along with the potential for increased taxes) should have been expected under a Democratic Administration (we have accounted for this in our downside scenario; apparently, the street did not).
- **Even if pursued, this will be a lengthy process.** For context, the review of menthol started in 2009 and has still not been fully resolved. The next step in the process will be a notice of proposed rulemaking by the FDA - at a minimum, there is a mandatory 1-2 year delay between issuing a final rule and policy implementation. And, of course, there is still a non-zero probability that nothing is implemented at all.
- **If regulation does eventually pass, we would expect it to be contested** – an equally complicated and drawn-out process driven by powerful lobbies. And if the FDA doesn't act in accordance with regulatory guidelines or if the tobacco manufacturers believe they are overstepping boundaries, they will challenge the FDA (as Lorillard successfully did in response to the menthol ban).
- **Only then do we start to think about potential outcomes (and unintended consequences) of any regulation.** If nicotine is reduced, do people smoke more to get the same fix? Do other countries follow suit? And if the U.S. is the only market in the world that sells low nicotine cigarettes, will that encourage illicit trade or unregulated home manufacturing?
- **If passed, the most likely outcome would be an acceleration of market share gains for "reduced-risk products."** Companies with the strongest offerings – i.e. MO (JUUL) and PM (IQOS) – would be the primary beneficiaries, in our opinion.
- **All that being said, headline risk will likely continue as an overhang on tobacco multiples.** Nothing new here as ESG-driven fund flows away from the sector have weighed on valuations for the past few years (and provided us with an attractive, contrarian entry point).

BOTTOM LINE

While we see a long and uncertain road to establishing new regulations and expect heightened headline risk throughout the process, we ultimately think the sell-off in tobacco stocks is overdone. A bit more perspective on valuation below.

- **MO Valuation.** MO is up ~ 18% YTD (even accounting for the recent sell-off). We expect MO to generate close to $5 in annual FCF per share over the next few years, putting the stock at ~ 10x, which is less than half the market's multiple today. Over the last decade, shares have traded at an average multiple of 15x and within a range of ~ 10x – 20x (+/-1 standard deviation). The stock yields 7.2% at the current price, close to a 6% premium to treasuries. Historically, shares have traded closer to a 3% premium to the 10Y, which would imply a ~ $75 share price.

- **PM Valuation.** PM is up ~ 15% YTD and would have the most to gain under a nicotine cap. A cap would likely accelerate conversion to iQOS, which is 100% incremental for PM (PM also has zero exposure to combustible cigarettes in the U.S. and licenses its IQOS product for MO to distribute domestically). As such, the decline in PM was much more muted, with the stock hitting new 52 week highs a day after the Biden headline, driven by yesterday's earnings release. It didn't take long for investors to shift their attention back to fundamentals and the fundamentals here are best in class. In short, results beat estimates across the board (a recurring theme here), and management raised guidance for the full year (another recurring theme). IQOS continued to deliver impressive growth, recording continued market share gains on the heels of continued user acquisition growth, up 1.5M to 19.1M total users. Importantly, IQOS now represents nearly 30% of PM net revenues (management expects "smoke-free" products to represent more than half of their business by 2025, which should make the ESG folks happy), which is driving top-line growth and margin expansion. Hard to believe that they have created a product with higher margins than combustible cigarettes!! We expect PM operating margins to increase by 100bps – 200bps annually as IQOS continues to gain share. The stock trades at ~ 15x today or 2/3 of the market's multiple for a business likely to generate $35B in cash flow – or 25% of the market cap - in just the next three years. Over the last decade, shares have traded at an average multiple of 18x and within a range of ~ 14x – 22x (+/-1 standard deviation). The stock yields 5.1% at the current price, and we expect management to resume share purchases in the back half of this year.

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