

European Investing Summit 2018 Preview: Imperial Brands

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Stockpicking is a zero-sum game. You can't expect to produce alpha by buying the same shares as others — you need to do something different. One way to set yourself apart is to be a genius and see things that others cannot, which tends to be the unspoken assumption in the typical “stock pitch”. While this can work occasionally, it rarely does consistently. No matter how smart you may be, it's very unlikely that you are so intelligent that you can keep beating the competition for years on end.

At Orbis, we prefer instead to focus on situations in which the odds may be stacked in our favour. This approach doesn't necessarily require genius or brilliant intellectual insights. We just need to be able to decide if the person selling us a particular stock might be making a mistake. Fortunately, human nature provides plenty of reasons why this might happen.

Short-term noise is one of the more obvious examples. Few investors are willing or able to look past recent headlines or the next few quarters. Fewer still take the time to look further back for meaningful historical insights. We try to do both. In many industries, starting your analysis by looking at what's happened to a company and its competitors over the last forty years can give a substantial advantage against those competitors for whom four years is ancient history.

Another frequent source of opportunity is the emotional roller-coaster of greed and fear. Frustrated holders of companies that have disappointed for a year or more are often eager — or even forced — to sell in despair, while potential new buyers have been scared away. This reduces competition for the shares, and can set the stage for pleasant surprises if there is even a modest improvement in the company's fortunes. A similar dynamic is at play in the opposite direction with market darlings. Greed and euphoria can push prices far beyond any rational appraisal of intrinsic value, exposing shares to severe punishment on even the slightest disappointment.

Of course, the crowd is often right. Sometimes companies that have been a disappointment for a while really are doomed. While not necessarily being smarter than everyone else, if one can develop a deep enough understanding of the fundamentals to separate even some of those that are temporarily out of favour from those in terminal decline, then the odds become more favourable. We don't always get these decisions right, but they almost always boil down to the same key question: What mistake are sellers making to create this mispricing?

In my talk at European Investment Summit 2018, hosted by MOI Global, I examine this question through the lens of one of our current holdings: Imperial Brands. Founded in 1901, Imperial was for many years the dominant tobacco company in the UK before diversifying into other industries in the 1970s. The company was acquired by the conglomerate Hanson in 1986, and later spun off and listed as a pure-play UK tobacco business in 1996. Since then, Imperial has expanded through international acquisitions in Europe, the US, and Australia.

By looking at the long-term view history of both Imperial and the tobacco sector across different geographic regions, we can form a view of what the future might look like. Regulations and social norms obviously differ from one market to another, but tobacco is fundamentally the same product and the same business that it has always been. And in many countries, tobacco has been the best-performing stock market sub-sector over the last half century or even longer. The combination of industry consolidation, a particularly benign competitive environment and low investor expectations have more than compensated for the impact of declining smoking rates and increased regulation.

Even better, tobacco shares have tended to exhibit defensive characteristics and can outperform when markets fall. We are confident that Imperial can raise prices sufficiently to drive continued earnings growth and dividend hikes, even as smoking rates continue to decline in most parts of the world. That makes Imperial particularly attractive to us at a time when many developed equity markets appear fully valued.

That said, tobacco investors have had plenty to worry about in the past 12 to 18 months. The US Food and Drug Administration (FDA) is pushing to reduce nicotine in cigarettes to trace levels, which would make the product less addictive and earnings streams less reliable. New “Heat Not Burn” technology has been showing promise, especially in Japan and Korea. Imperial is a laggard in this technology relative to competitors British American Tobacco and, especially, Philip Morris International’s IQOS. And Imperial has gone from one of the leading players in vaping to a laggard relative to US start-up JUUL. These seem to be the market’s core concerns, and we think there’s something to each of them. So what’s the mistake sellers are making? While they are all valid worries, we think it’s wrong to jump from these recent developments to the conclusion that the traditional cigarette business model is broken.

Firstly, we think some of these worries may be overblown. In the cigarette business, government efforts to persuade fewer people to buy your products are a given. Similarly, less harmful alternatives to smoking have been entering the market since nicotine patches and gum became widely available more than a generation ago. Each of the trends investors are currently worried about have major hurdles to navigate if they’re to continue at anything like their current rates for years to come, as I’ll discuss further in the presentation.

Secondly, and more importantly, quite a lot of pessimism appears to be priced into tobacco shares. At a current valuation of 10 times earnings versus its long-term historical average of 12 and the current market average of 18, the stock market believes that the future for Imperial is much worse than its past. This may be true—up to a point—but the relative valuation in an expensive market appears extreme to us. If even a bit of good news turns up to dispel the gloom then we believe the shares are likely to re-rate substantially. While we wait, Imperial’s 6%-plus dividend yield (versus about 2% for the global benchmark) compensates us well for owning it.

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