Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

Tobacco: Smoke Without Fire

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The tobacco industry was surprised by the July 28 announcement from the U.S. regulator that the Food and Drug Administration (FDA) was looking to reduce the nicotine in traditional combustible cigarettes to non-addictive levels, and questioning the role of menthol. Our view is that any action is likely to be many years away, and is arguably balanced by the opportunity in Next Generation products for those who are well positioned. Our portfolio is concentrated on tobacco names with access to the Next Generation products, and in particular heat-not-burn, and thus should be well-placed.

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Tobacco has long been a steady compounder. The industry has grown its earnings at 7% per year in U.S. dollars over the last decade, while paying a healthy yield of around 4%. By contrast, the MSCI World Index has grown its earnings at just 0.5% with a lower yield.[1] The sector's price-to-earnings multiple can be volatile, as shown at the end of July, but over the long term the relentless compounding has driven strong share price outperformance. The key to this compounding has been pricing power. Combining a concentrated industry with limits on advertising in most markets to constrain new entrants, along with a taxation regime that gives cover to price rises, makes for a perfect environment to raise prices steadily – price/mix is of the order of 5% annually. It is important to note that the industry's

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[1] Source: FactSet, July 31, 2017.

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compounding has happened in the face of regulatory pressure that has steadily reduced the volumes of cigarettes sold in Developed Markets, though some of the regulatory changes, such as the rising weight of taxation and advertising bans, have actually helped boost pricing power. While the July 28 announcement by the U.S. regulator is significant, we do not see it as a break with the model of the last 40 years of regulation.

Looking forward, we believe that some tobacco companies can continue to compound successfully, but it is becoming more important to be selective, just as in the case of other Consumer Staples, as described in last month's update. With other Staples, one of the key issues is technological change, and the threat of a certain e-commerce giant. For tobacco, it is the 'Next Generation', or 'Reduced Harm' products that provide the threat – and the opportunity. Our belief is that companies strongly positioned in these areas, in heat-not-burn or e-cigarettes, are likely to gain share at the expense of other players, and thus continue to compound. At the margin, the U.S. regulator's move is likely to help this process.

It is understandable that the U.S. regulatory framework announced on July 28 spooked the markets. The new head of the FDA is aspiring to reduce the nicotine in combustible (i.e., traditional) cigarettes to non-addictive levels, while also expressing concern about the role that flavorings (notably menthol) play in attracting young people to smoking. However, it is important to note that the announcement was a press release rather than actual regulation, and that the process is likely to take multiple years, and may well result in a significant watering down of the proposals. Under the Tobacco Control Act, the FDA's decisions must be based on scientific evidence, much of which may not yet be in place, meaning extensive research may be required. The tobacco industry will be ready to offer strong legal challenges which could delay or block any reforms, while elements of the Republican Congress and Trump's base may not welcome government constraints on nicotine.

On the positive side, there was an explicit recognition in the FDA release that there are other less harmful means of delivering nicotine, a major endorsement of lower-risk Next Generation products, which are unlikely to have their nicotine content lowered. 'Big Tobacco' dominates the e-cigarette market, while the heat-not-burn category is led by Philip Morris International's IQOS, which has already taken 12% of the Japanese market (and will be licensed to Altria in the U.S.), followed by BAT's glo. The regulator's attitude should help the approval of heat-not-burn in the U.S. and may even strengthen the case for favorable tax treatment compared to combustible cigarettes, as has been the case in other markets. This should ensure that the products have economics as good, or even better, than traditional cigarettes, once scale is reached.

Our view is that the world is a profoundly unpredictable place at present, and that this unpredictability is not reflected in a market where MSCI World Index is trading at close to 17 times the next 12 months' earnings,[1] which themselves include an assumption of double-digit earnings growth. As a result, we favor quality compounders, which can grow earnings steadily at high returns on operating capital. We put tobacco companies in that category, despite the regulatory noise, provided they are well placed in Next Generation products. Tobacco's proven ability to compound over multiple decades is not reflected in the valuations post the recent events, with the industry's premium to the MSCI World Index having virtually disappeared.

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[1] Source: FactSet, July 31, 2017.

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