

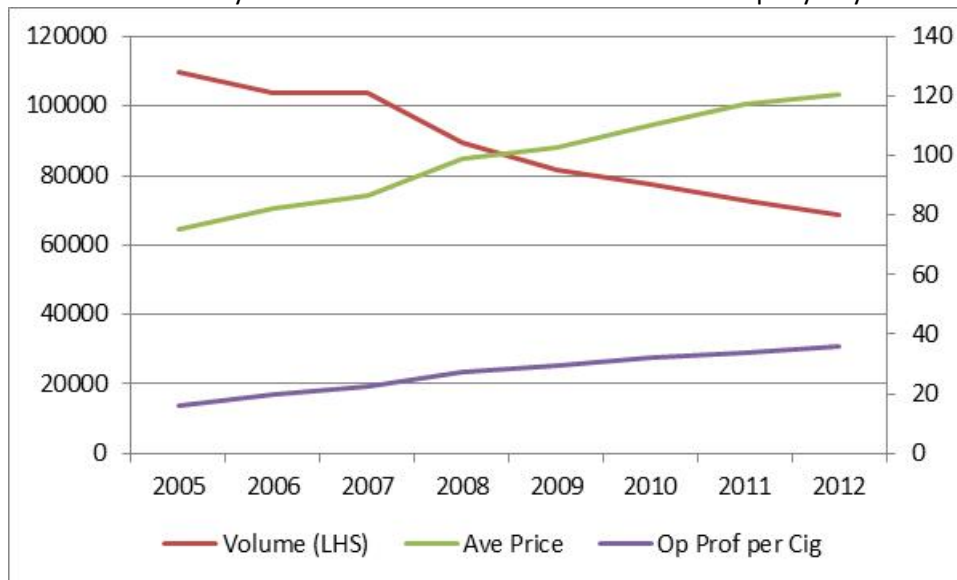


15 years ago tobacco stocks were very cheap as the market priced in large legal settlements that tobacco companies were being forced to pay to governments as well as focusing on the declining volume of tobacco sales in major markets. US Department of Agriculture estimates show that US cigarette consumption peaked at 640 bn sticks in 1981, and are now somewhere below 300 bn sticks. Despite this tobacco stocks have been great investments over the last fifteen years.

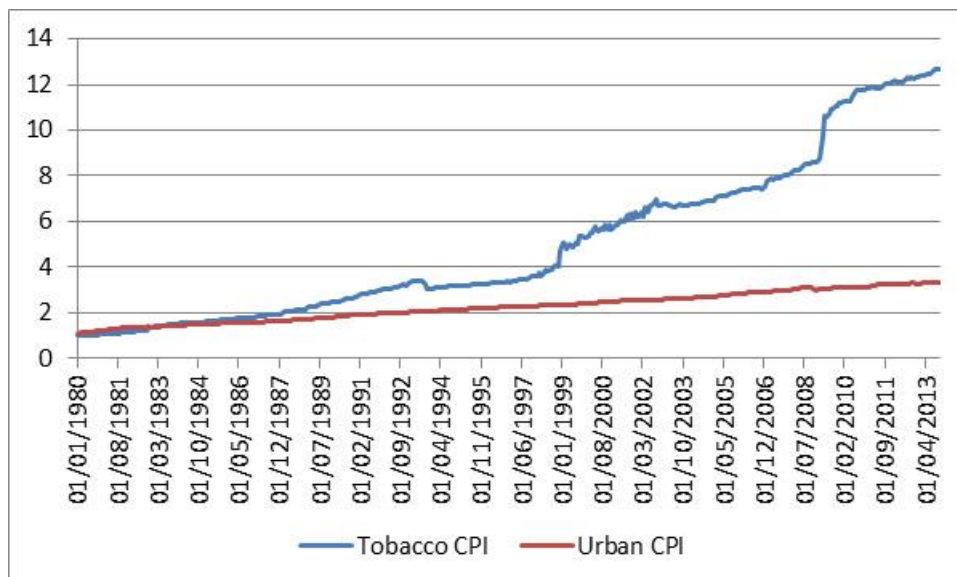
Tobacco stocks have benefitted from three different market trends. Firstly, the legal settlement in the US set up a de facto tobacco cartel, and tobacco producers have been able to raise prices to more than offset declines in volumes. Secondly, declining interest rates have made investors value the stable cash flows of tobacco companies ever more highly. Thirdly, for tobacco companies with international operations, the rise of emerging markets has provided them with a growth opportunity that was previously not apparent. In my view all three of these features are now disappearing, and the market is likely to focus again on a business that looks to be in terminal decline. Tobacco stocks look like good short candidates.

Cartel Pricing

Below is a summary of recent sales of US focused tobacco company Reynolds.



Even as volumes declined, Reynolds has managed to raise prices to grow operating profit per cigarette. In even more stark terms, we can look at the cost of tobacco products versus other products by comparing the CPI index for tobacco versus a general CPI index.

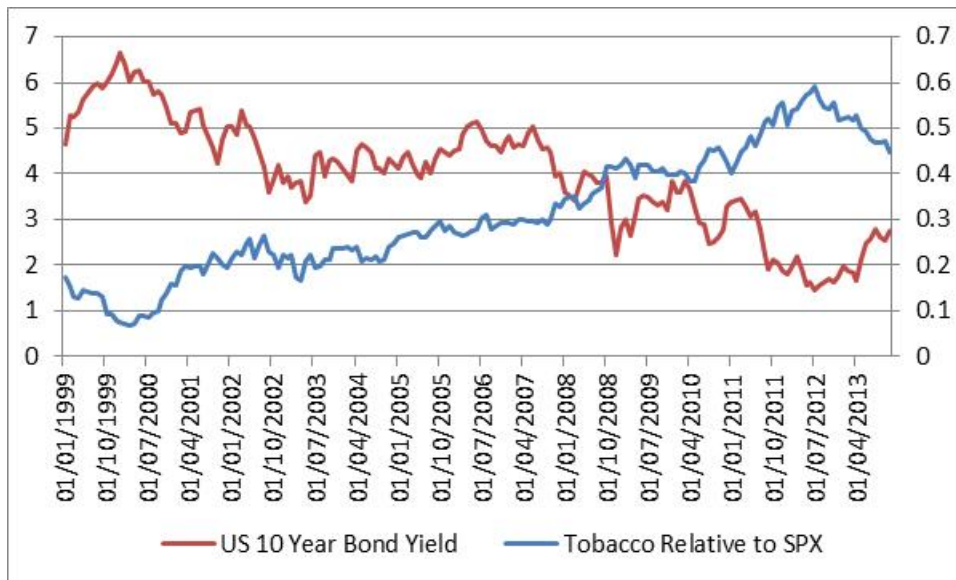


While much of the increase in cigarette prices have been due to taxes, it is obvious that tobacco companies have also increased prices. British American Tobacco has seen its net profit margin rise from 5% in 1998 to 25% today. While cartels are good for investors they can only survive if there is a barrier to new entrants. The rise of e-cigarettes could potentially bring competition back to the tobacco industry – particularly driven by websites such as this : <http://which-electronic-cigarette.org.uk/electronic-cigarette-refill-price-comparison/>

E-cigarettes threaten tobacco pricing. The main harm from cigarettes is from burning organic matter to allow nicotine to be inhaled. As e-cigarettes do not burn any matter they are far less harmful than cigarettes. Given that both e-cigarettes and cigarettes supply nicotine to smokers – but e-cigarettes do so with far fewer health risks, from a public health perspective there is a chance that governments could potentially encourage e-cigarettes over cigarettes. This would be extremely disruptive to the big tobacco business model.

Declining Interest Rates

Ever lower interest rates have been a strong tail wind for cash flow generative companies. Since 1999, tobacco stocks have performed well in periods of declining bond yields.



Emerging Markets

Cigarettes bn sticks	2006	2007	2008	2009	2010	2011	2012
World	5726	5809	5883	5840	5813	5843	5893
China	2007	2129	2195	2277	2338	2412	2470
World ex China	3719	3680	3688	3563	3475	3431	3423
Russia	400	397	390	388	378	370	370
US	391	374	351	315	308	300	291
Indonesia	213	222	223	227	215	225	238
Japan	306	280	273	245	218	195	197
India	97	99	101	103	90	111	116
Brazil	100	98	96	101	99	98	100
Philippines	95	93	90	90	101	97	100
Turkey	110	110	106	100	93.3	91	90
South Korea	88	92	90	86	90	90	89

While world consumption of cigarettes is still growing, if we exclude China, global consumption is declining. For global tobacco markets China is off limits as the state owned China Tobacco enjoys a legal monopoly. Russia is seeing volumes decline, while Brazil is seeing stagnant volumes. Of the large markets, India and possibly Indonesia hold the promise of growing volumes.

While pricing in emerging markets is relatively low, which offers the prospect of rising prices this is offset by the recent trend of emerging market currency weakness.

Conclusion

Tobacco companies have realised that many of their markets are mature and have sought to maximise their cash pay-outs to investors. In fact most tobacco companies return almost 100% of their cash flow via dividends and share buyback to investors. However they now face a series of complex problems. Growth markets are also slowing, bond yields are rising and emerging market currencies are devaluing. All of these should weigh on the share prices. Furthermore, e-cigarettes could prompt governments to change how they regulate cigarette products, threatening big tobacco business models. The outlook to tobacco stocks and the earnings are unclear to me – and yet many investors own them as bond proxies. Risk reward for shorting tobacco stocks looks very good to me.

Information

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- Source: Bloomberg
- Investor Relations: Alain Zakeossian, Carol Brown
- Email: info@horsemancapital.com
- Telephone: +44 (0)20 7838 7580
- Website: www.horsemancapital.com
- Business and registered address: Horseman Capital Management Limited, 9 Chester Close, London SW1X 7BE, United Kingdom. Registered in England and Wales - Company number: 04034280

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