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Big Tobacco's Future: Big Pot

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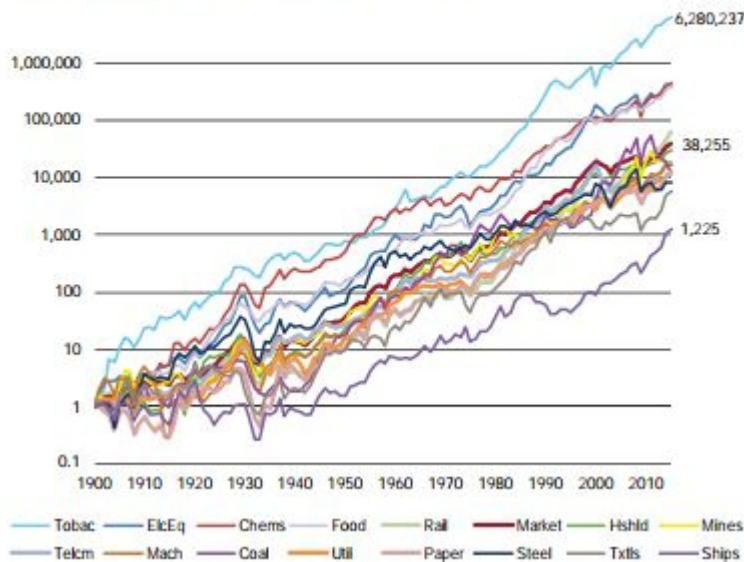
You may like technology (who doesn't these days) or the energy sector (where would we be without it) -- but if you're making a long-term bet as an investor, there's a lot going for Big Tobacco. It's not just that tobacco boasts the best historical performance of all U.S. industries. The industry's future seems especially bright. As marijuana gradually becomes a legal drug, Big Tobacco is poised to dominate the market.

According to the 2015 edition of Credit Suisse's Global Investment Returns Yearbook (I thank my Bloomberg View colleague Justin Fox for bringing it to my attention), a dollar invested in tobacco in 1900 would have turned into \$6.3 million by the end of 2014, by far the best performance of all the industries that existed at the start of the 20th century:

Long-run performance of industries in the USA

Source: Elroy Dimson, Paul Marsh and Mike Staunton; Cowles (1938), Ken French industry data; DMS USA index

Cumulative value of USD 1 invested in US industries at the start of 1900



That, of course, reflects the decline of some old industries, like coal, railroads and shipbuilding, and fails to account for the emergence of new ones. (A small investment in "some kind of fruit company," called Apple Inc., is how Forrest Gump earned his fortune.) So perhaps the last ten years are a better indicator of tobacco's resilience.

Since the beginning of 2005, the MSCI Global Tobacco Index has risen 196.4 percent, providing an 11 percent annual return. It far outperformed the catch-all MSCI World Index, which went up 50.6 percent in the same period:



It even did better than the MSCI World Information Technology Index, which rose 94.4 percent in the past decade:



Despite governments' efforts to get people to quit smoking, a lot of them still do, and they represent a stable core market for Big Tobacco. In the U.S., for example, 20.9 percent of adults smoked in 2004 and 19 percent still had the habit in 2011. Markets for addictive products are less susceptible to economic crises than any others, and -- in part because they're so politically toxic -- they are less bubbly. So investors tend to get a steady return.

Right now, the industry is undergoing a vaping revolution. A Bloomberg Intelligence analytical report from last December predicted sales of vapor products in the U.S. could climb 44 percent to \$2.6 billion this year. So far, much of that market has been in vaping liquids and the e-cigarettes that use them, but that technology is growing obsolete. The new cutting edge is in "heat not burn" devices, which, according to the Bloomberg Intelligence report, "may be highly disruptive to the existing tobacco industry" because they use real tobacco.

A "heat not burn" vaporizer heats ground tobacco leaves and delivers a nicotine hit to the user without producing much smoke or ashes. This still amounts to using an addictive substance in a slightly different way, but it's not hard to imagine why smokers might find it appealing to inhale less smoke, none of which contains burned paper. Such "heat not burn" devices are already available from a host of smaller companies, but the bigger tobacco companies, such as Philip Morris and Reynolds, have made it clear they're intent on catching up.

It may seem that Big Tobacco is merely cannibalizing its existing sales by putting out such products. Yet it may be something of a bet on the future, too. "Heat not burn" vaporizers can just as easily be used to smoke marijuana as tobacco. And they are already gaining popularity among cannabis users.

Tobacco companies have never said publicly that they'd like to get in on the marijuana business. That's understandable. Selling marijuana is still largely illegal in Europe and in the U.S., and it would be politically suicidal for companies that face as many regulatory barriers as tobacco companies do to suggest that they want to go into soft drug dealing. But they have long watched marijuana as a potential market.

In a 2014 paper entitled "Waiting for the Opportune Moment: The Tobacco Industry and Marijuana Legalization", the political scientist Rachel Ann Barry and her colleagues quoted internal documents from Philip Morris expressing an interest in marijuana as a tobacco competitor. These letters and memos date back to 1969. In 1970, an adviser to the board of British American Tobacco, Sir Charles Ellis, penned a proposal for a marijuana product to the company, claiming that "smoking such a cigarette is a natural expansion of current smoking habits which, if a more tolerant attitude were ever taken to cannabis, would be a change in habit comparable to moving over to cigars." The discussions and research paused in the 1980s as marijuana legalization prospects became more remote, but resumed in the 1990s.

More than 19 million Americans aged 12 and older reported using marijuana in 2012. If recreational marijuana is ever legalized beyond the four states where it's currently permitted, the tobacco companies will be perfectly positioned to capture this vast market. They already have distribution systems (licensed tobacco sellers already dispense medical marijuana in a number of states), marketing machines, industrial facilities to make marijuana cigarettes and package cannabis for use in vaporizers, patented designs for the vaporizers themselves, research laboratories (and possibly even a head start on commercial product development) and, last but not least, cash resources.

"Marijuana legalization advocates," Barry and her colleagues wrote, "have not considered the potential effects of the multinational tobacco companies entering the market (or other corporations such as the food and beverage industries), with their substantial marketing power and capacity to engineer marijuana cigarettes to maximize efficacy as drug delivery systems, in the way that modern cigarettes are designed, whose primary objective is maximizing profits through higher sales." I'm not sure that's true: The legalization advocates probably wouldn't mind Big Tobacco's participation in developing the market.

After all, these corporations can do it better than the tiny companies that have attracted the early marijuana investment into their penny stocks. Companies listed on Marijuanastocks.com may survive on the fringes of the post-legalization industry, but many of them will be put out of business or acquired by the big league players who have survived all the upheavals of the last 115 years while producing top returns for their investors. For those not overly worried about the moral strings attached to investing in companies that pander to addictions, a greener future for Big Tobacco may be one of the biggest opportunities of a lifetime.

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