CREDO WEALTH

Not up in smoke yet

We often use this space to discuss a recent addition, or to comment on the economy at large. This time, however, we would like to draw our readers' attention to one of our long-term holdings which, though often overlooked, is among the largest contributors to the total return of both the Best Ideas Portfolio and the Dividend Growth Portfolio.

As a market leader in a capital-light industry, we bought Imperial Tobacco as a value proposition with a secure dividend, whose pricing power proffered a bulwark to the vicissitudes of a market still bearing the scars of 2008. Having been held since inception, Imperial Tobacco has more than earned its keep, rallying to record highs over the previous year in spite of secular headwinds. In the last quarter alone, the company posted a 15% jump in pre-tax profits, continuing the trend of the previous 9 months. While sales volume undershot by almost 3%, the impact was muted amidst Imperial's wide-ranging cost reductions.

Though volumes have been hard hit, over half of this can be attributed to the conflict in Iraq and Syria, which account for a large share of the company's growth markets. While decline may be halted, opportunities for organic growth are unlikely to be found. Rather, growth will more likely come from acquisitions, where Imperial can bring to bear efficiencies and economies of scale to smaller, regional brands. For instance, the company spent $7.1bn buying the brands orphaned by the Reynolds American merger with Lorillard, tripling their US exposure to nearly 10%, and providing them with the requisite scale they had previously lacked in the region. In the most recent quarter, these adopted brands maintained their market share, halting the long-term and continuous decline they suffered under the stewardship of their previous masters.

Yet Imperial itself has been rumoured to be an acquisition target: over the past few years takeover rumours have circulated, probably due to Imperial's smaller size relative to peers BAT, Philip Morris, and Japan Tobacco. While claims have surfaced that BAT have corralled together a syndicate of investment banks willing to support a bid for their smaller rival, with Imperial trading at near record highs, the risk of overpaying is high, not to mention the barrage of antitrust hurdles such a deal would pose. In recent meetings with investors Japan Tobacco's management dismissed the rumours for precisely these reasons.

Deal or no deal, Imperial Tobacco piqued our interest as a value proposition and despite the recent rally, on a P/E basis, it remains as such. Though the industry has continued to feel the sting of declining volumes, Imperial remains highly profitable and commands considerable pricing power. Standing resilient in the face of broad market turbulence in the first few weeks of the year, the tobacco giant is not up in smoke yet.

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