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Explainer: how big tobacco turns profits

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Surviving or thriving? britta heise, CC BY

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In 2013 Imperial Tobacco, one of four major transnational tobacco companies, posted its first fall in profits in 17 years. One could be forgiven for thinking from the proposed introduction of new restrictions on tobacco products, such as standardised packaging, that Imperial's announcement was symptomatic of the industry's terminal decline.

Declining rates of smoking in many developed countries and the introduction of the Framework Convention on Tobacco Control (FCTC), a global public health treaty which requires its signatories to introduce measures aimed at reducing tobacco-related diseases, may only serve to reinforce this impression. But despite growing regulatory risks there has always been a tendency to exaggerate news of the industry's demise.

Tobacco is still highly valued as an investment by financial institutions, with reports last summer of several funds holding an excess amount of tobacco stock in their portfolios; usually a sign that portfolio managers believe the stock will outperform other securities.

Diversification into e-cigarettes might pay off some day, but profit margins are, for now, significantly lower, and proposed regulation could dramatically affect the market's growth potential. The simple fact is that, for the foreseeable future at least, the financial strength of major tobacco manufacturers rests on conventional cigarettes.

New markets, stubborn core

Notwithstanding declines in smoking in some developed countries, globally, sales of the majors have been remarkably buoyant and, until very recently, growing. Between 1960 and 2000, global cigarette consumption increased by 4% a year, reflecting the industry's expansion into emerging markets. And despite signs of global volumes beginning to fall, more than three-quarters of the world's smokers now live in the developing world.

The significance of this is that, despite the successes of the FCTC (subsequent to ratification 127 parties have strengthened or adopted legislation), tobacco regulation is generally less restrictive in developing and transitional economies and is likely to remain so given that poorer countries have fewer resources to fight the huge range of strategies tobacco companies use to prevent, delay, and dilute public health measures. Of late, much attention has focused on international trade and investment treaties which tobacco companies have used to limit regulation. At least four African countries – Namibia, Gabon, Togo and Uganda – have received warnings from the tobacco industry that their laws violate international treaties, and in Namibia the government is still to put into effect a tobacco control law passed in 2010, following threats from the industry that the new statute violated the country's international legal obligations. Litigation is costly, the outcome of international arbitration is difficult to predict and tobacco companies have deep pockets; all of which is likely to influence how countries design and implement health policy.

Expansion in emerging markets is, therefore, likely to continue to offset declines in mature markets for a while yet. BAT's volumes continue to grow in Asia, for example, despite lower volumes in South Korea, Australia, and New Zealand. Moreover, disposable incomes tend to increase with economic development, which creates greater scope for tobacco companies to offset falls in sales by raising prices and shifting smokers onto premium brands. Further, even in developed countries, smoking is not deteriorating as fast as many people might think. Between 2005 and 2011, the number of US smokers declined from 45.1 million to 43.8 million, representing less than a half per cent drop per annum. The drop in the demand for cigarettes tends to tail off in mature markets, reflecting the existence of a stubborn core of typically poorer smokers who are more difficult to reach with public health interventions.

High margins and yields

Another major driver of the industry's rude financial health relates to the economics of the business itself. The major brands have evolved very little over some decades; the addictive nature of the product and brand loyalty mean there is little need for major product innovation which helps to keep research and development costs down. Similarly, the addictive nature of tobacco means that the price elasticity of cigarettes is relatively low (for a 1% increase in the price of cigarettes in high income countries, the demand declines by 0.4%). This permits persistent price rises that maintain relatively stable profit margins despite falling sales.

Consequently, most major financial indicators for tobacco manufacturers – earnings before interest and tax, operating margins, and returns on equity – are consistently strong relative to companies in other sectors. One measure of how well tobacco stocks have performed, suggests that they had the highest return of 67 industry groupings in the decade to 2011.

Stable and high profit margins underpin one of the major selling points of tobacco companies; persistently high dividend yields. Many fund managers pick stocks on their ability to reliably pay out dividends and, in the case of tobacco, high yields mean that investors can relatively quickly recoup their initial investment in the form of cash dividends irrespective of movements in the share price.

And herein lies the clue to the massive political mobilisation of tobacco companies against standardised packaging. On balance, the measure is likely to reduce consumption over the long term, but it is the removal of the industry's ability to charge a premium which constitutes the biggest threat to its status as a go-to investment. If allowed to spread, standardised packaging will put an end to the industry's pricing strategy and, therefore, to its historically high margins and, with that, potentially, to the industry in its current form.

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