Cigarettes, Booze, Gambling…and Economic Moats

Sin stocks boast some of the widest economic moats on the planet.

Stock Strategist
by Matthew Reilly

Cigarettes. Booze. Gambling. Rock and roll. Wide economic moats.

Which of these terms is out of place?

Rock and roll. Any hack can pick up a guitar, learn three chords, persuade a couple of buddies to grow big hair and six months later become the next Skid Row. Becoming a viable competitor in the world of tobacco, alcohol, or gaming is a much different story.

The leading companies in these industries make intriguing and in many cases shrewd long-term holdings for a number of reasons, but chief among them is the fact that they compete in arenas that invite heavy oversight and regulation, typically from governmental agencies. The interaction between regulatory bodies and the companies, though seemingly adversarial, has become more symbiotic in practice.

The companies behind "sin" or "vice" stocks produce goods and services that governments in general want to limit the public's access to and consumption of, but these same governments often collect huge sums in taxes from these activities. Government budgets have in many cases become dependent on these funds, often paradoxically looking to maximize revenue from these activities while not condoning them. This oversimplifies the interactions which vary from nation to nation and state to state, but we feel this is a key driver when considering a "sin" stock's long-term performance prospects.

Our Take on Tobacco

This is especially true in the domestic market for tobacco products. Though regulation and litigation have eaten into some of the profitability at tobacco firms, the businesses remain extremely attractive from a fundamental perspective. The Master Settlement Agreement (the MSA) in the United States has essentially created legal cigarette cartels, with federal and local governments dependent on the revenue streams raised from these payments. This relationship slowly made the transition from adversarial to more symbiotic in recent years, with the government balancing the conflicting goals of reducing consumption of cigarettes while maximizing funds generated from their sales. With barriers to entry extremely high and brand advertising severely restricted, it is difficult enough for existing companies to increase their current market shares. It is nearly impossible for new entrants to gain traction.

Thus Altria (MO) has one of the widest moats we have seen, boasting 50% American market share in cigarettes and returns on invested capital of close to 30%. Though cigarettes will likely be subject to ever-increasing levels of taxation—which could take a toll on volumes—the demand curve for the products has proven fairly inelastic to present (not surprising given the addictive nature of the product). Also, the overall market has become an extremely stable oligopoly, with Reynolds American (RAI) holding about 30% share and Carolina Group (CG) about 12%. These shares tumbled a bit between 1998 and 2004 when discount cigarette makers exploited a loophole in the MSA to escape payment. This loophole was closed, however, when Altria and its peers pointed out to governmental agencies that payments from the MSA were based on market share, and if Altria's market share declined, so would the payments made to the agencies.

Although we feel that Altria still carries above-average risk due to the uncertain litigation environment in the United States, we think investors should watch the stock price carefully for attractive entry points. The company's growth prospects are brighter overseas than domestically, but we think the company has ensured a hefty income stream from its U.S. operations well into the future. This is due to the strength of the firm's brands—especially Marlboro—that are almost impossible to assail, given the current restrictive advertising regulations as well as the government's dependence on its massive payments.

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UST (UST) also retains a dominant position in the U.S. market for tobacco products, but UST makes smokeless tobacco rather than cigarettes. The environment for smokeless products is less litigious than cigarettes, but the company has lost market share in recent years. However, it still boasts nearly 65% market share and returns on invested capital in excess of 50%. The company has long been rumored to be a potential acquisition target for Altria, and the two companies combined would truly have an astonishingly strong competitive position in the domestic market for tobacco products and an extraordinarily wide moat.

UST shareholders could see a nice premium if the company were to be bought, but Altria shareholders could be left with indigestion due to the large price tag on the deal. UST has the same advantage as Altria, Reynolds, and Carolina Group in that many of its brands were developed and gained leading market share positions before severe advertising restrictions hit tobacco products. UST's market share is also protected because the type of tobacco used for smokeless products is grown only in Kentucky and Tennessee, with the vast majority of each year's crop under long-term contract to one of the current industry players. On top of this, the typical aging period for premium smokeless product is three years. Though these advantages have not prevented a competitor, namely Conwood (recently purchased by Reynolds), from taking share in the category, this was in large part because UST lost an antitrust case to the company in 2003 and was forced to pay $1.3 billion and curtail certain anticompetitive activity. In other words, the company's competitive position had in fact become too strong.

Advantages in Alcohol

Shifting to the world of alcoholic beverages, Diageo (DEO) is the world's largest spirits firm, and it has successfully navigated the maze of regulations on alcoholic beverages in more than 180 markets throughout the world. Because the United States has a three-tier system regarding alcoholic beverages—meaning there must be an intermediate distributor between the manufacturer of an alcoholic beverage and a retailer—the company has developed an exclusive distributor base in the United States. This system is virtually impossible for its competitors to match due to Diageo's scale advantage. This plan was largely taken from Anheuser-Busch's (BUD) playbook, as the iconic American brewer has long used its scale advantage and exclusive distributor base, which handles about 60% of the company's total volume, to capture almost 50% of the American beer market.

Diageo is on the verge of becoming a 5-star stock, and we think it's an excellent long-term holding. For that matter, Anheuser-Busch has a 4-star rating, but we also consider it to be a strong long-term holding. Scale and regulation have also led to expansive moats in the Canadian beer market, where Molson Coors (TAP) and AmBev (ABV) compete in a stable duopoly. The same holds true in Mexico, where Femsa (FMX) and Grupo Modelo (half-owned by Anheuser-Busch) also compete in a stable duopoly. In both of these markets, in fact, the brewers have substantial ownership interests in retail outlets where their beer is sold, either with explicit government approval or at least government acceptance. If the recently announced formation of a joint venture between Molson Coors and SABMiller passes regulators, a stable duopoly will also exist in the U.S.

Moats for Gamblers

In the gambling world, we feel that several casinos boast narrow moats, but wide moats are reserved for companies like International Gaming Technology (IGT), where scale advantages once again meet governmental regulation. The industry is highly regulated, the process to obtain licensing is arduous, regulatory testing of slot machines is stringent, and customers are not particularly price-sensitive. With such attractive attributes from an incumbent's point of view, it is not surprising that IGT controls nearly 70% of the North American slot machine market and boasts returns on invested capital in excess of 25%. Much as companies like Diageo, Anheuser-Busch, and Altria are able to reinvest profits into marketing and innovation,

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IGT spends more than double what its competitors do on research and marketing—all in an effort to ensure that its scale advantage remains safely intact and its innovations patented. The company is also able to license and market premium brands such as Wheel of Fortune, while bolstering the reputation of the IGT brand within the industry. We still think that casinos can also be attractive businesses, but it is much more difficult to assail IGT's competitive position in slot-machine manufacturing than to build the next latest and greatest gambling mecca.

In the end, the need for regulatory approval from local and/or federal governmental agencies, as well as scale advantages, combine to create wide, long-lasting moats in industries of questionable social benefit. We believe these companies make attractive long-term holdings, and the Morningstar Rating for stocks is a perfect way to gauge whether or not current market prices represent attractive entry points.

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Mutual fund investing involves risk; principal loss is possible. The Fund is nondiversified, meaning it may concentrate its assets in fewer individual holdings than a diversified fund. Therefore, the Fund is more exposed to individual stock volatility than a diversified fund. The Fund invests in foreign securities which involve greater volatility and political, economic and currency risks and differences in accounting methods. The Fund also invests in smaller companies, which involve additional risks such as limited liquidity and greater volatility.

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As of 10/31/2007, the Vice Fund's top ten holdings and the percent of net asset value they comprised were as follows:

Altria (7.90%), Loews Corp (6.44%), Diageo (5.33%), British American Tobacco PLC (5.17%), Boeing Co (5.14%), Inbev SA (4.87%), International Gaming Technology (4.77%), MGM Mirage (4.46%), Heineken NV (4.41%), Wynn resorts LTD (4.37%).

Fund holdings are subject to change and are not recommendations to buy or sell any security.

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