Socially Responsible Investing

From Investopedia:

Socially Responsible Investing Vs. Sin Stocks

BY LISA SMITH Jun 25, 2019

... SRI fans prefer an investment strategy that views successful investment returns and responsible corporate behavior as going hand in hand. They believe that by combining certain social criteria with rigorous investment standards, they can identify securities that will earn competitive returns and help build a better world.

Proponents of sin stocks have traditionally favored companies in the gambling, alcohol, tobacco and firearms industries. ... This camp points out that somebody is going to profit from these industries, and argues that there's no reason to sit on the sidelines and miss out on the opportunity. ...

Buy in to Sin or Put Your Money Behind Your Convictions?

SRI fans argue that it's possible to do some good while making money. Their argument rests on the idea that socially responsible companies are likely to be well managed because their underpinnings are based on solid values. Sin stock fans argue that SRI mandates pass up good opportunities in companies that have strong fundamentals, trading profits for a feel-good factor. ... Modern portfolio theory (MPT) seems to back their argument, as constructing the optimal portfolio should be more challenging if some stocks are removed from the universe of possible investments.

A Look at the Numbers

The Pax Balanced fund, launched on August 10, 1971, is the oldest operating SRI fund in the business. The Barrier Fund, known as the Vice Fund, launched on August 30, 2002, is the industry's oldest sin fund. A look at the two funds' annualized returns (as of May 2017) tells an interesting story. For ten years running, the sinners have done better.

Fund Name	1 Year	3 Year	5 Year	10 Year	Since Inception
Pax Balanced	8.71%	5.8%	6.9%	4.27%	8.29%
Vice Fund	15.87%	7.54%	11.76%	6.83%	10.08%

Complications

While there is no unilateral victory for either camp, things are not always as they seem. Where SRI once avoided gambling and alcohol, the Pax fund and a few others have relaxed that mandate, arguing that there are greater social ills and corporate governance issues to be concerned about and that gambling and alcohol are no longer viewed in the same light as they once were. ...

It is also worth noting that the universe of SRI funds vastly outnumbers the universe of sin funds. There are dozens of SRI funds, including big names, such as Dow Jones and Calvert, and a number of exchange-traded funds (ETFs). ...

On the sin stock side, there are fewer than half a dozen offerings, even with ETFs included, although there are plenty of individual securities that fit the mold, so constructing a portfolio based on stocks that SRI funds won't hold is easy to do. ...

Our thoughts

Hughes Capital Management has a fiduciary responsibility to its clients, and I do not believe in foisting my own moral beliefs onto clients. While HCM does not practice Socially Responsible Investing (SRI), I do take a client's own moral preferences into account, and will not invest in individual stocks a client wishes to avoid for moral reasons.

If you are invested in individual stocks, and want us to consider adding the below stock to your portfolio, please let me know. While I have already asked newer clients, if there are industries you want me to avoid buying individual stock in for moral reasons going forward, please let me know so I can add that information to your IPS.

If you are a client for whom we invest in individual stocks, we need to know if IMBBY, which meets our criteria, is an acceptable investment.

Insider Buying:

	Trade Date	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
12)	09/30/2019	5	HILL RICHARD CHARLES, Will		3,201
13)	09/27/2019	4	Cooper Alison, Phillips Matt		20,865
14)	09/06/2019	5	Williamson Mark, Langelier		2,335

From High Dividend Opportunities on Sep. 30:

Buy Alert - IMBBY

We have a unique buying opportunity to our members today for **Imperial Brands PLC** (OTCQX:IMBBY) a global tobacco company that sold off recently due to negative investor sentiment rather than fundamental reasons. IMBBY offers today a gigantic yield of 11.6% at very attractive valuations. This **a dividend growth stock** that has been able to increase its dividends over the past two decades. It is also a defensive stock with a recession resilient business model. IMBBY's dividend is covered at 143% so it is a super safe dividend!
... IMBBY is a very strong buy at the current price.

Further Notes on IMBBY:

- IMBBY is added to our Core Portfolio with a "Buy Under" price of $22.50. ...
- We are assigning an average risk rating for IMBBY. Although at the current low price, this is probably a lower risk stock. It is worth it, even for our conservative members, to have a small allocation to this stock.
- Recommended maximum allocation is 3% of the overall portfolio.
- **Taxation**: Imperial Brands is a company based in the UK, with the ticker IMBBY trading on the U.S. stock exchanges. UK corporations like Imperial Brands are completely exempt from withholding taxes for U.S. investors. ...

Don't Let This 11.6% Yield Opportunity Go Up In Smoke: Buy Imperial Brands!

Summary

- *Imperial Brands PLC (OTCQX:IMBBY) recently pulled back sharply and now trades at less than 7X earnings.*
- *The 11.6% dividend is sustainable and very well-covered even in the face of declining markets.*
- *We would buy shares under $22.50, with a $30.00 price target.*
- *Opportunities like this don't come every day. Lock in a yield of 11.6% for the very long run!*

Imperial Brands PLC (OTCQX:IMBBY) is a UK listed entity that is hardly followed within the US. The dividend growth investors have followed the smoking giants of **Phillip Morris** (PM) and **Altria** (MO) over the years and these two get tons of coverage. Imperial Brands on the other hand, slips under the radar. We have taken a big interest in this industry as it presents some exceptional opportunities on account of its large cash flows alongside negative sentiment and regulatory hurdles. We believe Imperial today represents one unique buying opportunity.

Introduction

Smoking gets negative press. There is no doubt about that. The only comparable industry that we can think of that gets the same amount of flak is the private prison industry. That negativity often creates opportunities. Today the industry is facing a perfect storm of falling cigarette consumption rates and vaping related deaths. While Imperial appeared to have gone through the last few months without being hit, that changed on September 26.

Imperial announced that it would not be able to grow revenues at rates that it expected earlier in the year, leading the stock to decline by 15% in just a few days. This is in addition to steep declines the stock has already seen in the past 12 months.

Imperial Brands PLC today announces that, in light of a challenging NGP market in the USA and changes to our results expectations in the Africa, Asia and Australasia (AAA) division, Group net revenue for the year to 30 September 2019 is now expected to grow at around 2%, with EPS expected to be broadly flat at constant currencies. Whilst this is disappointing for the current year, we believe that NGP provides a significant opportunity to deliver additive growth to complement our Tobacco business. We continue to refine our investment behind building a strong and profitable NGP business in a rapidly evolving market.

Next Generation Products

We expect our overall NGP business will grow net revenue by around 50% this year, albeit below our expectations. *The USA NGP environment has deteriorated considerably over the last quarter with increased regulatory uncertainty, including individual US state actions. This has prompted a marked slowdown in the growth of the vapour category in recent weeks, with an increasing number of wholesalers and retailers not ordering or not allowing promotion of vaping products."*

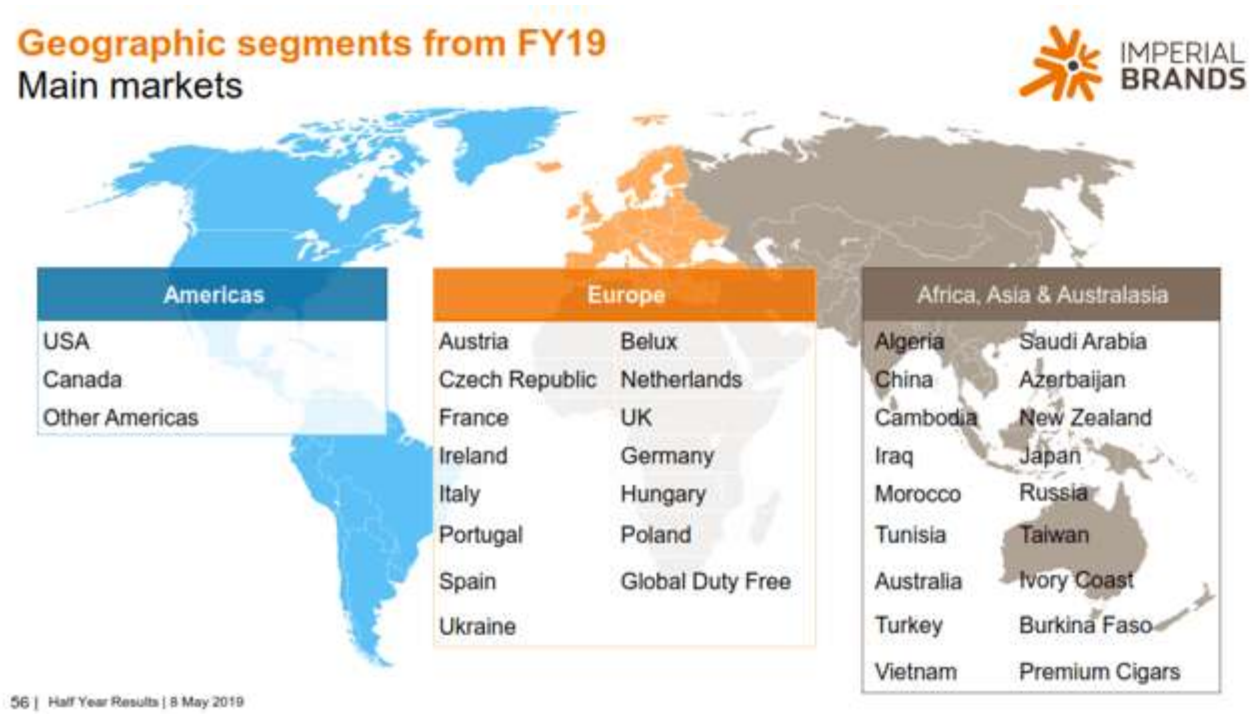
This drop while brutal for existing investors has opened the door for a remarkable opportunity to earn a spectacular dividend, with great upside potential. ...

The Business

Imperial Brands is a large global company headquartered in UK with about 31,000 employees, and has multiple brands it leverages to sell cigarettes around the globe.

Source: [Imperial Brands]

Imperial is a true global powerhouse with revenues in over 40 countries. The biggest percentage of its sales comes from Europe currently.



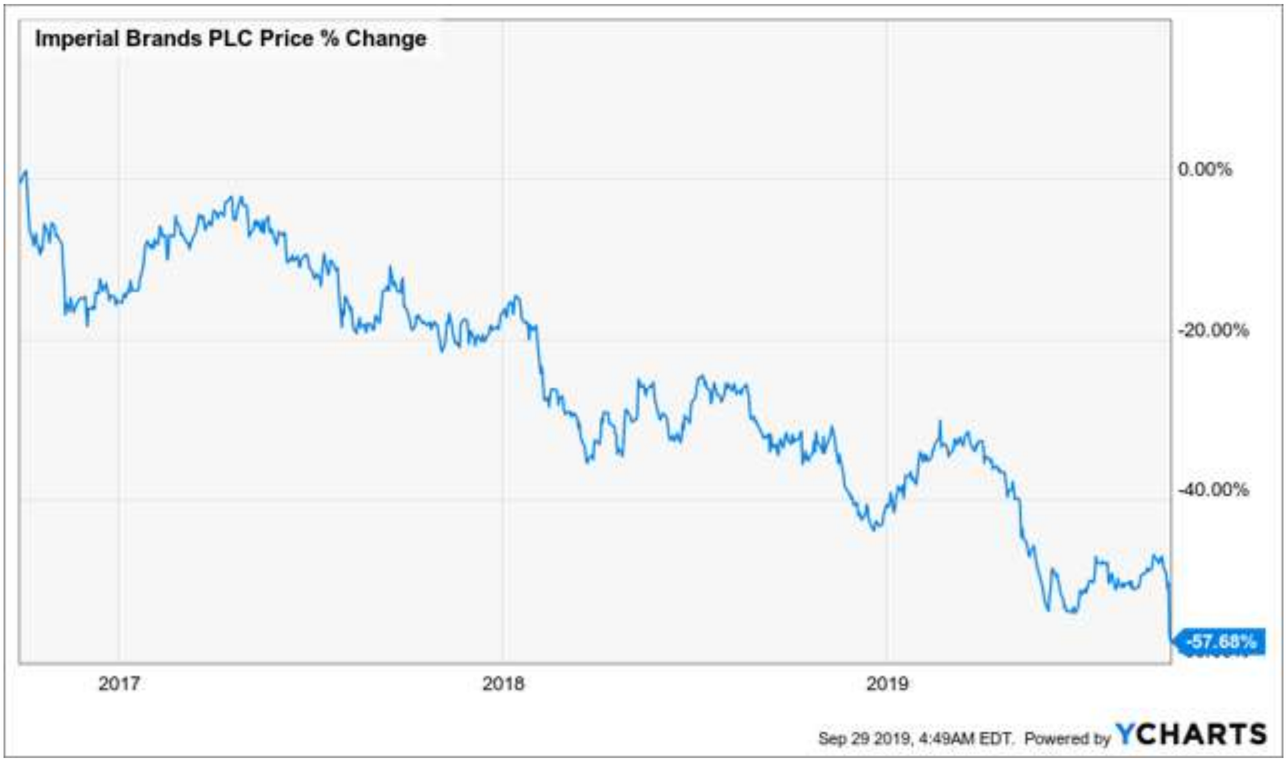
Source: Imperial Brands

Imperial is earning its bread and butter from cigarettes but is growing its other segments like cigars and smokeless products like chewing tobacco. A key area where it has focused its attention has been the category it calls its "next-generation products" or NGP. This area includes the vaping products and this is where it disappointed investors due to the recent regulatory pressures.

The bigger story

Before we get into specifics of the current issues, we need to take a longer term view of the stock. The recent dive of the stock has got it approaching the levels last seen at the depth of the 2008-2009 global financial crisis.

The share price of the stock have declined by close by over 57% in the past 3 years alone:



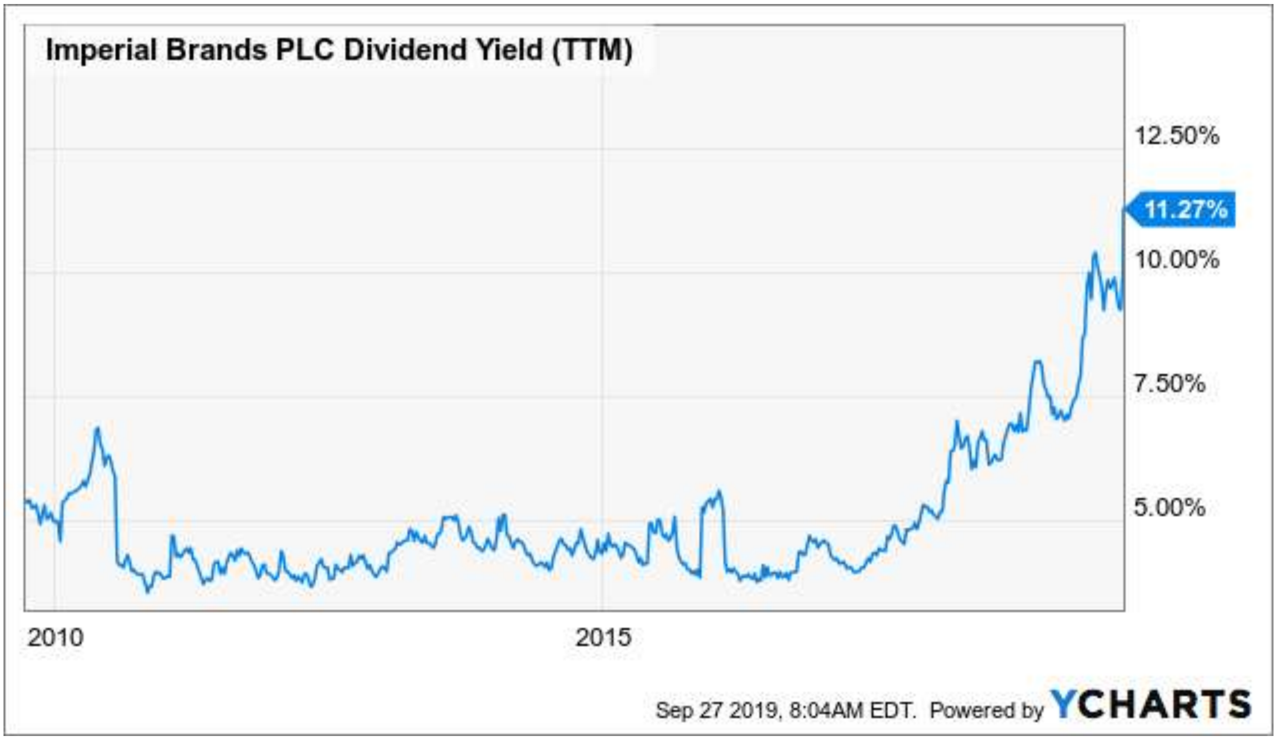
Fascinatingly, while price has gone in one direction, the fundamentals have been rather impressive. **Imperial has been able to increase its dividends for over two decades.** Its dividend in 2018 was triple that of what it paid in 2009. 2018 did mark the end of a long trend though of Imperial hiking its dividends by 10% a year.

Imperial recently revised its dividend policy and stated that the 10% dividend growth was no longer sustainable.

(Reuters) - British tobacco company Imperial Brands Plc (IMB.L) will drop its 10% dividend growth target from next year to focus on developing its e-cigarette portfolio and plans to buy back shares worth up to 200 million pounds ($246 million).

The company said on Monday it would increase its dividend payouts annually, but through a more progressive dividend policy that would take into account underlying business performance. ...

We saw this coming some time back as the dividend was consuming a very large amount of free cash flow. But at the same time the present dividend even if maintained, represents a rather astounding yield.



Recent results

Cigarette smoking is not a growth industry. The percentage of the population that smokes has declined over the last 50 years in pretty much every part of the world. While that has gone on, the companies making cigarettes have been able to buttress their profits via increasing prices. To a smaller extent population growth has also offset declines.

Investors had accepted that model of higher prices and lower volumes, but something changed in the last 3 years and volumes moved lower even quicker, alarming investors. We can see that by looking at H1-2019 results, we see that Imperial's profits barely moved, while the finance costs decreased a lot as a result of lower interest rates and deleveraging in the back half of 2018.

Income Statement

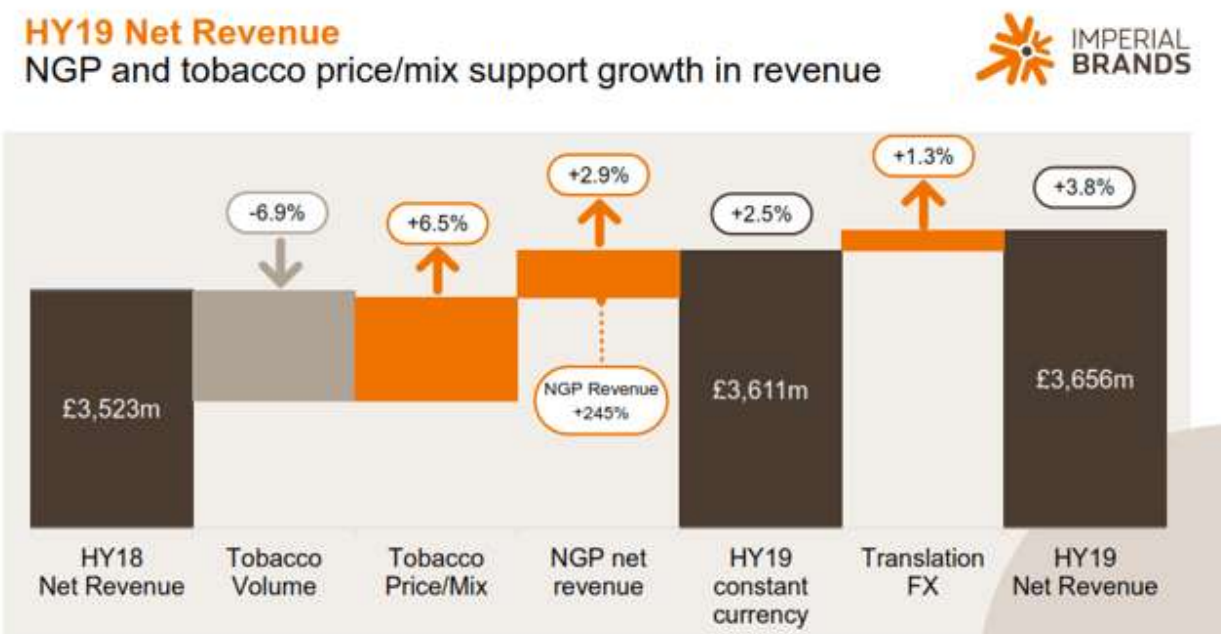
£m (unless otherwise stated)	HY19	HY18
Revenue (restated)	14,390	14,060
Adjusted operating profit	1,620	1,624
Amortisation and impairment of acquired intangibles	(297)	(526)
Restructuring costs	(54)	(105)
Share of profit of investments accounted for using the equity method	24	19
Administration of UK distributor	-	(160)
Von Erl Contingent Consideration	(119)	-
Net finance costs*	(156)	(252)
Profit before tax	1,018	600
Tax	(310)	(79)
Profit after tax	708	521
Minority interests	(29)	(30)
Basic EPS (pence)	71.2	51.7
Adjusted EPS (pence)	115.6	114.3

35 | Half Year Results | 8 May 2019

*Including net fair value and exchange gains/losses on financial instruments and post-employment benefits net financing costs

Source: Imperial Brands

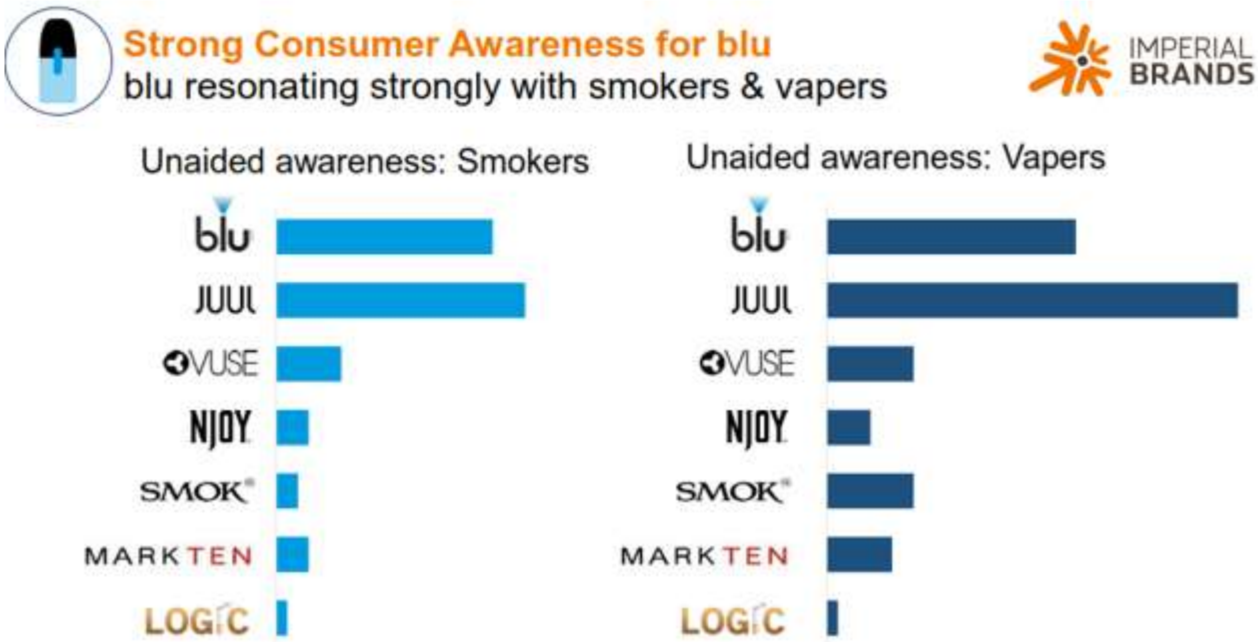
While the front line numbers look healthy the volumes are what have spooked investors.



Source: Imperial Brands

The recent drops that have exceeded the historic 3-4% volume drops have got investors rather nervous. Why exactly have volumes suddenly started falling faster? The answer we believe is the vaping segment growth.

E-cigarettes have been growing like a weed and have reached a point where they are big enough to steal market share in size. Even Imperial's own brand participated in the growth and the NGP segment growth (over 250%) was also breathtaking.



Source: Imperial Brands

This segment was supposed to offset revenue pressures but the recent events have made investors reconsider that line of thinking.

What changed

A new study from the [University of North Carolina at Chapel Hill]() showed that vaping may be [more dangerous]() than we previously thought.

Some may consider vaping safer than smoking traditional cigarettes, but new research from the UNC School of Medicine suggests that using e-cigarettes long-term may lead to a higher risk of emphysema.

In the study, lung fluids were sampled from 41 people - smokers, vapers and non-smokers. Researchers found that vapers, like smokers, had higher levels of protease enzymes - a trait that tends to cause emphysema.

If they keep using these products for about 20 years, it is likely that they will get emphysema," Robert Tarran, the professor who led the study, told The News & Observer.

Emphysema is a lung condition that causes a shortness of breath as a result of damage to the lung tissue, according to the American Lung Association."

While that was a long term study, the more recent news has focused on a [rapidly escalating crisis]().

An outbreak of a mysterious lung disease worsened over the last week with 805 confirmed or probable cases, a 52% surge over the previous week, the Centers for Disease Control and Prevention said Thursday.

At least 12 people have died across 10 states, the CDC said, citing data compiled through Tuesday.

Health officials still don't know what is making people sick. "Most patients have reported a history of using e-cigarette products containing THC. Many patients have reported using THC and nicotine. Some have reported the use of e-cigarette products containing only nicotine," CDC said."

While we hope that the cause is discovered soon, the impact to *vaping* from this and the multiple cities joining the ban, is likely to drag on. While that may appear to be horrible news for Imperial's growth segment, we believe the market is overreacting.

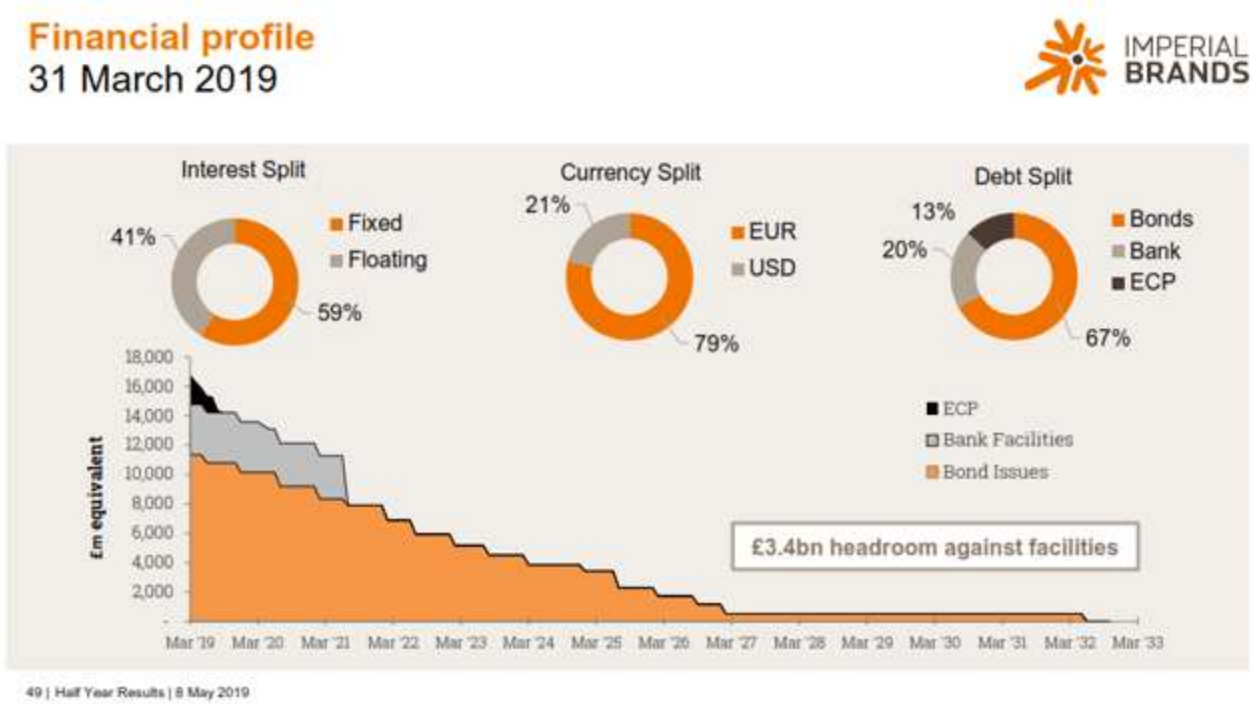
First, the markets in US will likely get a semblance of growth once the cause is discovered and a fix put in. Second, a key reason for drop-off in volumes in regular cigarettes was the switch to vaping. ***If vaping stops growing, we can expect regular cigarette smoking to decline more at historical rates. That is a decline rate that Imperial can easily offset with modest price hikes.*** Hence the big drop appears like an overreaction to us.

Financial Profile

When we look at the debt, we see that Imperial has reduced net debt rapidly after the acquisitions about 4 years ago.

Source: Imperial Brands

The company could reduce about $0.75 billion pounds of debt a year, assuming it does not hike the dividend further. Considering its debt maturity profile, we do not see this as an issue.



Source: Imperial Brands

Another key positive here is that almost half of its debt was floating and some of that should benefit from recent rate cuts. The combination of lower rates and debt payback will lower interest costs in 2020 versus 2019 as well .

One other set of fundamentals that we want to touch upon is the declining rates of smoking. These are the strongest in the US currently and Imperial by virtue of its global reach, is well-diversified and less vulnerable to the US market, which is shrinking rather briskly.

How is the Dividend Paid to Investors?

Imperial Brands pays the dividend in British Pounds but U.S. investors in the stock receive the dividend amounts in U.S. Dollars, converted on the payment date. Note that the yield will fluctuate a bit because of the currency exchange rate. They also pay 4 times a year .... They have paid 1 pound 93 pence and are on track to pay at least 2 Pounds 6 pence over the next 12 months. That is about $2.54 USD. At a price of $21.7 that is a 11.65% yield. Following the next two dividends, Imperial has guided for very slow dividend growth and we suspect it will use additional free cash flow for buybacks. We expect the dividend to continue to grow. In any case, the dividend as is represents a very good bargain and is well covered.

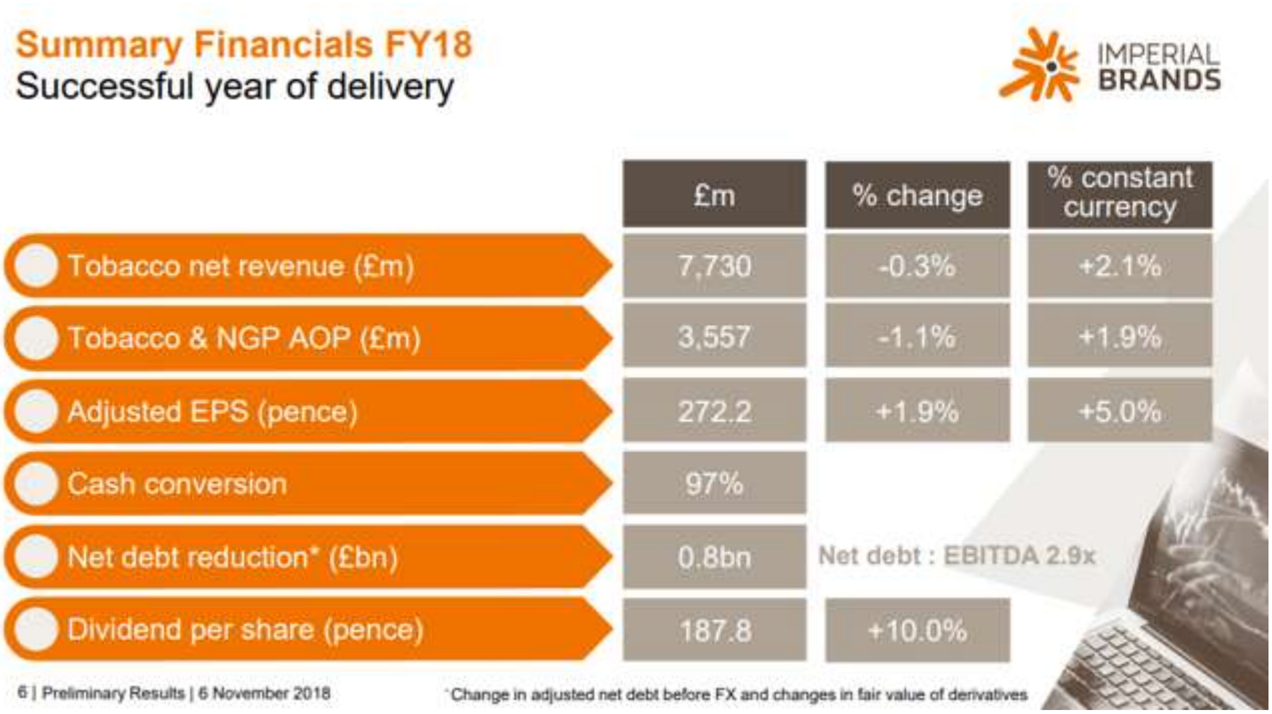
Taxation for U.S. Investors

One point we would like to emphasize here is that there are zero withholding taxes on British dividends from regular corporations. *...*

Conclusion

Imperial Brands is a dividend growth stock with an enormous yield and trades at under 7X earnings. The current issues on e-cigarettes are likely to actually lower decline rates on its key business. The company's global reach is a big plus and it is unlikely to be badly impacted by changes in any one specific country. The bulk of its debt is British pound-denominated debt as a hedge against a bad Brexit outcome. **The +11% dividend yield is**

covered by a huge margin. In 2018 Imperial had a sub 70% payout ratio based on earnings, or 142% dividend coverage!



Source: Imperial Brands

The current year earnings are likely to be higher but we think Imperial has lot of room to maneuver against any short term hiccups. Looking at the cash flow statement we can see that depreciation substantially exceeds capex.

£ million	2018	2017
Cash flows from operating activities		
Operating profit	2,407	2,278
Dividends received from investments accounted for under the equity method	25	28
Depreciation, amortisation and impairment	1,266	1,364
Profit on disposal of assets	(36)	(24)
Profit on disposal of brands	(40)	–
Post-employment benefits	(60)	(157)
Costs of employees' services compensated by share schemes	26	27
Provision in respect of loan to third parties	4	–
Movement in provisions	(87)	52
Operating cash flows before movement in working capital	3,505	3,568
Increase in inventories	(112)	(76)
(Increase)/decrease in trade and other receivables	(35)	189
Increase/(decrease) in trade and other payables	136	(46)
Movement in working capital	(11)	67
Tax paid	(407)	(570)
Net cash generated from operating activities	3,087	3,065
Cash flows from investing activities		
Interest received	10	11
Loan to joint ventures	–	(37)
Loan to third parties	28	(30)
Proceeds from sale of assets	87	30
Proceeds from the sale of brands	47	–
Purchase of property, plant and equipment	(259)	(191)

Source: Imperial Brands

Hence dividend coverage on a cash flow basis is even better than dividend coverage on an earnings basis. This level of cash flow coverage provides us with the cushion we want when investing in a segment that has concerns.

The pullback of 15% for this already very cheap stock last week is not justified and opens the door for a unique buying opportunity to earn an 11.6% for the long run. Opportunities like this don't come every day! ...