LUCRI ALPHA NEWSLETTER NR 28

12 JULY 2021

Dear Lucri friends,

We are witnessing the development of another strong agricultural year in the Overberg region. We are grateful.

On a personal note, I have just completed 126 one hour sessions at the feet of mentors Warren Buffett and Charlie Munger. I worked through the Berkshire Hathaway annual meetings from 1994 to present. Apart from the invaluable learning, one are also being treated to sharp humour – I can recommend it! The meetings are all available on YouTube, I used the "time-saver" versions.

Have you perhaps also noticed the following disappointing trend all across the world – there seems to be a strong inverse relationship between centralised power and the ethics, morals and character of the people at the top. It is so sad.

On a lighter note

Life through John's eyes…..

John: "I am not sure whether I ever want to get married."

John's friend: "Why?"

John: "I attended a wedding the other day, and the married couple was almost immediately disappointed."

John's friend: "How do you know that?"

John: "Well, they had a sign at the back of their car that was reading: Just married."

For my Afrikaans readers and those that can understand a bit of the language: The SABC will soon launch their brand new streaming service, by the name **Netniks**.

The wisdom that comes with age: "I changed my car hooter to gunshot sounds. People get out of the way much faster now."

It is now about 120 years after the Anglo-Boer war in South Africa. English and Afrikaans Boer farmers are farming next to each other in harmony. Koos van der Merwe and his neighbour, John Wilson, is a good example. Both of them recently faced the challenge that a prolonged drought brings – so Koos was in high spirits after a soaking rain. He noticed that the two dams of his neighbour were filled to the brim after the rain, so he mentioned to him: "You big dam fuul and you small dam fuul too!" Until today, he just cannot understand why he got a fat, blue eye that day. The English are so unpredictable!"

Now I believe you will get this one easily: "What do you call a man who stops a river?" "Adam."

Correction

Please refer to page 5 of newsletter 27:

Share count Indluplace: 3100

Price in cent: 399

There is no effect on the calculated value.

Quotes

"*Financial success is a soft skill. How you behave is more important than what you know."* Morgan Housel

"*Little by little, a little becomes a lot."* Tanzanian proverb. How true – invest regularly, with small amounts at a time.

"*Losing is a powerful management tool as long as it does not become a habit."* Alex Ferguson

"We constantly rub our own noses into our own mistakes." Charlie Munger

Learn from your mistakes – hopefully, one mistake in every area will be sufficient.

"Changing your mind means admitting that you were wrong. This is difficult, but investors should make a habit of admitting mistakes. Changing your mind based on new fundamental evidence is healthy, but changing your mind because the share price has influenced your mood can be fatal." Jacques Plaut

Lewis Group

In the January 2021 newsletter, I used a lot of airtime to sing the praises of the Lewis Group. So, a quick check on the progress of this company should be in order, I think. Over the first 9 months since they authorised the buy-back of up to 10% of their outstanding shares, they have completed the full buy-back. They also increased their annual dividend from 185 cents per share with 77% to 328 cents per share. Yes – as mentioned in January 2021, they again performed this without picking up any debt.

Not too many companies can afford to buy back 10% of themselves and increase their dividend by 77% per share in one year without getting into debt. They have now asked shareholders to provide them with permission (on a special virtual shareholders meeting) to buy back up to another 10% of the remaining shares, as the next annual meeting will only be on 22 October 2021 – they obviously signals that they want to keep on buying their own shares between now and then. (South African companies are only allowed to buy back a maximum of 20% of their own shares in one financial year.) Again, they are indicating that they plan to execute this from cash resources. Obviously, the more shares they buy back, the easier it becomes to increase the dividend on the remaining shares – this is a good example of the strong positive effects of concentrating the business interest of shareholders on each share that they have. You are getting a bigger share in the company without lifting a finger – how convenient and enjoyable.

For those of you that measures success mainly by looking at the share price (I normally try to convince you that price per share and value per share are two different things, and that a rising share price over a short time span is no indication that your analysis were correct) will be happy to learn that the share price of Lewis has reacted positively since January this year – the price is now 50% higher at R36, up from R24. The nett-nett value per share is now R43 compared to R40,66 in January – so the share price is closing in on the increasing nett-nett value. The Lucri quantitative model signals a value of R47 per share, and the net asset value per share increased from R61,26 in January to R68,14 now. So, the Lewis Group seems to grow fundamentally, and the share price is reflecting this. (At last, I may add – a quick look at the 5 year price trend of Lewis will signal to you that share price movement often demand patience).

Cash and the Lucri investment philosophy

Lucri has two main views on cash.

“Cash is trash”

Over the long term, this is 100% true. If you stay in cash for years, you will be taken to the cleaners due to inflation eating away your purchasing power.

“Cash is king”

Cash provides you with options. If you use your cash wisely towards exceptional investment opportunities (think Sasol at R22 in March 2020), you will find that cash can be extremely valuable over the short to medium term.

Super low interest rates

You may be aware of the fact that international interest rates have reached the lowest level almost ever (some put it at 5000 years) a few months ago. In the RSA, interest rates are the lowest in 50 years.

The combination of extremely low interest rates, accelerated printing of money, record high debt levels and the issuing of dollars for free to American citizens is creating a very serious situation in my opinion. Warren and Charlie said this promise to be like a good movie – we have not seen it before and we do not know how it will end. While I am normally optimistic in nature, I do not have a good feeling about this one.

Debt …the most serious of all global challenges

Please study the following numbers:

Global debt: $ 281 000 000 000 000 (12 zeros)

Global assets: $ 525 000 000 000 000 (12 zeros)

So, 53% of all the assets in the world is being based on debt!

Compare this to all the gold and silver: $ 4 700 000 000 000

Or compare it to the Bitcoin market capitalisation at its peak in April 2021: $ 1 100 000 000 000

Gross Global Product: $ 85 000 000 000 000 (this is the global version of the so-called GDP – Gross Domestic Product per country)

The global debt of all sovereign governments in the world combined is breaching 100% of the gross global product for the very first time in history at the moment. This is cause for concern. The rate of increase in debt to GDP at 30% and 28% for the USA and South Africa respectively is among the fastest in the world. While the debt to GDP ratio of the RSA is only about 60% of that of the USA, the ability of the RSA to pay the interest on their sovereign debt is much lower and weaker than that of the USA due to stagnant growth, a narrow tax base and much higher interest rates.

In this environment, the incentive to manipulate interest rates and inflation into opposite directions (interest rates lower and inflation higher) in South Africa is growing every day. This is called financial repression: It is a set of politics that result in negative real (after inflation) interest rates. The ultimate result of any such manipulation will be quite visible in the devaluation of the rand opposite a basket of so-called hard currencies like the dollar, British pound, euro and yen.

So, I have been looking for a reliable dividend machine that produces a slowly growing hard currency dividend stream, starting from a base (expressed as a % of share price) much higher than international interest rates. In rand terms, I expect the dividend stream to grow relatively faster if I am roughly correct in my reasoning above. The dividend must also be produced from productive assets all over the world, generating cash in almost all the global currencies to reduce location risk and generate a reliable hard currency dividend. The good news is – I believe I have found “the real thing” – and it is not Coke ☺.

Where there is smoke…there is a smoothly running dividend machine

Disclaimer: I am aware of the fact that some of the readers of the Lucri newsletter may have a moral or social issue with smoking. Thankfully, no-one in my immediate family unit are smokers. I am personally not in support of the smoking habit.

The lockdown of 2020 opened my eyes to the extremely strong business franchises of the large tobacco companies. I saw that smokers are prepared to pay 150% to 200% more to indulge in this habit – and still regard it as a bargain. When British American Tobacco (ticker symbol BTI) continued to pay their usual quarterly dividend in the middle of the hard lockdown while 90% of their market share has disappeared in South Africa, the international scope of the company and their robustness hit home. They reported that their growth rate will reduce by about 1% due to the lockdowns across the globe. Surely, in February 2021, they announced an increased dividend in British Pounds – after their market volume had been reduced by two factors: The hard lockdowns as well as a gradual reduction in the smoking habit worldwide.

Please cast your eye over the last 21 years of BTI dividends per share in British Pound and converted into Rand:

Year	Dividend per share	Rand to Pound exchange rate	Dividend per share
	British Pound		Rand
2001	0.29	10.25	2.97
2002	0.32	12.81	4.10
2003	0.352	16.38	5.76
2004	0.388	11.81	4.58
2005	0.419	11.85	4.97
2006	0.47	11.65	5.48
2007	0.559	13.88	7.76
2008	0.662	14.59	9.66
2009	0.837	14.49	12.13
2010	0.995	12.95	12.89
2011	1.142	11.39	13
2012	1.265	11.02	13.94
2013	1.349	13.10	17.67
2014	1.424	15	21.36
2015	1.48	17.97	26.59
2016	1.54	21.32	32.83
2017	1.69	16.32	27.58
2018	1.95	16.49	32.16
2019	2.03	19.04	38.65
2020	2.104	20.11	42.31
2021	2.156	20.47	44.13

This obviously reflects the performance of a true dividend machine – remember, the dividend is being declared in British Pounds. The rand dividend is volatile due to the volatility in the pound to rand exchange rate, but the pound dividend is smooth and instils confidence, right through difficult economic periods like the bursting of the dotcom bubble, the credit crunch in 2008 and Covid in 2020 and 2021. BTI will most probably become a dividend aristocrat in 2025 with 25 years of continual growth in dividend per share.

It is also very important to note that you can buy into this dividend stream at a low price currently – for a value investor like Lucri, it is important to get more value than you pay for. I shall shortly discuss the fundamental quality of the company, as this is also of extreme importance. For now, you should take note of the fact that the starting point of this growing dividend stream is currently available at about 7.7% - it is indeed very rare and special to buy a growing future cash flow stream in hard currency at this starting point. So, there surely are good reasons why investors tend to shy away from BTI as an investment – and no, in most cases it is not due to their moral or social concern with the health risks associated with a tobacco company. I believe they are scared of the shrinking market volume.

BTI – where moat meets value

Basically, companies can be divided into 4 categories based on whether they have a high or low relative market share, and whether their market has a high or low growth rate.

A company with a high market share in a fast growing market is called a “star”. These companies often cost a pretty penny – consider Tesla who can be seen as a star in the EV market. I believe Lucri friends should also stay away from the “dogs” (low market share in low growth market) and “question marks” (low market share in high growth market).

Value investors may find great deals in the so-called “cash cow” quadrant – namely a high market share in a low growth market. BTI is the largest listed tobacco company in the world based on revenue. So, it has a large market share – both in the developed and developing world. The tobacco market is boring with low to negative growth. While the tobacco market is experiencing a decline in volume, the pricing power is massive – resulting in a slowly growing market on a revenue basis. The tobacco industry does not have any appeal – with many cash cow companies trading at great prices.

The tobacco industry has high barriers to entry due to head winds caused by legislation. The industry has consolidated into an oligopoly where just a few players hold the majority of the market share. The big players have the best products (due to massive research spending) and the strong brand names – they also have the money to buy the little guys that try to compete. Low competition in general due to the shrinking market volume and negative sentiment leads to abnormally high gross margins – which is also an indication that the few large players have no interest in any pricing wars – they do not lower prices in order to gain market share. The tobacco industry is non-cyclical – as the industry sells addictive products (this is an uncomfortable, inconvenient truth). Due to the addictive nature, tobacco companies have stable earnings and stable cash flows.

While BTI does not grow their balance sheet, they are very generous on dividends with a safe cover ratio between free cash flow and dividend pay-out.

Strong points emerging from BTI fundamental analysis

- BTI is priced for negative growth – but low growth of about 3% is possible (BTI management aims for 7% growth)
- The current BTI PE ratio of about 8 times is the lowest PE ratio in 20 years
- BTI is in its second worst bear market in 34 years – it is in a 52% bear market.
- In the last 34 years, a $1000 investment into BTI yielded $ 81 170
- In the last 34 years, the Vanguard 500 index yielded $ 37 904 from a $1000
- In spite of this, the S & P 500 is currently over valued while BTI is under valued
- Looking at how the bond investors rate BTI: The longest duration bond of BTI matures in Nov 2055 and yields 3.8% to maturity. Clearly, bond holders believe BTI will have stable cash flows for the next 35 years.

- After the Reynolds Tobacco take-over in North America, BTI had an unhealthy ratio of debt to EBITDA and a low interest coverage. In 2020, the debt to EBITDA reduced to 3.6 times, with targets of 3.3 times in 2021 and 3 times in 2022. The interest cover improved to 6.7 times in 2020, with targets of 7.5 times in 2021 and 8.3 times in 2022. Both debt to EBITDA and interest cover is targeted to reach safe levels by the end of 2022. A re-rating of the BTI stock price is therefore highly likely in 2022.

So, in a world where people bemoan a lack of safe yield BTI yields 7.7% and has a 21 year dividend growth streak. It is an anti-bubble, anti-fragile blue chip bargain in my view. This is the typical “fat pitch” investment that Warren Buffett refers to – according to him: “when you find a fat pitch, swing for the fences!”

Jerry Rice also had some wise words: “Today I buy what others won’t, so tomorrow I earn returns others don’t.”

Questions to be kept in mind towards risk quantification:

- Will BTI de-leverage fast enough to counter the reduction in smoking worldwide?
- Will BTI be able to keep the current dividend intact without market volume growth? A positive answer (this is my view) will already indicate value in the share – as the current price signals a dividend reduction into the future.
- Will the BTI profitability be sustained high enough to buy back shares after de-leveraging? Will the buyback be at a faster rate than the market volume reduction, to ensure a growing market volume per each share outstanding? Yes, given low competition and high profitability, a growing market volume per share can be achieved in a shrinking market – most investors will not realise this.

I am including these questions, to indicate that an investor should perform deep fundamental analysis on all known factors.

Now, how would you like to receive the BTI investment totally for free as part of an investment portfolio where you only pay for the non-BTI portion of the portfolio? Yes, this opportunity is available right now – you can also see this opportunity as investing into a managed portfolio at a significant **negative** management fee – these guys are working for you, but they do not charge you a cent – in fact, the BTI dividend acts like a negative fee. Curious? Newsletter 29 will reveal the secret.

Lucri housekeeping

Please always remember to tell me via SMS, WhatsApp or e-mail when you move cash in or out of your account.

All Lucri communication is only via e-mail. If you send an e-mail to streicher.simonj@gmail.com, I promise to answer in a few days.

Kind regards and BTI investing,

Simon Streicher