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Can these income stalwarts keep up with their payments?

Tobacco and insurance have been long-term safe havens for income investors. Two leading lights in these sectors, Imperial Brands and Legal & General, are favourites in the equity income space, but can their high payouts be sustained? One faces structural industry shifts and has cut its dividend already in favour of lowering debt and the other seems to prefer to build a more defensive balance sheet at the expense of dividend distribution. While both still offer well above market average yields, scope to expand income and stand on substantially sub-market P/E ratios, investors in both may struggle to make a total return greater than the yield alone.

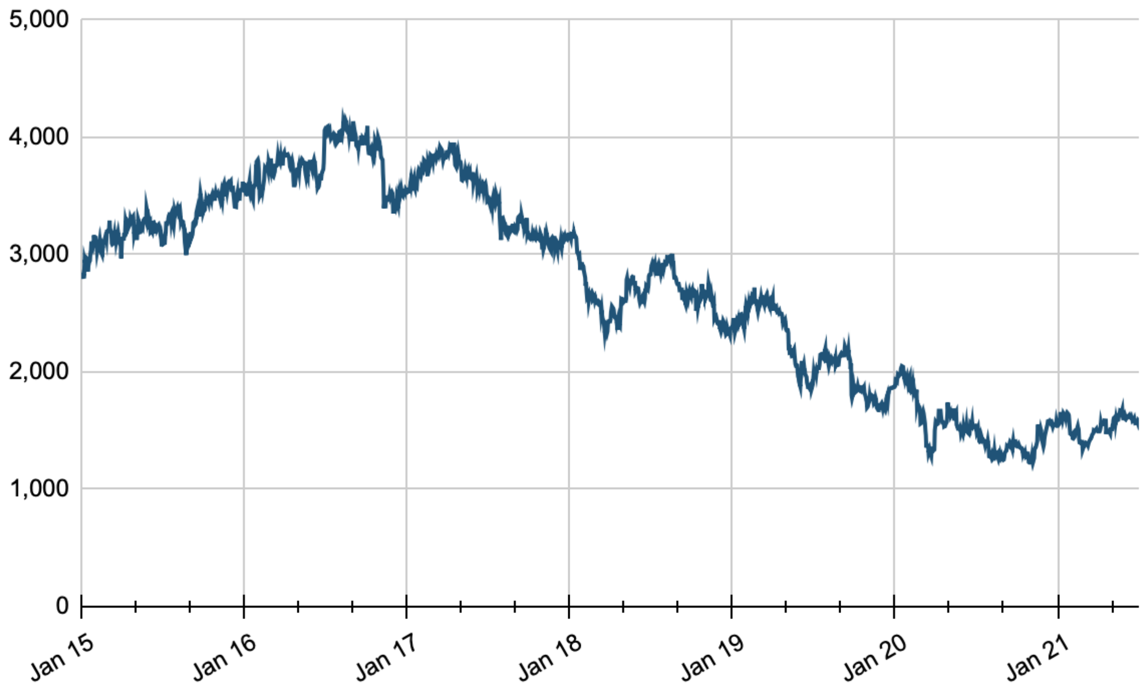
Looking at the long-term case for two FTSE 100 income stalwarts:

- **Imperial Brands (IMB)** – as the global number four in tobacco, Imperial looks to be lagging a little behind the industry's 'big three' in managing a changing market environment. New generation products are seen as the key driver in tobacco, but the competition looks to be a long way ahead. The once seemingly very safe and well-funded dividend was cut in 2020 in order to help reduce debt – income investors are not used to taking second place in this industry's priorities. Was this the first of many cuts or can investors now begin to believe that positive total returns are available again?

- **Legal & General Group (LGEN)** has evolved from an insurer into a retirement-oriented, broader financial services business. This gives it access to large pools of potential future business, although its key market in pension risk transfer looks likely to struggle for long-term growth being finite and limited. The income profile here has been impressive, but the board has lowered dividend growth aspirations and has made cash and surplus generation higher priority. The dividend looks safe, but less enticing than it was historically. However, the share price may break out, having moved essentially nowhere in the past six years.

Analyst: **Robin Hardy**

Imperial Brands – smoke signals



Source: FactSet

Imperial Brands (IMB), the owner of tobacco brands such as Gaulois, John Player, Rizla and Lambert & Butler, has long been a staple for income investors. The smokers' market is undergoing structural change as alternatives replace tobacco and illicit sales are rising, while regulation and taxation remain onerous. After a profit warning and a hefty dividend cut in 2020, can investors still rely on this stock for income?

One might be forgiven for thinking that smoking tobacco is dying out rapidly, with healthier lifestyles, nicotine patches/gum/etc and the seemingly ubiquitous vaping causing smoking to wither. Not so. Globally, the prevalence of smoking has dropped from 28 per cent in 1990 to just under 20 per cent today, but as the world population rises, there are estimated to be 12 per cent more smokers today than 30 years ago at around 1.125 billion globally (The Lancet). Cigarette unit sales are falling, but slowly – from a peak in 2009 of 5.88 trn, but still total 5.2 trn. The market value of cigarettes sold is rising again (showing first ever declines in 2014 to 2016) as premium brands take market share and manufacturers push prices.

So traditional factory-made cigarettes (FMC) still look to have substantial demand and as Chart 1 below shows, Imperial estimates that sales in 2025 globally would have increased from last year's £78bn to £87bn (excluding taxes/duties), still exhibiting 2 per cent CAGR. This assumes steady regulatory frameworks, but that is an area of persistent risk.

The focus amongst all tobacco companies is to lower reliance on traditional cigarette sales through the continued development of the so-called New Generation smoking products (NGP). The most well-known area is vaping or e-cigarettes, although this is not the largest market segment. Heated tobacco (where normal tobacco is heated to 300°C rather than the 500°C combustion temperature – nicotine release, less smoke, less toxins) is a larger and faster growing market. NGPs account for around 14 per cent of industry sales today and this share is expected to almost double in the next five years.

Imperial is present in the vapour market with its 'Blu' brand, but its heated tobacco product 'Pulze' is still largely at the R&D/testing stage. In both product markets, there are large, well-established market positions held by the 'big three' tobacco companies – RJ Reynolds, BAT and Altria (Philip Morris) – which could make meaningful headway more difficult for Imperial. However, at its most recent capital markets day (November 2020), the board laid out plans to deliver group annual revenue growth of 1-2 per cent through to 2025 and earnings before interest and taxes (Ebit) growth of 5-6 per cent. This is to come in part from cost savings, but primarily through growth in NGPs.

While NGPs might be seen as safer alternatives to traditional smoking, they are not without health risks, and various health agencies have hardened regulation. Vaping is still illegal in Australia, for example, the FDA recently banned various vapour flavours (those more likely to attract young users) and also grudgingly allowed heated tobacco products to be sold, while stating robustly that it saw the product overall as 'not safe'. The flavours ban was the primary cause of Imperial's 2020 profit warning, so a strategy built on NGPs is not without risk.

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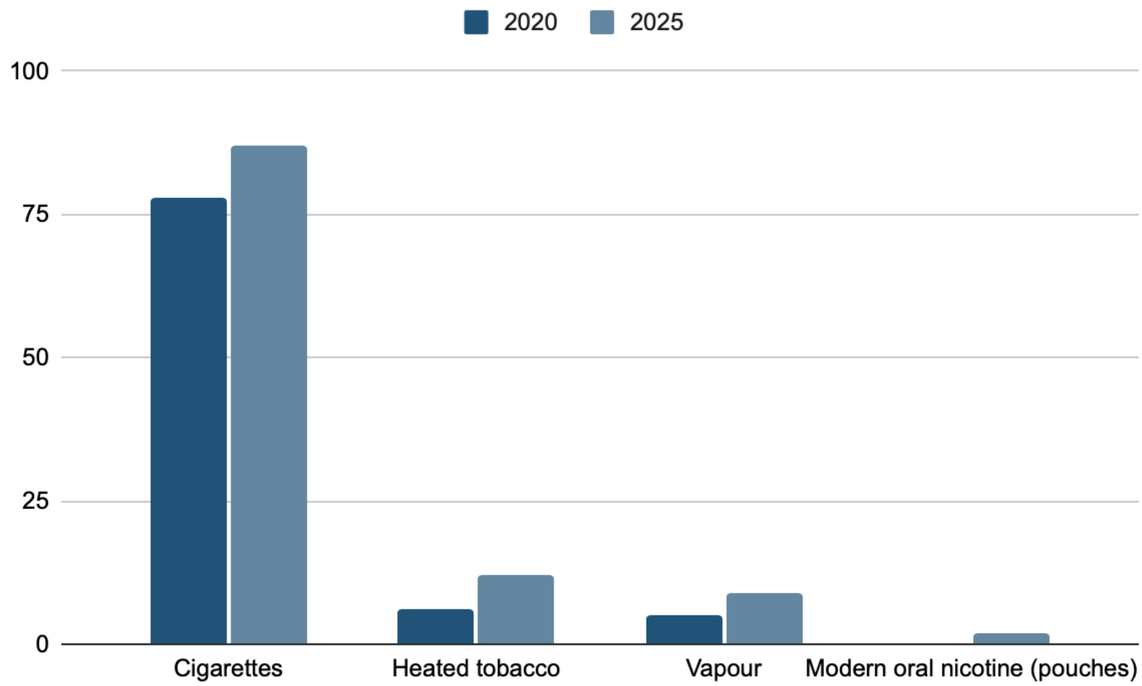
Chart 1: Global sales of cigarettes and NGPs - £bn



Source: Imperial Brands

For national governments, regulation of smoking *et al* is a thorny issue with high tax revenues and, especially in the US as a grower, significant employment, needing to be balanced against healthcare costs and lost worker days through illness. Globally, smoking alone generates around £450bn in tax and duties per annum. For this reason regulation is not likely to be allowed to cause significant harm to the industry, but could still throw obstacles into its path and make growth ambitions harder to achieve.

So, the market fundamentals appear reasonably sound and we know that smoking is both a defensive market (smokers still find it very hard to quit) and exhibits a high level of price inelasticity, but our main question is whether Imperial can and will sustain its dividend? It seems unlikely today that profits or cash flow will shrink materially at a market level and the internal improvements now in hand are expected to keep revenues and profits inching ahead. The dividend is still very affordable, consuming comfortably less than half of the group's free cash flow.

The question does need to be asked, however, because Imperial has already cut or euphemistically 'rebased' its dividend in FY2020 to 137p (historic >200p) primarily to reduce debt. At the end of FY2020, gearing was 245 per cent and debt-to-Ebitda (earnings before interest, tax, depreciation and amortisation) was similarly high at 2.6x – net debt totalled £10.2bn. The target debt ratio is around 2.1x Ebitda, indicating net debt of nearer £7.5bn: the dividend savings total some £650m per annum. The debt target, all things remaining equal, should be achievable without cutting the dividend any further.

One problem with investing in tobacco stocks in the past five years has been that while the income was high (average yield since 2016 for Imperial has been 7.9 per cent and peaked at >17 per cent), the total return has been negative as the share price dropped by an average 15.2 per cent per annum – this decline coincided with the start of more aggressive moves against tobacco by the FDA in the US and similar moves globally. That long-term share price decline was finally arrested in 2020 when the dividend was cut and the operational strategy was re-oriented towards NGPs, operational simplification, cost cutting and debt reduction.

If these actions can at least stabilise the share price, the draw of the shares changes with the total return turning positive again, as it was from 2000 through to 2016, with a slight hiccup during the 2007-09 financial crisis. The shares appear very cheap on a P/E basis with the stock trading at 6.5x (notably lower than the yield at 8.8 per cent), almost one-third of the UK market average. This is lower than the sector's global leaders, but does feel right given the weaker position in NGPs, the high debt, the dividend cut and Imperial's smaller scale. That low P/E can feel something of a value trap and investors interested in this stock should concentrate on the dividend as their main driver of total return. Despite the low rating, a bid feels unlikely due to competition concentration issues and returns from this industry along with regulatory risk are not attractive enough for private equity investors.

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Legal & General – ambitions versus obligations

Source: FactSet

Despite being listed in the UK alongside multi-line insurance companies, **Legal & General (L&G)** is today a retirement-oriented financial services business with the main thrust of its operations in the slightly obscure field of Pension Risk Transfer (PRT): this is where insurance meets asset management. PRT is where a company that still runs a defined benefit (DB) or final salary pension scheme (the 'sponsor') wishes to de-risk its obligations or fully remove the pension scheme from its own balance sheet and cash flows as they are increasingly seen as a burden.

Why are DB pension schemes a problem to sponsors? While almost all DB schemes are closed to new members and no longer have to deal with new contributions, the payment commitments to existing members are still large and somewhat unknown. While the salary level that sets the pension payment is known there are unknowns, primarily how long the pensioner will live, how well the pension scheme assets will perform to fund payments and how high high inflation will be (as most DB payments are indexed).

Many DB pensions are also under-funded (they cannot easily meet their expected payments over time) and the sponsor is likely to need to top up the fund to re-balance it. This can be expensive and pension fund trustees hold a lot of sway in ensuring these corrective payments are made. They can insist, for example, that a dividend is not increased or share buy-back delayed until a pension fund deficit is addressed. A large hole in a pension fund can also harm credit ratings, making debt interest rates higher, prevent a business from being taken over or depress its valuation.

Another pressing issue for DB schemes is how to ensure adequate funding at a time of ultra-low interest rates and balance risk. A large and regulated proportion of pension fund investment must be in low-risk (bonds) or risk-free (sovereign debt) debt instruments with debt maturities matched to the profile of pension payments. If bond yields remain as low as they are today, some previously seemingly well-funded pension funds may have to top up.

So, running a pension scheme has become a more substantial and unwanted burden for many sponsors who want to be rid of their obligations – this is where PRT steps in. A provider such as L&G agrees to assume the risk and long-term management of the pension scheme in exchange for a substantial premium or fee and the right to manage the accrued pension fund assets.

The PRT provider works with the sponsor and pension trustees to construct the most acceptable solution for shifting the risk off the company balance sheet. While solvent, the sponsor cannot simply terminate a scheme or substantially reduce benefits and must present a revised pension structure that best protects members' retirement incomes. That can be anything from a complete status quo with lifetime payments assured as existing, right through to buying out all members with a lump sum requiring them to transfer to a self-invested personal pension (Sipp) or equivalent. Why would L&G want to take on these risky, potentially ultra-long-term commitments when sponsors are in a rush to exit and there is poorer visibility of how schemes can easily plan for adequate returns when bond market yields are so low?

Two key issues play out here. Firstly, the scheme sponsor almost certainly faces higher contributions and funding if it sticks with a typical, low-risk pension provider and faces an increasingly expensive-to-manage long tail as the number of active scheme members declines over time. Secondly, L&G has some greater freedom (always in agreement with the trustees) in that it can shift the pension scheme's risk profile a little and seek higher returns. Regulations on risk profile and liability matching remain, but through its Capital Investment arm, for example, it can invest in better returning areas such as alternative energy or built-for-rent housing. Its bond portfolio can also be more skewed towards corporate bonds than sovereign (around one-third of the bond portfolio is corporate BBB rated) and be more international (only around half is invested in UK-issued bonds). Taken with the often substantial premiums paid to take over the liability, this allows L&G to see a way to both meet the pension obligations and potentially make a surplus return.

PRT is a potentially immense source of business for L&G. The market size by 2025 is estimated to be some £415bn in the UK alone and the US market (less mature and where L&G's market share is only 4 per cent) could be worth another $150bn. However, a problem here is that the PRT market is finite. New schemes are not being created, L&G already has 25 per cent of the UK market, other providers are equally active/ambitious and L&G's own plan is to take another 12-15 per cent of the remaining pool of DB schemes under its wing in the next five years. The pool risks being drained quickly. PRT is 45 per cent to 50 per cent of L&G's total normalised Ebit and if the capital investment arm is included (this is primarily fed by risk diversification from PRT funds), it moves nearer to 60 per cent. The other arms of the business are solid, but generally slower growing (CAGR for general insurance has been 3 per cent and for asset management 2 per cent – together these account for c.30 per cent of group Ebit) rendering them unlikely to provide cover for PRT when it ultimately starts to lose momentum.

Retail retirement products (13 per cent of Ebit) have been fast growing, but annuities look to be less popular with growing pension freedoms and lifetime mortgages (equity release) being a star performer – the risks here are becoming more fully appreciated by customers. Even at today's lower equity release interest rates of around 3.5 per cent, the compounding effect is significant and risks destroying family inheritances. General asset management is another huge pool of potential with global personal wealth available for the industry to manage estimated at $140trn-$150trn – while an asset manager may only collect a fee of 1 per cent in an individual savings account (Isa) or international equivalent, investment risk sits with the investor making potential earnings from this area of business high quality. Advised investment is more lucrative but carries risk. L&G has less than a 2 per cent market share of global assets under management (AUM) but the field here, unlike PRT, is crowded and competitive.

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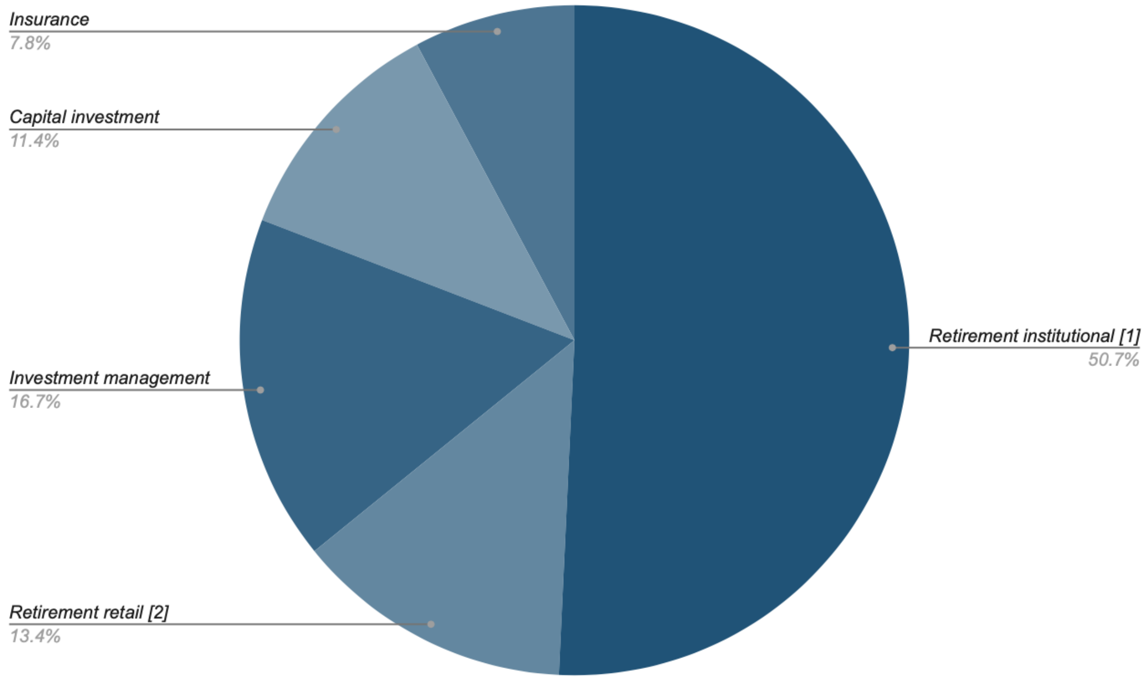
Chart 2: Breakdown of L&G's Ebit by discipline



Source: Legal & General [1] Primarily PRT [2] Annuities and Lifetime mortgages

So overall, the trading environment looks solid for the time being across L&G, although there are some caveats looking further out, but what of the dividend? L&G has been a key income stock for many years and, in addition to an attractive initial yield, dividend growth had been high with a 10-year CAGR of 14 per cent. Dividend growth has slowed recently and, significantly, the board's attitude towards it has changed. There is now a lower dividend growth target (3-6 per cent CAGR) with a drive to ensure that cash generation and the building of surpluses grow faster and are a higher priority, in order to make the balance sheet more defensive: this must lower the income attraction a little. Still with an initial yield of over 6.5 per cent and a seemingly robust business outlook, L&G should retain its appeal to income-oriented investors.

Although the yield has been high here, this has been almost the entirety of the total shareholder return – the share price today is almost exactly where it was at the beginning of 2015. That is despite delivering 12 per cent compound EPS growth, and close to double that in PRT and lifetime mortgages. PRT is a finite source of growth and does present as yet unknown long-term risks, but at almost twice the market average yield and well below half the average P/E, those risks seem fairly well reflected. The shares may finally stop being range-bound and enable a strong total return to be made.

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