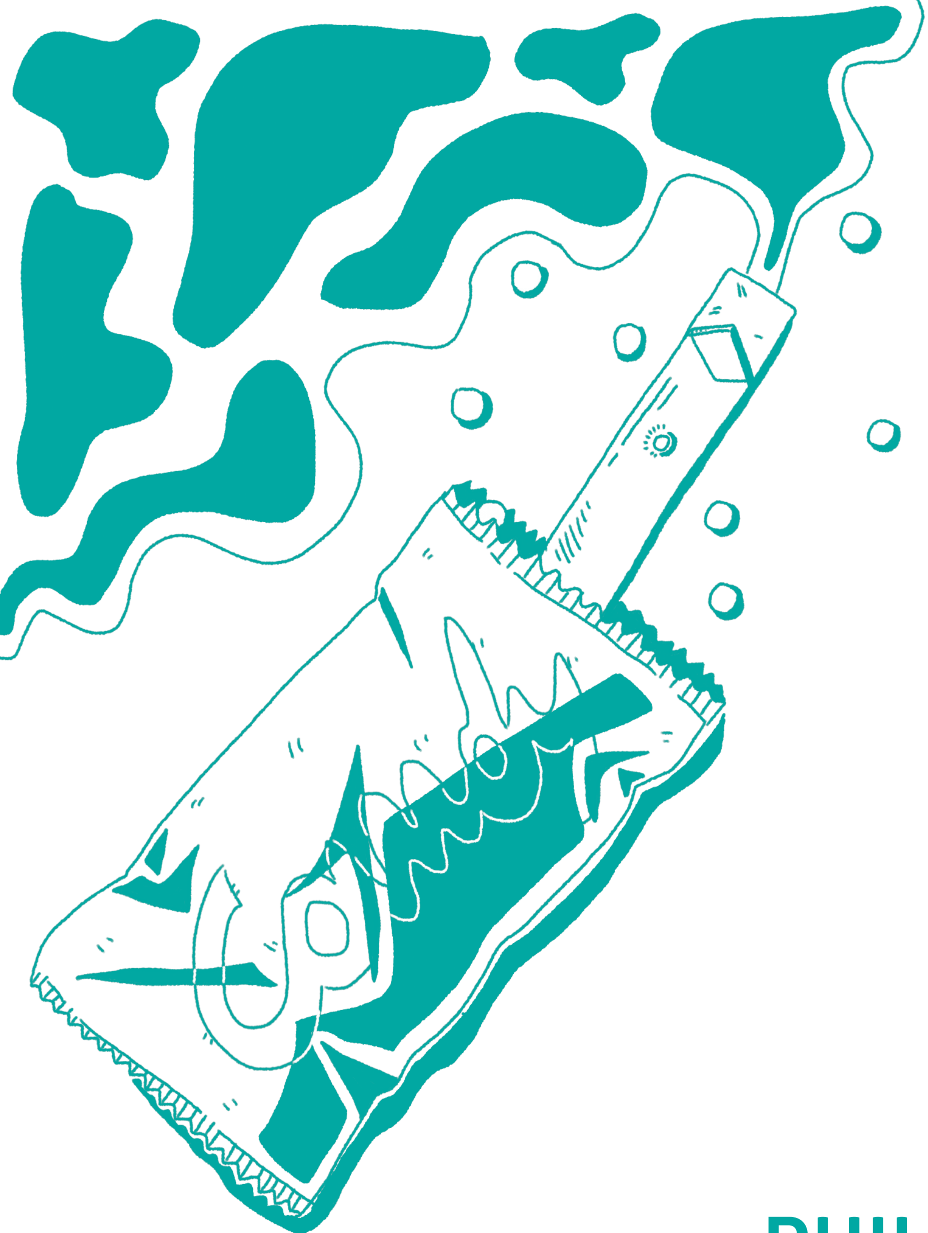

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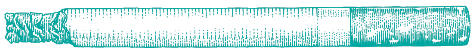
# PHILIP MORRIS ALTRIA MERGER?

## Fool Me Twice, Shame on Me

Authored by Blaine Townsend, CIMA®, CIMC® | September 2019



In the beginning, socially responsible investment firms (SRI/ESG) avoided Big Tobacco because the product was damaging to individuals and society, and the industry's targeting of the poor and young was seen as beyond the pale. It was a moral stand. By the 1990s, this sentiment began to trickle up to institutional investors. In April of 1996, the American Medical Association began pushing professional investors to divest, calling tobacco a "ruinous and enslaving product that has brought misery, disease, anguish, and death."[1] Ten years later, the U.S. Department of Justice (DOJ) concurred. In the landmark *United States v. Philip Morris* case, the DOJ ruled that Big Tobacco committed deliberate fraud against consumers for fifty years. So while some on Wall Street are still rooting to see Philip Morris (PM) and Altria (MO) reunite to control the global e-cigarette and cannabis markets, it may be good to remember why the company split in the first place. Some things may be better left alone.

Philip Morris and Altria split in 2008 facing a tsunami of legal and public scrutiny. The thinking at the time was to concentrate the overseas tobacco market under Philip Morris and the more diversified domestic business under a new brand name Altria (which carried less baggage). The move may have succeeded in providing some cover for Altria in the court of public opinion. In the actual courts, not so much. Philip Morris and Altria were two of 11 defendants in *United States v. Philip Morris*. In the case, U.S. District Court Judge Judith Kessler found the 11 companies in violation of civil racketeering laws (RICO). In the tome-like ruling opinion, Judge Kessler detailed how tobacco companies "marketed and sold their lethal products with zeal, with deception, with a single-minded focus on their financial success, and without regard for the human tragedy or social costs that success exacted."[2]

A RICO case? To the average American, RICO cases were something you heard about only in mob movies. To SRI/ESG investors, there was nothing novel about the ruling. They had already decided the industry's pattern of behavior was unacceptable. It also wasn't subtle. The DOJ concluded that Big Tobacco: (1) misled the public about the risks of smoking, (2) misled the public about the danger of secondhand smoke, (3) misrepresented the addictiveness of nicotine, (4) manipulated the nicotine delivery of cigarettes, (5) deceptively marketed cigarettes characterized as "light" or "low tar," while knowing that those cigarettes were at least as hazardous as full-flavored cigarettes, (6) targeted the youth market, and (7) did not produce safer cigarettes.[3] For SRI/ESG investors, cash flow and the defensive nature of the stocks were never enough to entice them. Following the ruling, there was a capitulation by institutional investors as well. Five decades of fraud and societal harm was apparently enough to justify divestment from tobacco.

## A Memory Lapse on Wall Street?

Against this historical backdrop, it is somewhat stunning to see Wall Street's reaction to the proposed reassembly of PM and MO. When the merger was announced in early September, there was considerable talk about the strategic drivers for the merger but few cautionary tales about the past behavior. Bloomberg said the merger would create "…a more geographically diverse and product-rich tobacco company, a deeper-resourced competitor in the vapor-device market and an entity better able to exploit legal cannabis market opportunities worldwide.[4] So basically, a combined entity would be back in charge of not only tobacco but also vaping and cannabis. There was little talk about the proven pattern of lying about the health risks of products, fraud and marketing a highly addictive product to minors (both of which were heavily detailed in the U.S. case.)

## Teen Tobacco Usage Skyrockets

It is understandable why the proposed mega merger had piqued investors' interest. Combining tobacco's historically defensive nature as an investment with the growth potential of vaping and cannabis, the synergies are obvious. Nevertheless, it was the skeptics on Main Street that won the temporary stay in the merger talks. Vaping in particular is perceived as a rapidly growing problem with teens and minors. Just when teen smoking had been driven to a historic low in the decade following the ruling,[5] vaping or e-cigarette smoking rose 900% among teens between 2011 and 2015.[6]

The increase in teen use stands to reason. Nicotine is highly addictive and vaping does not produce the smoke that adults and others find distasteful. They are also cheaper than cigarettes and are often flavored like candy. For example, companies like Juul have e-cigarettes that taste like apple pie and watermelon. Vaping companies also reportedly targeted juveniles by paying social media influencers to promote the popular product as less harmful than traditional smoking. Unfortunately, the industry was largely unregulated during the early 2000s.[7] The FDA's "deeming rule," which kicked off formal regulation of the industry, didn't even go into effect until August of 2016.[8]

With the vaping epidemic now a true crisis, the FDA is getting more aggressive. Shortly after the proposed merger, the Food and Drug Administration (FDA) issued a warning letter to Juul about their deceptive marketing practices to juveniles. Sound familiar? Indeed, the marketing of vaping e-cigarettes bears all the hallmarks of Big Tobacco's heyday, and the FDA letter is like an echo of the 2006 ruling against Big Tobacco. In the letter, the FDA accused Juul of misrepresenting the additive aspect of vaping to teens.[9] Altria owns a 35% stake in Juul.

**1 in 13**

According to the CDC, "if smoking continues at the current rate among U.S. youth, 5.6 million of today's Americans younger than 18 years of age are expected to die prematurely from a smoking-related illness. This represents about one in every 13 Americans aged 17 years or younger who are alive today."[17]

## Cannabis May be a Driving Merger Force

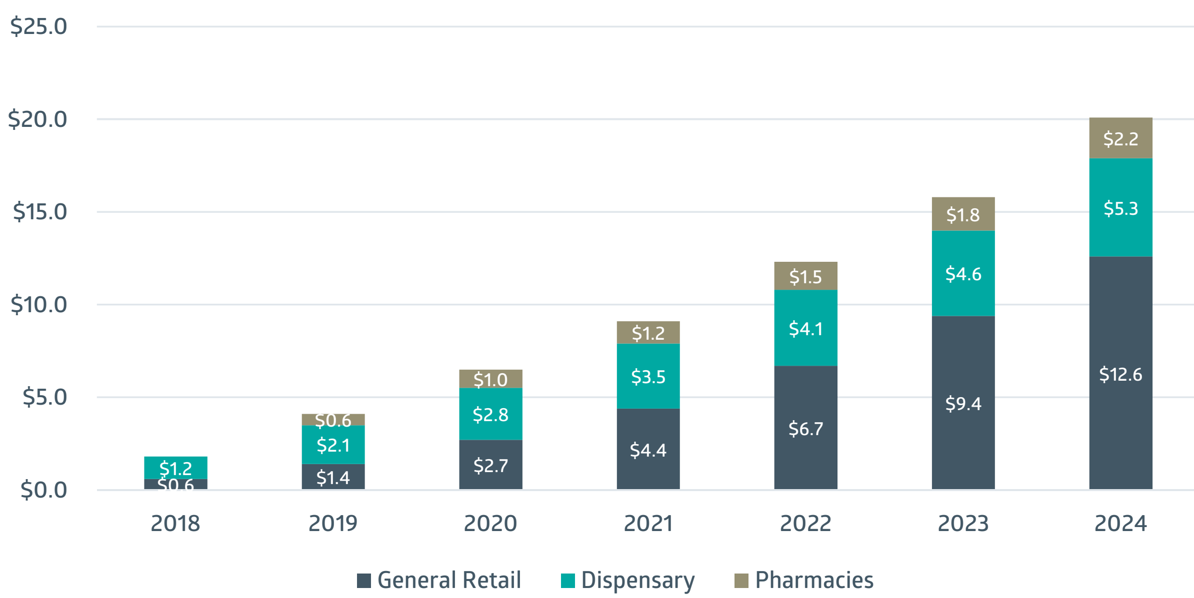
The Trump administration has now joined the fray specifically targeting flavored e-cigarettes. This may make the Philip Morris electronic cigarette technology (IQOS) used overseas a hedge against changes in how vaping may be regulated in the U.S. However, even with vaping sales worldwide expected to grow 8% per year annually,[10] cannabis may be the real attraction for the combined entity. Altria also owns a 45% stake in the Canadian cannabis company Cronos, so the combined entity would have a global footprint in tobacco, vaping and cannabis.

Canada is the first of the G7 countries to have legalized marijuana on the Federal level. In the United States, 11 states have legalized recreational cannabis and 33 have legalized medical marijuana.[11] It is widely expected that other G7 countries may follow Canada's lead to legalize cannabis on the Federal level.

As a result of the legalization of cannabis over the past decade, there has been a rapidly growing market for non-psychotropic cannabidol-related products (CBD). Although the jury is still out on the societal effects of legalized recreational cannabis (the apt comparison would be in relation to alcohol or tobacco), CBD compounds are widely available to address everything from pain relief and anxiety to insomnia and epilepsy.[12] Unlike tobacco, there may in fact be real medical uses for cannabis. The research on that front, however, has been severely limited by the federal classification of cannabis as a Schedule I controlled substance. If the federal classification changes and real medical breakthroughs follow, the market for cannabis could grow exponentially and the combined PM/MO entity would be well-positioned internationally.

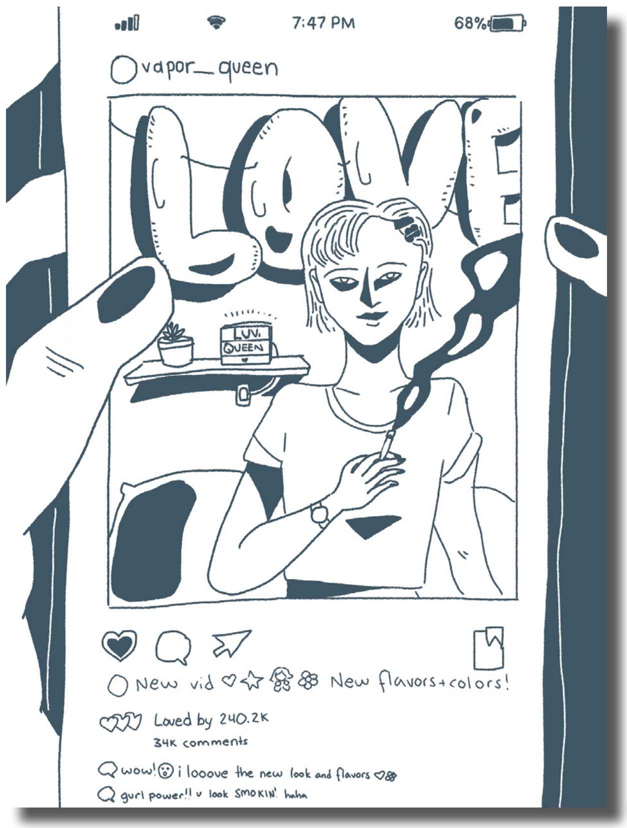
While concerns over vaping may have derailed the merger talks for now, the larger question is whether Big Tobacco is the right steward for an industry like cannabis with potential medicinal benefits. Despite the pause in the merger talks, many believe the possibility still looms. As it stands now, labeling of CBD products is a real issue.[13] The lack of accurate dose or side effect information and false claims are hurting the credibility of the industry. No one has ever accused Big Tobacco of providing clear and honest

**U.S. CBD SALES BY CHANNEL ($ BILLIONS, 2019 - 2024 ESTIMATED)**




*Source: Arcview Market Research/BDS Analytics, Bloomberg.*

information about their products to the public. In fact, the 2006 ruling was supposed to force Big Tobacco to make “corrective statements” on their packaging, on websites, on TV and in newspapers to make up for half a century of misinformation. Those statements did not start to appear until a District Court ruling in 2018 finally killed the nearly decade-long, aggressive appeals process by the industry.




Make no mistake, Big Tobacco was dead-set on watering down those corrective statements.[14] Sadly, by the time the court order finally forced the companies to make the corrective statements, the principle targets of those ads — young people — had stopped watching TV or reading newspapers.[15] They had moved on to social media, which was pushing vaping and e-cigarettes as a “safe” alternative to cigarettes.

In the U.S., the tobacco industry spends close to $9 billion per year promoting their products. The industry also employs over 11,000 people nationwide. This may sound positive, but the net contribution to the gross national product (GDP) looks a bit worse. Society ends up with nearly 400,000 tobacco-related deaths per year with a $300 billion burden absorbed by the health care system and businesses related to tobacco use.[16] Those costs are not captured in the rose-colored-glass alchemy that is GDP accounting.

If vaping and e-cigarettes become the domain of the tobacco industry, the industry’s track record suggests that a heavy dose of regulation will need to follow or this catastrophic economic and health pattern will be repeated. If medicinal cannabis and CBD are proven to have real potential and efficacy combatting illness, pain and anxiety, you need an ecosystem with public trust — not Big Tobacco — to oversee its adoption. So while putting vaping, cannabis and tobacco under one global, mega-cap corporate roof might seem like a promising future to some investors, history might suggest otherwise. For now, at least, the companies are taking a break on the merger talks. Stay tuned. Smoke ‘em if you got ‘em.

*Only you know how I loathe, Tobacco Road.*

— John D. Loudermilk, “Tobacco Road”

## ABOUT THE AUTHOR

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Blaine serves as a Senior Vice President and the Director of Bailard Wealth Management's Sustainable, Responsible and Impact Investing (SRII) group. Blaine is on both Bailard's fundamental and SRII investment committees, conducts social research, oversees corporate engagement efforts and maintains client relationships.

Blaine began researching and writing about corporate social responsibility in the late 1980s. He started his career in Socially Responsible Investing in 1991 at the Muir Investment Trust, the nation's first environmentally screened bond fund. In 1996, he opened the California office for Trillium Asset Management, which he led for thirteen years. While at Trillium, Blaine managed socially responsible and sustainably focused portfolios, served on the firm's investment committee and worked on corporate engagement efforts on a host of social and environmental issues from deforestation to media reform. Blaine also led the effort to create the "Joan Bavaria Awards for Building Sustainability in the Capital Markets", which are presented each year at the Ceres annual conference and was part of the working group that created OpenMic to address net neutrality and media reform. In 2009, he joined Nelson Capital Management, where he was a partner and a senior portfolio manager. He also served on the firm's leadership team and investment committee. Blaine chaired the company's corporate engagement committee and was on the Extraction-Free and Animal-Welfare model teams. Blaine joined Bailard in 2016.

Blaine holds a BA from the University of California, Berkeley and CIMC® and CIMA® credentials. His writings on social investing have appeared in numerous publications including the *San Francisco Chronicle*, *Houston Chronicle*, *San Jose Mercury News* and London's *Environmental Finance* magazine. Blaine has three children in college and lives with his wife and two dogs in Mill Valley, California. He has an eclectic taste in music and is an avid sports fan.

## FOOTNOTES

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## SPECIAL THANKS

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## DISCLOSURES

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