



# Vector Group (VGR)

Updated May 4<sup>th</sup>, 2018 by Josh Arnold

## Key Metrics

<b>Current Price:</b> \$20	<b>5 Year CAGR Estimate:</b> 12.8%	<b>Quality Percentile:</b> N/A
<b>Fair Value Price:</b> \$19	<b>5 Year Growth Estimate:</b> 4.0%	<b>Momentum Percentile:</b> N/A
<b>% Fair Value:</b> 97%	<b>5 Year Valuation Multiple Estimate:</b> 0.6%	<b>Total Return Percentile:</b> N/A
<b>Dividend Yield:</b> 8.2%	<b>5 Year Price Target:</b> \$25	<b>Valuation Percentile:</b> N/A

## Overview & Current Events

Vector Group is a somewhat unusual combination of a real estate investment firm and a tobacco company. The latter was founded in 1873 and continues to operate today as the Liggett Group while the real estate business came later. Vector has a market cap of \$2.4B and is slated to produce \$1.9B in total revenue this year.

Vector recently reported full-year results for 2017 and financial performance was mixed. Revenue rose almost 7% on strength in both its tobacco and real estate businesses, but much higher cost of goods sold kept a lid on operating income, which was basically flat against 2016. Vector's margins tend to be somewhat volatile as they fell in 2016 despite a revenue gain over the prior year as well. In addition, interest expense continues to grow and in 2017, that number represented 74% of operating income, highlighting Vector's reliance upon debt. However, it has managed to continue to pay its ample dividend and grow revenue over time, two very important items that look set to continue.

## Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
<b>EPS</b>	\$0.76	\$0.32	\$0.50	\$0.38	\$0.27	\$0.98	\$0.30	\$0.44	\$0.52	\$0.59	<b>\$0.60</b>	<b>\$0.73</b>
<b>DPS</b>	\$1.00	\$1.04	\$1.09	\$1.15	\$1.21	\$1.27	\$1.33	\$1.40	\$1.47	\$1.54	<b>\$1.60</b>	<b>\$2.00</b>

EPS has been tremendously volatile for Vector over the past decade as its margins have fluctuated, interest expense has moved steadily higher and its real estate business has seen some depreciation and other impairment charges against it. In other words, the fact that EPS has moved around so much isn't as big of a concern as it would be potentially for other companies as Vector's appeal is in its dividend. It has continued its ability to pay the dividend and with \$450M in cash and equivalents on the balance sheet, there is no reason to think that will change. We do see 4% EPS growth going forward, consisting of low to mid-single digit revenue growth and a slight headwind from margins. One thing Vector has done very consistently is increase its revenue and given the strength and stability of its two lines of business, we see that continuing going forward. Margins will remain a concern but management is focused on improving tobacco margins.

We also see 4% growth in the payout to bring it to \$2.00 from the current \$1.60 in five years. Importantly, Vector issues a 5% stock dividend each year, meaning the 8.2% yield can become a 13.2% cash yield if the extra shares are sold. This leads to dilution over time and slows EPS growth, but it is extremely shareholder-friendly. Net operating cash hasn't covered the dividend in recent years but the deficits are small enough – roughly \$80M last year - that Vector can cover them with borrowings and its ample cash reserves. This cannot continue forever but for now, the payout appears safe.

## Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
<b>Avg. P/E</b>	13.3	29.8	23.1	33.8	46.8	13.2	57.6	45.6	38.5	35.2	<b>32.7</b>	<b>33.7</b>
<b>Avg. Yld.</b>	9.9%	11.1%	9.4%	9.0%	9.4%	9.8%	7.7%	6.9%	7.3%	7.4%	<b>8.2%</b>	<b>8.0%</b>

Vector's P/E multiple has bounced around a lot due to volatile EPS. The stock is trading near its historical average at present and thus, we aren't expecting a meaningful move in the valuation. Indeed, we are forecasting just a 0.6% annual tailwind to total returns from the valuation drifting slightly higher. Given that we see a flat valuation along with roughly congruent EPS and dividend growth rates, the yield should remain around current levels as well. Vector looks fairly valued here so we aren't expecting any meaningful changes in either the PE multiple or yield.

## Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
<b>GP/A</b>	40.7%	28.0%	20.5%	21.2%	24.3%	29.6%	31.1%	33.0%	35.1%	32.1%	<b>32.0%</b>	<b>31.5%</b>
<b>Debt/A</b>	95%	101%	105%	110%	107%	102%	101%	110%	118%	125%	<b>125%</b>	<b>130%</b>
<b>Int. Cov.</b>	2.8	1.4	2.0	2.2	1.5	1.5	1.5	2.0	2.0	1.6	<b>1.6</b>	<b>1.5</b>
<b>Payout</b>	132%	325%	218%	303%	448%	130%	443%	318%	283%	261%	<b>267%</b>	<b>274%</b>
<b>Std. Dev.</b>	25.0%	22.9%	18.1%	15.3%	10.1%	7.4%	22.5%	14.5%	15.4%	14.6%	<b>15.0%</b>	<b>16.6%</b>

Vector's quality metrics have deteriorated over time to some extent. Gross margins have moved down since peaking in 2016 and given that there is no catalyst for improvement, we see gross margins slightly declining, providing a small headwind to profit growth. Debt has risen over time and we expect that will continue as Vector is certainly not afraid of a little leverage. Profit growth should lead to a basically flat interest coverage ratio, although we do see higher leverage for Vector going forward, which has the ability to decrease interest coverage. The payout ratio should remain basically flat to today as EPS and dividend growth remain similar. Overall, Vector employs a significant amount of leverage but its cash reserves allow it to do so safely and continue to pay the all-important dividend.

Vector's main advantage is in its somewhat odd business model that combines an ultra-conservative tobacco business with a highly cyclical real estate business. This is a very unique combination that helps Vector grow during good times but provides stability during downturns. Indeed, its tobacco business performed admirably during and after the Great Recession, something we expect will be the case next time a recession hits.

### Final Thoughts & Recommendation

Overall we see Vector as a potentially strong pick here because of its high current yield, relative safety and annual stock dividend. We are forecasting 12.8% total annual returns consisting of 4.0% EPS growth, a 0.6% tailwind from the valuation and the robust 8.2% dividend yield. Investors interested in a high current yield are the obvious buyers for Vector as it doesn't offer much in terms of value or growth; the yield is high enough that it has a lot of appeal here.

### Total Return Breakdown by Year

