Vector Group (VGR)

Updated August 14th, 2018 by Josh Arnold

Key Metrics

Current Price:	$17	**5 Year CAGR Estimate:**	14.0%	**Volatility Percentile:**	11.2%
Fair Value Price:	$17	**5 Year Growth Estimate:**	4.0%	**Momentum Percentile:**	12.3%
% Fair Value:	99%	**5 Year Valuation Multiple Estimate:**	0.3%	**Valuation Percentile:**	64.9%
Dividend Yield:	9.7%	**5 Year Price Target**	$21	**Total Return Percentile:**	89.0%

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 $2.2 billion and is slated to produce $1.9 billion in total revenue this year.

Vector reported Q2 earnings on 8/6/18 and results were not well received by investors. Revenue was up slightly as the tobacco business picked up volume again, and the real estate business saw revenue rise about 3%. However, the total cost of sales rose 3% for the tobacco segment and 9% for the real estate business. Further, SG&A costs rose 4%, which also crimped margins. Finally, interest expense rose to 78% of operating income against 63% in last year's Q2. Vector's Q2 highlighted some of its issues related to margins as well as its very high debt load and as a result, we've lowered our earnings-per-share estimate for this year to 50 cents from 60 cents.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$0.76	$0.32	$0.50	$0.38	$0.27	$0.98	$0.30	$0.44	$0.52	$0.59	***$0.50***	***$0.61***
DPS	$1.00	$1.04	$1.09	$1.15	$1.21	$1.27	$1.33	$1.40	$1.47	$1.54	***$1.60***	***$2.00***

Earnings-per-share 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 earnings-per-share has moved around so much is not 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 with cash reserves, and there is no reason to think that will change. We do see 4% earnings-per-share 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 them. Q2's results weren't good, but we don't see this weakness perpetuating.

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 9.7% yield can become a 14.7% cash yield if the extra shares are sold. This leads to dilution over time and slows earnings-per-share growth, but it is shareholder-friendly. Net operating cash has not covered the dividend in recent years, but the deficits are small enough that Vector can cover them with borrowings and its ample cash reserves. This cannot continue forever but for the foreseeable future, the payout appears safe.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	13.3	29.8	23.1	33.8	46.8	13.2	57.6	45.6	38.5	35.2	***33.2***	***33.7***
Avg. Yld.	9.9%	11.1%	9.4%	9.0%	9.4%	9.8%	7.7%	6.9%	7.3%	7.4%	***9.7%***	***9.5%***

Vector's price-to-earnings multiple has bounced around a lot due to volatile earnings. 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 0.3% annual tailwind to total returns from the valuation drifting slightly higher. Given that we see a flat valuation along with roughly congruent earnings and dividend growth rates, the yield should remain around current levels. Vector looks fairly valued here so we are not expecting any meaningful changes in either the valuation or yield.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	40.7%	28.0%	20.5%	21.2%	24.3%	29.6%	31.1%	33.0%	35.1%	32.1%	***32.0%***	***31.5%***
Debt/A	95%	101%	105%	110%	107%	102%	101%	110%	118%	125%	***125%***	***130%***
Int. Cov.	2.8	1.4	2.0	2.2	1.5	1.5	1.5	2.0	2.0	1.6	***1.5***	***1.4***
Payout	132%	325%	218%	303%	448%	130%	443%	318%	283%	261%	***320%***	***328%***
Std. Dev.	25.0%	22.9%	18.1%	15.3%	10.1%	7.4%	22.5%	14.5%	15.4%	14.6%	***15.0%***	***16.6%***

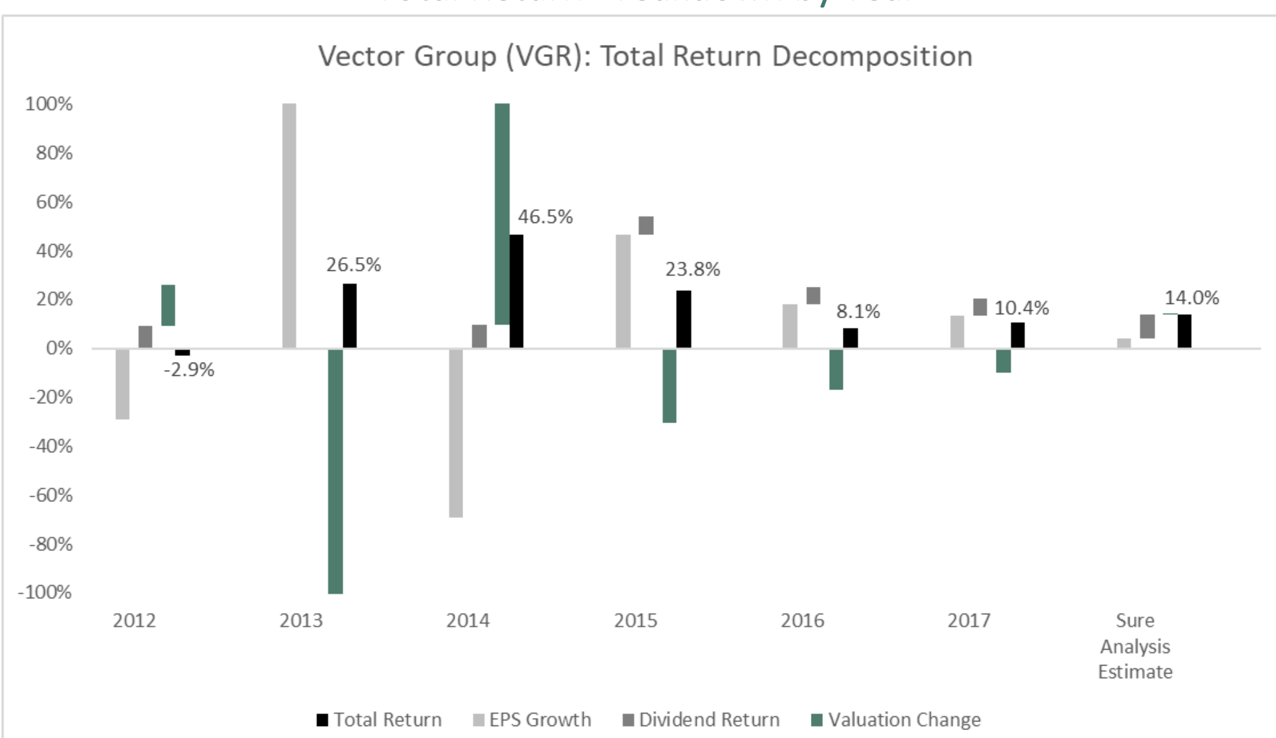
Vector's quality metrics have deteriorated over time to some extent. Gross margins have moved down since peaking in 2016 and given that there is no catalyst for improvement, we see gross margins slightly declining, providing a small headwind to profit growth. Debt has risen over time and we expect that will continue as Vector is certainly not afraid of 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 earnings-per-share 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 14.0% total annual returns consisting of 4.0% earnings-per-share growth, a 0.3% tailwind from the valuation and the robust 9.7% dividend yield. Vector certainly is not without its risks as highlighted by the Q2 report. However, we rate Vector as a buy given the very high yield, which we see as safe in the coming years.

Total Return Breakdown by Year



Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.