



Vector Group (VGR)

Updated November 13th, 2018 by Josh Arnold

Key Metrics

Current Price:	\$14	5 Year CAGR Estimate:	16.7%	Volatility Percentile:	25.4%
Fair Value Price:	\$15	5 Year Growth Estimate:	4.0%	Momentum Percentile:	7.0%
% Fair Value:	94%	5 Year Valuation Multiple Estimate:	1.3%	Growth Percentile:	20.3%
Dividend Yield:	11.4%	5 Year Price Target	\$18	Valuation Percentile:	58.5%
Dividend Risk Score:	F	Retirement Suitability Score:	C	Total Return Percentile:	90.2%

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 capitalization of \$2 billion and is slated to produce \$1.9 billion in total revenue this year.

Vector reported Q3 earnings on 11/7/18 and results were strong compared to the year-ago period. Revenue increased 6% against last year's Q3 to \$514 million. Strength came from a 2.7% increase in sales volume for the tobacco business, which helped Vector produce a similar gain in revenue. This increase was a slight improvement on the company's 2% year-to-date volume gain for this year. Market share increased to 4.2% from 3.9% in the year-ago period thanks to the volume gains. Vector said overall industry retail shipments declined during the period by 4.8%, but the company saw an increase, which helped it gain market share. Operating income for the segment was essentially flat year-over-year as margins declined slightly, offsetting volume gains.

The real estate segment saw an 11% increase in revenue during the quarter as closed sales volume rose 11% as well. Net income for the segment more than doubled to \$10 million during Q3. In total, adjusted net income for Vector Group was \$0.14 against \$0.15 cents in the same period last year as the cost of sales for both segments increased at rates higher than that of revenue. Interest expense also increased by 18% year-over-year. We're reiterating our estimate of \$0.50 for 2018 following a largely in-line Q3 report.

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
Shares	N/A	N/A	111	112	120	124	139	143	141	141	141	160

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. However, 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 given that the company still has more than \$400 million of cash on its balance sheet. For context, Vector paid \$170 million in common share dividends last quarter. 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, as it did in Q3.

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 11.4% yield can become a 16.4% 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. This is not ideal, but its enormous cash reserves, willingness to borrow and issue new shares should keep the payout safe.

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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	28.1	30.0
Avg. Yld.	9.9%	11.1%	9.4%	9.0%	9.4%	9.8%	7.7%	6.9%	7.3%	7.4%	11.4%	11.1%

Vector's price-to-earnings multiple has been volatile, but we expect minimal impact moving forward. Indeed, we are forecasting just a 1.3% annual headwind 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%	31.5%	31.0%
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%

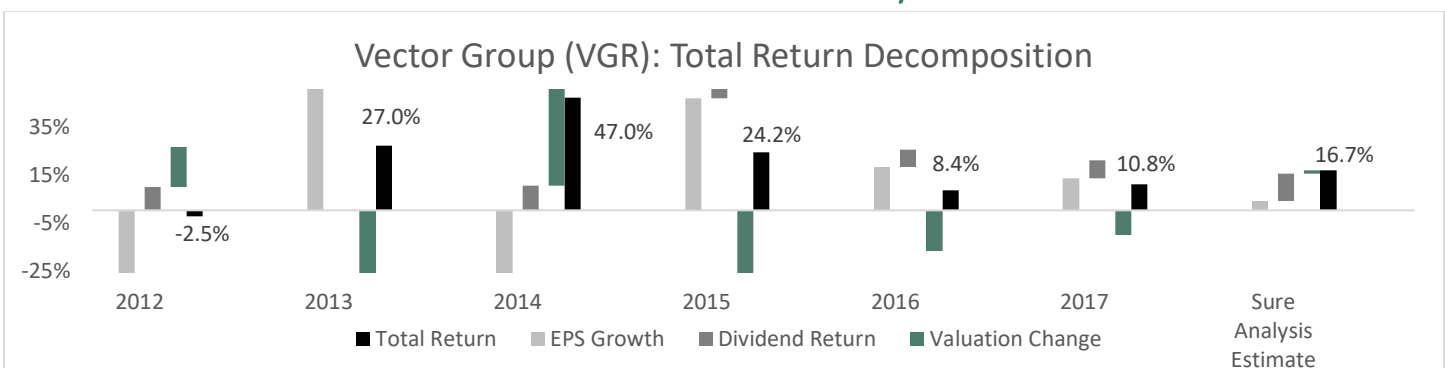
Vector's quality metrics have deteriorated over time to some extent. Gross margins have moved down since peaking in 2016 and given that there is no catalyst for improvement, we see gross margins slightly declining, providing a small headwind to profit growth. Debt has risen over time and we expect that will continue as Vector is certainly not afraid of leverage. 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.

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 and annual stock dividend. We are forecasting 16.7% total annual returns consisting of 4.0% earnings-per-share growth, a 1.3% tailwind from the valuation and the robust 11.4% dividend yield. Vector certainly is not without its risks as highlighted by the Q3 report. However, we rate Vector as a buy for risk-tolerant investors given the high yield and potential for modest growth.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	565	801	1063	1133	1096	1080	1591	1657	1691	1807
Gross Profit	230	224	218	240	263	313	494	547	594	579
Gross Margin	40.7%	28.0%	20.5%	21.2%	24.0%	29.0%	31.1%	33.0%	35.1%	32.1%
SG&A Exp.	95	85	91	97	108	114	279	320	341	339
D&A Exp.	10	10	11	11	11	13	24	26	22	19
Operating Profit	135	139	127	143	155	199	215	227	253	240
Operating Margin	23.9%	17.4%	12.0%	12.6%	14.1%	18.5%	13.5%	13.7%	15.0%	13.3%
Net Profit	61	25	54	75	31	37	37	59	71	85
Net Margin	10.7%	3.1%	5.1%	6.6%	2.8%	3.5%	2.3%	3.6%	4.2%	4.7%
Free Cash Flow	85	2	44	24	73	39	84	134	71	112
Income Tax	34	4	31	48	23	24	33	41	49	-2

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets	718	736	950	928	1087	1264	1423	1281	1404	1328
Cash & Equivalents	211	209	300	241	406	234	326	240	394	301
Accounts Receivable	10	8	2	25	11	12	23	24	19	29
Inventories	93	98	107	109	100	93	90	87	90	90
Goodwill & Int. Ass.	108	108	108	108	108	275	270	264	262	268
Total Liabilities	684	740	996	1017	1166	1286	1444	1403	1657	1660
Accounts Payable	6	4	9	10	6		11	20	11	19
Long-Term Debt	308	357	558	544	624	692	913	865	1172	1228
Shareholder's Equity	34	-5	-46	-89	-79	-95	-100	-206	-332	-414
D/E Ratio	9.16	-76.21	-12.07	-6.11	-7.87	-7.29	-9.16	-4.20	-3.53	-2.97

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	8.1%	3.4%	6.4%	8.0%	3.0%	3.2%	2.7%	4.4%	5.3%	6.2%
Return on Equity	90.0%	171.5%	-212%	-111%	-36.4%	-42.8%	-37.8%	-38.7%	-26.4%	-23%
ROIC	16.4%	7.2%	12.5%	15.5%	6.1%	6.1%	4.7%	7.2%	8.6%	9.3%
Shares Out.	N/A	N/A	111	112	120	124	139	143	141	141
Revenue/Share	4.88	7.43	9.64	10.21	9.65	9.22	12.71	12.15	12.34	12.97
FCF/Share	0.73	0.02	0.40	0.22	0.64	0.33	0.67	0.98	0.52	0.80

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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