Dividends and Buybacks at Potentially Non-Durable Businesses: Altria (MO) vs. NACCO (NC)

A Focused Compounding App subscriber had a question about something I said in a recent podcast:

"In your recent podcast you said you thought a tobacco firm should buy back its own stock rather than pay dividends - you said you don't think it should pay a dividend at all and instead should avoid acquisitions and buy back its stock.

Could you expand on that?

This is somewhat similar to NC, actually, and why this stood out to me. You've told me before why you don't want to see NC buy back stock (although now that we're in the upper teen price range you may feel differently), because the coal business is challenged and shrinking. I think we may be able to agree that US lignite coal has a shorter life than cigarettes. But still, it seems directionally the same sort of situation with a dying cash generative business."

Ask Geoff a Question of Your Own

I feel cigarettes are a much safer business than lignite coal. Much more durable.

I could be very wrong about this. But, it's about the extent to which it is integrated into society and the difficulty of removing that. Decades ago, I would have had much more serious doubts. But, the fact people keep smoking cigarettes in the numbers they do even when there are plenty of other methods of getting nicotine widely available now, strong inconveniences to the actual smoking of cigarettes, higher pricing (including taxes) on the people buying the cigarettes relative to their income, etc. It just shows me the durability of cigarettes specifically - as opposed to just nicotine consumption generally - is much higher than I might have guessed decades ago.

This isn't true with lignite. You are depending on a few corporations as customers instead of millions of consumers. They are eager to substitute to other kinds of power if it is roughly equalized. The customers are probably more rational - more open to considering alternatives. With cigarettes, we've seen continued use of cigarettes even when people could substitute to smokeless tobacco, vaping, etc. and even with increasing laws making life less convenient for smokers and rising prices. So, clearly, the degree to which there is seen as being "no substitute" to cigarettes is really high vs. the extent to which there is seen as being "no substitutes" to lignite. Lignite is seen as easily substitute-able. Cigarettes are seen by many customers as having absolutely no substitutes.

Now, it is true that I may have exaggerated the idea of just buying back stock - not paying any dividends - in a cigarette company, because if they never diversify at all by product (at least into other tobacco products) or by geography they could have a meaningful risk of losing everything. There is some risk that cigarettes could actually be outlawed in a single jurisdiction like the U.S. So, you can never have a 0% risk of losing everything if you don't borrow, don't pay dividends, but just buy back your stock. I think the risk is much lower than the risk of competition in a growing industry wiping out a company entirely. But, it's certainly not 0%. So, should a cigarette company like just buy back its own stock AND diversify into owning at least minority stakes or something in differently regulated businesses - non-cigarette tobacco, alcohol, cannabis, gambling, etc. - or like just at least holding some marketable securities and such? Maybe. It's a hard question to answer, because it's unlikely anyone is putting 100% of their savings into a single cigarette company. So, rationally, should the actual investors that own a cigarette company just keep their ownership in the stock from getting excessive and let the company stay 100% non-diversified. Probably.

It's a really interesting question. I mean, I wouldn't personally want to own/control etc. a cigarette company just because that's not what I'd like to do with my life - it does kill a fair number of people over time.

So, I'd never actually get in a situation where I was controlling person in a single cigarette company.

But, if I was - and if all of my own net worth was in it -- what, would I do?

I'd probably diversify slightly. That is, I'd make opportunistic purchases of businesses in part or whole that were somehow regulation-wise diversified away from sharing the exact same risks. So, companies in other countries and companies in businesses that face different legal risks. But, it's hard. It's hard to find businesses as good as cigarettes. And presumably you wouldn't know about other kinds of industries that well. So, diversifying is risky.

You would only be able to buy companies in industries that are in some sense "vice" industries. Otherwise, you would risk harming the brands of the cereal companies, soft drinks companies, etc. that these companies had once diversified into. It would be hard to own Dr. Pepper or Oreos or something today and be a cigarette producing parent company. You could do that 40 years ago - but, I don't think today.

You could definitely invest easily in alcohol, cannabis, gambling, and guns. I'm not sure those are necessarily good industries. But, they have enough stigma attached to them that no one would be horrified if they were owned by a cigarette maker.

You could diversify into buying something like Turning Point Brands since that is rolling paper and smokeless tobacco. It diversifies you a bit. There's also European based businesses that are big in cigars and smokeless products - but, those don't have the same economics exactly.

I'm not really sure what I'd do. In the case of both NC and something like MO - I am sure I wouldn't pay any dividends at all. I also wouldn't do REGULAR stock buybacks or borrow short (or as heavily as cigarette companies do). I might keep a portfolio of stocks, bonds, cash, etc. on hand at least to the extent the SEC would allow without threatening to make me an investment company. I think the opportunity to do big buybacks when you want, diversifying acquisitions if you get a chance, etc. might make sense. I also don't think it'd be important these be control deals if the purpose is just diversifying. But, I really wouldn't want to risk giving away most of my cash flows in regular dividends, interest and principal payments, etc. If you are in a business where there's a lot of risk to the durability of the business - you want to have a ton of free cash flow each year that isn't automatically allocated for you.

There are examples of companies that successfully diversified away from a non-durable or seemingly non-durable business. Berkshire took all the cash from textiles and re-deployed it. Atlantic Tele-Network (ATNI) - I think the corporate name's been changed, but that was its old name - was originally a company with a monopoly on the long-distance business in a country they always feared would just pull the plug on their deal. So, they took all the free cash flow from that and bought up other telecom stuff in other small island nations, rural U.S., etc. over time. You're right that they could have - instead - just pay out like all the free cash flow from that originally at risk monopoly to shareholders and that would've protected the family's wealth as well.

So, you could do it either way. You could pay out high dividends. Or you could diversify into something else.

NACCO went the diversification route decades ago in the totally unrelated business way.

Now, NACCO is trying to diversify into related businesses.

I'd be really cautious about borrowing in amounts that are meaningful in terms of annual debt payments in cash and any sort of regular dividends at companies like this. I know regular dividends have worked really, really well for big cigarette companies. But, I'm not at all sure that regular stock buybacks would've done worse for them. And it would've left them with more financial flexibility. I haven't checked their filings - but, going off what is in websites that show these states - it seems like Altria has been paying out around 75% of their cash flow from operations in dividends. NACCO is paying out more like 10%. I think I'd be worried if they had been doing anything like 75% in dividends the way Altria has, because then you wouldn't have fast FCF build.

I do think it's much more critical to the long-term survival of NC that they diversify away from lignite in the next 5 years than that Altria diversify away from cigarettes in the next 5 years. I think cigarettes are a much, much safer product in terms of durability than lignite is. So, I think long-term business survival - putting financial position aside - is so much higher at Altria than NACCO. I don't see the two as comparable that way. Really, more like complete opposite sides of the durability spectrum.

But, this might be a misjudgment on my part. It's just based on observing cigarette smoker behavior in the face of alternatives they could try out, switch to, etc. and don't despite increasing social restrictions, increasing price differentials between cigarettes and other sources of nicotine, and more widely distributed choices for nicotine substitutes that they aren't adopting. When I compare this to like wind adoption by utilities - I see the two as completely different.

But, whether a company should do like 100% stock buybacks when in a business like cigarettes. That's hard to answer.

Realistically, too, it'd be hard for a company of Altria's size to do a transaction that works well as a diversifier at a good price in anything except super troubled times. The company is just so big. I mean, you'd need a multi-tens of billions of dollars acquisition in something completely unrelated to cigarettes to move the needle long-term in getting you diversified to preserve your net worth if cigarettes are outlawed in the U.S. or something so catastrophic. NACCO is of a size where it'd be very easy for them to make a diversifying deal that makes sense price-wise and totally shifts their business mix away from lignite. Those deals are hard to do because management might know nothing about the business it's getting into etc. But, for a micro-cap company, it's easy to diversify. For a mega-cap it's a lot harder.

But, yeah, if they both traded at like the same EV/FCF etc. - I'd be more comfortable with big share buybacks at Altria than at NACCO. As you know, though, NC is many times cheaper than Altria - so, I'm not saying buybacks at NC wouldn't be better. They might work out very well simply because the stock is so cheap. But, other than cheapness - I wouldn't want them to devote 100% of FCF to buybacks.

Ask Geoff a Question of Your Own