



July 2022

It's Boomer Time!

Thanks, Vitaliy.

We've had a long day, so I'm going to kick off with something a little lighter.

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Additional information and statistics on the strategy are available upon request at ir@broyhillasset.com.

Not this.



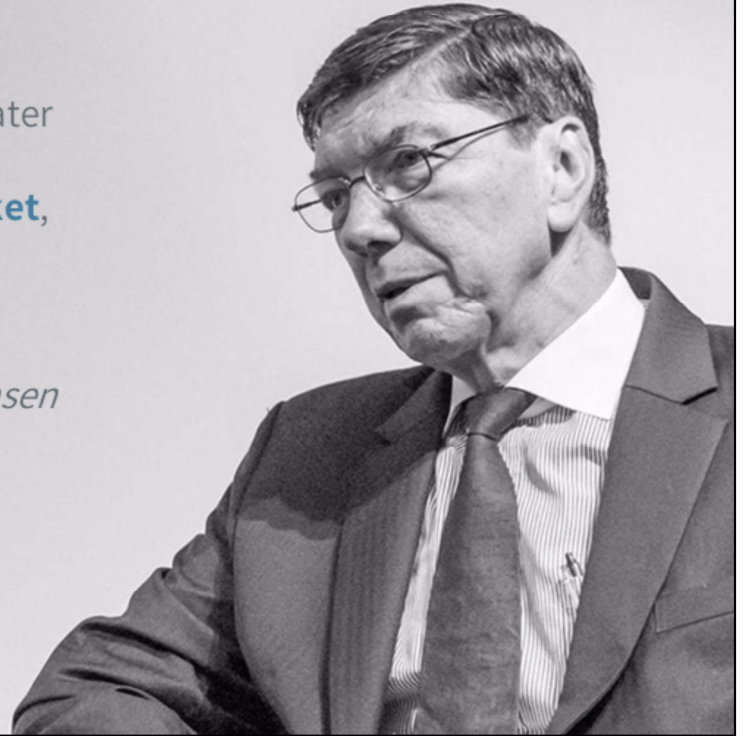
Let's start with a pop quiz.

The winner gets a prize. Later.

What do these things have in common?

“ **Smart companies fail because** they do everything right. They cater to high-margin customers and **ignore the low end of the market,** where disruptive innovations emerge from.

- Clayton Christensen



Clayton Christensen showed us just how rare it is for a successful company to disrupt itself. But there have been a few notable exceptions in corporate history:

- DRAM at one point in time accounted for over 90% of Intel’s sales.
- The iPod accounted for ~ 40% of Apple’s sales the year before the iPhone was released.
- NFLX famously disrupted its entire DVD-by-mail business, betting the entire company on an emerging “streaming” technology.

Better not burnt.

Same goes for tobacco.

IQOS heats tobacco instead of burning it, so it doesn't produce fire, ash or smoke.

This makes IQOS a better choice compared to continued smoking.

IMPORTANT INFORMATION: IQOS is not risk-free. It delivers nicotine, which is addictive.

IQOS
TOGETHER FORWARD

This product is not risk-free. It contains nicotine, which is addictive. Only for use by adults who would otherwise continue to smoke or use nicotine products.

Today, I'd like to discuss a company disrupting one of the most profitable industries in history.

This is Big Tobacco's Kodak Moment.



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Tobacco Road
Why The Opportunity Exists
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Tobacco is somewhat controversial these days.

So let me say upfront that I'm not here to defend the industry.

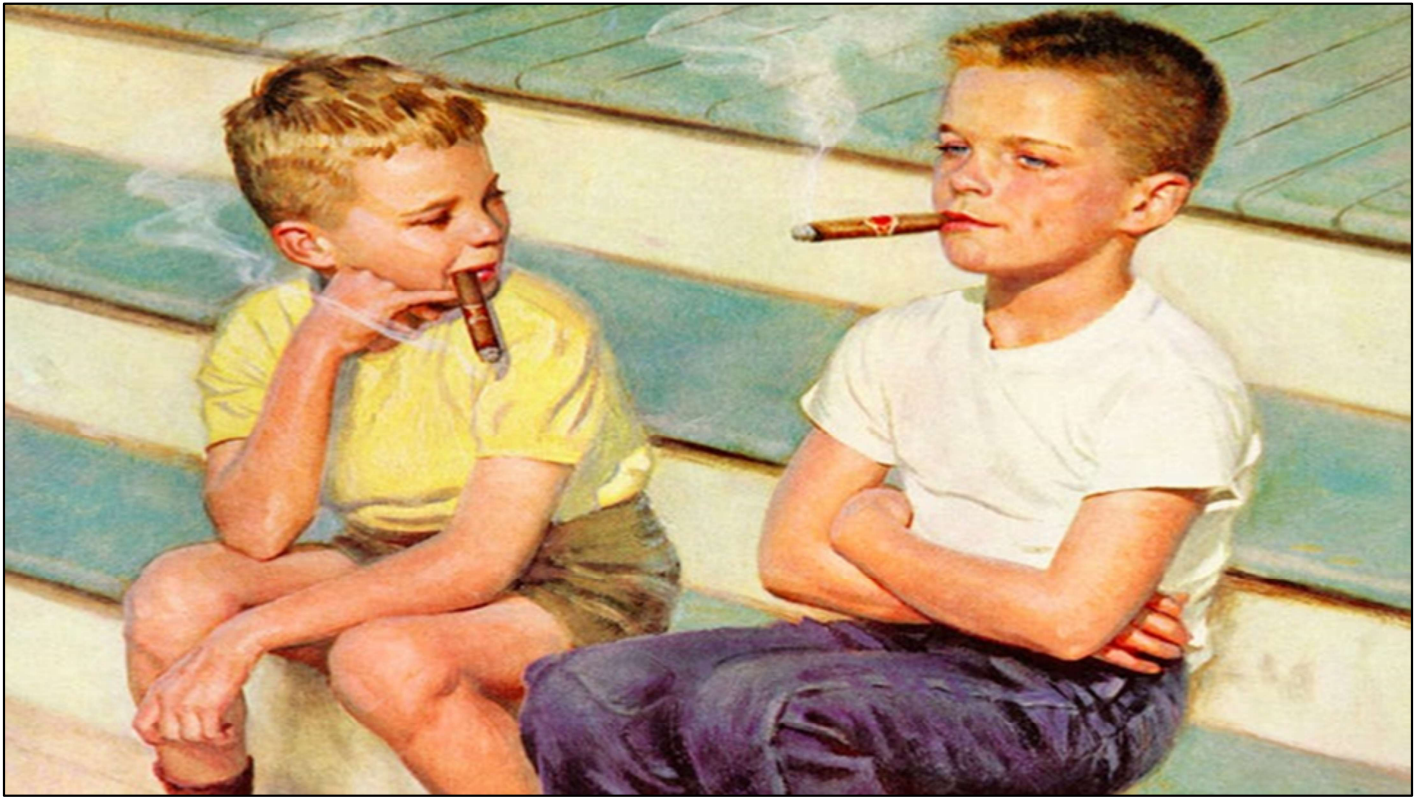
Cigarettes are bad for you. And Big Tobacco isn't the Virgin Mary.

But we are not trying to change the world. That's not our mandate.

Our investors hire us to preserve and compound their capital. We think the tobacco industry serves both purposes today.



Previous advertising campaigns may have been a little suspect.



Little boys were much cooler those days.



So were little girls . . .

But a lot has changed since then and we think the tobacco companies of today are different than those in the past.



Let's start with a quick trip down tobacco road.

I fart rainbows



But first . . .

Some perspective on where we are coming from.

We've been living in a strange world for the past several years.

● WATCH LIVE

CRYPTO DECODED

Somebody just paid \$1.3 million for a picture of a rock

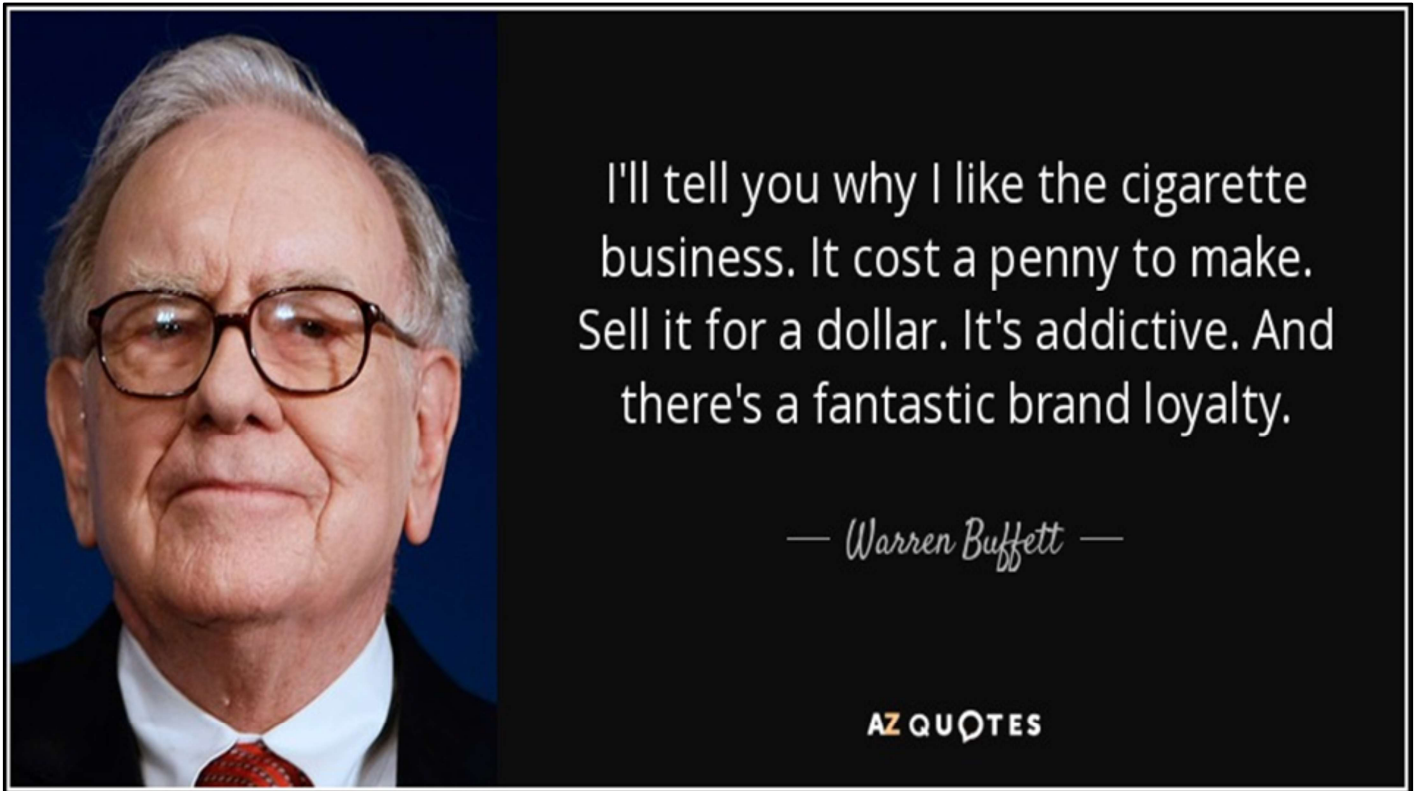
PUBLISHED MON, AUG 23 2021 6:17 PM EDT

UPDATED MON, AUG 23 2021 9:37 PM EDT

A decade of speculation has distorted "normal" for an entire generation of investors.

So it's probably no surprise that consumer staples posted one of their worst stretches of underperformance in a century.

But investors are now waking up to the reality that they've been living in a world of fantasy. And good, old-fashioned value investing is again proving its merit. It's Boomer Time!

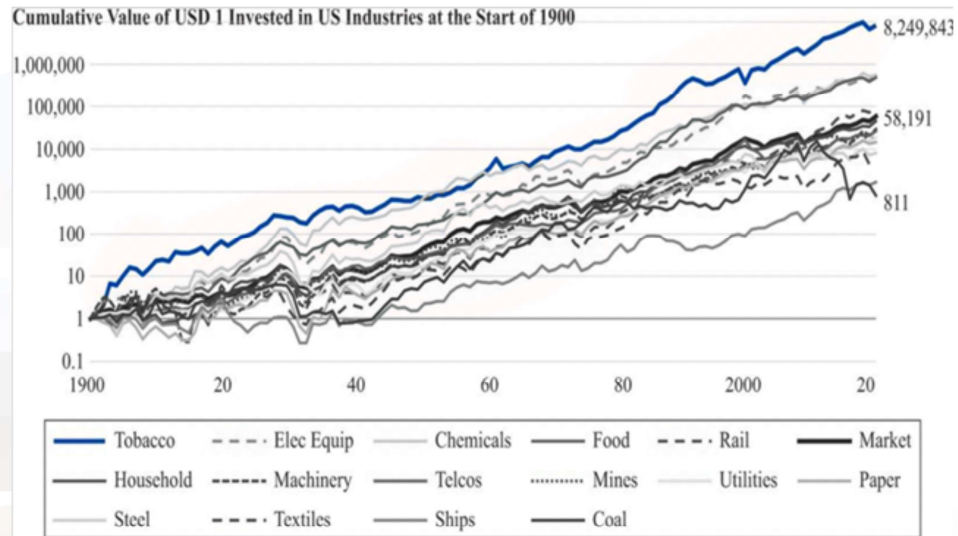


We believe tobacco is extremely well-positioned in a world that's woken up from this fantasy, where profits are again more important than promises.

It's a countercyclical business, selling a highly addictive product with tremendous brand loyalty, that prints almost as much cash as the Fed.

Perhaps the Most Profitable Industry in History

A dollar invested in tobacco in 1900 is worth over \$8 million today.



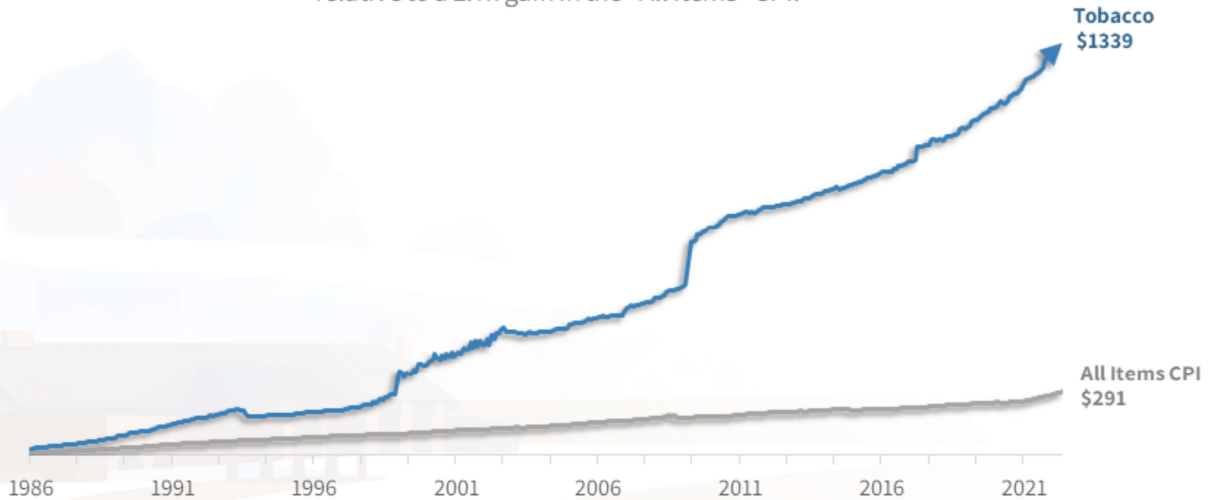
Source: Credit Suisse

It may lack the sex appeal of rocket ships or driverless cars but tobacco more than makes up for it in consistency.

That consistency has driven over a century of long-term outperformance.

Pricing (Super) Power Drives Super Margins

The Consumer Price Index for “Tobacco & Smoking Products” has **increased 11-fold** since 1986, relative to a 2.7x gain in the “All Items” CPI.



Source: Federal Reserve Bank of St. Louis

Consumer businesses with strong brands and inelastic demand demonstrate tremendous pricing power.

The tobacco industry is perhaps the single best example of this dynamic.

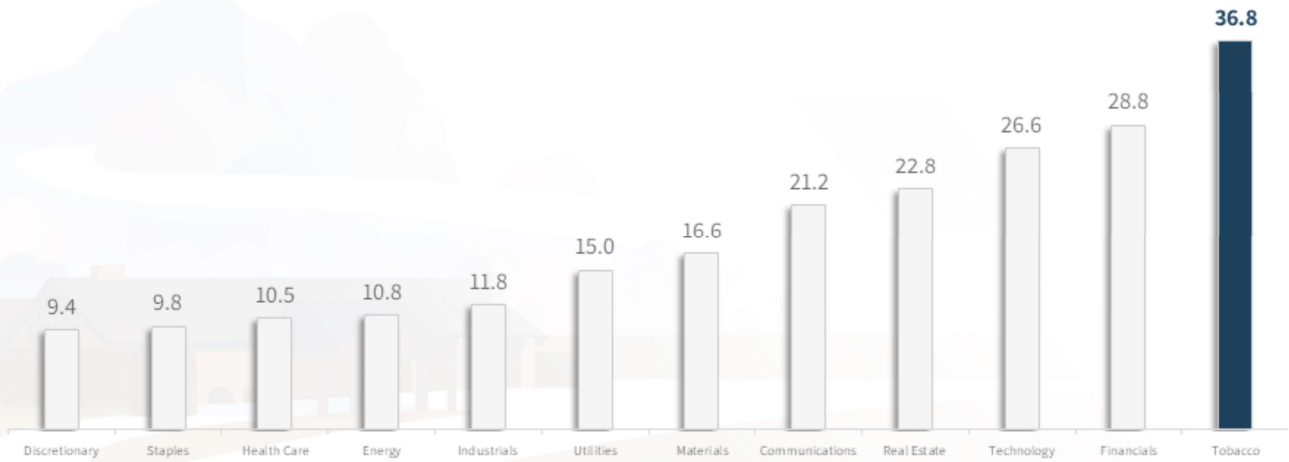
Simply put, price is not the primary determinant of choice in tobacco.

If it was, Marlboro wouldn't control the US market.

Tobacco Margins Light Up The Competition

Robust tech margins pale in comparison to the tobacco sector.

S&P 500 Sector Operating Margins (%)



Source: Bloomberg

Brand loyalty, pricing power, and highly attractive unit economics generate best-in-class margins.



The Opportunity

So why is the sector mispriced?

We believe the relentless selling was primarily driven by two factors.



Greta and her friends are the first factor we'll discuss today.

Bull market millennial mentality has facilitated a furious flow into ESG funds.

Dr Tedros Adhanom Ghebreyesus, Director-General, World Health Organization

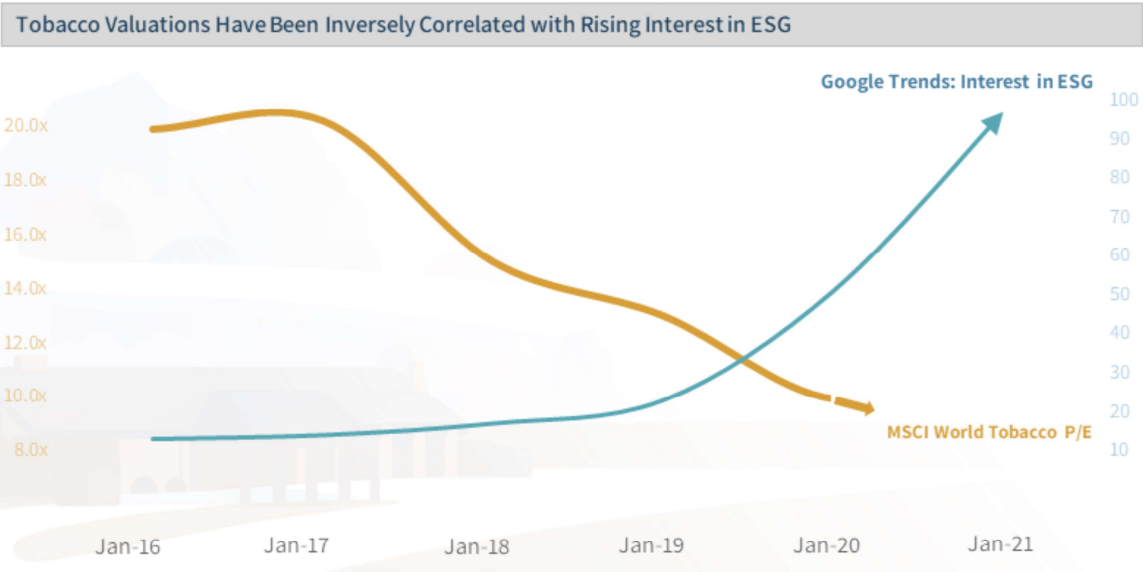
"...it makes no sense to fight tobacco and the tobacco industry with one hand, while financing it with the other."

Launch of the Tobacco-Free Finance Pledge, United Nations Headquarters
(September 2018)

Signatures on The Tobacco-Free Finance Pledge represent over \$12 TRILLION in AUM.

The impact is even larger in Europe where exclusions cover up to a third of assets in the region.

ESG Has Been a Huge Headwind for Tobacco



Source: Bloomberg, Google Trends

Interest in ESG and the resulting capital flows have clearly weighed on tobacco sector valuations.

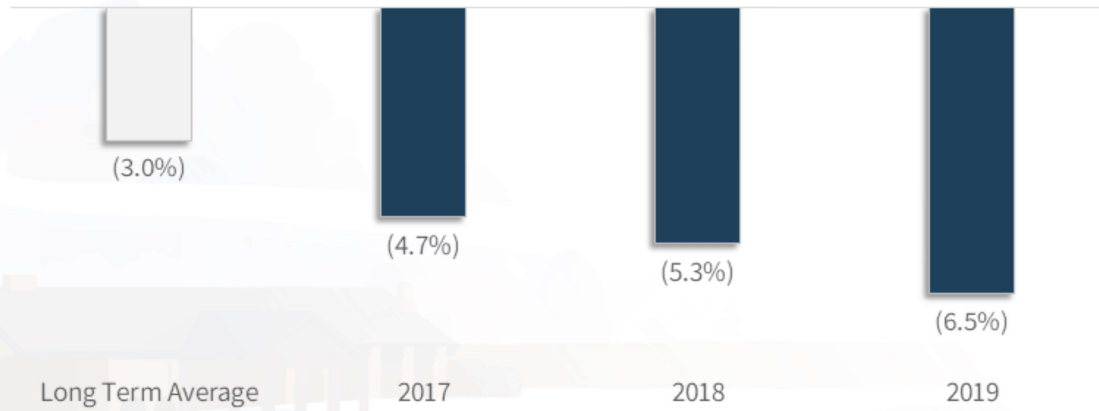


Greta and her friends also played a role in the second factor creating today's opportunity.

Volume Declines Have Accelerated in Recent Years

Vaping and e-cigarettes have accelerated the industry's rate of decline.

US Cigarette Unit Sales Growth



Source: US Federal Trade Commission

JUUL's growth exploded in 2017.

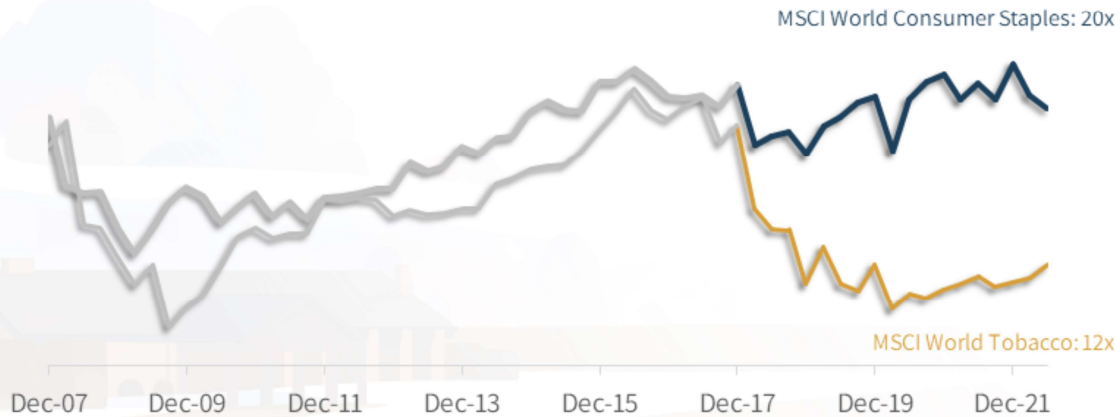
And with it, the decline in tobacco volumes accelerated.

Valuations Decoupled as Declines Accelerated

Historically, the tobacco sector traded in line with consumer staples.

Recently, it traded at a 50% discount!

Global Tobacco vs Global Staples Price/Earnings Ratio



Source: Bloomberg

Historically, the tobacco sector traded in line with consumer staples.

But the sector de-rated aggressively on the heels of accelerating volume declines.

Tobacco recently traded at a 50% discount to the consumer sector. We think this is overdone and may now be reversing.



The Tobacco GOAT

PMI is the single best-positioned company in the industry to capitalize on emerging trends.

The stock does not yet reflect the massive opportunity in front of it or the shifting economics of its business.

So, in our remaining time, we'll provide a quick overview of the company, how it's disrupting the industry, and close with some thoughts on valuation.

The Largest Tobacco Company in the World

Philip Morris International Inc.	
Ticker:	PM
Market Capitalization:	\$140.4B
Enterprise Value:	\$167.0B
Shares Outstanding:	1.55MM
Stock Price:	\$89.6
LTM EPS:	\$6.07
LTM P/E:	14.8x
Dividend Yield:	5.5%



PMI is the largest tobacco company in the world (ex-China).

The Story Begins On Bond Street in 1847



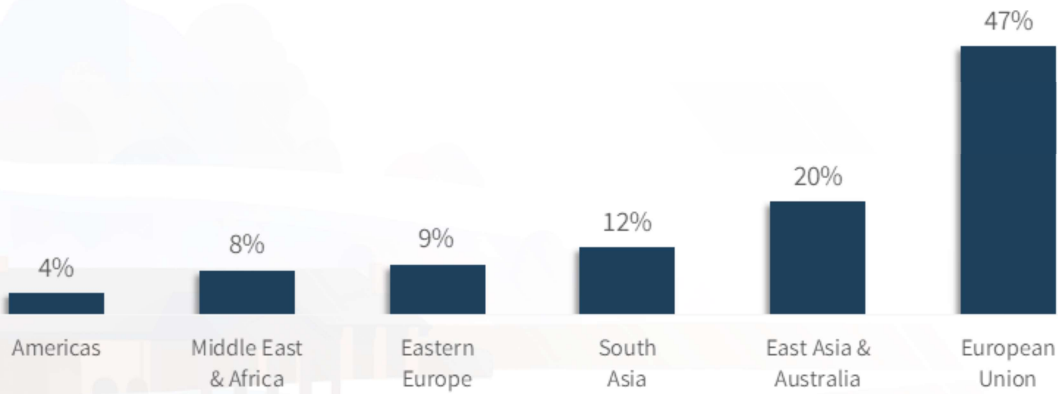
Its roots date back to a tobacco shop on Bond Street in 1847.

Since its initial stock listing in 1919, PMI has experienced quite the evolution acquiring Miller Brewing Company, General Foods, and Kraft, before changing its name to Altria and spinning most of these businesses off, along with its international operations – PMI.

Sales Span the Globe

Following the split, Altria maintained the US business, while PMI conquered the rest of the world.

PMI FY21 Operating Income by Segment



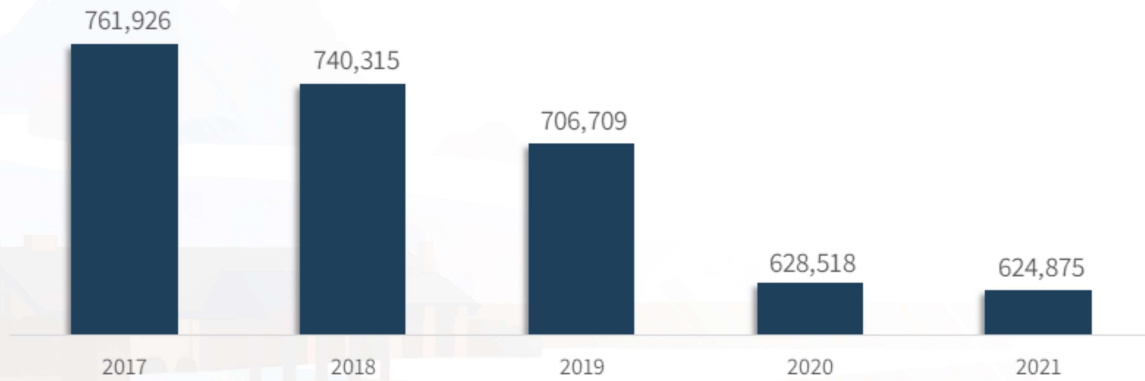
Source: Company Filings

That business today, PMI, sells Phillip Morris products around the world with the exception of the US and China.

PMI Cigarette Volumes Are In Decline . . .

The core cigarette business is a low-single-digit volume decliner.

PMI Cigarettes Shipped (millions)



Source: Company Filings

Everyone knows that the cigarette business is in decline.

But Pricing Power Drives Revenue Growth

Mid-single-digit pricing power enables PM's premium brands to drive higher revenues.

PMI Net Revenues (millions)



Source: Company Filings

But volume declines to date have not translated into top-line declines.

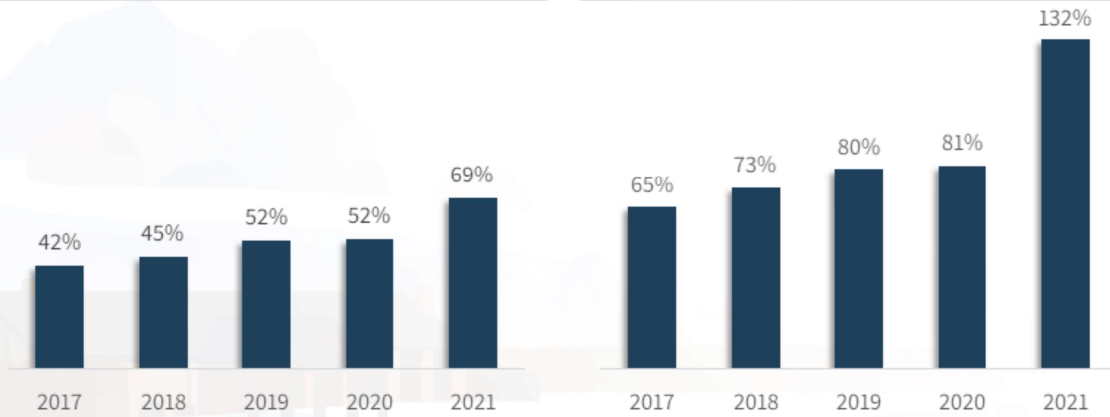
PMI continues to generate healthy sales growth.

Cash Cows Generate High Returns on Capital

An insulated oligopoly with inelastic demand is an attractive climate for generating high returns on capital.

Return on Invested Capital

ROIC ex Goodwill & Intangibles

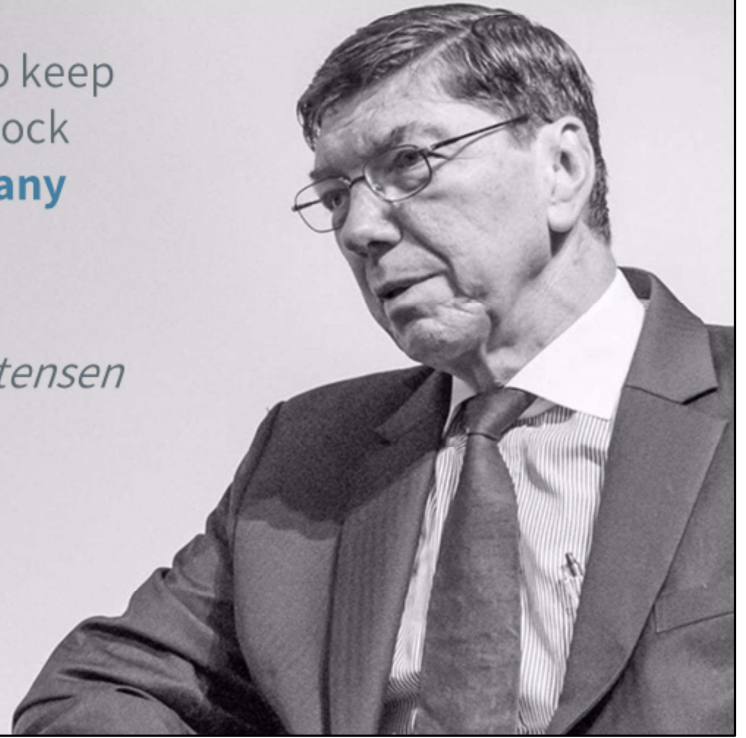


Source: Company Filings, Broyhill Asset Management Estimates

And returns on capital are off the charts.

“ By doing what they must to keep margins strong and their stock price healthy, **every company paves the way for its own disruption.**

- Clayton Christensen



But, since we only have 15 minutes to spend on the company today, I want to spend our remaining time on how PMI is disrupting its business.

IQOS

SIMPLY AMAZING

PM made the greatest cumulative investment in RRP's of the major tobacco players, investing over \$9B over the past decade. The results speak for themselves – IQOS is the single most successful alternative nicotine brand.

Consider that Marlboro has ~ 13% share of the global nicotine market after five decades; IQOS has captured more than half of that share within five years.

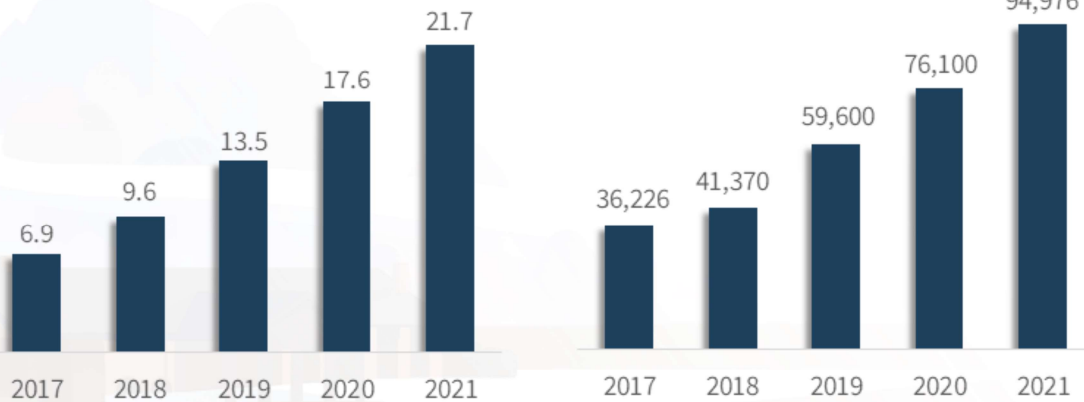
And it's one of only two products that has received the FDA's first-ever modified risk status.

We'll get to the second in a moment.

Already the Number Three Brand in its Markets

PMI HTP Customers (millions)

PMI HTP Volumes (billions)



Source: Company Filings

IQOS is already the number two brand in markets where it is present. It should reach the number two position – globally - next year, despite being available in only half the world.

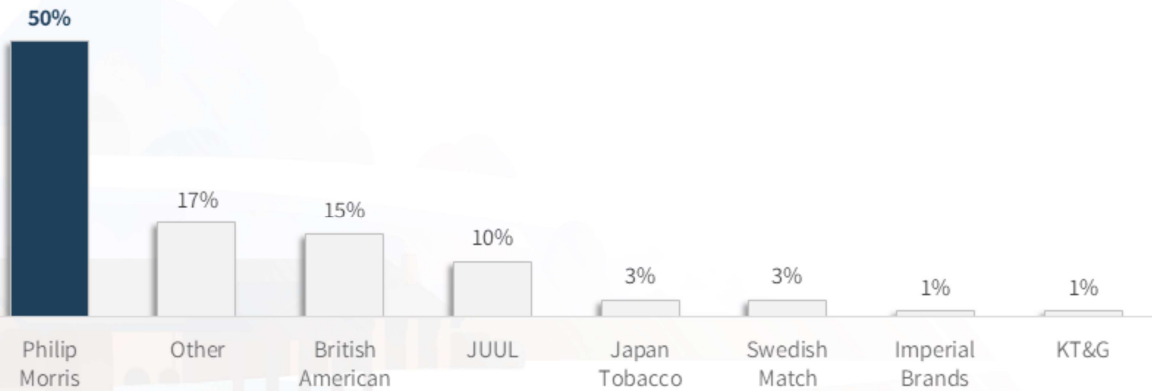
It launched in 2015 and already has over 20 million customers worldwide.

About 70% of those customers were PMI customers.

The balance represents share gains.

PM Has Captured 50% Share of Global RRP

Global (ex China) RRP Market Share as of FY21



Source: J.P. Morgan, European Tobacco

Overall RRP holds about ~ 12% share of the global nicotine market. And PM has captured half of this market.

Heated Tobacco Products are the largest category within RRP.

PM's share here is even more dominant at about 80% today.

RRPs are Just Scratching the Surface

The global cigarette market ex-China is ~ 35x the size of Heated Tobacco Products.

Global Nicotine Retail Value (millions)

Cigarettes

\$717,310

Heated Tobacco Products

\$20,775

Source: Foundation For a Smoke-Free World, Global Trends in Nicotine 2021

While iQOS has already passed 20M users, RRP's are only a sliver of the total nicotine market.

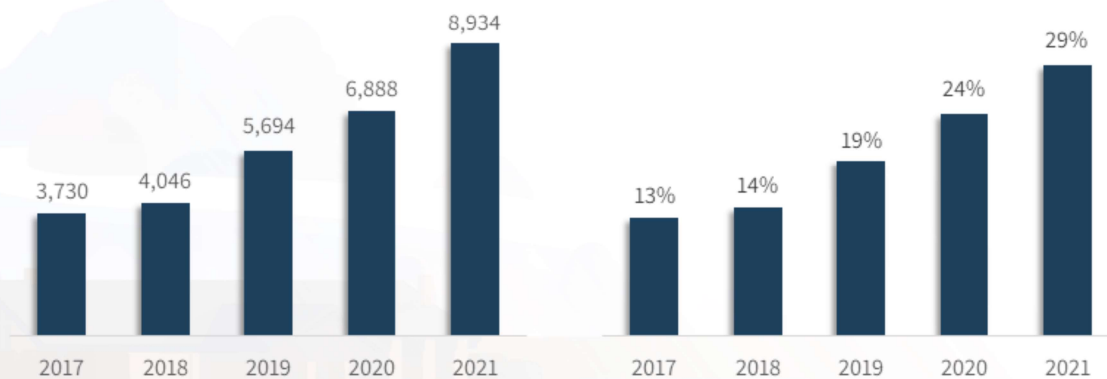
The global cigarette market ex-China is ~ 35x the size of HTP's.

Volumes Aren't The Whole Story

IQOS revenue per unit is ~2.5x combustible revenues and converted customers smoke more often.

PMI RRP Revenues (millions)

PMI RRP Revenues as % of Sales



Source: Company Filings

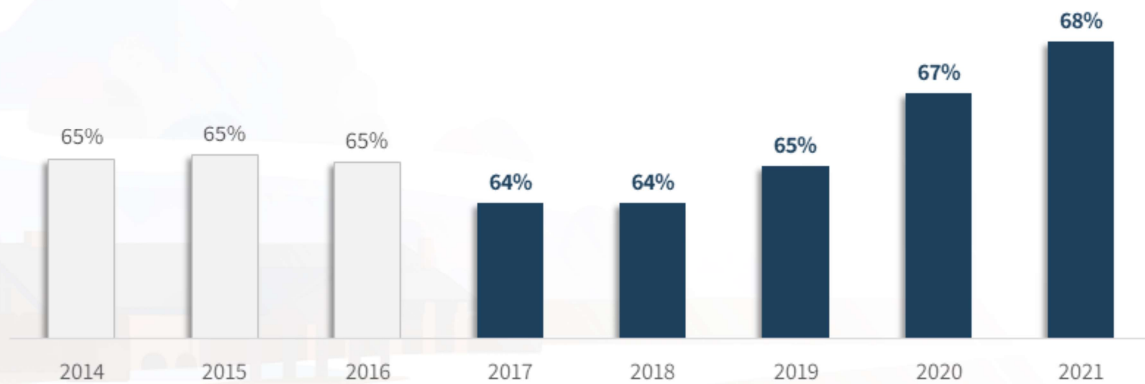
IQOS revenue per unit is ~ 2.5x combustible revenues so volume growth comes with accelerating revenue growth.

Converted iQOS users also smoke more to achieve the same level of nicotine so we get increased frequency as well.

From Cash Cow to Premium Wagyu

Cash cows are rare. Those able to successfully disrupt the whole farm are almost unimaginable.

PMI Gross Margins



Source: Company Filings

But revenues don't tell the whole story either. GMs - at about 75% - are 10 points higher than the already incredible GMs on combustible cigarettes. And SG&A should continue to scale ultimately exceeding combustible operating margins. As a result, IQOS is 2-4x more profitable than combustibles depending on geography.

Bottom Line: cows that generate this much cash for this long are a rare breed. It's even more rare to find cash-generating animals willing to disrupt the entire farm. And it's almost unimaginable that one of the most profitable cows in farm history transforms itself into a different animal altogether, while actually improving unit economics.



Okay.

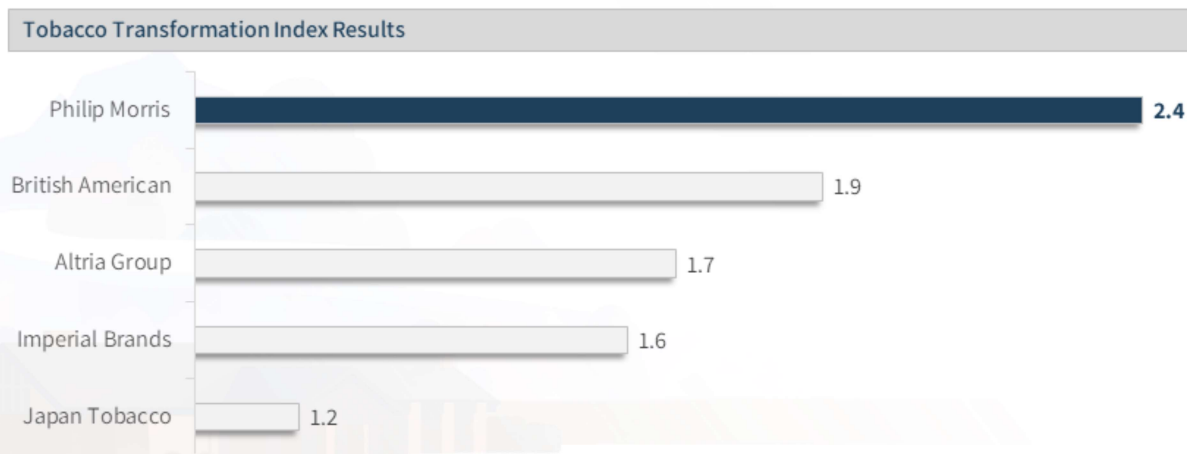
Let's back up for a second before wrapping up.

And let's say ESG isn't a complete scam. Let's give Greta the benefit of the doubt . . . even if just as a thought experiment.

What if near-term outperformance, driven by a return to fundamentals, prompted the ESG crowd to reconsider their "strict" requirements for inclusion?

The energy sector is crushing it year-to-date. And guess what, the number of ESG investors allocating to the industry has doubled. Could we see a similar setup in tobacco? Could ESG investors start looking for excuses to invest in transformational companies?

PM Is Leading Big Tobacco's Transformation



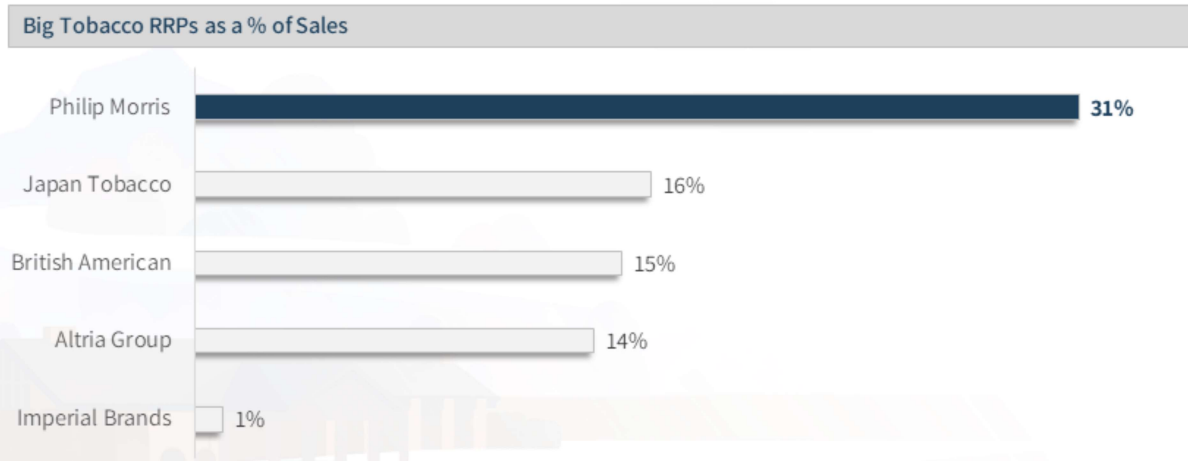
Source: Tobacco Transformation Index

If so, PMI is leading the pack.

It's the top-ranked Big Tobacco company in terms of its commitment to tobacco harm reduction, as measured by The Tobacco Transformation Index.

It's also been included in the Dow Jones Sustainability Index for the second consecutive year. This puts PM among the top 20% of companies in ESG performance, per S&P Global.

RRPs Make Up the Biggest Slice of the PMI Pie



Source: Company Filings

RRPs make up more than 30% of PMI sales today. Nearly twice the level of the next biggest player in the market.

And management has accomplished this from a standing start via 100% organic growth.

NEWS | July 12, 2021

Cigarette maker Philip Morris acquires another inhaled therapeutic company

AUGUST 9, 2021 BY SEAN WHOOLEY

Philip Morris agrees to acquire Vectura for \$1.45bn

The acquisition will aid the companies to create a pipeline of products in the prescription drug and OTC sectors.

NEWS | September 16, 2021

Philip Morris International acquires Fertin Pharma for \$820m

Leveraging Fertin Pharma's expertise, PMI plans to offer a wide range of smoke-free products such as nicotine pouches.

DRUG DELIVERY

Philip Morris adds to pharma unit with acquisition of inhaled-drug firm OtiTopic

by Megha Satyanarayana

August 19, 2021 | A version of this story appeared in **Volume 99, Issue 30**

The next phase is strategic expansion. Unlike some of their peers, we think PMI management has an excellent capital allocation track record.



PHILIP MORRIS
INTERNATIONAL

Swedish
Match®

This one is a game changer.

The synergies here are perhaps the greatest we've seen in a strategic acquisition.

Swedish . . . Match (Point)

Accelerated Transformation	Zyn's rapid growth would accelerate PM's transition to a predominantly smoke-free company.
Excellent Strategic Fit	Combined geographic footprint would represent a comprehensive global smoke-free portfolio.
Entry Into US Market	Accelerated entry into the US - the most lucrative nicotine market in the world.
Larger Addressable Market	PM's addressable market for smoke-free products would increase by ~60% with the US alone.
Growing Product Portfolio	The combined company would have a presence in e-vapor, heated tobacco, and oral tobacco.
Potential IQOS Distribution	Match could provide PM with potential distribution (and full margin capture) for IQOS in the US.
Global SWMA Distribution	Longer term opportunity to add SWMA products to PM's broad, global distribution network.
Enhances Top Line Growth	Immediately improved revenue growth profile led by pouches expected to grow 30% - 40% annually.
Accretive to Margins	Proposed transaction is accretive to PM's operating margins, before synergies.
Improved FX Profile	Significant boost to USD income would dramatically improve PM's currency profile.

We think this deal is a home run.

Match dominates the market for nicotine pouches and stands to benefit most from its growth.

The category should grow volumes at better than 30% annually, with little cyclicity, high gross margins, and strong cash generation.

Smokeless Tobacco Growth is Off the Charts

Nicotine Category Growth (Trailing Five Year Average)



Source: Euromonitor, MSAL, Company Reports, Nielsen, Barclays Research Estimates

Who here has heard of Zyn? Who's tried it?

I'm asking because I think you need to have a sense of what this product is to understand these numbers. So here's your chance.

The nicotine pouch user base is likely to double to over 4MM users by FY25 while the average number of cans per consumer continues to increase, driving a ~4x increase in US sales to \$4B.

A Comprehensive Global Smoke-Free Portfolio



Match provides PM with a global presence in every category.

And a leading smoke-free portfolio.

Match Point.



What's It Worth?

So ...

What's it worth?

Valuation is an imprecise science.

So, we triangulate our fair value estimates from several different angles to increase our degree of confidence.

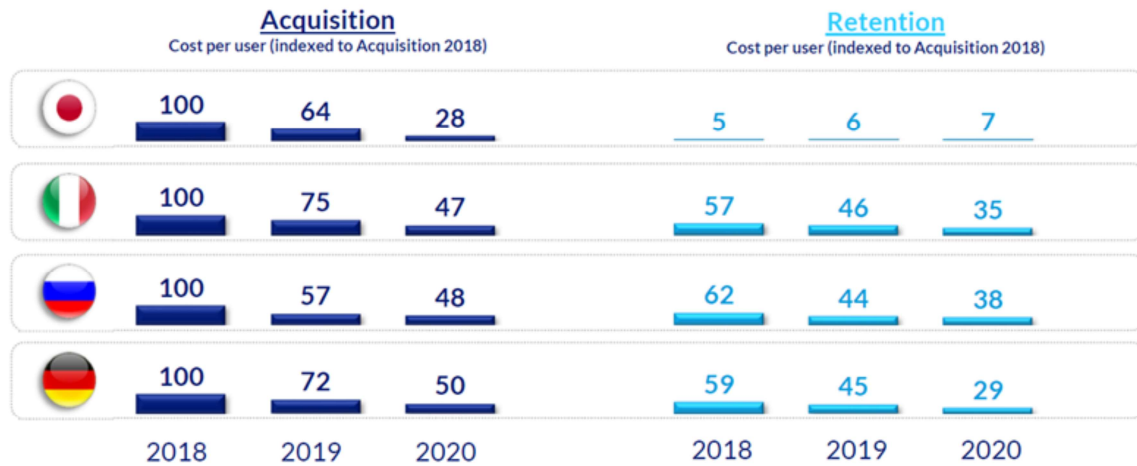


SaaS businesses are all the rage today, but the model is not new.



I present to you . . . Smokes as a Service!

Increasing Economies of Scale



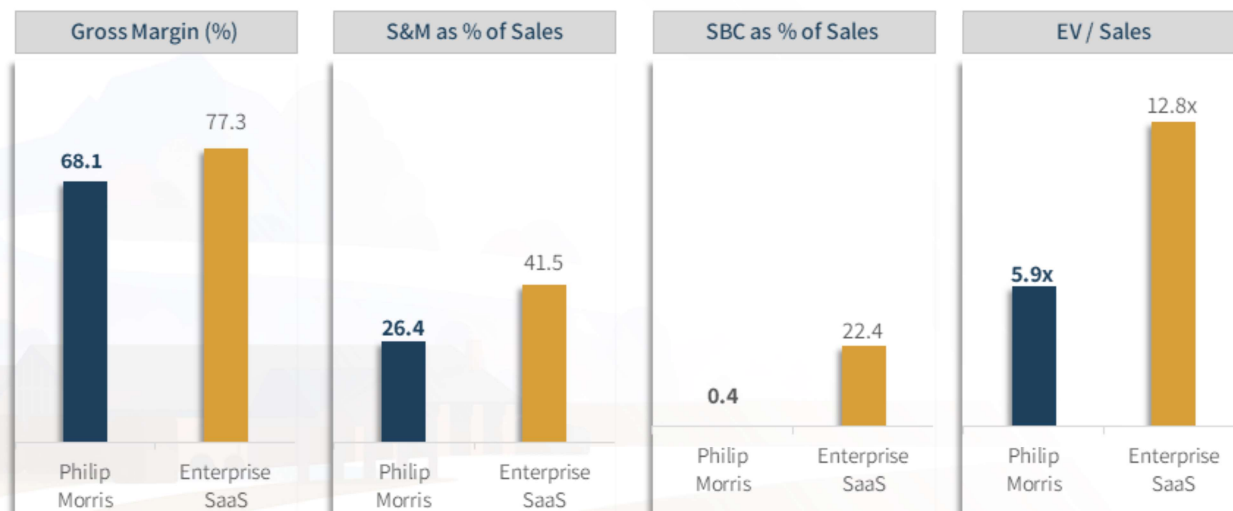
Source: Company Filings

Smokes as a Service boasts unmatched unit economics.

To start, churn is essentially zero. Customer lifetime value really is the customer's lifetime in most cases.

At the same time, Customer Acquisition Costs are low and declining. Breakeven in new markets is less than a year now so margin gains should accelerate.

One Of These Things is Not Like The Other



Source: Bloomberg, Broyhill Asset Management Estimates

Gross margins are a tad below the largest enterprise SaaS companies.

But PM doesn't require nearly as much marketing spend to drive growth.

And it certainly doesn't need to give away the company to incentive employees.

Yet, despite similar or perhaps superior economics, the company still trades at a massive discount to its sexier software peers.

All Multiples Are Not Created Equal

		Return on Invested Capital			
		4%	8%	16%	24%
Growth	4%	7.1x	12.5x	15.2x	16.1x
	6%	3.3x	12.5x	17.1x	21.8x
	8%	N/A	12.5x	19.4x	21.8x
	10%	N/A	12.5x	22.4x	25.7x

Source: Credit Suisse, What Does a Price-Earnings Multiple Mean?

Many would point to the delta in growth rates as the driver of this disconnect. But high multiples are about more than growth.

Growth rates and multiples don't move in lockstep since growth requires investment.

As a result, returns on capital play a key role in translating growth into multiples.

One Of These Things is Not Like The Other



Source: Bloomberg, Broyhill Asset Management Estimates

Some of you might struggle comping PM to SNOW.

So let's take a look at how we measure up to the top five global consumer companies.

PM's ROIC is more than 3x the average, is growing 50% faster, and trading at a massive discount to the group. Something doesn't add up here.

“

We said it and we mean it.

It's not a question of if . . . it's a question of when. One day, **PMI will be a smoke-free company.**

I'm not able to tell you whether it's going to happen because we will have put an end to the combustible cigarette or whether at a certain point, **the combustible business will leave the company.**

But the direction is clear. We are going to be a smoke-free company.



PM will be a smoke-free company.

It's not a question of *if*. It's a question of *when*.

And at some point between now and then, the market will value PMI MUCH differently.

PM + IQOS = A Unique Value Opportunity

	FY25 Sales	FY25 Margin	FY25 EBIT	EV / EBIT	Enterprise Value
Combustibles	16,862	45.0%	7,588	12.5x	94,851
RRPs	16,862	45.0%	7,588	25.0x	189,703
Total	33,725	45.0%	15,176	18.8x	284,554
(-) Net Debt					23,720
Equity Market Value					\$260,834
Shares Outstanding					1,550
Future Share Price					\$168
(+) Cumulative Dividends					\$20
Expected Value per Share					\$188
<i>Cumulative Return</i>					<i>110%</i>

Source: Broyhill Asset Management Estimates

Most SoTP analyses are purely academic exercises. But in this case, we think it makes sense to take management at their word and value the individual parts separately.

This is our “back of the napkin” valuation.

- We start with current run rate revenues ex Russia.
- We assume revenues grow at 5% annually (we think this is conservative given the accelerating uptake of IQOS, new product launches, and the potential to re-enter the US market, which is not currently in our numbers).
- We assume both segments earn 45% EBIT margins (as discussed earlier, we believe IQOS margins should ultimately exceed combustible margins as SG&A declines and the business begins to demonstrate its inherent operating leverage).
- We assume the combustible segment trades at 12.5x – in line with the tobacco sector’s historical average. And we assume RRP’s trade at 25x – roughly in line with the top global consumer staples franchises, which earn a fraction of the returns on capital and generate little, if any, organic growth. We believe this could prove to be very conservative.

Bottom line: after backing out net debt and accounting for cumulative dividends, we believe shares have the potential to double over the next few years.

Why I'm quitting Tobacco.

Recently my advertising agency ended a long relationship with Lucky Strike cigarettes.

And I'm relieved.

For over twenty-five years we devoted ourselves to peddling a product for which good work is irrelevant, because people can't stop themselves from buying it. A product that never improves, that causes illness, and makes people unhappy.

But there was money in it. A lot of money.

In fact, our entire business depended on it. We knew it wasn't good for us, but we couldn't stop.

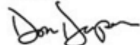
And then, when Lucky Strike moved their business elsewhere, I realized, here was my chance to be someone who could sleep at night, because I know what I'm selling doesn't kill my customers.

So as of today, Sterling Cooper Draper Pryce will no longer take tobacco accounts. We know it's going to be hard.

If you're interested in cigarette work, here's a list of agencies that do it well: BBDO, Leo Burnett, McCann Erickson, Cutler Gleason & Chaough, and Benton & Bowles.

As for us, we welcome all other business because we're certain that our best work is still ahead of us.

Sincerely,



Donald F. Draper
Creative Director
Sterling Cooper Draper Pryce



MAD MEN

Everyone is quitting tobacco these days.

The stocks haven't seen this magnitude of underperformance since the late 90s.

Back then, tech was roaring, value was dead, and the sector was uninvestable.

The stocks went on to outperform the market by several hundred percent over the next decade. We think the setup is incredibly similar today.

It's Boomer Time.

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