**Tidefall Capital LP**
**Q4 2023**
**January 21, 2024**

| | Q4 2023 | 2023 | Since Inception *(Jan 21, 2020)* | Since Inception *CAGR* |
|---|---|---|---|---|
| **TIDEFALL LP** *(Net)* | -0.6% | 2.2% | 192.4% | 31.3% |
| **S&P** *(TR)* | 11.7% | 26.3% | 52.7% | 11.3% |
| **TSX** *(TR)* | 8.1% | 11.8% | 34.8% | 7.9% |

We remained conservatively positioned during the quarter and our lack of technology stocks continued to hold back our returns. We are finding more compelling investment opportunities outside of the *'Magnificent Seven'*. We recently took a position in British American Tobacco (BAT), a global tobacco company with 46% of its revenue from the US. Despite increasingly moving away from traditional cigarettes *(83% of revenue)* and a transition to smokeless products *(17% of revenue, with a goal of 50% by 2035)*, the company has been abandoned by many active managers and passive funds due to an assumed terminal decline and ESG mandates. However, even under this backdrop of falling cigarette volumes, revenues and profits have steadily increased due to higher prices as customers have limited price sensitivity. For example, from 2018 to 2022 cigarette volumes at BAT declined from 701bn to 605bn yet revenue increased from £22bn to £23bn and earnings per share increased from 263 to 291 pence *(even with the majority of profits being paid out as dividends)*. With a pack of cigarettes costing just $9 in the US vs higher tax countries with similar smoking rates like Australia where a pack costs $26, we feel there is still further pricing power to offset the future volume declines and continue to increase profits.

This bull thesis of raising prices to more than offset volumes has long been understood by investors and for many years tobacco companies traded at a respectable 12x earnings. However, in 2015 the first successful commercial vaporizer was developed by Juul Labs. Vaping, which heats up nicotine liquid into vapor, is not only less harmful than smoking due to the lack of combustion but it allows for consumption in locations where traditional smoking would have typically left strong odors or easily set off fire alarms. Juul's vape product looked more like an iPod or USB stick than a cigarette and although officially positioned as a smoking cessation device, Juul's viral growth was actually fuelled by teenagers and new users who found the sweet smelling fruity flavours particularly appealing. Vaping's so called *'holy grail innovation'* reignited investor interest and the sector rallied higher with BAT shares trading at 18x earnings.

Unfortunately, economic reality did not live up to the rosy expectations of investors. The increase in teen usage pressured regulators to force Juul and US vape manufacturers to withdraw their enticing flavours. This product gap left vape users searching for a replacement. Nearly all users transitioned to illegal Chinese disposables that are now widely available at the approximately 10,000 independent cigarette and vape shops in the US. These illegal devices come in a myriad of sweet flavors, have zero oversight on safety from the FDA, do not pay duty or excise taxes and are intentionally mislabeled at ports as *'flashlights'* and *'battery chargers'*. The imported shipping containers of illegal disposables are sold to smaller distributors, who service the independent stores via an underground network of vans and trucks. At present, it is estimated by multiple studies that at least 60% of the US vape industry are illegal disposables *(compared to 10% illicit sales for cigarettes)*. The growth of illegal vaping not only hurt profits of big tobacco's next generation of products but even accelerated the volume decline of its traditional cigarette business which were also coming under increasingly tough FDA restrictions. These difficult conditions combined with an ill-timed massive purchase of tobacco company RJ Reynolds in 2017 saw the growth narrative quickly reverse and BAT shares have since traded down to 14 year lows and an all time low 6x earnings multiple.


We believe that the market is missing the potential for the removal of illegal vape devices in BAT's key US market. Although, there was a blistering expert report in 2022 which described the FDA's failed efforts on the vape market as *'reactive and ineffective'*, it was not until later in 2023, that the problem of China's exporting of illegal disposables vapes finally came under public pressure. Exceptionally well written articles by Matthew Perrone of the AP and Chris Kirkham and David Kirton at Reuters succinctly highlighted that '*The FDA has confiscated more heads of romaine lettuce than it has illegal e-cigarettes in the last five years.'* This finally kickstarted Washington into addressing the problem. Thankfully, in December, members of the the new congressional committee on US-China Relations sent a request to the Justice Department and the FDA calling attention to *'the extreme proliferation of illicit vaping products*'. The US International Trade Commission also voted to institute an investigation of *'disposable vaporizer devices'*. Shortly thereafter, Federal agents seized 1.4 million illegal Chinese vapes at the Los Angeles International airport that had intentionally been mislabeled and valued as *'toys and shoes*'. Big Tobacco is also going directly after the problem with both BAT and Altria recently launching separate legal actions against illegal manufacturers and retailers.

With the Biden administration set to implement a menthol ban and illegal Chinese disposables running wild, we believe we are nearing peak pessimism in the tobacco market. Any sustained enforcement success against illegal Chinese vapes would immediately turn a major headwind into a tailwind and potentially re-rate BAT's PE multiple. BAT is especially interesting due to their ownership of VUSE, the number one legal vape brand in the US. Even with illegal competitors, BAT's next generation of products division has already turned from a £1.1bn loss in 2020 to breakeven a full two years ahead of schedule. Following the recent investor update, we purchased our shares in BAT. Its largest shareholder Ken Dart, who has been improving management incentives, also increased his position from 8% to 10.5%. We note that with net debt to EBITDA having declined from 5.3x in 2017 to 2.7x in 2023, additional stock buybacks and/or a dividend increase (a 10% yield at the time of our purchase) is increasingly likely in 2024. Finally, BAT has 29% ownership in the India Tobacco company which is equal to a third of BAT's market capitalization despite contributing just 4% of company profits. Although there are no plans to spin off this investment presently, if ever approved and at today's prices, it would further lower the PE ratio from 6x to just 4x.

We are pleased to announce that Tidefall is now open to accredited investors in Alberta and Nova Scotia.

Trevor Scott

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