BEHIND THE NUMBERS
Quality of Earnings Analysis

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Behind the Numbers

Companies in this Issue

Altria Group, Inc. (MO)
Earnings Quality Update

We are maintaining our earnings quality rating of MO at 2- (Weak).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

MO's 4Q23 adjusted EPS of $1.18 met forecasts and was flat y/y. That does not sound impressive to us and to achieve that MO needed:

- A reduced share count adding 1.5 cents
- MO added back 2 cents of ABI investment losses
- NJOY acquisition put $1.6 billion of the total $2.9 billion cost into goodwill that is not amortized. That is giving MO 0.6 cents in EPS per quarter.
- NJOY assigned another $1.4 billion to intangibles largely in technology. It is amortizing that over 13-18 years. We believe this added 1.4 cents to quarterly EPS vs. a 5-year amortization period.

The market cheered MO's announcement of a new $1 billion share repurchase plan. However, it guided to a back-loaded 2024 and EPS growth of only 1%-4% for $5.00-$5.15 vs $4.95. That forecast will benefit from two extra shipping days which we estimate is worth 3-4 cents and the share count at the end of 2023 is lower by 13.6 million shares from the weighted average of 2023 shares – which is already worth 1 cent in EPS. Plus, one of the extra shipping days occurs in 1Q as MO calls for a backloaded year. The low end of guidance is already achieved. We would be concerned about the following:

- MO's cash flow for 2023 was helped by booking a $6.5 billion ordinary loss on JUUL, which was non-cash, but allowed MO to record a tax benefit of $1.1 billion. This was a huge one-time item for 2023 as cash from operations rose from $8.3 billion to $9.3 billion.

- Along with the tax benefit, MO received $1.7 billion for unwinding the joint venture with PM for heated tobacco in the US. That cash was spent on the $2.75 billion acquisition of NJOY and $1 billion in stock repurchases. What is the encore? Going forward, MO's cash flow should drop by $1 billion producing at best $8 billion in free cash flow. The dividend is now $7 billion and MO plans to repurchase another $1 billion in stock. There is not much cushion here.

- Pressure on smoking income continues. MO has lost more volume than the market with price hikes for years. Until very recently, it further spiked pricing by curtailing promotional spending. That spending nets against pricing in the revenue line and MO saw it return in 3Q and again in 4Q.

- We need the 10-K to see the actual 4Q figures, but we estimated the price and volume figures for 4Q based on comments on volume and using the total revenue reported. Already, volume loss had exceeded pricing for some time, and smoking income is no longer rising:

MO Smoking	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22
Price gain	$300	$420	$488	$472	$622	$480	$570	$411
Volume loss	($482)	($725)	($542)	($654)	($764)	($584)	($757)	($401)
Op. Income	$2,568	$2,741	$2,866	$2,515	$2,603	$2,812	$2,800	$2,511

- Even MO expects more promotional spending in 2024 for the tobacco unit. Tobacco is still 86% of the income here and 2023 enjoyed lower promotional spending in the first half.

- In December, British American Tobacco which owns Reynolds Tobacco in the US took a $31.5 billion impairment against its US cigarette assets due to customers trading down to non-premium brands at a faster pace following years of price increases. BAT not only took the impairment, but it also reduced estimates for the useful lives of these brands and cut revenue guidance – despite seeing growth elsewhere in the world. BAT also indicated it has reduced pricing for its US cigarettes to offer better value and is seeing market share tick up. MO doesn't have goodwill and brand valuations on its balance sheet to record impairments related it its Tobacco business, but it is impacted by the same trends.

- Here comes Philip Morris and heated tobacco in 2024 too. PM's IQOS heated tobacco device was already authorized by the FDA years ago. What halted the roll-out was a patent infringement ruling from the International Trade Commission. PM and MO parted ways on their JV to import and distributed IQOS in the US. In July, PM requested reauthorization for IQOS in the US from the FDA. In October, it added ILUMA (a different heated tobacco device design) to the FDA request. On February 1, British American Tobacco and PM reached a settlement on their patent dispute on IQOS and will both ask the ITC to rescind their ruling. PM could be in a position to start rolling out heated tobacco in the US in 2024. MO has a new JV with Japan Tobacco but does not plan to file with the FDA until 1H25.

- How much longer before MO reports an impairment for Skoal and perhaps Copenhagen? Skoal's trademark is a $3.9 billion asset and Skoal and Copenhagen are $5.0 billion of MO's Goodwill balance. Last year, MO reported that Skoal's valuation only exceeded the carrying value for the trademark by 12% and a 1% higher discount rate would cut that cushion to only 2%. Here are the volume trends for these two products:

	Skoal				Copenhagen			
	4Q	3Q	2Q	1Q	4Q	3Q	2Q	1Q
2023	-8.1%	-10.8%	-9.2%	-8.2%	-6.4%	-7.4%	-6.7%	-5.4%
2022	-11.7%	-5.0%	-10.3%	-8.9%	-11.3%	-2.6%	-8.2%	-6.3%
2021	-4.1%	-8.8%	-2.4%	-6.0%	-1.7%	-7.4%	-3.5%	-1.7%
2020	-4.3%	-6.1%	-7.9%	2.0%	-1.3%	-3.0%	4.7%	-0.2%
2019	-5.3%	-6.7%	-2.7%	-8.5%	-3.3%	-0.4%	-3.9%	0.6%

- MO is doing the same thing with snuff as cigarettes – responding to volume decay with price increases and reduced promotional spending. Skoal has lost 30% of its volume in five years and Copenhagen 22%. They have lost retail share too. At only 14% of operating income, we doubt this can carry the company. A new product roll-out for *on!* has offset some of the lost market share. But now growth for *on!* is stalling. Remember, the total market is declining so gaining retail share is still not a recipe for long-term success. o*n!* had 0.5% of the oral tobacco market in 2020 and rose to 7.0% in 2023. Look at the recent share percentage:

	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22
On! retail share	6.9%	6.9%	7.0%	6.5%	5.8%	5.2%	4.9%	4.1%

Post Holdings, Inc. (POST)
Earnings Quality Update

We are maintaining our earnings quality rating of POST at 2- (Weak).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

POST's adjusted EPS for 1Q24 of $1.69 beat forecasts by 59 cents. POST only gives EBITDA guidance which was $1.2-$1.26 billion coming into fiscal 2024 and did not include any benefit from the Perfection Pet Foods deal that was completed in December. With 1Q results, the outlook was raised to $1.29-$1.34 billion which does include Perfection Pet, which POST said would add $25 million to EBITDA when the deal was announced.

- We see that at least 1 cent in 1Q24 came from the Perfection Pet deal that wasn't in guidance and likely $6 million in EBITDA.

- POST picked up over 60 cents from pricing exceeding raw material change. Eventually, the pricing should fall roughly the same amount as raw materials. Pricing can go down and did fall $21 million with consumer brands still positive while raw material costs fell $53 million.

- POST is a growth-through-acquisition company. It made more deals in the last 12 months. We would argue that restructuring and integration are normal costs for POST given this business model. That was 22 cents of Adjusted EPS.

- Another warning is amid negative volume growth and falling raw material costs, inventory is up in dollar terms and days. The Pet Food deals would impact but the largest part of that has been in place for multiple quarters now:

	1Q24	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22
Inv DSIs	54.5	52.1	52.2	44.4	47.7	42.6	41.1	45.2	56.7
Inventory $	$825	$790	$779	$594	$597	$549	$525	$518	$622

We do not see sustainable real growth at POST. Instead, growth is coming from costs falling faster than pricing and buying more sales with acquisitions. Plus, POST still has some past price hikes annualizing adding to results – some units already see pricing going negative at this point:

- Post Consumer Brands without the pet food acquisitions saw sales rise by only $7.3 million. This was -6.6% volume growth (-$28.6 million) and 8.3% pricing growth ($35.9 million). The pricing was due to past increases still annualizing. PCB saw customers trading down which hurt volume. The full amount of non-acquired cost increases were only $10.5 million. **It looks to us like this net pricing will continue to be pressured downward because volume is negative, customers are trading down, and raw material inflation is basically gone.** Here is the pricing for this unit vs. the raw material increases for the last five quarters:

Post Consumer	4Q23	3Q23	2Q23	1Q23	4Q22
Pricing Gain	8.3%	8.9%	9.4%	10.7%	10.5%
Pricing in $	$35.9	$52.3	$54.1	$61.5	$53.5
Raw Materials	$4.2	$19.5	$30.2	$34.0	$33.0
Net Pricing	$31.7	$32.8	$23.9	$27.5	$20.5

We believe at worst case, POST picked up $11.2 million here last quarter, or 13 cents in EPS. However, we expect raw materials to turn negative and force pricing down even more. If the amount of pricing equals raw material changes – POST was $31.7 million at risk or 37 cents of EPS.

- **Refrigerated Retail saw pricing fall 0.5% ($1.6 million) and volume fall 3.6%($10.5 million).** The key to this was egg sales seeing a 12% pricing loss and a 10% volume loss totaling a $10.7 million loss of sales.

EBITDA grew $13.6 million and operating income by $14.6 million because lower energy, lower raw material costs, and lower freight costs net of some higher warehousing were down $16.9 million. **That $14.6 million growth was 16 cents of EPS for 1Q24.**

POST said this unit still had pricing gains realized – not because of new hikes, but past hikes annualizing so that steam will run out. POST also said promotional spending is rising that comes out of pricing. It is losing volume which deleverages fixed costs. **Egg prices were down 50% y/y in 1Q24 and we believe there is considerable pricing that will unwind here going forward.**

- Foodservice is another egg-heavy unit (about 75%-80% of sales). It saw sales decline by 5.6% y/y ($33.4 million). Egg sales were down $35.2 million based on 4% higher volume ($20.1 million) and 12% lower prices (-$55.3 million). **Income and EBITDA declined by $3.4 million and $3.2 million). That hurt EPS by 4 cents.**

Income was preserved because raw materials and freight cost declines were offset by manufacturing costs which dropped by $52.7 million from an unusually high level. Again, POST noted that this unit benefited from some old price hikes still annualizing in the quarter, not new pricing gains. Those will lap soon. **We believe pricing can come under additional pressure and every $10 million is 11 cents in EPS.**

- Weetabix posted flat results with operating income down $0.5 million and EBITDA up $0.9 million. We will just point out that organic growth was only $1.8 million and came with -2% volume and past price hikes still annualizing. It further sees customers trading down which is further impacting pricing.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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