BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Altria Group, Inc. (MO)
Earnings Quality Preview of 9/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earnings quality rating of MO at 3- (Minor Concern) as well as our Top Sell rating.

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

Summary

MO is scheduled to report 3Q21 earnings on October 28. The company beat forecasts in 1Q by 2-cents and 2Q by 6-cents. On top of that, MO announced in early July that it was selling its Ste. Michelle wine unit for $1.2 billion in cash and would apply much of that toward share repurchases. That would add another 1.4-cents to quarterly EPS (maybe 2-cents combined for 3Q and 4Q) and wasn't a known event when the original 2021 guidance was made. However, MO never raised the top-end of its 2021 guidance and only boosted the low-end by 7-cents.

We see several areas of concern for 3Q21 earnings, but even larger ones for 4Q21, and believe MO may give a less robust outlook.

- Our main point against MO remains its dependence on smoking which regularly generates over 100% of cash flow. The regular decay in cigarette volume slowed during the pandemic as people were home from work and able to smoke more plus higher unemployment payments and lower gas prices freed up more disposable income for cigarettes. Now people are returning to the workplace smoking bans, extra unemployment payments have dried up, gas is more expensive, and inflation is eating into disposable income. Not surprisingly the decay has returned and we see those headwinds continuing.

- Many court cases were delayed due to the pandemic but are now resuming which will likely result in more negative settlements for MO. In addition, graphic packaging is set to debut in October of 2022 with precedents in other countries pointing to a material hit to smoking demand. More concerning is the FDA working towards a methol ban. With menthol 36% of the market and a key gateway to new smokers, we view this as a potential game-changer.

- Can MO continue to ignore its bad acquisition of BUD? It has been underwater for years and has cut the dividend multiple times. MO has steadfastly stated that it views the decline as temporary even though it is now selling for half its value 5-years ago. On 12/31/20, MO's stake was worth $13.8 billion in the market and its carrying value was $16.7 billion. Since then, BUD stock has dropped from $69.91 to $55.04, which would put the value of MO's stake under $11 billion.

Review of the Degree of Dependence on Smoking

We believe our standard look at how dependent MO is on smoking remains the key to understanding this situation for MO. Smoking income at MO is consistently over 100% of total cash flow. Covid is largely over and the smoking volume decay has resumed:

y/y chg in Cig Vol	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19
Altria	-4.5%	-3.5%	-1.0%	-1.0%	-2.0%	-3.5%	-6.0%	-7.0%	-7.0%
Industry	-5.0%	-2.0%	0.5%	1.0%	0.0%	-2.0%	-4.5%	-5.5%	-6.0%

MO has been offsetting this decay with price increases. It noted last quarter that competition was showing more promotion in the branded discount area – but it continued to taking pricing and the spread between Marlboro pricing and that of the lowest price cigarettes is above normal at 37%. That pricing resulted in smoking operating income rising 13% y/y in 2Q on a 4.5% drop in volume. There are several headwinds pointed at this market in our view:

- Extra unemployment payments ended during 3Q. This was a driver in people trading up to more expensive cigarettes. There should be some impact of this in 3Q, compared to 0% in 2Q and 1Q and 100% for 4Q.

- More people are going back to work rather than staying at home full-time. At home, they could smoke and not impact others. At home, they could take more frequent smoke breaks – that gave MO higher volume overall. They had been seeing -7% y/y comps for several years coming into Covid.

- Inflation is chewing up the extra income people were earning. Now they have to commute again and oil is $75-$80 vs. less than $25 during Covid. Food prices, household goods, shipping costs are all up too. MO had talked many times that the price of gas moves inversely with cigarette purchases and the price people are willing to pay for cigarettes

- All of these items should have negative impacts on both volumes and pricing for this key unit that remains between 87%-92% of total MO operating income.

- And don't forget how many lawsuits MO has pending against it – many courts were closed for parts of Covid and schedules were limited when open. This spending has not started to increase yet at $43 million vs. $39 million for the 1H21 vs 1H20. However, payments have picked up to $52 million vs. $34 million and MO posted a $50 million bond for appeals in June.

- The new graphic warnings on cigarette packages have now been set for October 2022 by a district court in August 2021. We have talked several times about how other countries have seen declines in rates of smoking and fewer newer smokers starting as a result of this type of packaging. This will not impact 3Q21 results or even 4Q21 guidance, but the time when this has a negative impact on forward estimates is getting closer.

- The FDA said in April 2021 it is working to issue a menthol ban for cigarettes within the next year. This has been the strongest area of cigarette sales for some time. In the last week, the FDA laid out its new rules for companies to follow when submitting new tobacco-related products for FDA approval. At that same time, the FDA noted it is still working toward the menthol ban rules. In 2018, menthol was 36% of the cigarette market. This is a game-changer if it happens and it should be appearing more often in the news within the next two quarters given the timeline the FDA laid out.

IQOS Product Problems

The US International Trade Commission ruled on September 29 that the IQOS heated tobacco device made by Philip Morris, which is distributed by MO in the US – violates patents held by British American Tobacco. The Commission ordered MO to stop importing IQOS products and the order should be effective by the end of November, barring a move by the Biden Administration to overturn the Commission.

There are several items at play here. The first is there has been considerable speculation that PM would acquire MO. The two companies have an agreement to split MO's heated tobacco market in the US by using the PM IQOS product. Having this product stopped for US roll-out may derail further merger talks. This also pushes MO back to traditional cigarettes and to Juul e-cigarettes. Cigarettes are far more profitable for MO, but the volume is in decay as we noted above and price increases may only worsen that situation. Juul only pays MO 35% of equity (non-cash) income vs. 100% of cash income for cigarettes too.

BAT, PLC is taking market share with its Vuse e-cigarettes at the expense of JUUL and at the expense of traditional cigarettes in the US. That has the potential to hurt both markets for MO. British American has its own heated tobacco product called Glo that it sells in foreign markets but not the US. They may seek FDA approval to introduce it in the US with IQOS derailed. That would take some time, but British American already has infrastructure in place in the US from its Reynold's purchase several years ago and it could have the US heated tobacco market to itself – cannibalizing both its US cigarette volume but also grabbing share from MO.

We know from Philip Morris data that:

- Total PM volumes sold in 2016 were 820,340 billion cigarettes and less than 1% were heated tobacco products.

- In 2020, PM's volumes were 704,629 billion units down 14% while heated was now 11% of total volume. Cigarettes fell 23% in volume while heated units rose about 11-fold.

- Philip Morris has not introduced heated tobacco into all markets, East Asia (primarily Japan and Korea) is where the roll-outs were most heavy.

- East Asia in 2016, heated was 9% of PM's regional volume.

- In 2020, PM's East Asian heated volume rose to 43%. PM's cigarette volumes are down 40% in that region over four years.

We would think BAT is looking at that situation (and it lived it too in Japan and other markets) and thinking it has a heated product ready to go if it gets FDA approval. At the same time, MO may need some new designs for the product, testing, and another FDA approval. Also, MO was slow-playing the IQOS heated roll-out in only a few markets. BAT could be looking at a chance to take a material percentage of the US smoking market. Any announcements by BAT in that direction may create more headwinds for MO's earnings forecasts.

Interesting to consider, in the very short term, MO may actually be helped by the patent ruling. This is because it had slow-played the rollout to only a handful of markets and was spending heavily to promote IQOS. The 2Q earnings results are full of examples of MO having many people in the field to demonstrate IQOS to retailers and potential customers in the stores. That was consuming cash as cigarettes do not require that much support. This may have been a very expensive item for 3Q results but could fall noticeably in 4Q.

Also on the short-term positive side – MO splits revenues from IQOS with PM. If it sells cigarettes – all the revenues (net of excise taxes) belong to MO.

Thoughts on a Potential Acquisition by Philip Morris

We think derailing IQOS in the US takes away a large reason for PM to want to buy MO, but there are still reasons to consider it.

- PM trades for 12.4x EBITDA at $96/share vs. 9.4x EBITDA for MO at $46/share

- Combining the companies could unlock value by having MO's EBITDA trade for a higher multiple.

- If it could be done as a stock purchase – say 0.5 shares of PM for every share of MO – it would allow for a backdoor dividend cut at MO and keep more of the capital for other uses. The two companies pay $14.4 billion in dividends now, issuing 0.5 shares of PM for every MO share would cut the total pay-out to $12.4 billion.

- It would give PM access to more US dollars. Currently, PM has over $20 billion in debt payable in dollars and almost $9 billion in Euros and Swiss Francs, plus its dividend is payable in dollars. However, its revenues are in many other foreign currencies. A back-door cut of MO's dividend could free up more dollars.

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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