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# Altria Group (MO) – 3Q18 Update

Altria tightened guidance by 1-cent following 3Q earnings. It now expects EPS in the range of $3.95-$4.03, up from $3.94-$4.03. The stock is 16x EPS with all the recent EPS growth and dividend growth due to the tax cut of 2017 – not from operations. The 5% yield is attractive to many, but as we have discussed in reports on June 14 and June 21, we still question how sustainable it is. The company targets an 80% payout of earnings. Given low capital spending that does not sound too high. However, free cash flow seldom equals earnings and we see several potential hits to the business including: continued volume decay, higher excise taxes and price hikes driving volume down further, FDA banning menthol, lowering nicotine levels, and implementing graphic packaging so cigarette packs show people with health issues.

We believe the company is very well managed and it can withstand a few pennies +/- in EPS changes without difficulty. However, many of these larger issues are game changers for MO and the dividend in our view. MO does not have another income tax cut coming for cash flow and earnings growth. Philip Morris has already shown that the heated tobacco market can quickly replace a large swath of the traditional smoking market and generate incremental sales related to the heating device. It also has shown in Japan and Korea that within a year, competition cuts pricing and the revenue produced by stocking the channel does not repeat.

- Smoking results are flat, helped by pricing, but MO is still losing market share and pricing is no longer offsetting volume declines

- 3Q cash flow benefited from timing of settlement payments and working capital changes

- Loss of $400 million in BUD dividends and falling cash from the leasing business PMCC are going to make a dent in the cash flow cushion as will IQOS support – the forward dividend already exceeds free cash flow by our estimates

- FDA is going after menthol and other flavorings as well as pulling products with multiple actions recently – this is key because it targets prevention of youth smoking – MO agreed to support raising the federal minimum age to 21 to buy any tobacco product

- FDA is accelerating its mandates for graphic packaging on cigarettes under court order

- FDA gave a presentation on October 11 highlighting the positives to cutting nicotine levels in cigarettes dramatically – focusing on more people quitting and fewer starting

- It seems unlikely MO will have heated tobacco to itself and studies show it does not stop the decay of smoking. It may add some extra costs that offset MO's efforts to cut expenses as smoking volumes decline

## Lack of Growth Continues to Accelerate

We still look at MO as a smoking story as that is over 85% of the income. It simply isn't growing and 3Q and YTD has not changed that. The rate of decline for the industry and MO continues to accelerate:

| Cig. Vol. | YTD 18 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| US Market | -4.5% | -4.4% | -2.4% | 0.1% | -3.4% |
| Altria | -6.3% | -5.1% | -2.5% | 0.5% | -3.0% |
| Marlboro | -5.8% | -5.0% | -2.6% | 0.0% | -3.1% |

Distributors tend to buy ahead of price increases and excise tax increases. In early 2017, California raised the excise tax by $2 per pack, which hurt 2017 results vs. 2016. However, 2018 has not bounced back. Also, MO raised prices in September 2018, which also led to more buying ahead of that in the quarter. The 2018 YTD figures adjust for that.

In good years, MO has operating income growth from smoking products. That can be impacted by charges to streamline the business, litigation payments, and adjustments to master settlement deals. That speaks well to MO's prowess at cutting costs as volume falls as well as the power of price increases that drop to the operating income line with very little incremental expense. However, we believe MO has reached the tipping point where pricing is not offsetting volume loss:

| MO Smoke Revenue | YTD 18 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Pricing | $829 | $1,058 | $636 | $720 | $795 |
| Volume | -$1,188 | -$1,273 | -$577 | $133 | -$724 |

Adjusted operating income, which excludes restructuring charges and litigation issues is not growing any longer either. 2017 saw a one-time pop in growth with a $288 million cut in marketing and administrative costs, but those are rising again:

| MO Smoke Income | YTD 18 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Adj. Op Inc | $6,462 | $8,561 | $8,002 | $7,599 | $6,851 |
| Growth | -1.6% | 7.0%* | 5.3% | 10.9% | 6.7% |

- 2017 growth would be 3.4% adjusted for cut in marketing and admin.

Without earnings growth in this area, it becomes more difficult to boost dividends and continue share repurchases.

## Cash Flow Benefits and Headwinds

While MO talks in terms of the dividend payout of 80% vs. EPS, we prefer to look at the situation from a cash flow standpoint. We pointed out the basic issue in the June report – Cash from operations is normally under $5 billion, capital spending about $200 million, and the dividend about $4.8 billion and growing.

The tax reform will add about $1.0-$1.1 billion to cash flow. That's a big positive for MO. Of that money, MO is ear-marking one-third for new products/investments and the rest for shareholders. That leaves a $700 million cushion for the dividend situation. Here are other issues to consider:

- Anheuser Busch Inbev cut its dividend in half last week. That dividend gives MO about $800 million of its cash flow per year, and going forward, $400 million is gone.
- PMCC's portfolio is in run-off and contribution to cash has been declining.

| PMCC Cash | YTD 18 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Cash in | $0 | $133 | $231 | $354 | $369 |

- Free Cash Flow has already benefitted from falling capital spending, which is expected to be $200-$250 million in 2018. It is also common for MO to make some acquisitions:

| MO spending | YTD 18 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Cap Exp | $132 | $199 | $189 | $229 | $163 |
| Acquisitions | $0 | $415 | $45 | $0 | $102 |

- The $0.80 quarterly dividend already annualizes out to $5.38 billion, up $569 million from what was spent in 2017.
- Share repurchases have mitigated the full impact of dividend per share growth, but it is unlikely MO can afford to keep buying shares at past rates.

| MO spending | YTD 18 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|
| Dividend/Share | $2.86 | $2.54 | $2.35 | $2.17 | $2.00 |
| Growth/Share | 14.9% | 8.1% | 8.3% | 8.5% | 8.7% |
| Total Dividend | $3,909 | $4,807 | $4,512 | $4,179 | $3,892 |
| Total Growth | 10.3% | 6.5% | 8.0% | 7.4% | 7.8% |
| Share Repurchases | $1,317 | $2,917 | $1,030 | $544 | $939 |

- Don't cheer the $2.4 billion positive move in cash flow for YTD 2018. Much of that is the remaining benefit of taxes that will lap in 2019 ($440 million), higher settlement charges that are negatively impacting earnings but are accrued and MO will have to pay them ($1.1 billion), and working capital changes of $270 million. Also, of the $300-$350 million from the $1.0-$1.1 billion in tax savings estimated to be spent on new products this year – much of that was not spent yet. That's the bulk of improved cash flow and it does not appear sustainable.

So here is cash flow for the last several years before the tax reform.

| | 2017 | 2016 | 2015 | 2014 | 2013 |
|---|---|---|---|---|---|
| CFO | $4,922 | $3,821 | $5,843 | $4,663 | $4,375 |

Be generous and call it $5 billion per year. Going forward, add in $1.0 billion for the lower tax rate and subtract $400 million for the reduced BUD dividend and subtract $300 million in product investment spurred by the tax cuts. That leaves MO with $5.3 million on average in cash from operations. Pay out $200 million in capital spending and the Free Cash Flow is $5.1 billion.

The $5.1 billion in Free Cash Flow does not have much cushion from PMCC at this point. A smoking division with no growth or negative growth is going to be a headwind on that Free Cash Flow too. From that $5.1 billion, MO has to pay a dividend of over $5.3 billion and repurchase shares. That also assumes no increase in litigation costs or settlements and no acquisitions.

## The Frog Is in Hot Water Already

One of the points that always makes us chuckle is the bullish view on Altria that says, "Hey the Government is being very benign here." As we noted in the June 14 and June 21 reports, between excise taxes, healthcare settlements, and income taxes – governments take 42% of Altria's revenue off the top and another 21%+ of its income.

The same is said about the FDA, which has regulated tobacco sales, marketing, use, and along with state and local governments banned people from smoking almost everywhere in public. Too few people do not look back and see that 481 billion cigarettes were sold in the US during 1995 (hardly the days of the chain-smoking Rat Pack) and in 2015 the volume was 247 billion and falling faster since. The view of the bulls remains, "Oh any FDA action won't happen for many many years."

We will update some of the recent actions from just the last couple of months in the rest of this report. It is important to remember that even shrinking cigarette volumes are kept at higher levels by new smokers starting. 95% of smokers start before age 21. Also, menthol cigarettes have been the only area of smoking showing flat to higher smoking rates. If something disrupts the path that creates new smokers – the drop in smoking volumes could accelerate much more.

## FDA Is Cracking Down on Youth Gateways, Flavors, and Menthol Now

We noted in June that the FDA was disturbed with how many kids were vaping and using e-cigarettes. It did not want young people getting addicted to nicotine and then becoming smokers. Far from taking years to act, the FDA is cracking down in September and October.

What makes the news is the investigation into JUUL and many of its flavored e-cigarette products. However, in September the FDA cracked down on Reynolds for its Camel Crush Bold – which has a menthol capsule in the filter that can be used to give menthol flavoring to a regular cigarette. According to Matt Myers the President of the Campaign for Tobacco-Free Kids, the capsule delivered menthol at higher levels than other menthol cigarettes and added sugars and sweeteners. The FDA is prohibiting the sale of Camel Crush Bold. The FDA also had Reynolds pull Deep Set Recessed Filter cigarettes in regular and menthol varieties and Vantage Tech 13.

The FDA approached Altria in September as well and in October, MO pulled products off the market too. These include MarkTen Elite and Apex pod-based products. Also, all cig-a-like products in any other flavors besides tobacco, menthol or mint flavors. That will result in 20% of MO's e-vapor products being removed the market. MO actually provided data to the FDA showing that adult non-smokers did not find the flavors appealing – further highlighting that removing them should help prevent young smokers from starting.

That sounds like a small hit overall, but it's rare that the FDA has pulled products from the major players off the market. It is specifically targeting ways that enable the young to get gateways to smoking which means making early smoking experiences more pleasant with flavors and menthol.

**Perhaps, most important – MO has now agreed to support the FDA in pushing for federal legislation to make 21 the minimum age to purchase any tobacco product.** That would include snuff, heated tobacco, as well as regular cigarettes. Remember, 95% of smokers start before age 21. If the volume of cigarettes is declining at 4% now, it probably means that it is really falling at 6%-7% with 2%-3% growth from new smokers. So, the decay rate could accelerate very quickly with this type of push. We would also ask; what politician would ever vote "No" on this? This may be quick moving legislation.

As far as the overall consideration to ban menthol – the FDA is gathering comments and started this process in March 2018. The EU is already imposing a ban in 2020. Canada banned menthol in 2017. Various health organizations and the FDA do not see menthol as an addictive substance. However, they do view it as a way to mask the harshness of tobacco smoking and allow smokers to inhale deeper, smoke more often, and more easily pick up the nicotine addiction. The FDA's goal is to reduce the number of people smoking and even though all forms of cigarettes are declining, menthol brands are showing the strongest resiliency and even posting positive growth in some years. With Camel Crush Bold and Pall Mall's Deep Recessed Filter, they have now pulled some menthol cigarettes off the market. Also, the trend is toward bans – other countries beyond the EU and Canada have adopted them. Oakland banned menthol in 2017, San Francisco banned it in June, New Jersey is working to ban this year too.

We think the FDA is moving more quickly than others believe to stop young people from smoking, vaping, dipping, or any other form of nicotine/tobacco use. Given the usage stats on menthol, its appeal to youth and helping people start smoking, and the growing number of bans – the FDA may take some negative action here much quicker than others think. Moreover, it doesn't have to be a sweeping ban to impact the market. A 21-and-over age limit would be a small step and would do considerable damage to cigarette volumes and all other forms of tobacco. Other smaller steps could be more specific product bans, continued delays in approving heated tobacco products like IQOS, or graphic packaging.

## Court Orders FDA to Speed-Up Graphic Packaging in September

Graphic packaging on cigarettes involves showing pictures of people with black or no teeth, late-stage cancer, and other ill-effects of smoking. This also targets youth smoking prevention as well as pushes current smokers more toward stopping. Over 120 countries have already adopted this and seen strong results in reducing cigarette purchases. The results are driven by changing the photos on the package so people do not become immune to them. Also, cigarettes are one of the few packages that people carry around all the time. If you eat a cheeseburger, you throw the wrapper away in probably a minute. But, a pack of cigarettes contains 20 so the pack is on display often and regular smokers nearly always have a pack and look at the pack often. Kids and other non-smokers see the packs more often too with the photos.

A 2013 study by Johns Hopkins looked at the effectiveness of graphic warnings and found that they are effective in lowering smoking rates along many paths. Young and adult non-smokers are deterred from trying cigarettes more often in places with graphic warnings. It increases knowledge among the population on the harmful effects of smoking. Smokers who quit already are unlikely to relapse back to smoking again. Current smokers are more likely to skip having a cigarette when seeing the package. Current smokers are also more likely to boost efforts to quit. This again could cut volumes at MO in 3 ways: More smokers quit, more current smokers cut their consumption level, fewer non-smokers start. This is not a far-away problem for MO and cigarette volumes.

Congress asked for an FDA plan in 2009. In September a federal judge gave the FDA three-weeks to come up with a plan and they filed one in October. The FDA is planning to complete its study in the spring of 2019 and have a final rule in the federal register by May 2021. The judge has been very displeased with the multi-year delay already and said in the ruling that the FDA has already "unreasonably delayed" the enactment of this policy. Any changes he may enforce are likely to cut the time for the final rule to sometime earlier than May 2021.

## Cutting Nicotine Levels in Cigarettes is also Moving Forward at the FDA

We wrote about this plan extensively in June. A quick summary is that cutting nicotine levels in cigarettes is possible and when it has been tested, people quit smoking. This is helped by the acknowledgement that 2/3 of smokers want to quit. The research shows of 30 million adult smokers in the US – 5 million could quit in the first year if nicotine levels are reduced. That could rise to 13 million over 5-years. That is 16%-40% of the US cigarette market. In our June 21 report, we estimated that these forecasts could cut MO's cash flow by $1.0-$1.5 billion in the first year and rise after that if low nicotine standards are adopted.

The head of the FDA has addressed this issue as very promising in his goal of recognizing smoking cigarettes as the most harmful way to deliver nicotine and therefore he wants to reduce the amount of smoking. This also works to help kids not become addicted – giving this the potential to cut current smokers and reduce the number of new smokers.

Dr. Lynn Hull, the lead pharmacologist at the FDA held an hour-long webinar on October 11, 2018 to discuss the science and effectiveness behind Very Low Nicotine Content. VLNC cigarettes have 0.2-0.7mg of nicotine vs. 7.2-13.4mg for regular cigarettes. She highlighted noted a number of studies and the findings. Keys are that it cuts the number of cigarettes smoked per day, does not change how cigarettes are smoked (no deeper inhales or more puffs per cigarette), reduces addiction, may increase attempts to quit, and there was no evidence that it increases cravings or withdrawal symptoms. It also made it less likely that non-smokers would become addicted if they experiment with VLNC cigarettes.

## IQOS from Philip Morris Could Give MO a Short-Lived Bump

Altria hopes to get approval from the FDA to roll-out heated tobacco products soon. This involves a device that users load with replacement sticks that are sold similar to a pack of cigarettes. Philip Morris saw rapid adoption when it rolled out this product in Japan and Korea. We do believe that this could give MO a bump because it would stock the inventory channels with devices that cost more than a pack of cigarettes and the replacement packs.

Many smokers may be willing to try them, and the excise tax situation may be more favorable in the early days. Some excise taxes are based on amount of tobacco weight and heated tobacco has less than regular cigarettes. Because heated tobacco packs would replace regular packs of cigarettes – we believe the federal, state, and local governments would move quickly to adjust the tax situations.

There are several downsides to heated tobacco for Altria. First, it further crushes the sale of regular cigarettes, as smokers switch. Second, heated tobacco delivers less nicotine, which could help people quit altogether. It is not at the VLNC level, but if lower nicotine makes people start to smoke less and quit – that may hold true here too. The data we have seen shows that even the tobacco companies believe heated tobacco does not stop the long-term decay rate of smoking overall. Instead, they believe that smokers who do not quit may live longer (due to less exposure to toxins in smoke) and thus continue as customers for more years. Third, a big rollout will likely come with higher marketing and support spending and thus could happen at a lower margin than regular smoking – MO has maintained earnings with consistent cost cutting. Fourth, the FDA has made it very clear that it does not want a bunch of young people addicted to nicotine, which is why it is cracking down on flavors with e-cigarettes and calling for a minimum age of 21 to buy any form of tobacco. That could limit the market for heated tobacco and keep pressure on to restrict young non-smokers from starting.

We have written about this in various reports on Philip Morris. What PM found was fast growth that stalled after a year in Japan and Korea. PM found competitors quickly rolled out competing devices and took back market share with price cutting. The primary competitor for MO is British American Tobacco who bought Reynolds – BAT already has a heated tobacco product too in foreign markets. We think MO is unlikely to have the same first to market advantage that PM enjoyed in Japan. PM has the benefit of rolling out heated tobacco in many more countries in the future to show new areas of initial stocking growth. MO only has the US, thus will only get one roll-out.

## Conclusion:

Altria has enough cash and borrowing ability to maintain its dividend even though free cash flow no longer does. However, that won't last forever as smoking rates continue to erode. MO is also losing volumes faster than the industry and its price increases are no longer offsetting the impact of volume decay. That's the current situation.

We see several reasons to expect the decay rate to accelerate – especially with MO now supporting the FDA's efforts to raise the minimum age to buy any tobacco product to 21. If 95% of smokers start before age 21, this has the potential to cut the number of new smokers to replace those who quit or die and accelerate the decay. The FDA has already started pulling products and flavorings that make it easier for young people to take up smoking via e-cigarettes and ways to mask the harshness of tobacco. That includes pulling menthol related product. The FDA is now accelerating the roll-out of graphic warnings on packaging and is continuing to tout cutting nicotine levels in cigarettes as a way to reduce smoking. Both of those have proven effective in cutting cigarette volumes. Many countries have menthol bans with the EU's starting in 2020 and the FDA is looking at that too. As the one area of the smoking market that has seen some resiliency – restrictions on menthol would also cut volumes quickly. Canada showed double-digit drops after the ban.

If the decay rate continues to accelerate as it has for three years at this point, we think the dividend comes under pressure as these new FDA policies gain more traction. Much of this doesn't even require a full-out ban of the product. Age limits and graphic packaging wouldn't change the content of cigarettes at all. Allowing other manufacturers to release lower nicotine cigarettes may win over some current smokers and help them quit without outright banning higher nicotine cigarettes in the early stages.

A roll-out of heated tobacco has the potential to give MO a bump for a year or maybe two. However, we believe this roll-out will cost more to market than current cigarettes and will not create new smokers. Its major competitor also has heated tobacco products so firstmover advantages are unlikely to last. Moreover, the FDA will not want young non-smokers picking up the habit via heated tobacco. All the signs are there that the decay rate will remain in place for smoking volumes after a year of stocking the channel.

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