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Altria (MO) 3Q'19 Update
Maintain SELL

We are keeping our SELL rating on MO after 3Q19 results. The company reduced its EPS forecasts from 2020-2022 to 5%-8% from 7%-9%. The claim is this will be driven by boosting promotion and investment spending to help brands and rollout of IQOS. Given that MO has been talking about IQOS for quite some time, we put less weight on the idea that new marketing plans suddenly are in the works for it vs. continued erosion of the cigarette market. MO just posted another 7% volume drop in cigarette volumes. They are continually losing more volume than the industry and these recent accelerating drops are coming against easy comps:

Cigarette Unit Growth	3Q19	2Q19	1Q19	4Q18
Industry	-5.5%	-6.0%	-5.0%	-5.0%
Altria	-7.0%	-7.0%	-7.0%	-5.5%

Those comps are coming against the prior 12 months where comps were -5% to -7%. Remember, decay used to be 2%. So, -7% on top of -7% is getting ugly. We think investors should also keep in mind:

- Promotional spending is netted against the price impacts. What really drives revenue and operating income are periods when the company reduces promotional spending. If we look at 2Q19 when promotion was increasing, revenue growth was considerably below periods where MO was cutting promotional spending. It's basically an additional $150 million of no-expense quarterly revenue hitting the operating income line. MO is almost promising more promotional investments.

- The rate of price increases is likely helping drive down volumes at this point. Volumes are down 13%-14% in the last two years and about 18% over three years. Yet, quarterly gains in y/y pricing are over $400 million now vs. about $250 million in recent years with lower promotional spending. Against quarters with higher promotional spending, quarterly y/y price hikes are $270-$290 million now vs. $160-$180 million in prior years with higher volumes. These accelerating rates of price hikes are helping cash flow, even though cash flow is still falling. What if the rate of price increases slows?

- Vaping is another headwind driving down volume growth according to the 3Q19 call. That is a different story than what MO said on the 2Q19 call where they downplayed the cannibalization risk. That is an odd change given all the negative attention vaping has received of late. As we talked after last quarter, IQOS is cigarette volume killer so far in every market PM has rolled it out.

- Here comes graphic packaging. The final FDA rule mandated by a federal judge must be completed by March 15, 2020. It would take effect 15-months later, but it should be receiving significant attention in the coming months, especially if the cigarette companies fight it. Numerous studies in multiple countries that have followed smoking rates after graphic packaging showing the health impacts of smoking can point to large decreases in smoking. It also keeps youth from starting. This could accelerate the decline.

- The new On! raises several questions. MO touted that it comes in seven flavors. Do we really need to go through this again? The FDA has been abundantly clear that it doesn't want flavors causing new people to become addicted to nicotine. Second, On! comes in five different strengths of nicotine. That may help people quit tobacco altogether and adds credence to the FDA's current work on potentially lowering the nicotine content in cigarettes, which could really hurt the smoking market.

- Cash flow remains tight. Cash from operations after capital spending and the dividend is expected to be $1 billion this year. The problem is it was $2 billion in 2017 and $1.6 billion in 2018. The dividend continues to rise, working capital seems likely to rise with new product rollouts, interest expense for the JUUL investment is crimping cash flow. Plus, that $1 billion forecast comes with a big swing in lower promotional spending – which appears likely to reverse as could lower spending on strategic initiatives, which also may not continue or actually reverse. That $1 billion figure is also tied to the company's ability to boost prices at an ever-faster rate as volume decline accelerates.

Price Increases and Promotional Spending

It is widely known that MO's goal is to manage its decay in cigarettes by raising prices to offset volume loss. Another factor that is not as widely known is that promotional spending is netted against revenue. The result is pricing power looks even more explosive when MO cuts promotions and more subdued when it raises promotions. That is a big issue because in their outlook that lowered EPS growth for the coming 3-years, MO cited higher promotion as a likely cause. Here are some quarters where promotion was up and others where promotion was down:

Promotion Up	2Q19	3Q18	1Q18
Rev Growth from Price	$289	$272	$200
Rev Growth from Vol.	$20	-$221	-$252

Promotion Down	3Q19	1Q19	2Q18
Rev Growth from Price	$460	$399	$349
Rev Growth from Vol.	-$443	-$872	-$715

Two things to notice:

- In periods with lower promotion, MO is picking up about $150 million in higher revenue that flows at over 95% to operating income. In 3Q19 $460 million in pricing became $447 million in operating income. IN 1Q19, $399 in revenue was $396 in income. That $150 million is 6-cents in EPS per quarter.

- During periods of lower promotion, MO frequently pushed volume up ahead of the price increases and volume tanks in the quarter. That's how they managed a positive $20 million in volume revenues in 2Q19 as it fallowed a quarter of -$872 million in volume.

We also looked back at past years when volume was higher for the rate of price increase. We believe MO is reaching the point where it is accelerating its own volume decay with large price increases and that is why it is not only seeing decay rates of 7% vs. 2%-3% only three years ago, but also losing volume faster than the market. As we will point out in the next section, the price gap between cigarettes and e-cigarettes is getting wider:

	3Q17	2Q17	1Q17	3Q16
Rev Growth from Price	$250	$252	$180	$163
Promotion trend	Down	up	up	up

We know that after a few years of 5%-7% declines, the market today is about 86%-87% the size it was in 2017 and about 82% of what is it was in 2016. Yet, now it is taking over $400 million in pricing on a smaller volume vs. $250 million on a larger volume when promotional spending is down. When promotions are up, the story is the same. They now take nearly $300 million in pricing vs. $160-$180 million. We think this really demonstrates how dependent MO has become not only on taking price – but also reducing promotional spending.

Let's look at one more step for operating income. In 2018, MO boosted spending on strategic initiatives to help preserve market share and look to grow. In 2018, the company was reporting these costs were a drag on operating income for the smokeable segment. **In 2019, these costs have been cut and it's become a big source of income y/y. Is this sustainable given the company announcing it may need to invest more and certainly JUUL has some issues to fix?**

In the first 9-months of 2018, MO had an increase in costs for smokeable products of $231 million. This was related to litigation and strategic initiatives. As a result, even with higher pricing offsetting volume decay, MO's smokeable segment reported flat earnings compared to 2017.

In the first 9-months of 2019, MO saw these costs decline by $247 million along with restructuring charges that were $82 million higher for a net positive of $165 million. **That is a positive swing of $396 million y/y. Operating income with higher pricing, lower promotion, and lower volume only rose $348 million.** Without cutting back on the various costs – the smoking unit may be unable to raise pricing fast enough to offset the decay. At the same time, they are paying interest costs on $14 billion in new debt.

Can MO cut costs again? They are telling us they need more promotional spending and investment going forward too.

So, Vaping Does Cannibalize Smoking?

We are going to reprint some of the 2Q19 call because when asked about JUUL and e-cigarette cannibalization, Altria was not concerned. Despite lowering its guidance after 2Q, it did not see a big impact from e-cigarettes:

Gaurav Jain – Analyst:

> *"So on cigarettes -- what we have seen this year is that pricing has gone up above expectations and volumes have come in below expectations and that substitute product which is e-cigarettes they aren't really taking any pricing and they haven't taken any pricing for two years. So, as we look out* ***does the e-cigarette cannibalization increase over time as price gaps keep widening****? And what has been your experience over the last two years?"*

Howard Willard – CEO:

> "*Yes. I'm not going to speculate on future pricing.* ***I think that consumers are moving into e-vapor because of significant benefits that those products have unrelated to price*** *and I'm not going to speculate on future pricing."*

Jennifer Maloney – Analyst

> "*I wonder if you* ***can give us an update on direct mailings to your cigarette consumers and onserts or inserts in cigarette packs on behalf of Juul.*** *How many have you sent out? And what are the redemption rates looking like?"*

Howard Willard – CEO"

> "*Yes. We don't share level of that detail.* ***Both direct mailings and onserts to date have occurred.*** *And I know that there is further activity that's planned between now and the end of the year communicating about the benefits of JUUL, but we haven't shared numbers or fine details on that."*

Jennifer Maloney – Analyst:

> *"Broadly speaking, **<u>have the results of those changed your estimates for sort of what cannibalization</u> you expect to see specifically on your brands from JUUL?***

Howard Willard – CEO

> *"No it hasn't. **<u>I don't think we've seen anything that caused us to change our views on JUUL's growth rate or the cannibalization</u> of our products."***
>
> **Now, despite all the various issues at JUUL and new regulation that is causing the company to lay-off staff, and MO is revising its forecasts there downward:**

Howard Willard

> *"Given the dramatic shifts in the current e-vapor regulatory and marketplace environments, we have revised our transaction assumptions. In preparing our financials this quarter, we performed a valuation analysis on our JUUL investment, which considered multiple regulatory and marketplace scenarios. In aggregate, **<u>we're now projecting lower e-vapor category volumes in the U.S.</u>** versus our original estimates, which resulted in a third quarter non-cash impairment charge of $4.5 billion related to our JUUL investment. Also factoring into this determination where other changes to our original assumptions. For example, we expect it may take longer for JUUL to realize the strong margin performance that we previously communicated."*

However, also on the 3Q19 call – apparently, JUUL and e-cigarettes do cause cannibalization. As the company cut forecasts again for 3-year growth rates on EPS:

Howard Willard:

> *"We estimate that U.S. cigarette industry volumes declined by 5.5% in the third quarter and first nine months when adjusted for trade inventory movements, calendar differences and other factors. **<u>We continue to believe that increased adult smoker movement to e-vapor and high levels of exclusive e-vapor category usage were the primary drivers of the accelerated decline rate over the past year.</u>***
>
> *Based on our 12-month moving data, **we estimate there are now 12.6 million adult vapers 21-plus as of September 2019, up from 10.3 million at the end of 2018.***

Importantly that growth trend coincides with the trend toward more exclusive usage in the category. According to our adult consumer tracking data, ***we estimate that 6 million adults 21-plus vape and do not smoke*** *as of September 2019, which is the highest number of exclusive users since our study began in 2014."*

And later in the call, it is cannibalizing snuff too:

"*USSTC's smokeless volumes decreased an estimated 3% in the first nine months of the year when adjusted for trade inventory movements and calendar differences. In the last six months smokeless industry volume decreased by an estimated 1.5%.* ***We believe these declines reflect increasing adult tobacco consumer interests in both e-vapor products and oral nicotine pouches."***

We've talked quite alot about JUUL and the accounting there. Our view is the JUUL does cannibalize cigarettes and for MO that is a problem because cigarettes represent cash flow and JUUL represents a 35% stake in non-cash earnings. It's the loss of cash that will hurt MO, along with paying the interest expense on the debt used to buy the stake in JUUL. That interest expense will need to be paid from cash out of the smoking division which is in decline.

We just thought it was interesting that in 2Q19, lower prices and advertising for JUUL in Marlboro packs were not going to hurt cigarette volumes but in 3Q19, cannibalization is now an issue.

Graphic Packaging Rules Are Coming and Have Negative Impacts on Cigarette Volume

Graphic packaging means cigarette packs will come with pictures of health impacts from smoking. They will cover a high percentage of the front and back of the package with people without teeth, advanced cancers, and larger warnings of other problems. There are two key things about cigarette packs. The first is that it is one of the few containers that people carry around all day and look at many times every day. Second, it is one of the few containers that non-smokers see very frequently as they are often near cash registers and smoking friends/parents have them in cars and on countertops.

The thinking is that the Surgeon General's text warning on the side of a pack is not very noticeable and is easy to ignore as more people look at the front of the pack. Also, the text has had only minor changes in decades. By having several different pictures and text warnings that rotate and having them cover the top 50% of the front and back of each pack – these warnings will much more difficult to ignore.

Congress ordered the FDA to adopt graphic packaging in 2009. The tobacco companies sued as a violation of free speech claiming the images were designed to cause fear or distress instead of educating smokers. The FDA sought to allay those legal concerns with new warnings but dropped the ball. In 2016, the FDA was sued by health groups over the delay and a federal judge ordered the FDA to issue a proposed rule by August 15, 2019, and a final rule by March 15, 2020.

That has happened and the FDA has a new rule, and the 60-day comment period is over. The FDA's first new batch of warnings don't go 100% for the gross-out factor of showing people with no lower jaw or smoking through a tracheotomy hole. Instead, the FDA has combined pictures of people with impaired health along with very large text that Smoking harms babies, harms children, can lead to blindness, cause several cancers, amputations… Therefore, it is believed that the text brings education to the mix and the photos will still draw attention. Also, by rotating and adding newer warnings more frequently, people will not become immune to the impact. The FDA sees this as addressing the free speech issues and "if we are sued after we issue the final rule, we strongly believe that this will hold up under any legal challenges under the First Amendment, under our statute or under administrative procedure, according to Mitch Zeller, the director of the FDA's Center for Tobacco Products."

There has also been more of a truce of late between the FDA and tobacco companies. Both are supporting allowing only people 21 and over to purchase nicotine products. Both are openly talking about cigarettes being harmful and focusing on reduced-risk products such as vaper, heated tobacco, gum… If there are legal challenges – the issue will get much more media attention and the proposed packages will appear often in various stories. Even if they work together, the new packages will also start appearing in public over the next 4-6 months long before the final rule goes into effect in 2021.

Numerous countries already have graphic packaging and their results show strong results for driving down smoking:

- *Social Science & Medicine* in 2016 published reviews of results of 20 countries that adopted graphic packaging and found that hotline calls increased from people asking for help to quit, smokers increased attempts to quit, there were more smokers who reduced the amount they smoke as well as taking breaks from smoking altogether.

- Canada found that graphic warnings reduced the number of new people taking up smoking and increased the number of smokers quitting.

- Studies from Singapore found that graphic warnings caused 28% of smokers saying they smoke fewer cigarettes, 14% decided to not smoke in front of children, and 8% said they smoked less at home.

- Brazil, Thailand, Australia, UK all reported that more smokers wanted to quit after seeing the new warnings.

- A small clinical study was published in JAMA in 2016 tracking 2,000 smokers over 4-weeks. Those exposed to graphic warnings were 50% more likely to have quit smoking at least a week by the end of 4-weeks and total quit attempts were up.

In our view, the threat to cigarette volume decay is that it continues to accelerate. Graphic packaging is coming at this point and simply showing the warnings and discussing them in public may start another source of volume decay in the near future. In 2021, the new packaging could be on the shelves of retailers and pockets of smokers. It is estimated that a pack-a-day smoker looks at the package over 7,000 times per year. All the evidence and studies point to graphic packaging hurting smoking demand.

Since kids see the labels too, we think this also along with the 21-and older laws again make it less likely that young smokers start. We have always held that when smoking volumes fall 5% that is a net number – meaning 8% quit and 3% growth from new smokers became the 5%. The efforts by FDA and tobacco companies are already pushing to hold down the new smoking entry market. Graphic packaging seems like another way this will happen and accelerate the negative volume growth.

While it is not being talked about – at least we haven't found much discussion on it – but do graphic warnings eventually spread to other forms of tobacco? Snuff is certainly a cause of many oral cancers.

Does the Roll-out of On! Bring Some Potentially Bad News Too?

On! is something MO invested in back in 2016. It is now planning to roll it out in larger volumes. This is essentially a tobacco-derived source of dissolving nicotine. People don't have spit to use it, so it more like nicotine gum than snuff. And the nicotine enters via the gums and mouth.

We don't have a great deal of information about this, but it received some attention on the last call that caught our eye:

Howard Willard, CEO:

> *"We expect to begin production of on! in our Richmond manufacturing center beginning first quarter next year.* ***In 2020, we are targeting annualized capacity of 50 million cans by mid-year and 75 million cans by year-end with additional capacity available if necessary****. In addition, our strong regulatory affairs team is preparing PMTAs for the on! portfolio for the May 2020 deadline.*
>
> *As a reminder, Altria owns 80% of the Helix Innovations joint venture that will commercialize on! globally.* ***On! has a product portfolio consisting of 35 unique SKUs; seven flavor varieties across five nicotine strengths.*** *We believe the breadth of nicotine strengths and flavors is a tremendous competitive advantage as both adult smokers and dippers can find satisfying options within the on! portfolio."*

Our first thought is: "Flavors? Really?" Has the FDA not been clear enough that it regards flavored nicotine as taboo and largely a way to make it appealing to under-age non-users? The FDA banned all flavors other than menthol many years ago. It became alarmed about vaping because kid usage was exploding upward because of the flavors and it is banning flavors there now. There is an open debate on-going to ban menthol because it makes it easier to start smoking as well as transition from vaping. So, at the same time, MO wants to rollout a tobacco/nicotine product that is offered in Berry, Cinnamon, Citrus, Coffee, Mint, Wintergreen, and Tobacco flavors? Do we really need to go through this again?

Second, the FDA has been abundantly clear. It does not view nicotine addiction as a good thing. What it has said is that the most hazardous way to obtain nicotine is through smoking. Therefore, for current addicts, it would prefer they use other methods like vaping, heated tobacco, gum, dissolving tobacco. However, it wants that transition to also lead to people quitting altogether. Moreover, the effort to regulate JUUL and the vaping/e-cigarette industry didn't start because people were using the device to smoke pot. It was tied to the FDA's goal of not having it become the gateway to getting more young people addicted to nicotine who may become smokers too. We think trying to roll out flavored tobacco pouches may have much of the same appeal to youth especially the flavors. Will the FDA allow the flavors and the product to continue to be widely available?

Third, the On! product comes in different levels of nicotine. That is likely a way to help people kick the nicotine habit altogether. However, the FDA is also doing a great deal of work on lowering the nicotine content in cigarettes. We have talked about these studies in the past and results show that the smoking market could lose 16% of its business in a year and 40% over five years. We do not think Altria could withstand that rate of decay. Yet, while the FDA debates that concept, Altria may be giving them additional cover by rolling out a product with five different levels of nicotine.

The Company's Cash Flow Situation Still Looks Very Tight to Us

On the 3Q19 call, MO touted that it generally has about $1 billion in excess cash flow after paying the dividend to use for strategic initiatives, pay down debt, and repurchase shares. We are still going to quibble with this quite a bit. First of all – in 2018 and 2017, free cash flow before working capital swings was $1.6-$2.0 billion after the dividend. We're now supposed to cheer that falling to $1 billion?

Cash Flow	2019ytd	2018ytd	2018	2017
CFO pre Wrk Cap	$5,567	$5,826	$7,291	$7,101
Wrk Cap	-$293	-$740	$1,100	-$2,200
CapX	$160	$132	$238	$199
FCF pre wrk Cap	$5,407	$5,694	$7,053	$6,902
Dividend	$4,498	$3,909	$5,415	$4,807
Repurchases	$346	$1,317	$1,673	$2,917

For the first nine-months of 2019, CFO before working capital changes is down $259 million y/y. That's with the company's efforts to reduce costs, the higher than normal price increases taken, and less promotional spending. Higher interest costs are taking a toll. Capital spending is up slightly and so are acquisition costs with Cronos. While they spent $4.5 billion on the dividend in the first nine months, the new annual rate is $4.7 billion ($6.3 billion annually) up $225 million for nine months.

The only thing that improved on cash flow was working capital was a smaller drag in 2019. Yet, now the company wants to roll out IQOS heated tobacco and On! That sounds like a larger working capital investment may be coming.

Investors should be scared by the basic numbers already. The higher interest costs and lower BUD dividend are already crimping cash flow. Then this company used to buy $3 billion in stock back in a year, now investors should cheer $1 billion over 2-years? The problem with that is the total dividend outlay is growing faster than in the past because the share count isn't falling as much. In 2017, the total paid on the dividend only rose 7%. In 2018, it rose 13%, so far in 2019, it's up 15%. The new run rate is only going to rise 5% because the dividend increases per share have slowed dramatically.

We think the change in cash flow after the dividend is likely to come in under $1 billion down from $2 billion only two years ago. That $1 billion already has a positive swing of strategic costs of $313 million net of taxes included in the first 9-months of 2019. MO has also been taking on about $150 million more per quarter in accelerating higher pricing on lower volumes than it was just a couple years ago. The decay in volumes is accelerating – that is evident. What if MO, can only take $100 million in higher pricing y/y going forward? That lost $50 million per quarter is $158 million in lower annual cash flow too. The pressures against that $1 billion cushion are getting larger in our view not smaller – especially if MO has to start paying down debt. And, investors will expect another dividend hike next year too.

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