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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

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Altria (MO) – Recent/Proposed FDA Actions

We remain negative on Altria and the US tobacco market because the industry is in long-term decay and the speed is accelerating. We further believe that there are several FDA catalysts that could boost the rate of decay further and perhaps gap the number of smokers down very quickly too. The FDA has been very clear what its goals are:

1. Continue efforts to convince more current smokers to stop using cigarettes – by switching to less harmful nicotine sources to quit

2. Restrict/Remove products that make smoking harder to quit

3. Stop replacement smokers from starting by restricting access to youth

The FDA has nearly everything working according to plan with two exceptions – 1) menthol cigarettes are not experiencing the same rate of decay and are growing in market share and 2) teens and pre-teens are taking up e-cigarettes at an alarming rate which could create nicotine addiction that transitions them to smoking cigarettes too.

We noted in our report two weeks ago that, the FDA pulled several e-cigarette products and menthol cigarettes off the market. Last week it was leaked that the FDA is preparing to restrict the sale of flavored e-cigarettes in convenience stores and starting the move to ban menthol cigarettes. The plan was confirmed today and efforts are focusing heavily on preventing youth smokers. Scott Gottlieb, the head of the FDA has said that he does not want the youth of America getting addicted to nicotine, "We now have evidence that a new generation is being addicted to nicotine (via e-cigarettes), and we can't tolerate that." He said last week, "*We are going to be putting in place some additional restrictions on how these products can be sold, particularly the flavored products. That's my legal mandate, is to bring down smoking rates.*"

- Tobacco companies already losing again – companies now support minimum age to purchase tobacco products at 21. All of them now support it. Only 5% of smokers start after age 21. Without new smokers replacing those who quit, the decay rate for cigarettes should accelerate.

- The menthol ban may take years, but the FDA has already concluded in 2013 that menthol makes it harder to quit and likely poses greater health risks than non-menthol cigarettes. Now the FDA is advancing rules to ban menthol cigarettes. We expect the industry to go along with many compromises to postpone a full ban. Compromises may still hurt sales too and this has been one area of non-decay for the industry.

- The numbers are on the FDA's side. They can show sales trends youth being attracted to flavored products, menthol products, and growing demand only in those areas. It is focused heavily on stopping any trend that is growing.

The Basic Tobacco Company Story

The goal is to manage the decay that everyone sees – fewer people are smoking, those that do are often smoking less frequently, and the majority of smokers want to quit. The goal is to transition people to other nicotine products that extend their lives and allows them to remain customers for a longer period of time. Combine this transition with steady price increases to offset volume losses and maintain growing cash flow to support hefty dividends and share repurchases. As we noted two weeks ago – the price increases are no longer offsetting the volume declines at MO. Also, the company's free cash flow is only about $5.1 billion going forward now vs. a $5.3 billion dividend. There is no margin for error here.

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

Much of managing the decay involves having new smokers offset some of the volume losses. The basic statistics say that 90% of smokers begin before age 18. Every day 3,500 teens try a cigarette, and 2,100 become regular smokers. Most of the data beyond those figures focus only on smokers 18 and older so we will need to make an estimate. Simply multiplying the 2,100 figure by 365, would mean 766,000 new teen smokers emerge each year. Assuming that includes kids aged 14-17, many will still not reach 18 to be part of the older stats for 1-4 more years. It's probably conservative to then say that each year about 1.1-1.5 million of these teen smokers become part of the adult statistics

The number of total adult smokers over 18 is falling about 2-3 million per year and was 34.3 million in 2016 down from 39.8 million in 2014. The decline is net of new smokers. So, the net decline is about 4%-7% per year. But, if something disrupts the flow of new smokers by 0.5-1.0 million, suddenly the net decline becomes 2.5-4.0 million per year, which is another acceleration in the decay rate to as much as 10%. If the plan remains trying to raise prices faster than volumes decay – we believe the decay rate will accelerate even further. It would certainly price more teens out of the market and add to the problems of fewer replacement smokers.

The other part of managing the decay is Altria and others want FDA approval to sell other forms of tobacco such as e-cigarettes and heated tobacco. Thus, they have an incentive to go along with other FDA initiatives even if they will hurt the base tobacco market.

Here Comes a 21-Year Minimum Age to Buy Tobacco Products

So, 90% of smokers start before age 18. However, only 5% start after age 21. Even two-three years ago, the tobacco companies were very clear about wanting to keep the minimum age to buy cigarettes at 18. This is a big deal to the tobacco companies managing the decay plan.

As the FDA pulled products off the market in October including cigarettes and e-cigarettes from Altria and British American Tobacco, it picked up support from the companies to boost the federal minimum age to 21 for all tobacco products.

The *Winston-Salem Journal* noted on November 3, 2018, "The snowball effect on the age-21 movement for buying tobacco products has reached an acceleration point once thought unfathomable within the industry and society as a whole." The article noted how the industry had their heels dug in to protect the age-18 policy only 4 years ago.

In recent weeks, Altria, Reynolds (British American), Imperial Brands, and Juul all have come out in favor of the FDA's push to raise the minimum age to 21 for cigarettes, e-cigarettes, and other forms of tobacco. That presumably would include any heated tobacco product launch. There are already 6 states that have boosted their age: California, Hawaii, New Jersey, Maine, Oregon, and Massachusetts. In 2014, there were 40 cities with a 21-year minimum. Now, 350 cities have raised the age.

There are not many people left, who oppose this change if the companies are willing to support it now. Juul and Imperial already have a 21-year old minimum age to purchase their e-cigarette products online in effect. This could be something that becomes policy/law in a quick time-frame. Juul's CEO Kevin Burns said, "*We are committed to preventing underage use, and we want to engage with FDA, lawmakers, public health advocates and others to keep JUUL out of the hands of young people.*"

Remember a federal judge already is already requiring the procedures for graphic warnings for cigarette packaging to be in place by May 2021 at the latest. These have proven to be effective around the world as preventing young people who see the pictures from starting and encourages current smokers to quit or smoke less. So here are two events moving forward to disrupt new smokers from starting. If this industry loses up to one million replacement tobacco users annually going forward, with these types of changes – the decay rate for volumes should accelerate.

The FDA's Most Recent Outlined Plans Are to Remove More Paths to Youth Smoking

Last week, the FDA reacted quickly to a surge in young people using e-cigarettes. This is what is firing up the controversy in the last year. The FDA does not want e-cigarettes becoming a gateway to youth getting addicted to nicotine and becoming future cigarette smokers:

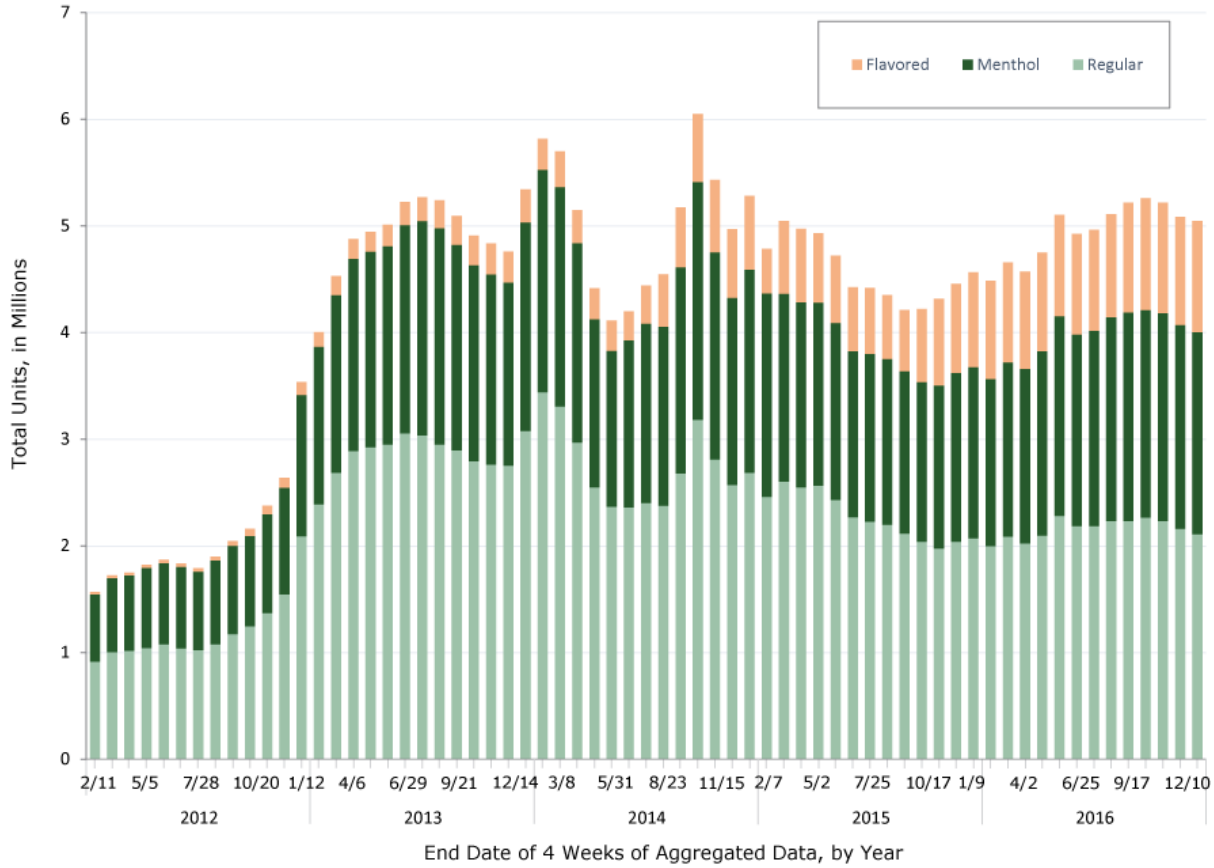
E-Cig % of Group	2017	2011
Middle School	3.3%	0.6%
High School	11.7%	1.5%

This data is also from CDC's *Morbidity and Mortality Weekly Report*. The recent data being cited by the FDA shows that e-cigarette usage by people under 21, continues to spike. We have seen numbers that usage among young people jumped anywhere from 50%-77% since 2017.

What is coming is a ban on flavored e-cigarettes sold at convenience stores and gas stations. The FDA sees age-checking as more lax in those locations. Also, there are many states with a minimum age to buy tobacco products of 18. The FDA has said that flavored e-cigarettes would still be available in specialty vape and tobacco stores for adults over 21. Scott Gotlieb noted this problem last week too, "*We are going to be putting in place some additional restrictions on how these [e-cigarette] products can be sold, particularly the flavored products."*

The tobacco companies are going to have to choose whether to fight pulling product out of certain stores or agreeing with their new policy to support no tobacco products being sold to people under 21. The FDA can show the numbers jumping for teens using nicotine – we're not certain the companies want to be seen publicly standing against curbing that growth. There is some serious attention focused on stopping youth nicotine addiction. But, without new smokers, Altria's current dividend is not sustainable in our view. We've written quite a bit about changes in the regulations in recent months and it surprises us how rapidly they are rolling out in a negative way for the tobacco industry.

The FDA can see that flavors play a role in people buying e-cigarettes. A CDC study looked at e-cigarette retail sales from 2012-16. During that time, e-cigarettes went from about 1.6 million units to 5.0 million units. Flavored e-cigarettes went from 0% to about 20% of the market and menthol to about 40% of the market.



The FDA is also being very clear to the industry. If the Tobacco companies do not help reduce young people using e-cigarettes by limiting products and selling locations – the FDA will take further actions. Moreover, while the FDA is leaving menthol and mint flavors on e-cigarettes alone for now – it will reexamine that if the e-cigarette trends do not reverse. According to the November 15, statement, "*The FDA will not ignore data regarding the popularity of mint and menthol-flavored ENDS (e-cigarettes) among kids. We will continue to use all available surveillance resources to monitor the rates and use patterns among youth and adults for these products, and we will reconsider our policies with respect to these products, if appropriate.*"

The FDA Continues to Focus on Menthol

As part of last week's precursor on e-cigarette distribution changes, the FDA noted that would not ban menthol versions of e-cigarettes in convenience stores. It confirmed that today in changes it is seeking for the e-cigarette market. The reasoning is they did not want people finding out there were no menthol e-cigarettes available, but regular tobacco cigarettes in menthol were available in that same store and thus opting for the more dangerous product.

However, it is still looking to restrict menthol like Canada and the EU are doing. The FDA said in 2013 that menthol increases health risks by masking the harshness of tobacco and allowing people to smoke more deeply and more often – making quitting even tougher. This week, Scott Gotlieb said, "Menthol is a significant problem."

The agency has been gathering data and support for a ban. It was announced today that the FDA will advance a Notice of Proposed Rulemaking to ban menthol in combustible tobacco products such as cigarettes. Scott Gottlieb specifically noted menthol cigarettes are unduly popular with youth smokers and "unlike menthol-flavored ENDS (e-cigarettes), there's no evidence to suggest that menthol-flavored cigarettes may play a role in harm reduction for adult smokers." It may take a few years to get it fully in place, but the writing will be on the wall as far as future cigarette sales and MO's dividend sustainability are concerned. A large part of cigarette sales will likely disappear in a few years. The tobacco companies will push back to delay this – but again the data and another case to prevent youth smoking is on the FDA's side.

FDA is Looking at Overall Smoking by Young and Old Falling

We think everyone understands by now that the number of smokers is declining. The CDC (Center for Disease Control) tracks this in its *Morbidity and Mortality Weekly Report*. They follow cigarette, cigar, e-cigarette, and smokeless tobacco trends. Here are the last three years available for the number of adult cigarette smokers over 18-years of age:

in mm's	2016	2015	2014
Adult Smokers	34.3	36.6	39.8

Youth cigarette smoking has also been on the decline. The CDC does not give a number of smokers these categories simply how many of the populations of middle school kids and high school kids have smoked cigarettes in the last 30-days:

% of Group	2017	2011
Middle School	2.1%	4.3%
High School	7.6%	15.8%

The Exception is Menthol (and E-Cigarettes as noted above)

We have talked about this considerably in past reports on Altria. In basic terms, menthol is not considered addictive. However, it smooths the harshness of tobacco and can make it easier for new smokers to start and allow current smokers to inhale deeper and smoke more frequently.

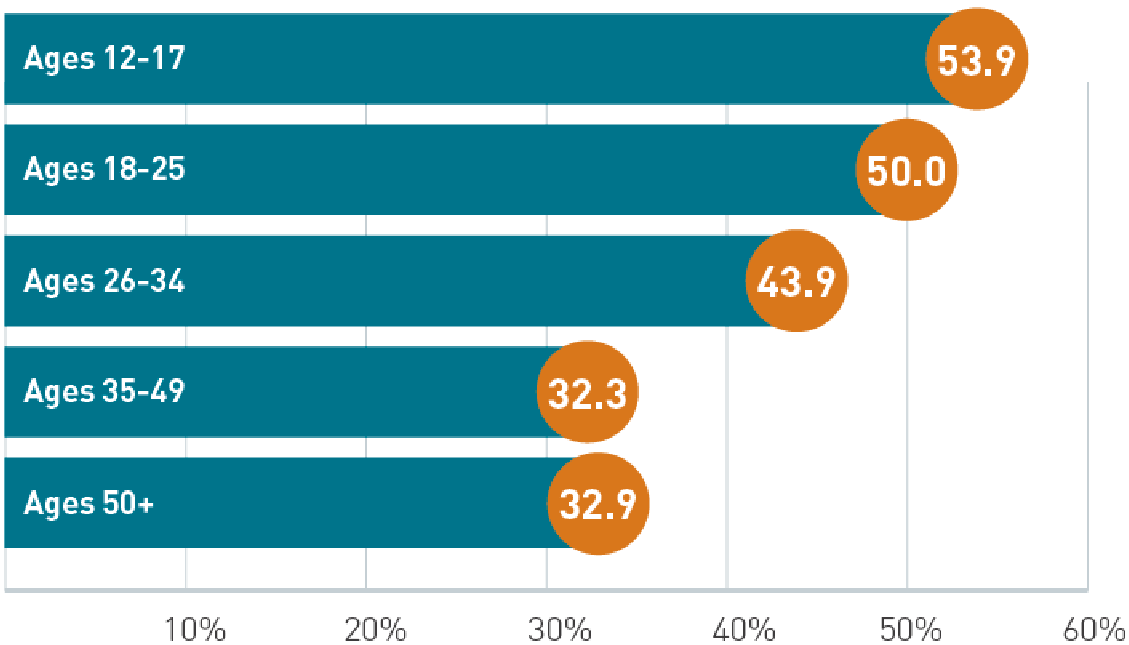
We have also pointed out in past Altria reports how the volumes for cigarettes have been on a steady decline that is now accelerating again. Yet, menthol cigarettes are taking market share and, in some years, posting volume growth:

Nielsen Data	2015	2014	2013	2012
Menthol % Cigarettes	32.5%	31.9%	31.3%	30.5%
Growth in Menthol	0.5%	-0.7%	0.0%	

That data is from Nielsen tracking product sales. We have seen estimates that now put menthol cigarettes at 35% of the US the market. So, menthol is not following the rest of tobacco usage down like the FDA wants.

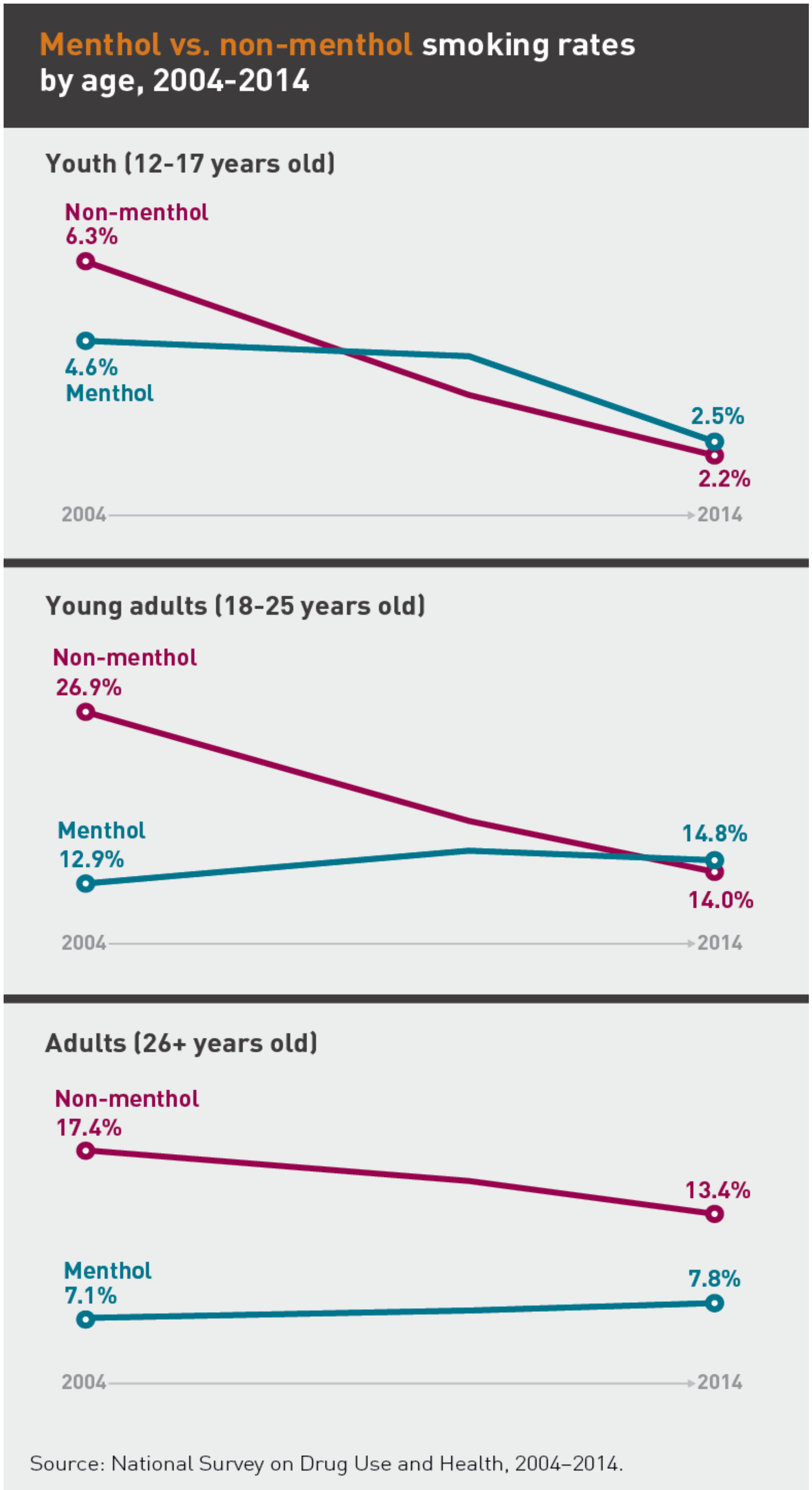
We will not cover the menthol issues again in depth, but this collection of studies and findings fact sheet will give you more of a primer. We will highlight some of the graphics showing that menthol remains very popular and non-menthol smokers are declining faster than menthol ones at all ages. If e-cigarettes are in the crosshairs of the FDA to prevent under 21-year old people from becoming addicted to nicotine, then menthol has to be addressed as well in our view:

Menthol cigarette use among current smokers in the U.S. by age, 2012-2014



Source: Tobacco control

Younger smokers are more likely to use menthol cigarettes. This is how the FDA can further push for menthol bans and restrictions – to prevent youth smoking. However, even among adults, the menthol smokers are rising in terms of market percentage.



Menthol vs. non-menthol smoking rates by age, 2004-2014
Youth (12-17 years old)
Non-menthol 6.3%
4.6% Menthol
2.5%
2.2%
2004
2014
Young adults (18-25 years old)
Non-menthol 26.9%
Menthol 12.9%
14.8%
14.0%
2004
2014
Adults (26+ years old)
Non-menthol 17.4%
13.4%
Menthol 7.1%
7.8%
2004
2014
Source: National Survey on Drug Use and Health, 2004–2014.

Further, let's compare the increase in cash generated by increased receivable sales to the year-ago period. During the first nine months of 2017, outstanding sold receivables increased by $50 million ($646m-$596m). This means that reported operating cash flow growth during the nine months ended 9/18 received a $331 million tailwind ($381m-$50m) from the increased rate of receivable sales. Consider that reported operating cash flow growth during the period was only $283 million, which implies that operating cash flow would have declined during in the first nine months of 2018 without the accelerated pace of receivables factoring. We understand that there are other factors impacting BLL's cash flow growth during the period including higher cash tax payments. However, cash flow also benefitted by a $148 million decline in cash pension contributions as well. It is clear that the receivables factoring program is having a major impact on the company's reported cash flow growth during the past year that may be giving investors a false picture of its true strength.

Days Payable (DSP) Continues to Climb YOY, But Are Leveling Off

We pointed out in our review of the 6/18 quarter that BLL's accounts payable balance has grown rapidly in the last several quarters. This trend continued into the 9/18 period as seen in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS Under Pre 606	$2,393	$2,522	$2,206	$2,134
Accounts Payable	$2,953	$2,937*	$2,822	$2,762
Adjusted Days Payable	112.6	106.3	116.7	118.1

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS Under Pre 606	$2,338	$2,270	$1,975	$2,009
Accounts Payable	$2,419	$2,146	$1,830	$2,033
Adjusted Days Payable	94.4	86.3	84.6	92.3

*Includes $198 million of payables classified as held for sale

While days payable (DSP) are still climbing on a year-over-year basis, the sequential growth has levelled out. Consider that payables at 9/18 increased by $191 million since the beginning of the year while they increased by $386 million in the comparable year-ago period. This is not a surprise given that the time the company was taking to pay suppliers had jumped to over 100 days. However, it highlights that a boost to cash flow growth is now turning the other direction.

Disclosure

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