BEHIND THE NUMBERS
Quality of Earnings Analysis

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Altria Group, Inc. (MO) Earnings Quality Review

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

We are initiating earnings quality coverage of MO with a 3- (Minor Concern) rating.

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

We discontinue our SELL rating on MO and initiate earnings quality coverage with a 3- (Minor Concern) rating. We are moving all our buy/sell ratings to earnings quality coverage and will use our quarterly Focus List to communicate top long ideas and sell recommendations. Note that we do consider several areas of MO's recent year unsustainable.

Summary

MO missed EPS forecasts by 3-cents which surprised us as adjusted EPS declined by 2-cents. There was a 2-cent headwind from a higher tax rate and a 4-cent headwind from writing down residual values on equipment from PMCC. However, MO has had a perfect situation in our view with people switching from e-cigarettes back to regular cigarettes, plus they had more time to actually smoke given a lack of restrictions at home vs. work. Also, disposable income was helped by buying less gasoline, eating at home more, and restrictions on bars. MO had 9-cents in higher EPS from an increase in smokeable operating income in 4Q. We don't have a quarterly break-down but we know for the year, MO spent $37 million less on R&D and $7 million less on advertising in 2020 vs. 2019. That combined for 2-cents during the year.

The biggest positive for MO from customers shunning e-cigarettes and switching back to regular cigarettes is the e-cigarettes cost less and MO gets a 35% share of equity income when someone buys JUUL instead of 100% of a higher priced product in cash when they buy

cigarettes. The same can be said of a very targeted roll-out of heated tobacco – where MO has to split some of the wealth with Philip Morris.

What is strong?

- COVID reversed the huge declines in cigarette volumes. Coming into 2021, MO was suffering from customers leaving for e-cigarettes, boosting the age of buying cigarettes to 21 (which cuts off future smokers), and growing restrictions on where people can smoke. Cigarette volume losses had been accelerating from 2% to 7% and MO was losing more than the industry. Suddenly COVID and JUUL problems saw people smoking more and switching back to cigarettes:

Y/Y Chg. Cig. Vol.	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Altria	-1.0%	-1.0%	-2.0%	-3.5%	-6.0%	-7.0%	-7.0%	-7.0%
Industry	0.5%	1.0%	0.0%	-2.0%	-4.5%	-5.5%	-6.0%	-5.0%

  People going back to work, buying more gasoline, gasoline prices increasing, people spending more money in other areas, may cause a return to competition for disposable dollars and less personal time causing many to smoke less. In years past, MO has called out small changes in gas prices hurting volumes by 2%-3%.

- The stronger volumes mean the price hikes that MO takes every year didn't need to offset big drops in volumes. Thus operating income from smoking rose by $938 million in 2020 vs. $724 million in 2019. We think this continues to underline how dependent MO is on smoking. This is driving the cash flow:

Cash Flow	2020	2019	2018
Cash from Ops	$8,385	$7,837	$8,391
CapX	$231	$246	$238
Free Cash Flow	$8,154	$7,591	$8,153
Dividend	$6,290	$6,069	$5,415
Dividend Payout	77%	80%	66%
Repurchases	$0	$845	$1,673

  $938 million in incremental smoking income is worth about $700 million net of tax. That's a sizeable gain in cash flow in 2020. A more normal year may see negative volume offset more than half that amount. Free cash flow is close to earnings before one-time items and MO is guiding to an 80% payout on the dividend in 2021 so some of the huge gain in 2020 may not repeat.

What is weak?

- Even management admits that cigarettes are a dying business and it plans to transition away into new areas. What else is working for them? Smoking products produced 85% of the operating companies adjusted income and oral tobacco has many downsides to health too is the other 15%. Volumes have been weak in for moist snuff too. MO is stocking the channel for the new *on!* dissolving tobacco by rolling it to many more stores. We think this cannibalizes snuff and the initial stocking growth will subside. We do not believe that consumer growth for any tobacco product is 27%. We saw the same situation with heated tobacco for Philp Morris in Japan and South Korea – huge growth as the channel was filled with inventory and then demand crashed as consumer sell-through became the actual source of demand.

- **There is no cash or declining cash from its equity investments. We are not certain what has to happen for MO's auditors to argue for an impairment in the ABI deal** – it's publicly traded so fair market value is easily determined without valuation assumptions. If one wants to look at ABI's valuation in the market – it's selling for 20x forward EPS with debt over 4x pre-COVID EBITDA. **We know that ABI has now written down its own goodwill in Africa in 2020.** The Africa market was a big part of the reason ABI bought SABMiller – which was MO's original investment. ABI has cut its dividend to MO twice at this point. Plus, by using the equity method to account for the deal, MO sees the value of its investment in ABI rise with its share of the earnings and the value falls with the ABI dividend. As the dividend gets smaller – it lowers the offset and the value of MO's investment can increase. Plus, this is not all COVID – the ABI investment owned by MO has been underwater since 2018. At the end of 2020, the difference between the fair market value of $13.8 billion and carrying value of $16.7 billion was $2.9 billion.

- Cronos is losing money in a huge way. Through September 2020, revenues of $29.7 million produced a gross profit of -$11.0 million after another inventory write-down of $11 million. Operating costs were another $110 million. **Cronos took a $40 million impairment to its goodwill and intangibles.** That's after the operating loss of $121 million. The only source of income at Cronos is marking the warrants MO holds to buy more shares to fair market value as the stock price changes. To MO's credit – it adjusts these marks to the warrants out of its non-GAAP EPS. But does Cronos sound like it's about to start paying large cash dividends to MO?

- We think the impairments at JUUL are widely known at this point. But we think investors should remember to the extent JUUL cannibalizes cigarettes – MO loses 100% cash income from the cigarette sale and gains a 35% share of JUUL's non-cash earnings.

Also, MO now has 1,563 e-vaper lawsuits against it, up from 101 in 2019 and 2 in 2018. Does it sound like JUUL is about to start paying cash to MO? It does not to us.

- Looking at the cash flow table above, we think investors should note that share repurchases have essentially stopped at MO. The company issued more debt than it repaid in 2020 and is sitting on $5 billion in cash against $29.5 billion in debt. MO authorized a $2 billion repurchase plan, for 18 months. But we think investors who count on this form of payment to drive EPS growth and share repurchases should note that MO has a history of spending $1-3 billion on stock annually and has now gone two years with only $845 million. Nor does it appear that cash flow even with the surge in smoking income under COVID does not support a big repurchase plan. At the same time, dividend growth had been 8%-9% in many years – it's now 4%.

What to watch

- Do corporate tax rates rise within 1-2 years and reduce cash flow? We believed MO was headed for a dividend cut in 2017 before corporate tax rates dropped and boosted cash flow by about $1 billion annually. The company is already back to paying out 80% of free cash flow at this point. They have few tax shields with depreciation of only about $250 million and interest expense of $1.2 billion. We estimate that a 500bp increase in the tax rate would cut between $400-$500 million off of free cash flow. That's in addition to any pressures from volume decay in cigarettes resuming.

- There is more pressure again for the FDA to ban menthol. The FDA has already concluded that menthol makes it easier for people to start smoking and for them to smoke more frequently. It even concluded in studies that banning menthol would benefit public health. Attorneys General of 23 states have now petitioned the FDA to remove menthol from cigarettes and e-cigarettes as of January of this year. California banned menthol but enforcement is delayed until a ballot measure on the subject in November 2022. Menthol has been the area of tobacco where demand had held up better than other forms of cigarettes. We have highlighted in the past that several states and cities as well as other countries have banned menthol already (other countries do not impact MO – but could give the FDA more cover if they adopt a ban too.). If the bans come from larger states people may need a 5-6 hour round trip to visit an adjoining state where it is still legal to buy their cigarettes of choice. We think this is a potential game-changer to gap cigarette volumes down.

- The graphic health warnings for cigarette packages continue to move forward too with a court order that they now begin in January 2022. The FDA is in the second round of final

submissions in this area that it expects to complete in March 2021. Again the use of graphic warnings has been ordered by courts at this point and are already widely in use around the world. Studies have shown that because cigarette packages are the one consumer product that smokers and non-smokers see many times per day and the graphic warnings have cut cigarette usage wherever they have gone into effect.

- In the case of the already in place 21-year age to buy tobacco nationwide, getting rid of flavored tobacco and e-cigarettes, some menthol bans already with more potentially coming, and graphic packaging – all of this has the ability to stop new smokers from even starting. When people see cigarette volumes fell 4% or 5% in a given year – that really means that perhaps 8%-9% of people quit smoking and were replaced by 4% new smokers for a net decline of 4%-5%. (We are just using these figures for an easy illustration). Many of these new rules are aimed at stopping new smokers. In our view, this could easily create a large gap down in cigarette volumes in the near future. MO looked well on this path and had COVID help in 2020. That may be a short-lived improvement.

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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