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Altria (MO) 4Q19 Update
Upgrade to NEUTRAL

We are moving MO to a Neutral rating after 4Q results – where it took its second $4+ billion write-down of JUUL within a year of purchasing it and cut forecasts. Much of what we have focused on as shortcomings for MO have proven to be problems that the company has now realized, and MO lowered its forecasts. We are moving this to Neutral at the moment – but do not see much evidence that the problems are over. However, the timing of additional catalysts is less clear (even as pressure grows) and MO may be able to get through a few quarters with only the inherent decay of its primary business to worry about. Plus, we think investors will cheer the roll-out of IQOS and think impairment charges are over for now. We were more than amused by several comments on the call and accounting issues and will discuss these:

- **Moving JUUL from Equity Method to Cost Minus Impairment method does not change how we viewed this investment from the start – but it could inflate MO's GAAP income.** Our view was that this investment was going cannibalize cigarettes where MO owned 100% of the transaction and it was essentially fully cash earnings. MO was trading cash earnings for a 35% stake in non-cash earnings as JUUL was not paying a dividend. Now, it will be certain to not recognize non-cash losses.

- **MO does not expect any cash flow from JUUL dividends for several years at this point and it has written off $8.6 billion of the $12.8 billion purchase price in a year.** It hasn't even cleared Anti-Trust review yet. We found several aspects of the JUUL accounting change curious given results and impairments not taken on other equity investments such as ABI and Cronos.

- **MO's debt load remains much higher after borrowing the money to buy the 35% stake in JUUL and this is impacting its share repurchase program that had been a big driver of EPS growth in the past.** We're always fascinated that stock repurchases

continue to violate basic economics 101 – when the price of the stock falls – companies just don't want to buy more stock. MO did not boost its share authorization and is guiding to only $500 million in repurchases in 2020.

- **Decay continues at peak rates for cigarettes and faster than the industry. Yet, MO plans to simply boost prices again.** We are intrigued that only two years ago, MO was complaining that small increases in gas prices hurt cigarette volumes when decay was 2%-3%. Today, it is touting that cigarette price hikes can easily offset lost volumes and boosting the age for buying tobacco to 21 can be overcome as volume falls by 6%-7%. We still see IQOS rolling out as another bomb for volumes.

- **Offering customers both JUUL and cigarettes in 2019 is now considered confusing and ineffective cross-distribution** (after MO pulled out of much of the distribution agreement). Of course, **rolling out a new IQOS (heated tobacco) won't have any of these problems with the same distribution and sales network**. Just ask management.

- **We noticed that of the $600 million run rate in cost-cutting achieved at MO - $88 million came from cutting R&D and advertising, $54 million came from lower litigation costs, and its accrued liability for litigation fell $98 million (a mere $14 million) as litigation levels increased.**

JUUL as a Cost-Minus Investment Doesn't Change that MO Will Not Receive Cash Flow on the Deal for Some Time – But It Could Help MO's EPS

We always believed that the hidden destruction of the JUUL deal was MO would help distribute it and put on shelves with cigarettes making it easier to buy JUUL – (It is cheaper too). For every JUUL purchase instead of cigarettes – MO would receive a 35% stake in equity income from JUUL and lose a 100% stake in income from the higher-priced cigarettes. That alone seemed to point to lower earnings going forward unless JUUL was selling more than 3x the volume it was cannibalizing. JUUL said its experience-driven data shows that 50% of the smokers who purchase JUUL switch away from cigarettes within 90 days.

It was worse than that at the onset – JUUL would have a higher cost structure to deal with too. Profits per unit would be lower. MO admitted this would be producing non-cash income.

In the 10-K for 2018, it expected "little to no cash earnings from Cronos or JUUL." In 1Q19, MO said this on their conference call:

> *"Then you asked a question about the five-year breakeven, and I think the way we calculated that; it was really taking the equity income we expect in five years tax affecting it and then dividing it by the overall investment in Juul.* ***So, it is an equity income return, not a cash return,*** *although obviously by that point, given the significant level of income, we would expect to have some dividends as well."*

Much has changed in under a year. E-cigarettes lost the ability to sell flavors in many retailers and the purchase age was moved to 21. JUUL also faces many lawsuits related to lung diseases.

MO still owns 35% of JUUL, has board seats, and continues to work closely with JUUL in regard to FDA issues, regulatory/merger issues, and litigation issues. While they never expected to receive dividends from JUUL for several years, they did anticipate non-cash equity income would arrive. MO now reduced its 3-year EPS forecast because it has changed JUUL out of the equity method of accounting (adding pro-rata share of gains and losses) to MO's income:

From 4Q19 conference call:

> *"We don't currently expect to receive equity earnings contributions from JUUL over the next three years. Therefore, we've lowered our 2020 through 2022 compounded annual adjusted diluted EPS earnings growth objective to 4% to 7% from our previously announced objective of 5% to 8%."*

It is also possible that MO anticipates some sizeable hits to JUUL's immediate income and thus changed to the cost-minus impairment approach even with the same 35% weighting and board representation. After writing off $8.6 billion of the $12.8 billion JUUL investment, MO will now carry the investment at cost minus any impairment charge. Thus, JUUL earnings will have no impact. **This accounting treatment will change again in the 2H of 2020.**

The transaction is still going through anti-trust review and MO expects that may be completed in the 1H of 2020. After that, the board will expand from 7 to 9 with MO having 3-seats. At that point, **MO expects to convert its accounting to the Fair Value method** where it will reflect any dividends received from JUUL as income and any changes in fair value of

the investment that will be computed quarterly. Plus, any impairment – MO will call it out as a special item and adjust it out. So, only upside will be considered:

From the 4Q19 call:

> *"When you look at the fair value option, you have two components that come through.* ***You only record, if you will, equity income related to dividends****. And then, you have, if you will, the change or adjustment to the fair value on a quarterly basis. And so,* ***since that equity line would include only dividends, we don't have any expectations that we would receive dividends over the next three years."***

We Also See Some Accounting Issues with Other Investments

MO also has a large investment in Anheuser-Busch Inbev that it accounts for under the equity method. As a result, it records its pro-rata share of ABI's income in its EPS. On the cash flow statement, it subtracts the non-cash income and adds in any dividends received. On the balance sheet, the income boosts the value of the investment and the dividend reduces it. MO also evaluates the carrying value of the investment against fair value to assess possible impairments.

ABI is publicly traded so it is easy to assess fair value. In 2019, the carrying value was $18.1 billion while the publicly traded value was only $16.1 billion. That was after a sizeable recovery in stock value during the year as in 2018 the public value was only $13.1 billion against a carrying value of $17.7 billion. MO did not book an impairment in either year – arguing that the decline in value was temporary.

We've talked about this in the past too. The reason ABI stock declined was the company had growth problems, had a leveraged balance sheet and was forced to cut its dividend and devote its focus to fixing the balance sheet over many years. MO now takes in only about half of its reported ABI income in cash. It still didn't report an impairment. PriceWaterhouseCoopers said it relied on significant judgement by management and a high degree of auditor judgement to evaluate the conclusion that the decline below carrying value could be justified as temporary.

Cronos is the marijuana company in Canada the MO purchased last year too. It was essentially a penny-stock and the company had $21 million in sales last year. It's $1.1

billion net profit was due to the increase in derivative instruments that rose after MO bought 45% of the company with an option to buy another 10% for a total price of $1.8 billion. This company is accounted for under the equity method too.

During 2019, the stock fell from $28.50 after MO's investment to under $10. As a result, MO saw the value of its warrant fall by $1.4 billion and it recorded that loss. For Cronos, the warrant's decline was a windfall profit and the net income from was $1.1 billion. MO reported its pro-rata share of that gain in income $496 million. The net was a loss for MO in 2019. We just find it peculiar to see huge loss flow back to the company as a gain at the same time for a company that obviously would have been in the red without MO's loss.

Cronos was also not considered impaired despite the huge drop in its stock and MO's warrant value. The fair value at the end of the year was $1.2 billion against MO's carrying value of $1.0 billion.

In both cases, we think there is a possibility of another impairment charge. Simply having Cronos at 36% of its peak value creates that risk.

MO Is Slowing Share Repurchases

We have talked before that the company has little free cash flow after the dividend to make share repurchases at this point:

	2019	2018	2017	2016	2015
CFO	$7,837	$8,391	$4,901	$3,821	$5,843
CapX	$246	$238	$199	$189	$229
Minor Acq	$421	$15	$415	$45	$0
FCF	$7,170	$8,138	$4,287	$3,587	$5,614
Dividend	$6,069	$5,415	$4,807	$4,512	$4,179
Repurchases	$845	$1,673	$2,917	$1,031	$554

Don't forget, tax reform added nearly $1 billion to MO's cash flow. Also, in 2018, the company picked up another $1 billion in cash from a steep drop in accrued settlements. This does not include the purchase of Cronos or JUUL.

The company has also gone from growing the total dividend at 7% to 12%. Share repurchases have dropped considerably in recent years too. That had been helping mitigate the total dividend growth. Almost annually, MO increases its remaining share repurchase program. At the end of 2019 – it did not. In July it authorized $1 billion in share repurchases and filled about $500 million of that figure. It only has $500 million more remaining. Historically, spending more than $2-$3 billion on shares was common. Now, it's $500 million.

Where is the cash coming from to think of increasing this? We simply don't see it happening. That will put pressure on dividend growth too. MO has also already leveraged its balance sheet to buy JUUL and Cronos for $14.7 billion. Debt is $28 billion and 2.3x EBITDA.

We always like to point out that MO was a huge buyer of shares at $70. It should love the bargain price of $45. But no, suddenly buying stock doesn't seem like a great use of cash.

The Decay in Cigarette Volumes Continues at Peak Levels

We have talked of this extensively too. MO used to deal with 2%-3% volume decline with price hikes. The company spoke how it needed to be wary of price increases because customers had to choose between paying higher gas prices of 5-10 cents per gallon and buying cigarettes. Now the decay rate runs at 6%-7% against comps of 5%-7% decay. MO is also losing young smokers to replace existing ones with the age to buy tobacco rising to 21. Almost no one starts smoking after age 21.

	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18	2Q18	1Q18
MO Volume	-6.0%	-7.0%	-7.0%	-7.0%	-5.5%	-5.0%	-5.0%	-7.0%
Industry Vol.	-4.5%	-5.5%	-6.0%	-5.0%	-5.0%	-4.5%	-3.5%	-5.5%

MO is losing more than the industry and 4Q saw JUUL floundering. This is their most profitable business unit and it plans to roll out heated tobacco (IQOS) and dissolving lozenges too (On!). We know from other markets that IQOS tends to gap down smoking volumes by over 20%. On top of that, we believe the age restrictions will help prevent new nicotine addictions. So, we expect serious decay to continue in volumes.

The company is proud of pointing out that it can raise prices and a 1% price hike only hurts volume by 0.3%. It's a net winner. Last year, operating income rose by $724 million based

on price increases less volume losses – 8.6% growth. Yet, the company also cut operating costs on an annualized basis by $600 million. A great deal of the $724 million in our view came from that area and will be tough to duplicate.

In more detail, what we saw in cost-cutting was $88 million from lower R&D and advertising, $54 million in lower litigation costs, and a $98 million drop in litigation accruals. Try to repeat that. Litigation volume is rising with JUUL and MO is working with JUUL on that. It specifically cited litigation as a key part of the second write-down in JUUL's value in the 4Q. Their litigation accruals are only $14 million at this point.

On top of that, don't forget it borrowed $14.8 billion to buy JUUL and Cronos and has no cash flow coming in from those areas. The higher interest cost is running just under $600 million too. We simply are not seeing cigarette price hikes as being capable of offsetting all this if some of the discretionary costs in advertising and litigation do not continue to decline. And both will likely rise given litigation is increasing and MO wants to roll out new products.

Also, we were more than amused that how it would be easy to expand JUUL distribution last year according to MO. Put it on the same shelves as Marlboro, give customers a choice, advertise for it in Marlboro packs. After the second write-down in the JUUL investment, MO now says that duel distribution wasn't very effective:

Howard Willard on 4Q call:

> *"What we found was that having both JUUL personnel and Altria personnel that were sometimes involved in executing for JUUL at retail, that created confusion and that wasn't really an effective way to get the most out of the Altria sales organization. So, we ultimately agreed with JUUL that they'd continue to provide a number of services exclusively and that we'd pull back."*

So, it was confusing to offer cigarettes and e-cigarettes at the same time. But MO is going to roll out lozenges and heated tobacco at the same time going forward without confusion? They are only betting their cash cow on these roll-outs. Why should anyone be concerned? Plus, PM has demonstrated multiple times in several markets that heated tobacco crushes cigarette volumes.

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