BEHIND
THE NUMBERS
Quality of Earnings Analysis
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Altria Group (MO)
Earnings Quality Update- 3/21 Qtr.

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

We maintain our earnings quality rating of MO at 3- (Minor Concern).

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

Summary

MO's 1Q21 looked like we anticipated with smoking volumes dropping 2%, an acceleration of the decay from the prior two quarters. We still believe MO was one of COVID's biggest beneficiaries as people working from home had the ability to smoke more often. Going forward the comps get tougher for smoking and that is still the primary driver of MO results. With the volume decay resuming, Adjusted EPS fell 2-cents y/y as revenue declined 4.6% for smokeable products and operating income was down 0.7%. We believe decay rates will exceed -5% during 2021. Please review last Friday's note for more details on the significance of this problem.

Also as noted last week, the menthol ban potential is becoming a bigger news item and the FDA is proposing it again. The industry will predict it will take years. We will just point out that five states have already banned menthol – Massachusetts, New Jersey, New York, Rhode Island, and California. California's ban has been delayed as the matter will be on the November 2022 ballot. In terms of cities and counties, California has 90 that have menthol bans, Chicago, 13 in Minnesota too. Early in 2021, 23 state attorneys general asked the FDA to ban menthol. The important point we think is this is not an issue starting at step one when the industry predicts it

will take years to get a ban. The FDA already has numerous studies on the matter to support a ban, it has already banned other flavorings, and many countries including Canada and much of Europe have bans in place.

Finally, MO took another $200 million charge to write down the value of JUUL. It continues to avoid taking a charge on its BUD position as it remains underwater as valued on the stock market. We still expect an eventual write-down here. MO has been claiming it is a temporary decline, but this has lasted years and started long before COVID. Also, there is a very easy value to look at – the publicly traded stock price – in assessing if the carrying value is above the actual value.

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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