BEHIND THE NUMBERS

Quality of Earnings Analysis

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Altria (MO)

Update on 3/22 results and 10-Q review

We are maintaining our earnings quality coverage of MO at 2- (Weak) and maintain Top Sell rating.

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

Summary

Altria's adjusted EPS of $1.12 in 1Q22 beat forecasts by 3 cents. The company did not raise guidance and expects the modest EPS growth forecast of 4%-7% to be backloaded in the year. We noted that:

- Share repurchases added 2.3 cents to results. MO used the proceeds of $1.2 billion in proceeds from selling its wine business to repurchase shares. MO spent just under $1.3 billion on share repurchases in 4Q21 and 1Q22.

- Selling the wine business helped improve gross margin, and SG&A costs declined as well. However, in 1Q21, MO was ramping up marketing programs for IQOS (heated tobacco), which it has since been prohibited from doing. It was rolling out a new device, was offering Marlboro reward points to use for discounts buying an IQOS device (that sounds like trade marketing that would likely be recorded against sales), and it was educating retailers and customers on the product. We can't quantify how much spending was done in that area in 1Q21, and the fact that MO still had the wine business at that time, clouds this issue further. On the 1Q21 call – this marketing for IQOS was being rolled out in a big way with plans for that to grow further in 2Q21. So, we would speculate that this may have been the entire 3-cent beat y/y if MO spent over $70 million on this roll-out last year. 1Q21's smoking income only rose 0.1% y/y when the marketing started.

- Adjusted earnings add back a number of items – so these would NOT have an impact on y/y adjusted EPS or the 3-cent beat. But many are recurring items:

    - MO saw litigation costs fall from $35 million to $12 million y/y – adding 1 cent

- MO saw another impairment for JUUL due to higher discount rates – adding back 5 cents to adjusted EPS

The Bigger Picture

Altria is one of those stocks whose popularity continually stuns us because people absolutely love the dividend despite even the company admitting that it is unlikely to sell its top product forever. This quote is prominently displayed on MO's website and referred to throughout its earning calls and presentations:

> " ***Our Vision*** is to responsibly lead the transition of adult smokers to a smoke-free future."

We think this is a company that is followed too closely on a quarter-to-quarter basis and many investors do not realize how much cigarette demand has vanished. The market was doing a solid job eliminating smoking before this became MO's motto.

- In 2001, MO sold 207.1 billion cigarettes and was 51.0% of the US market

- In 2021, MO sold 93.8 billion cigarettes (55% less volume) and was 48.8% of the US market

- Covid gave MO a reprieve in 2020 as the decline almost disappeared for one year 101.4 billion cigarettes vs. 101.8 billion in 2019, but the decay rate was accelerating before and after:

Altria Cigarette Vol. Growth	4Q	3Q	2Q	1Q
2022				-8.0%
2021	-8.0%	-7.0%	-4.5%	-3.5%
2020	-1.0%	-1.0%	-2.0%	-3.5%
2019	-6.0%	-7.0%	-7.0%	-7.0%

- Smoking is 86%-88% of total company income and is helped by MO continually raising prices, but the rate of growth in this area has slowed considerably from a consistent 7%-10% in recent years to only 4% in 2021, which included a negative growth quarter in 3Q21 and a mere 0.1% growth in 1Q21.

- Smoking is getting hit from multiple angles of late and the squeeze may keep coming

    - Teens can't buy – The decay rate is a net figure of the people who quit + new people who start smoking. The research shows nearly all people who smoke started before age 21 and only 1% start after age 25. The new law nationwide requires people to be over 21 to purchase cigarettes. We think that is accelerating the net decay rate in volume.

- Graphic packaging showing negative health impacts of smoking begins in April 2023 – This has proven to cut smoking rates and reduce new smokers in every country where it has rolled out.

- Potential menthol bans – menthol cigarettes are estimated at about one-third of the smoking market. Some states have already moved to ban it and the FDA has been working toward a national ban for several years too. That is now moving forward in recent weeks and could become law in a couple of years.

- The FDA has also been studying lowering nicotine levels in cigarettes and has concluded it could quickly lower smoking levels. It is still researching this further.

- Inflation – MO is very clear that high gasoline and food prices drain consumer wallets and lower cigarette purchases.

What is MO’s plan to replace smoking? So far we’ve seen little tangible results

- JUUL has been a bust so far. Shortly after MO acquired its stake in JUUL and JUUL distributed MO’s cash to employees and other investors, JUUL’s outlook changed. The 21-year age limit was applied to e-cigarettes and vapor and many of the flavorings were banned. Plus, lawsuits began. MO spent $12.8 billion here and has written off $11.2 billion of the investment. Its carrying value is $1.6 billion after 1Q22. JUUL also cannibalized cigarettes. So MO was trading 100% cash income from cigarettes for a 35% share of equity income from vapor.

- The Cronos pot company in Canada was a $1.9 billion investment. This company has posted negative gross profit in some quarters. The carrying value for this is now $556 million.

- IQOS heated tobacco is on hold after courts determined MO and PM violated patent rights. The rollout in late 2020 and into 2021 was halted and MO cannot sell the product now. At some point, this may reemerge as a redesigned product. History has shown heated tobacco collapses cigarette smoking in markets quickly. It is more expensive for the company given marketing, research, and production spending are higher than with cigarettes. The goal here is also to help people quit nicotine altogether, not to become a permanent heated tobacco user. First-mover status could help as MO may have captured smokers from competitors, but it may not have that status now with the patent issues delaying the product.

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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