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Altria 1Q20 Update
Maintain SELL

We maintain our SELL rating on MO. The company continues to get 88% of revenue and 87% of operating income from selling cigarettes. It is still reporting market share losses as it raises prices and saw its adjusted volume fall 5% in 1Q20 against 7% drops in both 1Q19 and 1Q18. All of those declines are 150-200bp worse than the market overall. MO said it believes some older smokers may have switched to e-cigarettes but have now returned to regular cigarettes following negative publicity. **So, if -5% growth and coming in 150bp below the market is a recovery, there are still bigger problems here. It also believes distributors may lower their inventory levels which could hurt sales further throughout 2020.**

We have discussed this long term decay as a problem for MO and its history of diversifying into new areas has been mixed to say the least with write-downs, restatements, and carrying values exceeding fair market values. We won't discuss this decay issue too much more in this note other than to point out Altria has lost 18% of its volume since 2017 after -7%, -7%, and -5% growth. MO admits that this year its dividend should exceed its EPS target of 80%. **They also not only stopped share repurchases in 1Q, they canceled the remaining authorization for $500 million in repurchases on the July 2019 plan.** Share repurchases had already been declining significantly in recent years and MO simply has not had the cash flow to support both the dividend and repurchase program in our view. **It used to borrow money cover both but has now squandered a huge amount of borrowed money to invest in JUUL and Cronos with no cash flow coming in from those areas.**

Also, of note, the lawsuits for JUUL are beginning. After 1Q19, only 2 were outstanding. After 4Q19, there were 101. Now there are 202 lawsuits which include 24 class actions, 5 state/local governments, and 3 school districts. Those may require more cash costs going forward. We believe investors should still be concerned with:

- There is still no ABI Impairment and MO may actually continue boosting its carrying value amid the latest dividend cut and stock decline. ABI's stock could double and still be underwater.

- ABI's situation has worsened as it is debt/EBITDA ratios are likely rising. The lock-up on its ABI shares expires in 17 months for MO and the auditors have already highlighted an impairment in this area as a risk.

- The Cronos investment has also not seen an impairment even though its carrying value exceeds fair market value too. The company has restated revenues in 2019, it operating losses are growing and there's no cash flow. The stock now trades below levels before MO's announced purchase.

- The Wine business has seen impairments. This is interesting given that it is privately held whereas the ABI and Cronos have an easy check with market prices on the stock. Wine has had impairments and write-downs in three straight years.

- Graphic Packaging is likely to start in June 2021. This has been proven to be effective in causing people to smoke less frequently or quit altogether. The FDA has not exempted packages for heat sticks for the IQOS system MO is rolling out.

- Lawsuits by Reynolds and other tobacco companies may have a tougher hurdle to stop graphic packaging this time. In 2012, the courts overturned the specific photos being used – not the law requiring the FDA to mandate graphic packaging. The new graphics incorporate large text warnings that are research-driven about smoking health issues – and text warnings have been in place for decades now. Also, the pictures are tamer in appearance.

- Menthol issues have not disappeared either. The FDA has been heavily focused on youth smoking and e-cigarettes – boosting the age to purchase either to 21 and banning all flavors other than menthol. It continues to study a menthol ban in relation to helping people quit. Massachusetts has banned it, many cities and counties in California have banned it, the House passed a ban recently, and UK's ban takes effect on May 20.

Equity-Method Accounting is Pushing up MO's Carrying Value for ABI

MO essentially adds its pro-rata share of ABI's net income to its carrying value and any dividends received reduces the carrying value. When the dividend was 3.6 Euros per year, it was close to income and it was nearly a wash. As the stock fell when the dividend was cut to 1.8 Euros, MO not only didn't book an impairment – it saw the carrying value of its investment rise. Now that ABI cut the dividend again to 1.3 Euros, this situation could continue to boost the carrying value for an investment that is underwater based on market values:

ABI value	1Q20	2019	2018
Carrying value	$18.5	$18.1	$17.7
Fair value	$8.8	$16.1	$13.1

Most of the ABI shares owned by MO are restricted until October 2021. They will convert into ordinary shares 1:1. The carrying value has exceeded fair market value for years. ABI has been forced to focus its efforts on retiring debt with free cash flow for some time. With the virus, it has issued more debt to add to its liquidity and cut the dividend again. ABI is selling its Carlton operations in Australia and expects to close in the 2Q. With those proceeds that have not arrived yet, ABI's debt to EBITDA would have been 4.0x based on 2019 EBITDA. Since then, the virus is impairing EBITDA and ABI is borrowing more money. There are not many signs pointing to ABI restoring its dividend in the near future. If the value of that stock doubled, MO's investment would still be underwater.

Cronos Stock Has Continued to Fall

We noted last quarter that MO's Cronos investment was worth $1.2 billion against the carrying value of $1.0 billion. Its stock has continued to fall making MO's investment worth $0.9 billion and below the $1.0 billion carrying value in March 2020. Cronos restated results for quarters 1-3 in 2019 as well that reduced revenue by $2.5 million in 1Q and $5.1 million in 3Q. This is for a company with quarterly revenue not much higher than that before the restatements.

We have noted that the only source of profits at Cronos came from having its stock price collapse and the value of its derivatives related to MO's warrant to buy another 10% of its stock rise as the stock fell. Interesting to note that Cronos makes this statement in its financial statements, *"Share price is one of the significant observable inputs used in the fair value measurement of each of the Company's derivative instruments."* While MO doesn't change its carrying values of assets based on falling stock prices – Cronos does. It took a $1.3 billion gain in 2019 based on the derivative liabilities being revalued with its falling stock price. Its operating income was -$121 million and operating cash flow -$130 million.

With this stock below levels than before MO's first announcement of its investment, we would expect this investment could see impairments in the future.

MO Has Taken Many Write-downs for the Wine Business

JUUL is a private company and MO took several write-downs there in 2019. It even started accounting for JUUL on a cost less impairment method meaning it will not raise or lower the value on earnings/losses – only if it observes any price changes in orderly transactions of in the same class of shares in JUUL. Even with Covid-19, there were no further impairments. (There likely were not any "orderly" transactions even if private trades did occur.)

What is curious is another non-public entity – its wine unit - has seen many write-downs and impairments in recent years.

- 2018 saw wine operating income fall $96 million, fueled by a $54 million impairment of Columbia Crest's trademark.
- 2019 saw wine operating income fall another $53 million, driven by a $74 million impairment of goodwill.
- 1Q20 saw wine operating income fall $394 million y/y, caused by $292 million inventory write-off and a $100 million in losses on future non-cancellable grape purchase contracts.

Graphic Packaging is Coming in by June 2021

The FDA released its final rules for new warnings on cigarette packages. These will require a series of new warning labels that will include new text and color graphics.

Warnings will include new text warnings such as “smoking can cause bladder cancer” or “smoking can cause strokes by clogging arteries.” It will then have a color picture that in some way illustrates this to match the text topic. These warnings will cover the top 50% of space on the front and back of a package of cigarettes.

In early April, several of the tobacco companies (Altria was not included at that time) filed a lawsuit against the FDA challenging the new rules and mandates on warnings.

There are several reasons to believe the tobacco companies will fail in the attempt to stop the graphic packaging:

- The Family Smoking Prevention and Tobacco Control Act was passed into law in 2009. That law requires the FDA to mandate cigarette warnings be accompanied by graphic pictures showing the negative health effects of smoking.
- The FDA’s first shot at this essentially showed photos of people with tracheotomies smoking or people missing many teeth and the others being very gray. The tobacco companies filed suit against this type of packaging. A court overturned the specific images – but did not invalidate the mandate that the FDA require graphics.
- It was the federal courts again who reprimanded the FDA in 2017 and said they still have a mandate to implement graphic packaging and required a plan be in place within two-years.
- The FDA’s new attempt at meeting this mandate is to have research-driven findings made into health warnings that are part of the graphic, with pictures. The new text is generally about half the space used for the total text and picture.
- The focus is also that, many of the current text on the side of cigarette packages have been in place for so long that few people read them anymore. However, the text warnings having been in place for decades are widely accepted. So updated text as key parts of the graphic mandate should make it easier to clear legal challenges.

Our view is the original case denying graphic packaging was narrowly focused on the content of those photos – not that graphic packaging mandates should be overturned. It was more like banning profanity on the radio was not overturning all free speech. With new graphics that rely more heavily on text educating people on additional health impacts of smoking along with PG-rated pictures instead of NC-17 level –

these seem more likely to be upheld. Graphic packaging is also already in place in 125 other countries.

The problem for Altria and other cigarette companies is graphic packaging has been shown many times to cause more people to stop smoking. It also leads more people to avoid starting in the first place. A big part of this is cigarettes are one of the few types of packaging that people carry around and look at many times per day. That's not true of a hamburger wrapper or a beer can. Also, non-smokers will see the new cigarette packaging much more often if they are around smokers. Studies point to people smoking less overall after seeing the graphic warnings more often, more people focusing on quitting, and more people no longer smoking around children.

It is also worth mentioning that the FDA has not exempted Heat Sticks for the new IQOS heated tobacco the MO is currently rolling out from graphic packaging.

Menthol Issues Continue

We have talked about a potential menthol ban many times in reports on MO. The FDA continues to study whether to ban menthol in cigarettes. Most studies show that menthol is not addictive; however, it makes it easier to take up smoking and smoke more. Other studies show that 80% of young smokers start via flavored tobacco including menthol.

The FDA has been much more focused on stopping youth vaping and preventing nicotine addiction in that manner during late 2018 and 2019. It has banned flavors for cigarettes and e-cigarettes other than menthol. At the same time, it still sees e-cigarettes as a way to get smokers to stop using combustible cigarettes. Therefore, it does not want to create a situation where menthol cigarette smokers do not have a non-smoking menthol option – thus keeping menthol e-cigarettes available. It continues to study how best to deal with this issue and whether to ban menthol altogether, in stages, or not at all. Push back comes from civil-rights leaders also who note that more minorities smoke menthol cigarettes. While other civil-rights leaders argue, that's especially why menthol should be banned – minorities have higher smoking rates and problem rates as a result.

While that hot potato issue continues, the state of Massachusetts has banned menthol cigarettes. Also, numerous towns and counties in California have also banned them. The UK's ban begins on May 20, 2020. Canada has had a ban in place for a couple of years and studies are showing that more people have quit smoking after the ban.

Vaping among teens has taken most of the recent focus. But we do think menthol bans will be an issue that does not go away for Altria. More importantly, the national ban on selling any tobacco product including e-cigarettes to people under age 21, went into effect in December. At some point, the FDA may be able to reframe this debate around banning menthol in cigarettes pushes people to menthol e-cigarettes; with less worry that menthol e-cigarettes become the gateway for young people to start smoking menthol cigarettes. But it's only been 4-months of change at this time.

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 Concerns"	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 may 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 the next quarter. 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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