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Altria (MO) – Update 2Q18

As we were compiling this issue, Altria and British American Tobacco released earnings. We will review this more completely for a more thorough note, but on the surface, this is playing out as we forecasted.

The headline figure is a 10.8% drop in US cigarette volumes, which is overstating the situation. Last year, California had a sizeable increase in taxes and the trade channel bought heavily ahead of that. This happens frequently ahead of tax increases and Altria estimates an adjusted figure is closer to a 5% decrease. Even that is evidence that the decay in cigarette volumes is continuing to accelerate:

y/y change	1H18	2017	2016	2015
US Cig. Volume	-4.50%	-4.40%	-2.40%	0.10%

Altria's market share is dropping faster than the industry because it is unable to take share from other brands. We have been warning about this because we have seen how much market share lesser brands have already lost in recent years. Altria now has to fight with other heavyweights, who are investing in their brands to take share. In the 2Q and first half of 2018, Marlboro lost 40bp and 30bp of share; Other premium brands at Altria lost 10bp and 10bp of share; Discount brands at Altria lost 30bp and 30bp. This compares to British American Tobacco that reported in the US it gained 20bp of share with premium brands and overall lost 10bp of share in the first half of 2018. Among their brands, Newport added 10bp, Natural American Spirit added 10bp, Camel lost 10bp.

Altria's plan is to offset volume decay with price increases to grow earnings. However, competition makes it tougher to boost prices as aggressively without giving up more market share. It can reach the point where volume losses are not offset by pricing. That happened to Altria Smoking results in 2Q18:

$ in mm	2Q18	2Q17
Net Revenue	$4,158	$4,366
Adj. Op Income	$2,186	$2,248

The company saw an increase in litigation costs in 2Q and that is adjusted out in those figures. Smoking is still 88% of the operating income at Altria so if this area is not growing, it is a problem when the company wants to have a rising dividend that is about 80% of EPS. Already the dividend is about 70% of EPS, which was reset down due to the reduced tax rates. We estimate the dividend will consume about 85% of free cash flow this year, which will make it difficult for Altria to buy back shares as aggressively as in the past as well.

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