

October 28, 2021

Altria Group, Inc. (MO) Earnings Quality Review- 9/21 Qtr.

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

We are downgrading our earnings quality rating of MO to 2- (Weak) and maintaining our Top Sell rating.

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

Summary

MO posted an adjusted EPS of \$1.22 for 3Q21 and missed estimates by 4-cents. MO even benefited from having retirement benefits flip to a credit y/y giving it 2.6 cents in extra EPS. Many of the items we warned about in our 3Q preview happened and it may be time to start getting more concerned. MO narrowed guidance by raising the low end from \$4.56 to \$4.58 for 2021, but has not changed the high-end of \$4.62 despite adding to its share repurchase plan.

- Smoking is 89% of operating income. Smoking volume decay, which reversed during Covid, returned to historical trends of accelerating volume decay. The 7% decline in volume is back after the Covid hiatus. And two new red flags. 1) Smoking revenues after excise taxes declined 3.0% and 2) operating income for smoking was down y/y by 2.2% despite higher pricing and lower promotional spending.

y/y chg in Cig Vol	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19	2Q19
Altria	-7.0%	-4.5%	-3.5%	-1.0%	-1.0%	-2.0%	-3.5%	-6.0%	-7.0%	-7.0%
Industry	-6.5%	-5.0%	-2.0%	0.5%	1.0%	0.0%	-2.0%	-4.5%	-5.5%	-6.0%

- What is going to fill this loss of business? Altria may be one-month away from having the ban take effect for selling heated tobacco through the IQOS product. JUUL doesn't pay MO in cash earnings. And the bad news for cigarettes continues. Graphic health warning on cigarette packaging has cut cigarette volumes in numerous countries and those are currently ordered to roll out in less than one year in the US. The FDA is still pursuing a menthol ban in 2022 as well.
- MO finally took the hit and wrote down its BUD investment with a \$6.2 billion impairment. This investment had been growing on MO's books as its share of non-cash earnings was greater than the dividend it received from BUD.
- MO boosted its share repurchase plan from \$2.0 billion to \$3.5 billion. The \$1.2 billion from the sale of Ste. Michelle wine will pay for some of that. The problem we see is free cash flow is \$7.5-\$8.0 billion at MO. The dividend is \$6.7 billion. On top of that, it already has \$25 billion in net debt (2.2x trailing four-quarters, which are helped by Covid, 2.4-2.5x may be more realistic). Also as the backlog of court issues could move forward and MO may face higher cash payments for litigation in the future too (accruals for health litigation were \$99 million vs. \$34million in 3Q20). It may take longer to complete this share buyback than investors anticipate.
- The 3Q saw another 5-cent loss to lower the value of the Cronos warrants too. This was added back to adjusted EPS.

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.

Disclosure

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.

