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Philip Morris (PM) – 3Q'19 Update
Maintain NEUTRAL

We are maintaining our Neutral rating on PM after 3Q19 results. The company already announced it is no longer considering a merger with Altria. We think the best deals are often those that ARE NOT MADE and we view walking away as a positive for PM. As we noted in our September 12, 2019 issue, the cash flow situation at MO looks tighter than PM right now and more of the benefits would have flowed to MO, in our view, such as a backdoor dividend cut for MO and eliminating royalties on IQOS that will be paid to PM. PM is not immune to many of the issues impacting MO – but PM is not seeing the snowball of accelerating volume decay speeding up further as the company boosts price to offset it. At some point, that catalyst may intensify, but it is not critical yet.

- **On current guidance – PM's dividend consumes 90% of Free Cash Flow. It no longer buys back shares, and it already spent the tax cut savings on the dividend. We expect modest growth in this area at best.**

- **PM has a history of reducing guidance and that continued in 3Q'19.**

- **FX weakness is increasing mildly in 2019. We think half of PM's volume is sold in countries that would be considered troubled and therefore FX will nearly always be a drag on results.**

- **Pricing is driving sales and earnings. We do not see that as a permanent source of success, but PM is not close to seeing higher pricing lead to accelerating volume decay except in a couple of countries. Thus, we think PM has a few more years of single-digit growth overall.**

- **The long list of One-Time Events to adjust EPS seems aggressive to us. Reported EPS for 2018 was $5.08 and PM expects $4.73 this year. However, it is calling out $0.41 of one-time items and $0.14 of FX to add back to adjusted EPS to report growth.**

- **With FX being a drag essentially every year and litigation costs building and consuming cash – should these be viewed as one-time events?** They are lumpy to be sure, but they are recurring. Also, Russia's audit on intracompany sales to look for greater excise tax revenue looks one-time in nature – but they are the third country to do this. If cigarette volumes continue falling, this may become a more common event.

Current Guidance Does Not Point to Much Cushion on the Dividend

	2019e	2018	2017	2016
Cash Operations	$9,200	$9,478	$8,912	$8,077
CapEx/Inv in Subs	$1,054	$1,499	$1,659	$1,213
Free Cash	$8,146	$7,979	$7,253	$6,864
Dividend	$7,300	$6,885	$6,520	$6,378
Payout on CF	90%	86%	90%	93%
EPS	$4.73	$5.08	$4.72	$4.48
Div/Share	$4.62	$4.49	$4.22	$4.12
Payout on EPS	98%	88%	89%	92%

PM has not bought back any shares in recent years and guidance calls for none. PM hasn't bought shares since 2014 and had prior years when dividends and repurchases were roughly equal. It is obvious they cannot afford to do it anymore. Plus, they ramped up dividend growth from the normal 2% growth to 3% and then 6.5% as the tax cuts arrived. It has now fallen back to 2.6%. Because earnings come from overseas, PM had an effective tax rate of about 28% when the US rate was 35%. With the US rate at 21% - PM is about 23%. Based on pretax income, PM gained $500-$600 million in income from the tax cuts – and they already spent it on the dividends.

More importantly, PM has a recent history of cutting guidance. Coming into 2018 – it expected EPS in the $5.04-$5.19 range and after a strong 1Q raised forecasts by a nickel before cutting the high end repeatedly the rest of the year and coming in at $5.08. Constant Currency revenue growth forecasts fell rapidly too.

2018 est	CC Rev	Op CF	CapX	EPS low	EPS high
4Q17	>8.0%	$9,000	$1,700	$5.04	$5.19
1Q18	8.0%	$9,000	$1,700	$5.09	$5.24
2Q18	3-4%	$9,000	$1,500	$5.09	$5.19
3Q18	3.0%	$9,000	$1,500	$5.09	$5.14

In 2019, the company is boosting its Constant Currency revenue forecasts, yet with a series of one-time events of late, it continues to reduce cash flow forecasts and EPS guidance. In 2019, the EPS guidance is listed as only the low-end:

2019 est	CC Rev	Op CF	CapX	EPS low
4Q18	5.0%	$10,000	$1,100	$5.37
1Q19	5.0%	$10,000	$1,100	$4.87
2Q19	6.0%	$9,500	$1,100	$4.94
3Q19	6.0%	$9,200	$1,000	$4.73

Also, in 3Q19, after boosting volume guidance in 2Q19 to -1.0% from the start of the year guidance of -1.5% to -2.0%, that figure was cut again to -1.0% to -1.5%. We should also add that Argentina's hyperinflation is expected to be 0.7% of the Constant Currency revenue growth.

Some of the decline in the guidance on EPS in 2019 is due to one-time items that we will explore below in more detail.

FX Weakness Accelerated in 2019 Again

The US dollar has remained strong and that hurts PM. We have long believed that it is unlikely to ever have much positive from FX because 40% of its volume is sold to five countries that would normally be considered troubled/third world: Russia, Turkey, Indonesia, Philippines, and Argentina. It's possible to get to 50% of PM's volume adding in Ukraine and North Africa.

FX $ in bills	Sep-19	2018	2017	2016	2015
Rev Growth $	$0.0	$0.9	$2.0	-$0.1	-$3.0
FX impact	-$0.9	-$0.1	-$0.4	-$1.3	-$4.7
Op inc Growth $	$0.2	-$0.2	$0.7	$0.3	-$1.1
FX impact	-$0.3	-$0.2	-$0.2	-$1.0	-$2.3

While this has improved from the days when oil was collapsing and lingering issues from the recession, FX remains a continual drag on both revenue and operating income. We should also add that of these weaker countries, only Russia has seen the roll-out of IQOS (Heated Tobacco) at this point. Also, PM specifically called out the Philippines and Turkey for weaker volume due to price increases.

FX continues to hurt EPS by 2%-4% in recent years and has periods of being well over 10%.

Pricing Continues to Outpace Volume Decay - Positive

One of the biggest reasons we have PM as a Neutral instead of a Sell is their plan to essentially offset lost volume with higher prices is still working. When we see Altria, the volume decay is now accelerating, and the higher prices only spur further decay. In some periods, the volume loss exceeds the pricing gain. **At this point, that is still not true at PM.**

Price/Vol $ bills	Sep-19	2018	2017	2016	2015
Rev Growth $	$0.0	$0.9	$2.0	-$0.1	-$3.0
Pricing	$1.0	$1.5	$1.4	$1.6	$2.1
Volume *	-$0.1	-$0.7	$1.1	-$0.5	-$0.3
Op Inc. Growth $	$0.2	-$0.2	$0.7	$0.3	-$1.1
Pricing	$1.0	$1.5	$1.4	$1.6	$2.1
Volume *	$0.0	-$0.9	$0.0	-$0.7	-$0.5
Y/Y Vol units	-0.4%	-2.1%	-2.7%	-4.1%	-1.0%

- Volume change is netted against deconsolidation of RBH

At this point, volume decay is being more than offset by price hikes. We do not think that lasts forever, but the acceleration may still be a couple of years away.

We still think the bigger issue here is IQOS taking share from traditional smoking and then people quitting IQOS or competition taking market share. As we have noted in several past reports the one universal outcome of IQOS is a permanent drop in cigarette sales. This is being offset by IQOS sales which continue to roll-out. Introductions to new countries continue to show sizeable first-year growth, and too many markets simply haven't matured yet. That is the other reason, we do not think the volume decay situation is critical yet.

One-Time Events May Not All Be Single Events

As noted above, PM's guidance has been coming down. The company calls out several items that are noteworthy in hurting EPS forecasts:

	2019e	2018
Reported EPS	$4.73	$5.08
tax items	-$0.04	$0.02
Asset Impairment	$0.04	
Canadian Litigation	$0.09	
Deconsolidation of RBH	$0.12	
Russia excise VAT audit	$0.20	
Net EPS from RBH	$0.00	-$0.26
Adj. EPS	$5.14	$4.84

The tax items – We believe these are one-time events. They relate to changes in various assumptions from the new tax laws that changed.

The asset impairment – This relates to the company right-sizing its manufacturing to match its shrinking volume for cigarette demand. Cigarette volumes are in long-term decay, so this is not a one-time event. Give PM credit – most companies we see taking long-term restructuring actions report charges far greater than this. But, it is debatable this will be a one-time item.

Canadian Litigation – We do not consider this a one-time event. PM has 10-pages in its latest 10-Q filing related to tobacco litigation. It took a $194 million charge in 2019, but these cases have been building for some time. Related to this is the Canadian unit filed for court restructuring to pay its claims (this is RBH). This caused PM to determine that it no longer controls the equity in RBH and therefore it deconsolidated it. Despite being in court working on a plan, PM's other operations are still being sued. We are not familiar with Canadian bankruptcy reorganizations, but we do know that in the US – torts tend to continue following any remaining deep pockets. We do not mind calling this out because payments are sporadic and lumpy – but we do not regard tobacco litigation payments and court costs as a one-time event.

Deconsolidation of RBH is a one-time event. PM determined separated the assets from its consolidated financial statements and payments made. While this relates heavily to the litigation that the company lost in Canada – they cannot remove RBH a second time.

The Russian tax issue is now the third country to investigate PM for intracompany sales of cigarettes. What the Russian government is looking at is if the sales were done at lower prices to reduce excise taxes paid to Russia and whether sales took place before excise tax increases to avoid taxes. Again, this lumpy and not a continual 5-cents every year, so pointing out the size is fine. But, we're not sure this is a one-time event either:

- Thailand and Korea have both audited PM for similar issues regarding intracompany sales and whether it reduced the excise taxes paid.
- We also know there were tax issues in Japan early on with IQOS because it uses less tobacco than normal cigarettes and the excise taxes were based on tobacco weight. This is not an audit issue – but the government boosted excise taxes on IQOS shortly after that. We are pointing to this as another example of governments watching tax revenue closely.
- Cigarette volumes are in decay. Heated tobacco offsets some of this, which is why we reported volume loss as 0.4% in 2019. Cigarette volumes fell 3.4% for 2019 and 5.9% in 3Q19. Lower volume means less excise taxes to governments and could bring more scrutiny.

FX is another item PM calls out and for 2019 they see a $0.14 drag on EPS. Again, when isn't FX a drag on results. We're fine calling it out and quantifying it – but to add it back does not seem realistic given the nature of PM's markets.

The Street is going to use the numbers that PM provides and add back all of these items. **We think the way to view this that in any given year, there is a decent risk that PM will see reported GAAP EPS fall due to FX and litigation.** Tax audits will be rarer but can be significant and the risk of something happening again – after it has happened three times – is therefore real. **In addition, the reason the cash flow forecasts are coming down is PM is writing checks for these issues.** This isn't a goodwill write-down, it paid Canada and Russia this year.

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