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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Philip Morris (PM) – 3Q18 Update

We will need the 10-Q to update our *EQ Review* rating of a 3- (Minor Concern) to see the movement in receivables, inventories and changes in receivables sold. One of our concerns was that PM was stretching working capital. Overall, we saw that working capital was a $1.0 billion drain on cash flow in 3Q as current assets less cash declined producing $0.8 billion in cash as current liabilities less LT debt classified as current fell as well consuming $1.8 billion in cash.

We are keeping a neutral rating on the stock for fundamental reasons. The negatives of offsetting weak volumes and FX with pricing still seems like a tough proposition in the long run. But, the introduction of heated tobacco products into new markets continues to provide some lumpy growth and there are many more markets to expand heated tobacco still. At this time, that is a big tailwind to try to fight.

After 3Q results, not much has changed on the surface from our September 13 report except there are areas of guidance that came down further:

- Guidance on revenues, EPS, FX, and Japan's inventory channel all came down on the 3Q18 press release.

- Initial stocking of Heated Tobacco devices and refills is helping.

- Early heated tobacco markets are not showing much growth after a year.

- Price increases are still driving earnings growth and PM has little cushion on dividend payout ratios staying under 100% of EPS and FCF if pricing power does not hold.

Guidance Continues to Fall:

After missing on forecasts for nearly all of 2016 and 2017, PM has now beaten forecasts in each quarter of 2018. However, at the same time, it continues to lower guidance.

Constant currency revenue growth for 2018 was forecast at over 8% in the 4Q17 press release. It was dropped to 8% after 1Q18. It fell to 3%-4% after 2Q18, and now was reduced to just 3%.

EPS growth was expected to benefit from 16-cents of FX for 2018 in 4Q guidance and 1Q guidance. That benefit was forecasted to fall to a 7-cent negative impact in 2Q and 12-cents negative in 3Q guidance. We adjusted the 2018 EPS forecasts for this FX impact, and see that the top end of EPS guidance is falling and growth rate range is falling too:

FX adj EPS	EPS Low	EPS High	EPS Growth
4Q17	$5.04	$5.19	7%-10%
1Q18	$5.09	$5.24	8%-11%
2Q18	$5.09	$5.19	8%-10%
3Q18	$5.09	$5.14	8%-9%

We want to again point out that PM also cut guidance for its tax rate from 28% to 26% to 24% during this time. A 200bp move in the tax rate is worth about 13-cents in EPS.

At the same time, the inventory overhang for heated tobacco in Japan that hurt 2Q sentiment so much may have become worse again. After 2Q, guidance was for shipments of 41-42 billion units of heated tobacco in 2018 after a 3-billion-unit inventory reduction in Japan. After 3Q, guidance remains for shipments of 41-42 billion units. However, now the inventory reduction in Japan is 4 billion units offset by 1 billion units of growth in other markets.

The CFO was asked point blank on the call how they can be beating in quarters 1-3 and forecasting a weak 4Q to bring EPS growth down so much? The answer was:

- 4Q17 had a 7-billion-unit inventory build in Japan vs flat in 4Q18
- Another 1.5 billion sticks impacted in 4Q18 by distributors buying in 3Q18 ahead of a price increase

- A bigger part of the incremental $600 million of support spending for heated tobacco launches will fall in 4Q18

In our view, the tax rate alone should be pushing up forecasts. That the top end of guidance continues to be reduced is puzzling.

Heated Tobacco Helps Early On

As we said in September, PM's results are going to be helped as heated tobacco rolls out into new markets. It gets to stock inventory as well as the devices needed to use heated tobacco and those devices cost more. They book revenues when it sells product to distributors so initial stocking can provide a good boost. Growth continues for several quarters too. It comes at the expense of combustible cigarettes, but people are already expecting those to decay. That is the basic story why we are not more negative on PM at the moment. That is a big tailwind to fight this early in the roll-out.

Early results in Japan and Korea show that the market share gains are rapid, but they also are showing signs of stalling quickly too. Here is the market share of PM's heated tobacco in Japan and Korea:

HTU Market Share	3Q17	4Q17	1Q18	2Q18	3Q18
Japan	11.9%	13.9%	15.8%	15.5%	15.5%
Korea	2.5%	5.5%	7.3%	8.0%	7.4%

This is why the company and many investors are excited. Heated tobacco grabbed some big market share very quickly. However, 2Q18 results disappointed because PM announced that it would be adjusting inventory levels down in Japan by 3 billion units. In 3Q18, the forecast is a 4-billion-unit reduction in Japan. The success attracted competition and price cutting on devices has already begun. The result is rapid growth in 4Q17 quickly vanished:

Asia Results	4Q17	4Q16	change
Cigarette Vol	61,234	63,815	-2,581
Heated Vol.	14,032	3,510	10,522
Total Vol.	75,266	67,325	7,941
Asia Op Inc.	$1,396	$908	$488

- In 2017, Japan and Korea were in the Asian division before moving to the East Asia & Australia segment in 2018 so the numbers are not completely comparable.

E. Asia & Aust.	1Q18	1Q17	change
Cigarette Vol	14,091	17,243	-3,152
Heated Vol.	7,342	4,145	3,197
Total Vol.	21,433	21,388	45
Asia Op Inc.	$515	$472	$43

E. Asia & Aust.	2Q18	2Q17	change
Cigarette Vol	15,114	15,790	-676
Heated Vol.	7,838	5,726	2,112
Total Vol.	22,952	21,516	1,436
Asia Op Inc.	$498	$510	-$12

E. Asia & Aust.	3Q18	3Q17	change
Cigarette Vol	14,186	15,331	-1,145
Heated Vol.	4,575	8,826	-4,251
Total Vol.	18,761	24,157	-5,396
Asia Op Inc.	$426	$648	-$222

The growth vanished with destocking and changes in operating income become negative. In our view, the bigger problem is PM went from getting big gains in volume and pricing to getting little or negative impacts on operating income from both and this happened quickly:

Oper. Inc. Chg. E. Asia & Aust.	4Q17	1Q18	2Q18	3Q18
Volume	$471	$46	$99	-$307
Price	$114	$15	-$36	$86
FX	-$97	$16	-$5	-$6

The company is predicting that once this destocking is complete in Japan, it will set the stage for future growth in Japanese heated tobacco volumes. We think that ignores that the market share gains have stalled. It should level off at 8 billion units per quarter in East Asia – which is up from 3Q18 figures of 4.5 billion, but does it become flat at those levels and offset by falling cigarette volumes?

While we do not see heated tobacco as the panacea to all the problems facing PM, it is obvious that the early stage roll-out of this product in new markets can spur some growth. As it is now rolling out in some European markets and Russia, growth in those markets is still in the infancy:

HTU Market Share	3Q17	4Q17	1Q!8	2Q!8	3Q18
Eur. Union	0.3%	0.6%	0.8%	1.0%	1.2%
Russia	0.1%	0.2%	0.5%	0.8%	1.1%

These markets are also larger than Japan. In 2016, PM sold 43.9 billion cigarettes in Japan. The EU bought 440% more and Russia 180% more in 2016. So, market share points are worth more in these new markets and there is still the Philippines, Turkey, Indonesia where volumes are very high too.

Higher Taxes and Prices Continue to Hurt Volumes - PM May Be Too Dependent on Pricing

We talked about how many countries are seeking to curb smoking and raise revenue by boosting excise taxes. Given how many countries PM operates in, there are often several countries where taxes are on the rise in any given quarter. Higher taxes paid at retail are the same as a price increase for the consumer. Higher prices drive down volume. Excise tax increases hurt 3Q18 volume in France by 8.6%, Russia 7.8%, and Ukraine 9.4%.

The plan from PM is to boost prices to offset volume decay. When taxes are raised, and volumes fall, that just hurts PM. They will try to push through some pricing for themselves, but it unlikely fully offsets the lost volume. Among countries that saw price hikes hurt volume are Argentina down 8.5%, Brazil down 12.5%, North Africa down 4.4%, and Italy down 2.4%.

Overall, pricing continues to be the only thing driving results in 3Q:

3Q Op. Income	Price	Volume	FX	Cost	Total
Europe	$77	$110	$19	-$52	$154
East Europe	$91	-$10	-$56	$1	$26
M/E Africa	$19	$59	-$97	$15	-$4
S&SE Asia	$150	-$18	-$43	-$45	$44
E. Asia & Aust.	$86	-$307	-$6	$5	-$222
Lat Am & Can	$60	-$26	$16	$20	$70
Total	$483	-$192	-$167	-$56	$68

For the 3Q, pricing was worth $483 million in higher operating income from the various segments and the total gain was only $68 million. There are three things to focus on in this equation beyond the Japanese and Korean situations described above for the huge negative volume figure. First, the roll-out of heated tobacco in Europe and Eastern Europe helped even more because it improved volume too.

Volume	1Q18	2Q18	3Q18
Europe	-$67	$19	$110
East Europe	-$47	-$41	-$10

Cigarette volume was actually down 2% in Europe and 6% in Eastern Europe for 3Q. We also believe that as a roll-out for heated tobacco increases, people need to buy the device to use heated tobacco. Those add to pricing because they cost more.

The Middle East volumes were helped by lapping some earlier excise tax increases. Saudi Arabia was up 19% in 3Q after being down 41% in 1Q and 24% in 2Q. We would expect this to help in 4Q volume too. However, keep in mind that Martin King of PM also noted that one of the reasons for low guidance in 4Q is that 1.5 billion units in Japan were likely pulled into 3Q ahead of 4Q price increases. That already inflated 3Q volume figures.

In our opinion, the tax increases will continue as we noted in September plus there is also pressure to boost taxes on heated tobacco. Even PM acknowledges that the tax hikes accelerate volume cuts. The benefits of initial stocking for heated tobacco aside, we do not believe PM can continue offset higher costs, FX issues, and weaker volume all with price hikes for very long. There are mentions of illicit trade and smokers trading down as other negative impacts in PM's earnings discussions that are also the result of higher pricing.

We point this out because it simply doesn't take much decay to hurt the dividend sustainability. The current dividend is $4.56 with guidance of EPS of $5.09 without FX impacts forecast to be negative. That's a 90% payout prior to FX. On cash flow, the company continues to forecast $9.0 billion in Cash from Operations less $1.5 billion in capital spending or $7.5 billion in free cash flow. The dividend is $7.1 billion or a 95% payout ratio.

Share repurchases have stopped and spending to support heated tobacco roll-outs is rising. If the company cannot get pricing gains at historic levels, it becomes difficult to envision the dividend growing at rates investors have been accustomed.

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