BEHIND THE NUMBERS
Quality of Earnings Analysis

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Philip Morris International Inc. (PM) Earnings Quality Review

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

We are updating our earnings quality coverage of PM and reducing our rating to 3- (Minor Concern).

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

Summary

PM normally beats forecasts by a few cents and 2Q21 was a 2-cent beat. The company has been right-sizing its cigarette manufacturing footprint and exiting some facilities to reduce fixed costs. We do not have a big issue with that and the EPS adjustments in that area are minor. Earnings quality in that regard is reasonably high.

The issues we have with PM relate more to the dividend already being about 80% of free cash flow. That free cash flow is frequently moved by FX hedging results. The number of one-time items regarding taxation, litigation, and other similar events is becoming more frequent and those also negatively impact cash flow. Further, the company's move into Heated Tobacco cannibalizes its cigarette volumes and cigarettes are much more profitable and require less R&D, marketing, and capital spending.

We rate it a 3- (Minor Concern) rather than a 2 (Weak) because with debt at 1.74x EBITDA, PM can withstand some shocks. But every time we look at PM, we see reasons to expect lower

profitability going forward. In recent weeks, PM has spent $2 billion to acquire two companies at 15-16x EBITDA while it trades for 12.5x.

What is strong?

- The difference between GAAP and non-GAAP EPS is often minor. The most common issue is asset impairments and exit costs as PM restructures its factory footprint. PM also shows both GAAP and non-GAAP with and without FX gains or losses. When there are some fireworks such as 2019, 2020, and 2Q21 – we think the risks of litigation show themselves to be material. Given the uncertainty of timing, we understand why items such as a reassessment of Saudi customs fees or Russian VAT charges are listed as one-time items. But these do create some material events.

- PM is not amazingly leveraged at this point. Debt to EBITDA was 1.74x after 2Q21. Other companies in this space have higher debt ratios after some much more expensive acquisitions. Debt could rise slightly with the recent acquisitions and PM's new plan to acquire $7 billion in stock over the next three years.

- New IQOS device production is still ramping up, which could lead to better fixed cost absorption and economies of scale. Along with removing some fixed costs from traditional cigarette manufacturing, PM may see some improvements in these areas to help margins in the near term.

What is weak?

- Heated tobacco is simply not as profitable as cigarettes. PM used to spend about $400 million annually on advertising – now it spends about $800 million to support IQOS. We think PM picked up about $200 million in earnings and EBITDA in 2020 because Covid allowed marketing levels to fall to $637 million. It must subsidize the devices for the consumer too. It looks like the devices sell for about the same price as two cartons of replacement Heets. Plus, capital spending has been much higher in recent years too – reaching $1.5 billion vs. many years below $1 billion.

- PM is seeing heated tobacco accelerate the decline of cigarette volumes and growth in heated volume does not offset the decay so total units are falling. As PM laps Covid, there is a short reprieve in the decay because the lack of shipments early in the pandemic made 2020 fall faster than most years, and 2021 has some easy comps.

- Litigation, tax issues, and FX hedges are all volatile and represent sizeable swings for GAAP earnings and cash flow year-to-year. Litigation forced the Canadian sub into receivership in 2019 along with sizeable payments to deconsolidate it. Many more lawsuits are outstanding with governments seeking payments to cover health costs for smokers and many have larger populations than Canada. There have also been several governments claiming underpayment of excise taxes on cigarettes and PM has already made several payments in that area too. The timing is not clear, but the payments have been material.

- PM is addicted to price increases. For much of the last five years, PM has taken over $1.4 billion in higher prices annually that flows straight to operating income. This offset sizeable FX losses and volume decay. Yet operating income is essentially flat. If the company cannot take pricing to that degree, can operating income remain flat?

What to Watch?

- PM stopped repurchasing shares in 2014 as it could no longer afford to do it. It continued boosting the dividend though, but the growth rate has slowed from over 10% to only 2.6% now. With a 5% dividend, PM has not boosted debt to repurchase stock and make the argument that it could finance such a program cheaper than the 6.3% pretax cost of the dividend. While we understand the basic argument for near-term EPS growth and a lower total dividend payment, we would be skeptical if PM leverages itself and loses flexibility and liquidity by repurchasing more stock. The recent announcement that it wants to buy $7 billion in stock could lead PM to consider larger repurchases with debt.

- PM can cover its dividend at this point. The payout ratio is about 80% of free cash flow. However, we think investors should be more focused on the continued decay in overall volumes. So far in 2021, they have highlighted lower marketing and research costs as a percentage of sales. Plus, hedge income is positive in 2021. We believe several of these costs will increase going forward.

Supporting Details:

The Basic Picture of PM's Results

Philip Morris is a company that many own for the dividend yield and its growth. Based on the figures, the company covers the dividend with some degree of cushion:

	2020	2019	2018
Cash From Operations	$9,812	$10,090	$9,478
Capital Spending	$602	$852	$1,436
Free Cash Flow	$9,210	$9,238	$8,042
Dividend	$7,364	$7,161	$6,885
Dividend Coverage	80%	78%	86%

The first issue people should note is PM once was a heavy purchaser of its own shares. However, repurchases have been zero for many years and only in the 2Q21 did PM announce it intends to repurchase $7 billion in stock over 3-years. Also, dividend growth per share is running at only 2.6% now. It was not that long ago that dividend growth exceeded 10% annually. From an EBITDA standpoint, the only adjustment made is to remove the minor amount of equity investment income. It too shows a good consistent performance of producing over $12 billion per year.

	2Q21	1Q21	2020	2019	2018
Net Income	$2,298	$2,595	$8,592	$7,728	$8,286
Interest Exp.	$161	$167	$618	$570	$665
Taxes	$646	$697	$2,377	$2,293	$2,445
Depreciation/Amortiz.	$239	$245	$981	$964	$989
Equity Income/Loss	-$3	-$43	-$16	-$149	-$60
Impairments	$325	$48	$30	$1,229	$0
Adjusted EBITDA	$3,666	$3,709	$12,582	$12,635	$12,325

We noted earlier that the difference between GAAP and non-GAAP earnings is often only a couple of cents. That normally makes earnings quality very high. However, the first signs of risks are evident because there are many "one-time" items being adjusted for. There are items like restructuring costs to better align the cigarette manufacturing volume as well as marking securities to fair market value. However, the bigger risks seem to appear more often than investors like to admit. These include filing bankruptcy in Canada and tax disputes with many countries.

	2Q21	1Q21	2020	2019	2018
GAAP EPS	**$1.39**	**$1.55**	**$5.16**	**$4.61**	**$5.08**
Impairment/Exit Cost	$0.04	$0.02	$0.08	$0.23	
FMV Eq Securities			$0.04	-$0.02	
Saudi Custom Assessments	$0.14				
Brazil Tax Credit			-$0.05		
Canada Litigation Exp				$0.09	
Deconsolidate RBG Canada				$0.12	
Russian VAT charge				$0.20	
Tax Items	-	-	-$0.06	-$0.04	$0.02
Non-GAAP EPS	**$1.57**	**$1.57**	**$5.17**	**$5.19**	**$5.10**
FX Gain/Loss	$0.05	$0.10	-$0.32	-$0.13	-$0.11
GAAP EPS w/o Currency	$1.34	$1.45	$5.48	$4.74	$5.19
NonGAAP EPS w/o FX	$1.52	$1.47	$5.49	$5.32	$5.21

We will discuss these issues in more detail below. We think investors should take notice that the cushion of about $2 billion in the last two years of paying its dividend. After years of not repurchasing shares, PM recently announced a 3-year plan to repurchase $7 billion of its stock. That will consume more than all the cash flow after the dividend. There are also some potentially easy to list items that may impair the free cash flow too:

- Advertising was $896 million in 2018. PM is still rolling out Heated tobacco and other non-cigarette products. With Covid, advertising was not as necessary and declined to only $637 million. PM may lose $100 million of free cash flow in this area.

- Capital spending also dropped to only $602 million in 2020 and Covid. The forecast is for $800 million in 2021 which is another $200 million in lower free cash flow. It should be noted that capital spending is often > $1 billion so this may need to rise beyond $800 million.

- Changes in net investment hedges show up in the Investing Section of the cash flow statement. These are primarily related to hedging foreign currency exposure. There are years this is a source of cash, but the cumulative total over the last five years has been a use of cash:

	2020	2019	2018	2017	2016
Net Inv. Hedges	-511	386	416	-1527	295

- It is also worth noting that PM already factors over $11 billion of receivables per year. Thus, that source of cash has already been tapped.

While these items may total about $500 million and PM could still cover its dividend, the share repurchase plan may be difficult to complete without borrowing more money.

Does PM's Cash Flow Require Hefty Annual Price Hikes?

One of the bigger risks we see to PM's results comes from the huge price increases it takes. This offsets much of the FX loss that PM experiences too. These price hikes drop entirely to the operating income line. What is incredible is adjusted operating income has remained almost flat since 2015 with these large price hikes every year, which illustrates how much volume they are losing:

	1H21	2020	2019	2018	2017	2016	2015
Price Increases	$432	$794	$1,483	$1,488	$1,400	$1,600	$2,100
FX Impact	$645	-$475	-$292	-$214	-$157	-$1,000	-$2,300
Total Impact to Op. Income	$1,077	$319	$1,191	$1,274	$1,243	$600	-$200
Adjusted Op. Income	$6,632	$11,698	$11,760	$11,377	$11,581	$11,144	$11,040

- Adjusted operating income adds back restructuring charges and one-time items like deconsolidating Canadian operations in 2019.

- 2020 with Covid disrupted some of the supply chain to distributors so volumes fell more than normal and likely hurt PM's ability to take pricing. 2Q21 vs. 2Q20 showed volume growth for cigarettes because the supply chain is more normalized now compared to early in Covid.

- PM is being helped by FX being a positive this year more than pricing. However, how often is that the case? We would expect to see more FX losses than gains for PM as just a matter of serving many emerging market countries.

- The Covid recovery in 2021 may give PM a sizeable net pricing gain this year. Thus, the timing of this risk may be a few quarters away.

- The $1.2 billion in net pricing PM was taking in 2017-19 to its operating income line would be $948 million to free cash flow and earnings net of taxes. It's 61-cents in EPS for a company earning just over $5 per share.

- It is doubtful that PM ever loses the full ability to boost some prices, but it starts to shrink in size, it could quickly lead to lower operating income and free cash flow because the volume decay is well established.

	1H 21	1H20	2020	2019	2018	2017	2016	2015
Cigarette Volume	301.7	308.4	628.5	706.7	740.0	761.9	813.9	847.3
Non-Burning Volume	46.1	35.4	76.1	59.7	41.4	36.2	7.4	0.4
Total Volume	347.7	343.8	704.6	766.4	781.7	798.2	820.3	847.6
Cigarette Decay	-2.2%		-11.1%	-4.5%	-2.9%	-6.4%	-3.9%	
Non-Burning Growth	30.2%		27.5%	44.2%	14.4%	389.2%	1750.0%	
Total Decay	1.1%		-8.1%	-2.0%	-2.1%	-2.7%	-3.2%	

As noted above, the larger rate of decay in cigarettes in 2020 was helped by disruption of the distribution as Covid started. 2Q21 saw cigarette volumes increase against that situation y/y. We believe 2021 and 2020 will need to be looked at as one period.

PM has lost 26% of its cigarette volume since 2015. While non-combustible products are growing, they are nowhere near enough to offset the loss. It's currently about one-third of the lost cigarette volume. It is also important to keep in mind the cigarette business is likely much more profitable. It doesn't need advertising or capital spending. The distribution system is set up. R&D spending is likely lower. We also believe PM must subsidize the cost of the IQOS device. While it is obvious that the cigarette market is still much larger than the noncombustible unit, PM could see profit margins fall as the cigarette volume continues to get smaller. At this point, PM is cutting capacity in cigarettes to take more cost out of the system. We also believe that to the extent PM wants to use price hikes to offset loss volume and FX issues – it leads to more people quitting smoking too and the vicious circle continues.

Legal Contingencies Represent More Large Potential Risks

In an 84-page 10-Q, PM discusses litigation and government-related risks for 26-pages. Most importantly, several large situations have already hit in recent years.

Many foreign governments have looked at PM for underpayment of taxes and legal issues with the importation of cigarettes:

- Thailand had numerous investigations and PM ended up paying $42.3 million in 2019 and 2020.

- South Korea's review of excise taxes resulted in PM paying $243 million in 2016 and 2017. This is under appeal and could be reversed.

- Russia looked at excise tax issues and PM took a $374 million charge in 2019.

- Saudi Arabia's review of tax issues resulted in a $246 million charge in 2021.

On smoking health lawsuits PM has several outstanding class actions already:

- In Canada, PM lost two class actions and has damages of $2.2 billion against it. This led the company to deconsolidate its Canadian operations and file bankruptcy to work through the remaining process as there are 7 more class actions pending in Canada. Deconsolidating led to PM losing $1.3 billion in cash from its balance sheet. It also caused a $239 million charge in 2019.

- It has numerous governments suing to recover medical expenses being paid for health issues of smokers. These countries include Canada, Korea, Nigeria, Brazil, Argentina, and Venezuela. Given the relatively small population in Canada and the size of the class actions already seen there – countries like Nigeria and Brazil could be significantly higher.

- There are also lawsuits related to health risks of light cigarettes and the heated tobacco products.

The new products have patent infringement lawsuits too from British American Tobacco.

Looked at as a whole, we believe the legal issues represent a threat to PM's cash flow – although the timing is still not clear. Many of these cases have already been in progress for multiple years now. PM has already paid considerable amounts in several instances. The size of the Canadian cases is already in the billions of dollars and Canada only has 38 million citizens. Nigeria, Brazil and even South Korea are much larger and are pursuing similar cases.

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.

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