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Philip Morris (PM) EQ Review- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	NA

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

We initiate coverage of Philip Morris with a 3- (Minor Concern)

We have done more work on the fundamentals of PM in our Part 2 piece below. This review focuses on PM's accounting. The company beat forecasts in 2Q18 and 1Q18 after missing in 7 of the prior 8 quarters. More surprising is PM gave 2018 guidance with a 28% tax rate after 4Q17, 26% after 1Q18, and 24% after 2Q18 plus reduced capital spending forecasts – and still reduced guidance after last quarter. The actual accounting issues are mild such as stretching working capital to boost cash flow and FX hedging becoming a large cash drain at times. There is not much nefarious about that other than it appears that PM has pulled in incremental cash flow from short-lived sources and without those recurring, the dividend coverage could easily rise over 100% of EPS and free cash flow.

The company does essentially all its business overseas yet has sizeable US Dollar obligations in debt and dividends. It has some conservative hedging, but the cost of the hedge appears to be rising over time and becoming a cash drain too. There is not much cushion between cash in and cash out. Moreover, working with several depreciating currencies can make it tough to keep translating a smaller business back into enough dollars. At this point, PM has responded by boosting prices to offset lost volume, FX losses, and higher costs. The biggest near-term risks are missed forecasts and much slower dividend growth.

- Dividend coverage is masked by stretching working capital.

- Selling Accounts Receivable has helped Cash Flow but appears to have leveled off at 13% of sales. This could become a headwind for cash flow – Concern Medium

- Favorable FX in 2017 and 2018 helped Cash Flow also, but seems unlikely to repeat after PM lowered guidance with FX noted – Concern High

- Inventory fell while payables rose in 2017 to help cash flow – that is tough to repeat and is already reversing – Concern High

- Debt looks low at 2.5x EBITDA and the cash balance is adequate with credit lines available

- Cash flow from foreign operations services almost $8 billion in US Dollar obligations

- Many key currencies for PM have become volatile including significant devaluations against the US Dollar. That could reduce operating income before FX transactions and make it tough to translate foreign earnings into the same amount of dollars – Concern Medium

- Price hikes are carrying the day so far and offsetting lower volumes and negative FX issues. Price hikes tend to hurt volume more – Concern Medium
- Without initial stocking of heated tobacco products in Asia in 2017 and 2018 plus European FX gain in 2018, negative operating results may already be offsetting the price increases – Concern Medium

- Hedging transactions aren't free. PM has seen negative cash impacts of $2.5 billion in the last 3.5 years in this area – Concern Medium

Basic Cash Flow Model:

Philip Morris looks stronger than Altria (MO) at first glance. At no time has the dividend exceeded free cash flow, as has been the case at Altria. However, the company has already essentially discontinued share repurchases. This is starting to make the dividend growth in total dollars ramp up more quickly and led to a slowdown in dividend per share growth. The forward annual dividend is now $7.1 billion.

	TTM 2Q18	2017	2016	2015	2014	2013
Adj. EBITDA	$12,854	$12,378	$11,558	$11,445	$13,126	$14,706
Cash Ops	$10,214	$8,912	$8,077	$7,865	$7,739	$10,135
Cap. Exp.	$1,762	$1,548	$1,172	$960	$1,153	$1,200
Acquisitions	$122	$111	$41	$55	$139	$1,418
Free Cash Flow	$8,330	$7,253	$6,864	$6,850	$6,447	$7,517
Dividend	$6,616	$6,520	$6,378	$6,250	$6,035	$5,720
Repurchases	0	0	0	$48	$3,833	$5,963
Hedges *	-$927	-$1,527	$295	$239	$266	-$62

Hedges represent a cash cost in the investing section when negative and a source of cash when positive

We will explore FX more in this report – but notice that hedging has become a considerable cash expense for PM. Adjusting for this, suddenly paying out a $7.1 billion dividend becomes closer to 100% payout. From an earnings standpoint, PM routinely loses money on FX, but the amount can vary considerably.

	TTM 2Q18	2017	2016	2015	2014	2013
Adj. EPS	$5.00	$4.72	$4.48	$4.42	$4.76	$5.40
Dividend/share	$4.35	$4.22	$4.12	$4.04	$3.88	$3.58
Dividend/EPS	87%	89%	92%	91%	82%	66%
Dividend/FCF	79%	90%	93%	91%	94%	76%
FX EPS	$0.00	-$0.21	-$0.46	-$1.20	-$0.80	-$0.34
FX % EPS	0%	-4%	-9%	-21%	-14%	-6%

Several Areas Are Stretching Cash Flow:

PM has an Accounts Receivable Securitization Program in place with several banks. This allows the company to collect cash faster. It should also help speed some FX translation. This has been in place for many years. The amount of receivables sold during the various periods has been rising for years. Plus, the amount of receivables sold at the end of the period has effectively added to cash flow in several years by having receivables off the balance sheet.

	1H 18	2017	2016	2015	2014
Sales	39,526	78,098	74,953	73,908	80,106
Accounts Sold during period	5,300	10,003	9,447	3,299	1,569
% Sales Sold	13%	13%	13%	4%	2%
A/R sold at period end	600	1,092	729	888	120
A/R on Bal. Sheet	3,772	3,738	3,499	2,778	4,004

Selling receivables generates cash. It appears to be topping out at about 13% of total sales. Philip Morris has added basically $1 billion in cash flow over the last 3 years. This may not show as much growth going forward and it may become a headwind the first part of 2018 is becoming.

Favorable currency movements helped cash from operations in the first half of 2018 by $355 million and in 2017 by $392 million. That's a big swing from -$409 million in 2016 and -$1.9 billion in 2015. Several other common cash items have also been moving through the cash flow statement and helping much more of late.

	1H 18	2017	2016	2015
Cash From Ops	5,373	8,912	8,077	7,865
FX +/-	355	392	-409	-1,900
Inventory +/-	-526	730	-695	-841
Accts Payable +/-	-120	425	373	310
Pension funding	-41	-66	-191	-154
Adj Cash from Ops	5,041	7,431	8,999	10,450

We don't want to focus on each of these items in a major way. But, we do see that the company benefited in 2017 from having inventories fall while payables still grew along with receivables sold increase. That is reversing in 2018 so far. Also, pension funding has dropped versus 2016 and 2015.

Philip Morris guidance is for Cash from Operations to come in about $9 billion before changes in working capital and currency benefits/headwinds. It is also forecasting $1.5 billion in capital spending, which has already been cut by $200 million. That gives PM a pro forma free cash flow of $7.5 billion before working capital and FX impacts. The forward dividend is $7.1 billion and they are not buying back shares. That's a 95% payout ratio, up from 89% last year. It looks like inventory and receivables will be headwinds that will raise that figure even higher. Also, if currency hedges cost more in 2018 and the favorable benefits drop back, this ratio could easily push over 100%.

We will talk about the New Tax Law later, which has been favorable to 2017's cash flow and a headwind in 2018, but should level out as a net positive to cash flow going forward. It helped drive the dividend growth up to 6.5% recently from 2.9% and 2.0% for the previous hikes.

The point we want to make is the FX hedges are now costing cash, selling receivables may only move at the speed of sales growth at this point, inventories and payables may cost cash flow. The coverage on the dividend is tighter than it appears to be at first glance.

The Company's Balance Sheet Also Looks Fine at First Glance

	1H 18	2017	2016	2015
Cash	6,587	8,447	4,239	3,417
Gross Debt	31,665	34,339	29,067	28,480
Net Debt	25,078	25,892	24,828	25,063
Adj. EBITDA	12,854	12,378	11,558	11,445
Gross Debt/EBITDA	2.5	2.8	2.5	2.5
Net Debt/EBITDA	2.0	2.1	2.1	2.2

PM is not broke by any means and it's an A-rated credit with a stable outlook from two ratings agencies and a negative outlook from Fitch. This certainly does not appear to be a leveraged company at 2.0-2.5x debt to EBITDA. EBITDA used to be $14.7 billion in 2013 so it has come down as sales volumes have fallen and the company stopped buying back shares in any material way in 2014, which preserves cash and slows debt growth.

Enter Foreign Exchange….

The basic issue for PM is it operates all over the world – yet most of its debt, interest, dividends, and some taxes are paid in US Dollars. As of June 2018, 67% of the debt ($20.8 billion) was in US Dollars along with $691 million of interest expense. The dividend is $7.1 billion on a going forward basis and is paid in US dollars.

The new tax law has US companies paying a 15.5% repatriation rate on accumulated foreign earnings that were not reinvested and 8% on foreign earnings that were. These taxes can be paid over eight years in installments of 8% of the total for the first five years, then 15%, 20% and 25% for the final three. These taxes will also need to be paid in US Dollars.

From an earnings standpoint, PM expects a 21% US tax rate that will get about 2% more taxation due to a difference in foreign tax rates. Then, there are issues with non-deductibility of interest expense and potential disallowance of foreign tax credits. In 4Q17, they assumed that later catch-all would be about 5% and give PM a 28% tax rate. It has since reduced that guidance to 26% and now 24%.

Our reading is that foreign dividends paid to a US company can be deducted and that is how PM is paid – via dividends from the foreign subsidiaries. So, the best case for PM would be it pays its $1.7 billion repatriation tax as $136 million for each of the first five years. So, it needs to basically raise nearly $8 billion in dollars annually to pay interest, taxes, and dividends assuming it essentially rolls over most US debt at maturity.

The company has operated like this for years, so we certainly are not going to say it cannot be done. It maintains numerous hedges specifically to service US dollar debt, it routinely forecasts its currency needs and puts hedges in place to ensure it can cover those needs and PM has $8 billion in credit lines available, which can smooth out some of the swings. The company has plenty of cash flow in Euros to handle the Euro debt. Also, with capital spending being largely in foreign currencies that should not be an issue. Unlike Facebook, which derives much of its revenue from overseas while the production aspect is largely US, PM does not have much transfer pricing issues that could cause significant tax issues. Even the potential lawsuits are in foreign currency.

In our view, FX risk comes from two areas: many currencies are depreciating rapidly, which means revenues need to grow to still convert into the same number of dollars and the cost of hedging appears to be getting larger, which becomes a drag on cash flow also.

The Countries Where PM Operates:

Philip Morris sells cigarettes in 180 countries around the world. Indonesia is over 10% of sales and Germany about 9%-10%. The company lists the following as key currencies it works with:

"The primary currencies to which PMI is exposed include the Australian dollar, Canadian dollar, Euro, Indonesian rupiah, Japanese yen, Mexican peso, Philippine peso, Russian ruble, Swiss franc and Turkish lira. At June 30, 2018, PMI had contracts with aggregate notional amounts of $31.3 billion of which $4.2 billion related to cash flow hedges, $9.9 billion related to hedges of net investments in foreign operations and $17.2 billion related to other derivatives that primarily offset currency exposures on intercompany financing."

Several of these currencies have seen big depreciations against the US dollar this year. Turkey is down 73%, Russian about 18%, the Philippines 8%, Indonesia 10%, Australia 8%. Argentina is now classified as a highly inflationary and PM noted that it would now see its currency-neutral revenue growth forecast fall by 0.5% due to this. What if one of the bigger countries causes a larger problem?

Revenues are not growing at these rates, and volumes are declining in many of these markets too.

Volume y/y	1H 18	2017	2016
Germany	-5.8%	-1.3%	-2.8%
Indonesia	-0.4%	-4.0%	-3.9%
Russia	-14.3%	-9.1%	-5.7%
Turkey	13.6%	0.1%	1.2%
Philippines	1.7%	-10.6%	-14.5%
Mexico	-8.3%	-2.9%	7.9%
Canada	0.0%	-7.9%	1.2%
Argentina	-3.0%	-1.9%	-13.8%

These are some decent headwinds to fight. Some of this is due to higher excise taxes in various markets, which leads to lower volume and more illicit trade. Higher excise taxes are added into gross revenues for PM, but it's a pass-through – PM doesn't keep that revenue. The company is boosting prices as well, which further hurts volume but does help create higher revenue in local currencies to translate into US Dollars. But, PM has to overcome the lower volumes and FX depreciation all with price hikes. There is already evidence that showing up in the operating income figures. What should scare investors is the company started the year guiding to a 28% tax rate. After 1Q18, it was guiding to 26% and then 24% after 2Q18. 200bp on the tax rate is worth about 3-4 cents per share per quarter. That's a big tailwind in PM's favor. Yet the company cut guidance after 2Q. That likely is the result of volume, pricing, and FX issues.

6 Months 2018 Segment Operating Income Changes

6 mths 2018	FX	Price	Vol	Cost	Total
Europe	279	117	-48	-123	225
East Europe	-13	152	-88	-22	29
Mideast/Africa	-46	-51	-50	-44	-191
S&SE Asia	-31	251	-72	32	180
East Asia/Aust.	11	-21	145	-104	31
Lat Am & Can.	-37	234	-41	-64	92
Total	163	682	-154	-325	366

These are the major reasons cited for the change in operating income for each segment. The numbers may not add up due to minor issues not specified. The volume in East Asia was up with initial stocking of new heated tobacco products in Japan and Korea. Also, a rebound in the European currency helped on FX. Even with those positives, total volume was a negative drag on operating income and pricing drove all the results. The company noted that the build-up of heated tobacco units in the channel is now having negative impacts on growth in its 2Q18 guidance,

> *"While the inventory build of approximately 13 billion heated tobacco units was appropriate at the time given that then forecasted demand, our heavy reliance on a single production center and the shirt from air to heat rate, it is now resulting in lower heated tobacco unit shipments in the third quarter."*

We should note that PM is losing volume faster than the market, so pricing has longer-term negative impacts.

2017 Y/Y Segment Operating Income Changes

2017 y/y	FX	Price	Vol	Cost	Total
Europe	-43	156	-119	-209	-219
EE/ME Africa	81	364	-344	-201	-128
Asia	-123	559	622	101	953
Lat Am & Can.	-70	307	-152	-17	64
Total	-155	1,386	7	-326	670

In 2017, pricing was the only driver of income growth. The stocking of heated tobacco products in Asia drove volume and without that initial stocking, the decay here could already look much worse.

This is something we want to explore much more in a deeper report on the fundamental issues for Philip Morris and we will review that in a future report. We are talking about this as an accounting issue because PM relies on the ability to convert foreign currency back to US dollars to service its obligations. They look to have an extensive and well-run hedging system. They do not speculate or use leverage in that area. However, it is not possible to turn a shrinking income number into a larger source of income simply by translating the currency. Here, there is shrinking volume that is reducing operating income and currency headwinds cutting operating income. The only real item holding up operating income and offsetting these problems is pricing hikes. Yet even PM will admit and notes in its various commentaries that raising prices and/or higher taxes resulting in raising prices – hurts volume. In the 2Q18 call, management called out a 40% drop in volume for PM in Saudi Arabia due to higher excise taxes.

This may not be at a critical stage yet, but this is becoming a problem for a company that doesn't have much cushion between cash inflow and cash outflow.

All this FX hedging has a cost

Cash flow hedges designed around forecasted transactions such as exchanging currencies into dollars at a later date impact cash flow from operations. Gains and losses are deferred and reported until the transaction is complete and runs through the income statement.

PM also has hedges against the asset values of foreign operations – mostly in Europe. Most of the gains and losses here are netted against the value of the assets and likely offset gains and losses when those are marked to a different value based on the exchange rate. There are some of these gains and losses that can make it into income statement as well as part of interest expense. The cost and proceeds from these hedges are netted as a line item in the investing section of the cash flow statement.

Finally, there are hedges on intercompany loans and these gains and losses show up in marketing and administration costs.

Costs associated with FX have – here are the expenses for the income statement.

	TTM 2Q18	2017	2016	2015
Adj. EPS	$5.00	$4.72	$4.48	$4.42
FX impact on EPS	$0.00	-$0.21	-$0.46	-$1.20
% of FX impact	0%	-4%	-9%	-21%

And here are the components of FX for the cash flow statement.

	1H 18	2017	2016	2015
Cash From Ops	5,373	8,912	8,077	7,865
FX +/-	355	392	-409	-1,900
Hedges	77	-1,527	295	239

In the last 3.5 years, hedging has been a cumulative drain on cash flow of $2.5 billion. This is another potential headwind to cash for a company that doesn't have much cushion.

Lawsuits Have Been On-Going for Some Time

While the potential is here for multi-billion dollar payments to smokers claiming health problems from smoking, so far those cases have not resulted in much to date and have been outstanding for over a decade. In two cases in Canada, PM has posted $180 million of security at this point and the appeal was heard in November 2016.

Most of the other smokers' health claims have either been dismissed, awaiting appeal or have not started yet. They are also largely in Canada where the population is small. At this point, we would consider PM adequately reserved having posted cash security in a couple of cases.

Much of the rest of the claims are coming from governments – primarily states in Canada and Nigeria – seeking recovery of health payments made on behalf of smokers. Again, there is one case in Canada with a trial scheduled for November 2019 and either some pre-trial discovery or nothing has started for others. In many of the Nigerian cases, PM is still waiting to be served.

We will explore more of this in a report looking at fundamental issues for PM. On the surface, we see little to complain about from an accounting standpoint. PM has won several lawsuits in the past and many of these pending cases have already had victories for PM. Thus, it is difficult to make a case that there is a probable event that is material and determinable for PM to deal with on the financial statements.

Pension Assumptions Are Conservative

PM has a pension plan with a PBO of essentially $9 billion and Assets of $7.6 billion. We noted above that the cash funding has been declining here and creating a small tailwind for cash flow.

We see no reason for that to reverse and it could actually become a bigger tailwind. The discount rate to determine the PBO is 1.5%. It would come down quickly with some interest rate increases. Also, the expense is being calculated using a 4.8% rate of return and 1.7% interest cost on a high PBO figure. Those are about as low as we remember seeing in recent memory.

We are not going to find fault with this at all.

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 recent 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 Concerns"	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 may 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 the next quarter. 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

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