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Quick Thoughts on Altria (MO) – Philip Morris (PM) Merger Rumors

Current rating on MO: SELL
Current rating on PM: NEUTRAL

This idea that MO and PM will get back together has been floating around for a few weeks now. No details have been announced beyond it would not involve a premium paid by either company to acquire the other in a stock deal. What is touted is additional cost-cutting and closer relationship to roll out JUUL overseas and IQOS (Heated Tobacco) in the US. There has been no news or new numbers on the situation so we are going to make some quick observations.

On the surface – PM is basically $75 per share and MO is $45. So, either MO sends 1.66 shares of its stock to PM investors, or PM sends 0.6 shares of its stock to MO stockholders. The latter makes much more sense because it would allow a stealth dividend cut for MO and save cash. PM's $1.17 quarterly dividend becomes $0.70 when traded as 0.6 shares of PM for 1.0 share of MO. Currently, MO is paying $0.84 per quarter in dividend. On 1.87 billion MO shares, that would save $1 billion in annual cash outflow for dividends. Given the cash inflow vs. outflow squeeze at MO – that would be the main goal of a deal in our view. The combined company may use the name Philip Morris if this is done.

Beyond that, we're not seeing many other positives for the companies by doing this deal:

- They still would own 35% of JUUL and be earning non-cash equity income. The media continues to tout that JUUL could be distributed in a faster way overseas via the PM infrastructure – WHY would this be a huge goal at PM? It would take share away from cigarettes and heated tobacco (which they also want to grow) where they own 100% of the business and earn cash profits.

- PM's own history has been a country-by-country model with the motto – "If it ain't broke, don't fix it!" In areas where cigarettes continue to see minimal decay or even growth in volumes – they aren't introducing anything new in those markets. That is a strong admission that they make higher profits on cigarettes that occur in cash than any of the new products.

- JUUL has taken share in the US very quickly and is starting to feel the heavy hand of regulation coming after it. The minimum age to purchase has been raised, the various flavors have been taken out of convenience stores, discussions are now to ban even menthol and any other flavors even in Age-21 restricted vape shops.

- Investors should be wary of yesterday's news that the FDA called for a ban on menthol flavored e-cigarettes. The only reason they have kept menthol available for JUUL and other products is they did not want people who use menthol flavored nicotine to only have the option of buying cigarettes. We think this moves the ball forward again on a menthol cigarette ban – which has been one of the few areas where cigarette demand has been more stable with lower decay rates in volume.

- How much cost-cutting is possible here? The manufacturing facilities in the Eastern US for MO vs. Russia, Turkey, Indonesia, et al for PM have no geographic overlap to make easy closing decisions. Will rolling out new products mean less marketing and work with distributors? They don't sell in the same areas at all by design – so there's nothing to consolidate geographically for distribution. Smaller volumes allow consolidation over time, but both companies are already doing this. Combine the accounting systems, insurance, one board – sure. But, it's not as though both companies are selling Marlboro cigarettes in the same market now.

- The Cronos cannabis deal doesn't make money for MO either. Its sole source of profits of late has been gains on the reduction in liability in valuing MO's warrants in the deal. Cronos had a going concern warning when MO bought in and its operating losses are getting larger at this point as it works to build a larger distribution network. From our anecdotal observations, cannabis is also now everywhere – my dry cleaner now sells some type of Organic CBD. Cereal companies have talked about adding to food. I can think of a small strip-center with a Panera Bread that has three stores advertising that they sell cannabis products. This may be a much more difficult market to consolidate and control with oligopoly pricing like tobacco.

We think MO's Cash Squeeze Is the Rationale to Pursue a Merger

We have written about this many times and won't rehash it all here. MO is seeing its volume decay accelerate and has raised its guidance for the decay in each of the last 3 quarters. It has responded with price increases that further hurts volumes. With the $0.84 dividend – MO's total dividend outlay is $6.3 billion per year. Here is cash flow from operations adjusted for working capital:

MO Cash Flow	1H19	1H18	2018	2017
Reported CFO	$2,392	$3,850	$8,391	$4,901
Work Cap Chg.	$1,158	$14	-$1,100	$2,200
Adj. CFO	$3,550	$3,864	$7,291	$7,101

In 2018, MO lost $400 million per year in BUD dividends and it added $500-$600 million per year in higher interest expense for money borrowed to buy stakes in JUUL and Cronos. We think the company's cash flow before working capital changes is going under $7 billion this year just from those factors.

On top of that, the full cannibalization of JUUL against Marlboro has barely started where MO will trade 100% cash earnings for a 35% share of equity earnings from JUUL. That will drain cash flow too.

Capital spending remains about $200 million and the dividend is now $6.3 billion. They are at 100% payout as all the other problems build: lower volume from people quitting, higher taxes and higher prices; rollout of IQOS – which should take more cigarette volumes and cost MO payments to PM; JUUL rollout; with several FDA hammers coming for graphic packaging, potential bans on menthol and reducing nicotine content in cigarettes.

And don't forget, MO is promising investors it will repurchase shares as well as continue to grow the dividend. The numbers simply do not add up to a sustainable situation in our view. Hence the merger could give some relief via a stealth dividend cut at MO. Getting 0.6 shares of PM for every share of MO would also mean getting 60% of PM's $1.17 quarterly dividend or $0.70 instead of MO's $0.84. That alone would save $1.0 billion in cash flow.

PM's situation isn't much better either. It's cash flow before working capital changes is $9.0-$9.3 billion, which covers capital spending of $1.4 billion and a dividend of $7.3 billion. Both companies could benefit from retaining part of $1 billion via lower dividends.

We Do Not See JUUL Growth Overseas as a Reason for PM to Chase this Deal

In the first place, PM already has an agreement to market JUUL overseas. Merging with MO doesn't change that. Second, it has the same problem as MO – what is the big incentive for PM to give up cash earnings from IQOS or cigarettes to get a 35% share of non-cash equity income from selling JUUL? The rationale of 35% is better than 0% is fine. But, why race to zero?

PM already has a substitute product in IQOS that it owns 100% of and has been rolling out. The company has also been very strategic in rolling out IQOS because it knows it takes share away from cigarettes. It has been asked when they want to roll out IQOS in larger markets like Indonesia and the Philippines. PM has essentially said, if a market is seeing minimal decay in cigarettes, why should we mess up the situation by bringing in IQOS early. We believe PM would have the same rationale for JUUL.

We Do Not Have Extra Insight into JUUL – But Is Its Growth Rate Now the Same as 2018?

We have never been as fascinated with JUUL as the market. The FDA has specifically said it will not allow e-cigarettes/vaping to become a gateway for kids to get addicted to nicotine as one of its major goals. Just to get the purchase approved for MO to buy a stake in JUUL, the parties had to agree to support a federal minimum age of purchasing of 21, and limit availability in stores. On top of that, they agreed to limit widely distributed flavors to tobacco and menthol – with all others only available in specialty 21-and-over stores.

Teens are using 3rd party refills with pot in JUUL devices and many are suffering significant health issues. The FDA has been very critical that teens have gone to vaping and e-cigarettes via menthol, candy, and fruit flavorings. Just yesterday the FDA announced it will ban menthol and other flavors for JUUL products. That's a big part of JUUL's past growth rate.

The first commentaries we saw indicated JUUL will simply move overseas away from the heavy hand of the US FDA. We think that ignores that the rest of the world has regulators too. For example, the EU and Canada have bans on menthol in place and rolling out.

Numerous countries have age limits and graphic packaging on tobacco products already in place too. Moreover, many other countries are already adjusting taxes to raise consumer prices on non-cigarette purchases of nicotine products. On top of that, PM operates in all those countries now with cigarettes and many with IQOS – they are the ones that will be distributing JUUL. Everything in the basic math tells us that JUUL is last page in their pitch-book.

What should scare MO investors is the FDA already believes menthol makes it easier for people to smoke and harder to quit tobacco. It has long been moving toward a menthol ban in cigarettes. Its focus is on what is the most harmful way to get nicotine – that should be a top priority to eliminate - and its answer is cigarettes. It allowed JUUL and other e-cigarette makers to keep menthol and sell those more broadly (making other flavors unavailable in convenience stores) because it didn't want the logic being the only menthol flavor available is in the form of cigarettes and have more people opt for that purchase over a less-harmful menthol e-cigarette.

If the FDA is going to pull all menthol and flavors of e-cigarettes – what rationale is there anymore to keep menthol in tobacco cigarettes? We have noted in past reports if there has been one place of some resilience in demand for cigarettes – it has been menthol. Our view based on yesterday's news is menthol's future in the US may be seriously impaired today.

Also, is MO's investment possibly impaired if the growth rate at JUUL slows? We know it doesn't provide cash flow now.

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