CAPITOL SECURITIES MANAGEMENT, INC.

EQUITY RESEARCH

**May 2, 2018**

| | |
|---|---|
| CURRENT PRICE: | $55.69 |
| RATING: | HOLD |
| PRICE TARGET: | N/A |
| CURRENT YIELD: | 5.0% |

### EPS Estimates - Non-GAAP

| | DEC 17A | DEC 18E |
|---|---|---|
| 1Q | $0.72 A | $1.00A |
| 2Q | $1.03 A | $0.96 |
| 3Q | $0.97 A | $0.98 |
| 4Q | $2.60 A | $0.92 |
| | **$5.31** | **$3.86** |

### Trading Data

| | |
|---|---|
| 52-WEEK PRICE RANGE: | $77.79 - $54.23 |
| SHARES OUTSTANDING: | 1,899(M) |
| MARKET CAP: | $105.8(B) |
| AVG. DAILY TRADING VOLUME: | 9.1(M) |
| S&P 500: | 2,634 |

### Valuation Data

| | |
|---|---|
| BOOK VALUE: | $8.10 |
| PRICE TO BOOK: | 6.88x |
| DIVIDEND: | $2.80 |

# Altria Corp (NYSE: MO)

*1Q18 Earnings & Pressure on Sector*

## Highlights

- 1Q18 earnings of $1.00/share vs. $0.72/share during 1Q17
- Benefited from fewer shares, lower taxes, AB InBev, & Smokeless results
- 2018 guidance of $3.90-$4.03/share & raised dividend 6.1%
- Tobacco sector comes under selling pressure
- Maintain HOLD rating

## Investment Thesis

Altria Corp (MO-$65.43), formerly known as Philip Morris, is the largest US tobacco company. MO is focused on the US domestic tobacco business and has seen year-over-year revenue growth, on a pro-forma basis. Going forward management intends to grow earnings through revenue/cash flow growth, share repurchases, and cost reductions. Earnings growth may generate dividend increases in the future. MO's stock pays a current dividend yield of 5.0%.

## Company Summary

Altria Group, headquartered in Richmond VA, is the parent company of Philip Morris USA, US Smokeless Tobacco, John Middleton, Ste. Michelle Estate Wineries, and Philip Morris Capital Corp (PMCC). The company operates five segments: domestic cigarettes, smokeless tobacco products, machine made cigars, wineries, and financial services/real estate. The company has 9,900 employees located throughout the US. Philip Morris USA manufactures and sells cigarettes, and other tobacco products, in the US. This unit's cigarette brands include "Marlboro"(#1 in US market share), "Benson & Hedges", "Parliament", "Basic" and "Virginia Slims". This business gives MO approximately a 51.4% market share of the US cigarette market. Through 12/31/17 Philip Morris USA generated approximately 87.9% of overall revenues, or $22.6 billion. During 2009 MO completed its purchase of US Tobacco (Skoal/Copenhagen brands & Ste. Michele Wines) and currently gives MO 53.8% of the smokeless tobacco market share.

***For Important Disclosure information regarding the Firm's rating system, valuation methods and potential conflicts of interest, please refer to the last two pages of this report.***

## Business Overview

MO is the largest cigarette manufacturer in the US. In 2007 the company purchased the John Middleton Co which sells and manufactures machine-made cigars (Black &Mild)/pipe tobacco. The Smokeable business unit (includes cigarettes/cigars) generated 88..9% of MO's revenues, or $22.9 billion during FY17. PMCC owns a portfolio of leveraged/direct finance leases and produced lees than 1% of revenues. MO also owns approximately a 10.2% economic equity interest, with voting rights, in Anheuser-Busch InBev (BUD-$94.68). Over the past twenty years MO at one time owned, or acquired, Miller Brewing, Nabisco, Kraft, and Jacobs Suchard AG. These businesses were subsequently either sold or spun-off. During the past few years the company spun-off Kraft Foods (KHC-$54.20) and Philip Morris Intl (PM-$80.10).

## Recent Earnings

MO reported 1Q18 diluted earnings of $1.00/share vs. $0.72/share during 1Q17. The 38.9% improvement was the result of lower income taxes, higher contributions from the AB InBev equity investment ($342 million vs. $23 million), higher OCI in the smokeless unit and fewer shares outstanding. Net revenues rose to $6.11 billion, from $6.08 billion, due to higher smokeless segment revenues, and was somewhat offset by lower sales in the smokeable segment. MO’s adjusted diluted earnings increased over 30% to $0.95/share from $0.73/share when comparing the two quarters. The improvement came from higher adjusted equity earnings from AB InBev, lower income taxes, higher adjusted OCI in the smokeless unit, and fewer shares outstanding. This was partly offset by lower adjusted OCI in the smokeable unit. During 1Q18 MO repurchased $513 million shares of its common stock through its share repurchase program.

SEGMENT RESULTS

SMOKEABLE PRODUCTS: OCI rose 0.1% to $2.038 billion from $2.036 billion due to higher pricing and NPM Adjustment items, and despite revenues declining to $5.41 billion from $5.46 billion, and higher promotional expense. Adjusted OCI decreased 2.0% to $2.0 billion from $2.04 billion because of cigarette volume declines, business initiative spending, and higher resolution expenses. These were partly offset by higher product pricing. Meanwhile, adjusted OCI margins fell 1.2 percentage points to 49.7% from 50.9%.

MO’s cigarette shipment volumes decreased 4.2% to 27.5 billion sticks from 28.7 billion sticks. This occurred due to the industry’s overall rate of decline and lower retail store shipments, while being partly offset by trade inventory movements. MO’s saw decreases in volumes of Marlboro (-4.2%), Other Premiums (-2.8%), and Discount (-4.7%). After adjusting for trade inventory movements, MO’s shipments fell 7% while the industry’s volumes dropped by 5.5%.

Overall retail market share for MO's cigarette brands declined to 50.3% from 51.0%. Marlboro's declined 0.5 percentage points to 43.2%, Other Premiums' fell 0.1 percentage points to 2.6%, and Discounts' was lower by 0.1 percentage points to 4.5%.
Cigar shipments rose by 3.0% as Black & Mild's increased 3.3% to 375 million cigars from 363 million cigars. This gain was partly offset as Other's shipments fell to 3 million cigars from 4 million cigars.

SMOKELESS PRODUCTS: OCI rose 37.4% to $338 million from $246 million due to higher product pricing and the absence of 1Q17's product recall. Adjusted OCI rose 27.3% to $340 million from $267 million from the same factors. As a result, adjusted OCI improved 7.8 percentage points to 69.0% from 61.2%. Smokeless revenues, net of excise taxes, rose to $493 million from $436 million.

Total smokeless shipment volumes decreased 0.1% to 195.7 million cans/packs from 195.8 million cans/packs. This occurred as Copenhagen shipments fell 0.1% to 124.4 million cans/packs and Skoal's declined 1.1% to 55.0 million cans/packs. These decreases were partly offset by Others' shipments, rising 3.8% to 16.3 million cans/packs. The smokeless industry experienced volume declines of 1% during the past 6 months.

MO's total smokeless market share rose 0.1 percentage points to 53.8% from 53.7%. Copenhagen's market share increased to 34.3% from 33.2%, Others' improved to 3.3% from 3.1%, while Skoal's fell to 16.2% from 17.4%.

WINE SEGMENT: Reported and adjusted OCI both declined 19.0% to $17 million, from $20 million, due to one time employee bonuses and was partly offset by higher net revenues. The improvement in net revenues ($142 million vs. $140 million) came from wine shipments growing 6.1% to approximately 1.8 million cases and was negatively impacted by an unfavorable mix. Wine's OCI margins declined to 12.4% from 15.4%.

RECENT DEVELOPMENTS:

Chairman/CEO Marty Barrington announced he was retiring effective May 17, 2018. MO's Board of Directors elected Howard Willard to serve as the succeeding Chairman/CEO. Additionally, the Board elected Billy Gifford to serve as Vice Chairman/CFO.

MO purchased approximately $513 million worth of its common stock through the share repurchase program. As of 5/31/18, there is approximately $505 million left in the current repurchase program scheduled for completion by the end of 2018.

The Board of Directors recently increased the annual dividend 6.1% to $2.80/share.

During 1Q18 MO completed its facilities consolidation program with expectations of saving approximately $50 million/year in costs. Overall, MO recorded a total pre-tax charge of approximately $150 million, or $0.05/share, of which $3 million was recorded in 1Q18.

MO participated with Philip Morris International's (PM-$) presentation to the US Food & Drug Administration's (FDA) Tobacco Products Scientific Advisory Committee about the product, "IQOS MRTPA". Assuming FDA approval for this product, MO has contingent plans to immediately market "IQOS" throughout the USA.
The company submitted a modified risk tobacco product application to the FDA for its Copenhagen "Snuff Pine Cut".

MO's Nu Mark unit grew its e-vapor volumes by approximately 30% and expanded the "MarkTen Elite" product (pod-based closed systems product) to over 6,000 retail stores in the US.

## Our Thoughts

Despite a good quarterly earnings report, MO's shares, along with other tobacco stocks, have been under pressure for the past few weeks over new investor concerns. MO reported 1Q18 diluted earnings of $1.00/share vs. $0.72/share during 1Q17. The 38.9% improvement was the result of lower income taxes, higher contributions from the AB InBev equity investment ($342 million vs. $23 million), higher OCI in the smokeless unit and fewer shares outstanding. MO"s adjusted diluted earnings increased over 30% to $0.95/share from $0.73/share when comparing the two quarters.

Investor concerns arose following Philip Morris's (PM-$) earnings release on 4/24/18 when it reported the rate of industry decline rose to 7%, exceeding prior industry guidance of a 4% decline rate. Additionally, a cornerstone of tobacco companies' efforts to countering falling cigarette consumption with growing e-cig/smokeless product sales, were not accelerating at a pace expected by Wall Street. On this news from PM, a sell-off occurred in the tobacco stocks, dropping shares approximately 15%-20% in a few days. Presently, Wall Street is assessing what value to place upon this group given uncertainty on this sector's ability to offset declining cigarette consumption.

We continue to rate MO a HOLD until Wall Street decides what valuation (p/e multiple) is to be placed upon this stock , and all cigarette stocks, based on the current rate of industry decline and sales prospects for e-cig/smokeless products. This could be determined by earning releases from the tobacco stocks during 2018. Until then, MO's shareholders will be rewarded with a high current dividend yield of 5% and the potential of further increases by the Board of Directors. The company's goal is to pay out 80% of adjusted earnings to shareholders as dividends and portends another dividend later this year, given 2018 adjusted diluted earnings guidance of $3.90-$4.03/share.

## Risks

There is no guarantee MO will improve earnings/cash flow. Declining US cigarette volumes may hurt the company's revenues and profits. Litigation/regulation risks surround cigarette manufacturers. Rising interest rates, higher tobacco prices, tax issues, or rising operating costs could negatively impact MO's earnings. MO's stock may be adversely impacted by negative equity/credit markets, terrorist attacks, and failure to comply with Sarbanes Oxley guidelines.

Steven F. Marascia
Director of Research
Capitol Securities Management
804-612-9715

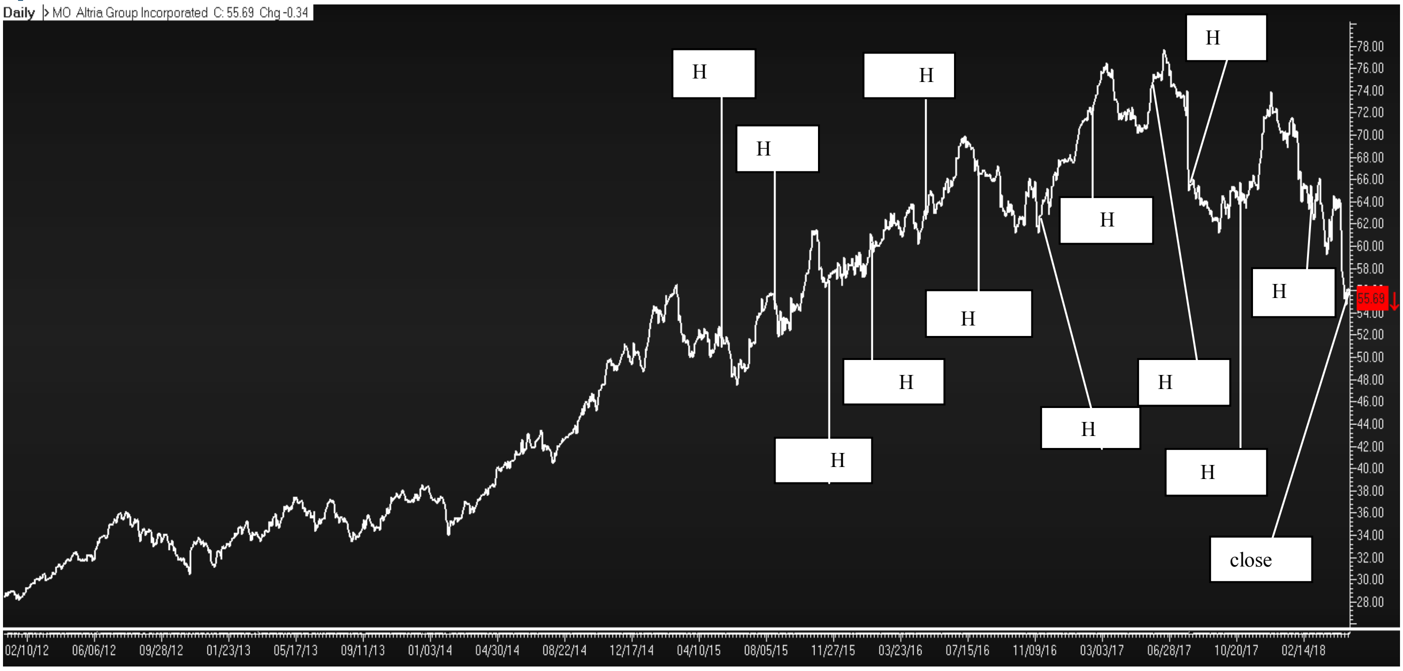
Altria Group, Inc.
(dollars in millions, except per share data

| | 1Q17 | 2Q17 | 3Q17 | 4Q17 | FY17e | 1Q18 | 2Q18e | 3Q18e | 4Q18e | FY18e |
|---|---|---|---|---|---|---|---|---|---|---|
| Net revenues | $6,083 | $6,663 | $6,729 | $6,101 | $25,576 | $6,108 | $6,576 | $6,692 | $6,246 | $25,622 |
| Cost of sales | 1,810 | 1,949 | 1,940 | 1,844 | 7,543 | 1,734 | 1,973 | 2,008 | 1,874 | 7,589 |
| Excise taxes on products | 1,494 | 1,595 | 1,606 | 1,387 | 6,082 | 1,438 | 1,512 | 1,606 | 1,493 | 6,049 |
| Gross profit | 2,779 | 3,119 | 3,183 | 2,870 | 11,951 | 2,936 | 3,091 | 3,078 | 2,879 | 11,984 |
| Marketing, administration, & research costs | 477 | 507 | 507 | 623 | 2,114 | 567 | 612 | 588 | 523 | 2,290 |
| Exit cost/asset impairment | 4 | 12 | 8 | 9 | 33 | 2 | 6 | 4 | 3 | 15 |
| Operating companies income | 2,298 | 2,600 | 2,668 | 2,238 | 9,804 | 2,367 | 2,473 | 2,486 | 2,353 | 9,679 |
| | | | | | | | | | | |
| Amortization of intangibles | -5 | -5 | -5 | -6 | -21 | -5 | -5 | -5 | -5 | -20 |
| General corporate expenses | -46 | -56 | -56 | -69 | -227 | -46 | -54 | -57 | -59 | -216 |
| Changes to MDLZ/PM tax-related receivables | | | | | | | | | | |
| Adjustment to 3rd party guarantee accrual | | | | | | | | | | |
| Corporate asset impairment/exit costs | | | | | | | | | | |
| Corporate exit cost | | | | | | | | | | |
| Operating income | 2,247 | 2,539 | 2,607 | 2,163 | 9,556 | 2,316 | 2,414 | 2,424 | 2,289 | 9,443 |
| Restructuring charege | | | | | | | | | | |
| Interest & other debt expense,net | 179 | 177 | 169 | 180 | 705 | 166 | 182 | 185 | 186 | 719 |
| Loss on early debt extinguishment | | | | | | | | | | |
| Earnings from SABMiller equity investment | 23 | 140 | 169 | 200 | 532 | 342 | 173 | 215 | 196 | 926 |
| Other Income | | 408 | 37 | | 445 | | | | | |
| Loss on AB InBev/SAB Miller business combination | | | | | | 33 | | | | 33 |
| Earnings before income taxes | 2,091 | 2,910 | 2,644 | 2,183 | 9,828 | 2,466 | 2,405 | 2,454 | 2,299 | 9,624 |
| | | | | | | | | | | |
| Income taxes | 689 | 920 | 777 | 2,785 | 399 | 571 | 577 | 589 | 552 | 2,289 |
| | | | | | | | | | | |
| Net earnings (continuing ops.) | 1,402 | 1,990 | 1,867 | 4,968 | 10,227 | 1,895 | 1,828 | 1,865 | 1,747 | 7,335 |
| | | | | | | | | | | |
| Earningns from discontinued ops. | | | | | | | | | | |
| Earnings attributable to non-controlling interests | -1 | -1 | -1 | -2 | -5 | -1 | -2 | -1 | -2 | -6 |
| Net earnings | $1,401 | $1,989 | $1,866 | $4,966 | $10,222 | $1,894 | $1,826 | $1,864 | $1,745 | $7,329 |
| | | | | | | | | | | |
| Net earnings attributable to Altria | $0.72 | $1.03 | $0.97 | $2.60 | $5.31 | $1.00 | $0.96 | $0.98 | $0.92 | $3.86 |
| | | | | | | | | | | |
| Earnings per share | $0.73 | $0.85 | $0.90 | $0.91 | $3.39 | $0.95 | $0.98 | $1.02 | $0.97 | $3.92 |
| Continuing operations earnings per share | $0.72 | $1.03 | $0.97 | $2.60 | $5.31 | $1.00 | $0.96 | $0.98 | $0.92 | $3.86 |

CAPITOL SECURITIES MANAGEMENT, INC.

EQUITY RESEARCH

## Important Disclosures




9/14/09 $17.99 Initiate BUY
5/18/10 Raised price target to $23/share
8/17/10 Raised price target to $24/share
11/16/10 Raised price target to $26/share
5/10/11 Raised price target to $29/share
2/28/12 Raised price target to $31/share
5/16/12 Raised price target to $33/share
8/31/12 Raised price target to $36/share
6/07/13 Raised price target to $38/share
6/24/14 Raised price target to $44/share
11/26/14 Reduced rating to HOLD
Ratings:
Buy: B
Hold: H
Sell: S

Steven Marascia certifies, with respect to the companies or securities that he analyzes, that (1) the views expressed in this report accurately reflect his personal views about all of the subject companies and securities and (2) no part of his compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

Stock ratings used in this report are defined as follows:

(1) Buy – The stock's total return including dividends is expected to exceed the industry or market average by at least 10% over the next twelve months.
(2) Hold – The stock's total return including dividends is expected to be in line with the industry or market average of +/- 10% over the next twelve months.
(3) Sell – The Stock's total return including dividends is expected to be below the industry or market average by 10% or more over the next twelve months.

The distribution of investment ratings for all companies in our coverage universe are as follows: (1) 37.5%, (2) 62.5%, (3) 0%

The distribution of investment ratings used for companies whom we have performed banking services in the last 12 months are (1)100%, (2) 0%, (3) 0%

Capitol Securities Management's Investment Banking/Public Finance unit has not received compensation for investment banking services from the subject company in the past 12 months. Nor does it expect to receive, or intend to seek compensation for, investment banking services from the subject company in the next 3 months.

No affiliate of Capitol Securities Management, or Capitol Securities Management, received compensation from the subject company for products or services during the past 12 months.

The subject company is not, or during the past 12 months, was not, a client of Capitol Securities Management's Investment Banking/Public Finance unit.

## Other Disclosures



**For more information on this report, please contact us at 800.612.1484 or write to Capitol Securities, 100 Concourse Boulevard, Suite 101, Glen Allen, Virginia 23059**