**September 11, 2019**

| | |
|---|---|
| CURRENT PRICE: | $44.72 |
| RATING: | HOLD |
| PRICE TARGET: | N/A |
| CURRENT YIELD: | 7.5% |

### EPS Estimates - Non-GAAP

| | DEC 18A | DEC 19E |
|---|---|---|
| 1Q | $1.00 A | $0.60A |
| 2Q | $0.99 A | $1.07A |
| 3Q | $1.03 A | $1.04 |
| 4Q | $0.66 A | $0.88 |
| | **$3.68** | **$3.59** |

### Trading Data

| | |
|---|---|
| 52-WEEK PRICE RANGE: | $66.04 - $42.40 |
| SHARES OUTSTANDING: | 1,870(M) |
| MARKET CAP: | $83.6(B) |
| AVG. DAILY TRADING VOLUME: | 10.5(M) |
| S&P 500: | 3,001 |

### Valuation Data

| | |
|---|---|
| BOOK VALUE: | $7.74 |
| PRICE TO BOOK: | 5.8x |
| DIVIDEND: | $3.36 |

# Altria Corp (NYSE: MO)

*2Q19 earnings & JUUL controversy*

## Highlights

- 2Q19 earnings of $1.07/share vs. $0.99/share during 2Q18
- Increased annual dividend 5%
- Potential merger with Philip Morris
- FDA proposes ban on flavored e-vapes
- Maintain HOLD rating

## Investment Thesis

Altria Corp (MO-$44.72), 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 7.5%.

## 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 50% market share of the US cigarette market. Through 12/31/18 Philip Morris USA generated approximately 87.9% of overall revenues, or $22.3 billion. During 2009 MO completed its purchase of US Tobacco (Skoal/Copenhagen brands & Ste. Michele Wines) and currently gives MO 53.9% 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 87.9% of MO's revenues, or $22.3 billion during FY18. 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-$94.27). 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-$29.28) and Philip Morris Intl (PM-$75.07). To reduce its dependence of tobacco revenue streams, MO recently acquired equity stakes in JUUL Labs and Cronos (CRON-$11.54).

## Recent Earnings

MO reported 2Q19 diluted earnings of $1.07/share vs. $0.99/share during 2Q18. The 8.1% improvement, when comparing the two quarters, was due to higher Operating Company Income (OCI) income and return from equity investments, as well as lower income taxes. These were partly offset by higher interest expense ($312 million vs. $178 million) and a loss from Cronos related financial instruments ($266 million). OCI improved in the Smokeable (+$170 million) and Smokeless segments (+$43 million), and more than offset a decline in the Wine segment (-$2 million). Overall revenues increased to $6.62 billion from $6.31 billion and operating income rose to $2.72 billion from $2.50 billion. MO’s 2Q19 adjusted earnings improved to $1.10/share from $1.01/share during 2Q18. This 8.9% increase was due to higher adjusted OCI in the Smokeable and Smokeless segments, higher adjusted earnings from its equity investment in Anheuser-Busch Inbev (BUD-$94.27) , and lower corporate spending which was partly offset by higher interest expense.

SEGMENT RESULTS

SMOKEABLE PRODUCTS: Reported OCI improved 7.7% to $2.38 billion from $2.20 billion because of higher pricing and lower costs (excluding health/litigation items). The gain was partly offset by higher resolution expenses and increased asset impairment/exit/implementation costs. When comparing the two quarters, adjusted OCI rose 11.0% to $2.43 billion from $2.19 billion due to higher prices and lower costs but were partially offset by higher resolution expenses. Adjusted OCI margins rose to 54.4% from 52.6%. Revenues increased by 5.5% to $5.85 billion from $5.55 billion.

MO’s total cigarette shipments improved 0.3% to 27.36 billion sticks from 27.27 billion sticks. The increase came from trade inventory movements, and was partly offset by the overall industry’s rate of decline and loss in MO’s retail share. If adjusted for trade inventory movements, and other factors, then smokeable’s cigarette shipments fell by 6%. MO's overall cigarette retail market share decreased to 49.9% from 50.3% as Marlboro's was flat at 43.3%, Other Premium fell to 2.5% from 2.6%, and Discounts declined to 4.1% from 4.4%.

Total cigar shipments improved to 428 million sticks from 417 million sticks. The 2.6% increase occurred as Black & Mild's shipments rose to 425 million sticks from 414 million sticks, while Other's was flat at 3 million sticks.

SMOKELESS PRODUCTS: Reported OCI increased 11.4% to $420 million from $377 million due to higher product pricing, lower promotional investments and costs. These were partly offset by lower shipment volumes. Adjusted OCI improved 10.8% to $422 million from $381 million and adjusted OCI margins rose to 74.0% from 69.9%. Net revenues increased 4.0% to $602 million from $579 million because of higher pricing and lower promotional investments, partially offset by a decrease in shipment volumes.

Total smokeless product shipment volumes declined 3.6% to 208.0 million cans/packs due to the overall industry's rate of decline, trade inventory movements, and retail share loss. When adjusted for inventory movements this unit's shipment volumes fell 3.0%.

MO's overall smokeless market share decreased to 53.9% from 54.1%. While Copenhagen's market share rose to 34.6% from 34.3%, Others' improved to 3.5% from 3.4%, and Skoal's fell to 15.8% from 16.4%.

WINE SEGMENT: Reported and adjusted OCI decreased to $19 million from $27 million due to higher costs and an unfavorable premium mix. OCI margins fell to 11.9% from 16.7% and reported wine shipments rose 2.7% to 2.0 million cases. Revenues decreased slightly to $165 million from $166 million.

RECENT DEVELOPMENTS:

MO announced it was considering a merger-of-equals with Phillip Morris (MO-$75.07) from which it spun-off several years ago. The merger is dependent on approvals from both Boards of Directors and needs regulatory approval from the US Government.

The Board of Directors recently raised the quarterly dividend to $0.84/share from $0.80/share.

Given recent news and deaths connected to e-vape product use, several states and Federal agencies announced investigations into the selling and health effects of e-vap products such as those sold by JUUL.

The Trump Administration expressed its desire to eliminate all flavored e-vapes in attempt to end underage use of the product. The FDA is proposing regulations requiring any flavored e-vape product , not including tobacco flavored, be removed from the market, until they apply and receive product approval from the FDA. Thus, the FDA may potentially regulate sales of all e-vape products in the US.

Potential future legislation is being considered to curb sales of JUUL products. San Francisco, CA is proposing legislation to prohibit e-vape sales. Michigan recently passed legislation forbidding flavored e-vape sales and the state of New York is considering a similar law. Earlier this year, MO purchased a 35% stake in JUUL.

As part of its share repurchase program, MO repurchased 3.7 million shares during 2Q19 and completed its $2 billion share repurchase program. Additionally, the Board of Directors approved a new $1 billion share repurchase program and expects completion by the end of 2020.

MO will acquire 80% ownership ($372 million) of certain companies of the Burger Group which will commercialize “on!” oral nicotine products.

This past April, the FDA authorized the sale of Philip Morris’s (PM-$75.07) IQOS heated tobacco systems in the US. MO anticipates selling this product throughout the US later this month. MO plans to initially introduce the product in the Atlanta GA market during 3Q19.

Thus far in 2019, 18 states and Washington DC increased the legal age to buy tobacco products to 21.

NEW DEBT INCURRED BY MO

To finance these acquisitions MO took a $14.6 billion term loan from JPMorgan (JPM-$117.19) , with $1.8 billion of the loan un-used and at an interest rate 100 bps above LIBOR, or ~3.5%. MO’s total debt will rise to $26.4 billion from $13 billion and MO’s debt/EBITDA ratio will rise to 2.7x from 1.3x. This additional debt will increase annual interest payments from $500 million - $600 million to over $1.1 billion. To counter this interest expense increase, MO announced a new cost-cutting program aimed at reducing annual operating costs by $575 million.

Due to the additional debt, S&P lowered MO’s credit rating to BBB from A- (with a steady outlook) and Moody’s cut its rating to a “negative outlook”. S&P believes FDA statements, about fighting underage use of e-vapes, creates uncertainty over JUUL’s long term valuation. Additionally, S&P said it ”does not believe JUUL or Cronos will provide significant near term investment returns to Altria and will not allow MO to deleverage new debt levels over the near term.” S&P further said, while the JUUL/CRONOS investments will not be adding to the company’s profits over the near term, MO is paying for future growth-assuming JUUL & Cronos grow revenues.

## Our Thoughts

MO had a good quarterly earings report producing 2Q19 diluted earnings of $1.07/share vs. $0.99/share during 2Q18. The improvement came mainly from higher OCI income and equity investments, as well as lower income taxes. These were partly offset by higher interest expense and a loss from the Cronos related financial instruments . MO's 2Q19 adjusted earnings improved to $1.10/share from $1.01/share during 2Q18 was due to higher adjusted OCI in the Smokeable and Smokeless segments, higher returns from its equity investment in Anheuser-Busch Inbev (BUD-$94.27) , and lower corporate spending, partly offset by higher interest expense.

The stock has been under recent selling pressure as Wall Street questions the potential merger with Philip Morris (PM-$75.07) and concerns over law makers moving against e-vape products, of which JUUL had a 78% US market share in 2018 while MO has a 35% stake in JUUL. Thus, investors'concerns are growing about MO's returns on its recent $12.6 billion investment in JUUL.

To quell Wall Street's concerns, MO will need to prove they can grow overall revenues despite the cigarette industry's overall annual rate of decline of 4%-5%, overcome investor fears of increased balance sheet debt, and receive returns on investments in JUUL and Cronos (CRON-$11.54). Assuming FDA approval, MO believes JUUL may contribute to its bottom line in 2020 while a contribution from CRON is unlikely until marijuana is legalized in the US. We anticipate more clarity on the JUUL regulatory situation during MO's 3Q earnings call. During 2Q19's earnings call, MO provided 2019 adjusted earnings guidance of $4.15-$4.27/share and stressed its goal of paying 80% of adjusted earnings as dividend to shareholders. Paying a current 7.5% dividend yield, we continue to rate this stock a HOLD.

## Risks

There is no guarantee MO will improve earnings/cash flow. Declining US cigarette consumption/volumes may hurt the company's revenues and profits. Decining earnings from MO's three operating units pose a risk to the company. The ownership stakes in Cronos (CRON-$) and JUUL may not produce enough profits to pay higher interest payments on subsequent debt incurred for these investments. Litigation/regulation risks and excise taxes threaten cigarette manufacturers. Rising interest rates/inflation, corporate tax rates, economic recessions, higher tobacco prices, increased gasoline prices, rising operating costs/debt expense, or tax issues could negatively impact MO's earnings. MO's stock may be adversely impacted by negative equity/credit markets, geopolitical events, wars, cyber hacking, terrorist attacks, and failure to comply with Sarbanes Oxley and generally accepted accounting guidelines.

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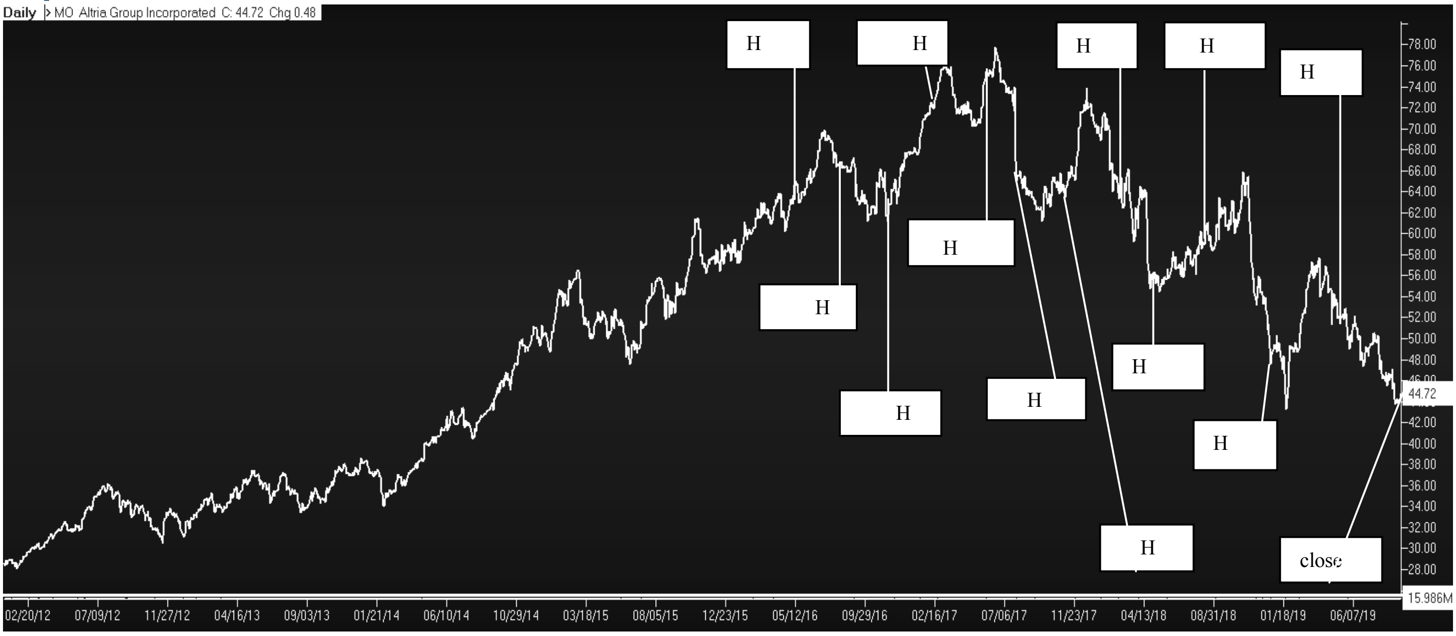
Altria Group, Inc.
(dollars in millions, except per share data

| | 1Q18 | 2Q18 | 3Q18 | 4Q18 | FY18 | 1Q19 | 2Q19 | 3Q19e | 4Q19e | FY19e |
|---|---|---|---|---|---|---|---|---|---|---|
| Net revenues | $6,108 | $6,305 | $6,837 | $6,114 | $25,364 | $5,628 | $6,619 | $6,798 | $ 5,993 | $25,038 |
| Cost of sales | 1,734 | 1,738 | 2,037 | 1,864 | 7,373 | 1,578 | 1,874 | 1,903 | 1,678 | 7,033 |
| Excise taxes on products | 1,438 | 1,426 | 1,545 | 1,328 | 5,737 | 1,239 | 1,426 | 1,529 | 1,348 | 5,542 |
| Gross profit | 2,936 | 3,141 | 3,255 | 2,922 | 12,254 | 2,811 | 3,319 | 3,366 | 2,967 | 12,463 |
| Marketing, administration, & research costs | 567 | 591 | 619 | 626 | 2,403 | 479 | 499 | 521 | 514 | 2,013 |
| Exit cost/asset impairment | 2 | 2 | 2 | 381 | 383 | 39 | 33 | 5 | 8 | 85 |
| Operating companies income | 2,367 | 2,548 | 2,638 | 1,915 | 9,468 | 2,293 | 2,787 | 2,840 | 2,445 | 10,365 |
| | | | | | | | | | | |
| Amortization of intangibles | 5 | 5 | 20 | 8 | 38 | 8 | 8 | 17 | 12 | 45 |
| General corporate expenses | 46 | 45 | 61 | 163 | 315 | 46 | 62 | 52 | 55 | 215 |
| Changes to MDLZ/PM tax-related receivables | | | | | | | | | | |
| Adjustment to 3rd party guarantee accrual | | | | | | | | | | |
| Corporate asset impairment/exit costs | | | | | | 1 | | | | 1 |
| Corporate exit cost | | | | | | | | | | |
| Operating income | 2,316 | 2,498 | 2,557 | 1,744 | 9,115 | 2,238 | 2,717 | 2,771 | 2,378 | 10,104 |
| Restructuring charege | | | | | | | | | | |
| Interest & other debt expense,net | 166 | 179 | 159 | 162 | 665 | 384 | 312 | 382 | 379 | 1,457 |
| Loss on early debt extinguishment | | | | | | | | | | |
| Earnings from SABMiller equity investment | 342 | 228 | 189 | 131 | 890 | 86 | 447 | 219 | 199 | 951 |
| Other Income | | 9 | 21 | 3 | 34 | 1 | 15 | 5 | 8 | 28 |
| Loss on AB InBev/SAB Miller business combination | 33 | | | | 33 | | | | | |
| Loss on Cronos-related financial instruments | | | | | | 425 | 266 | | | 691 |
| Earnings before income taxes | 2,466 | 2,557 | 2,608 | 1,710 | 9,341 | 1,516 | 2,601 | 2,613 | 2,206 | 8,936 |
| | | | | | | | | | | |
| Income taxes | 571 | 680 | 664 | 459 | 2,374 | 395 | 604 | 669 | 565 | 2,233 |
| | | | | | | | | | | |
| Net earnings (continuing ops.) | 1,895 | 1,877 | 1,944 | 1,251 | 6,967 | 1,121 | 1,997 | 1,944 | 1,641 | 6,703 |
| | | | | | | | | | | |
| Earningns from discontinued ops. | | | | | | | | | | |
| Earnings attributable to non-controlling interests | -1 | -1 | -1 | -1 | -4 | -1 | -1 | -1 | -1 | -4 |
| Net earnings | $1,894 | $1,876 | $1,943 | $1,251 | $6,963 | $1,120 | $1,996 | $1,943 | $1,640 | $6,699 |
| | | | | | | | | | | |
| Net earnings attributable to Altria | $1.00 | $0.99 | $1.03 | $0.66 | $3.68 | $0.60 | $1.07 | $1.04 | $0.88 | $3.59 |
| | | | | | | | | | | |
| Earnings per share | $0.95 | $1.01 | $1.08 | $0.95 | $3.99 | $0.90 | $1.10 | $1.20 | $1.02 | $4.22 |
| Continuing operations earnings per share | $1.00 | $0.99 | $1.03 | $0.66 | $3.68 | $0.60 | $1.07 | $1.04 | $0.88 | $3.59 |

## 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

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EQUITY RESEARCH

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