Capitol Securities Management, Inc. — Equity Research

January 4, 2019

Altria Corp (NYSE: MO)

Acquisitions & Added Debt

CURRENT PRICE:	$50.30
RATING:	HOLD
PRICE TARGET:	N/A
CURRENT YIELD:	6.4%

EPS Estimates - Non-GAAP

	DEC 17A	DEC 18E
1Q	$0.72 A	$1.00A
2Q	$1.03 A	$0.99A
3Q	$0.97 A	$1.03A
4Q	$2.60 A	$0.92
	$5.31	**$3.94**

Trading Data

52-WEEK PRICE RANGE:	$71.86 - $46.49
SHARES OUTSTANDING:	1,883(M)
MARKET CAP:	$94.8(B)
AVG. DAILY TRADING VOLUME:	10.3(M)
S&P 500:	2,532

Valuation Data

BOOK VALUE:	$8.23
PRICE TO BOOK:	6.1x
DIVIDEND:	$3.20

Highlights

- 3Q18 earnings of $1.03/share vs. $0.97/share during 3Q17
- Acquiring equity stakes in JUUL & CRONOS
- Debt level increases due to acquisitions
- Confluence of items hits stock price
- Maintain HOLD rating

Investment Thesis

Altria Corp (MO-$50.30), 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 6.4%.

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-$69.09). 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-$44.49) and Philip Morris Intl (PM-$69.50).

Recent Earnings

MO reported 3Q18 diluted earnings of $1.03/share vs. $0.97/share during 3Q17. Improved results came from lower income taxes and fewer shares outstanding, while being partly offset by the absence of a 2017 gain on the AB Inbev/SAB Miller business merger. Reported OCI increased 6.3% in the smokeless unit, was flat in smokeable, and declined 19.4% in the wine segment. MO's overall revenues rose 1.6% to $6.84 billion while gross operating income fell 1.2% to $2.56 billion due to higher operating costs and amortization of intangibles during 3Q18. MO's 3Q18 adjusted earnings rose to $1.08/share from $0.90/share during 3Q17 due to lower income taxes and fewer outstanding shares. During 3Q18 MO took a $0.03/share charge related to a tax basis adjustment to its AB InBev/SABMiller combination and for a variation allowance on non-realizable tax credit carry-forwards. MO repurchased 6.2 million shares of its common stock through the current $2 billion share repurchase program. $700 million worth of share repurchases remain in this program which management believes will be completed during 2Q19.

SEGMENT RESULTS

SMOKEABLE PRODUCTS: Reported OCI for 3Q18 was flat at $2.27 billion and adjusted OCE was also flat $2.28 billion when comparing the two quarters due to higher resolution expenses, lower shipment volume, and higher costs which were partly offset by higher pricing. When comparing the two quarters, adjusted OCI margins decrease to 50.4% from 51.8%. Revenues net of excise taxes rose 2.7% to $4.53 billion from $4.41 billion.

MO's total cigarette shipment fell 3.7% to 29.70 billion sticks from 30.83 billion sticks caused mainly by the industry's rate of decline (-4.5%) and retail share losses, which were partly offset by trade inventory movements. When adjusted for trade inventory movements, MO estimates domestic cigarette shipment volume decreased 5%. There were volume declines in its three cigarette categories: Marlboro (-3.2%), Other Premium (-6.0%), and Discount (-6.8%).

Overall cigarette retail market share fell to 50.1% from 50.6%. This occurred as all of MO's product categories experienced market share declines; Marlboro (43.1% vs. 43.2%), Other Premium (2.6% vs. 2.7%), and Discount (4.4% vs. 4.7%).

Cigar shipments rose 6.8% to 411 million sticks from 385 million sticks. The increase came from from "Black & Mild" volumes rising 7.1% to 408 million sticks and offset a 25.0% decline by Other to 3 million sticks.

SMOKELESS PRODUCTS: Reported OCI rose 6.5% to $586 million and adjusted OCI rose 7.0% to $383 million, when comparing 3Q18 to 3Q17. Both increases were attributable to higher pricing while being partly offset by higher costs. Adjusted OCI margins fell to 69.4% from 69.5% and revenues, net of excise taxes, increased 7.2% to $552 million.

Total smokeless product volumes improved slightly to 213.4 million cans/packs from 212.6 million. This resulted as Copenhagen shipments rose 1.2% to 135.7 million cans/packs and Other's increased 6.5% to 18.0 million cans/packs. These gains were partly offset by a 3.1% decrease in Skoal to 59.7 million cans/packs. MO's smokeless retail share rose to 54.1% from 54.0% as Copenhagen's rose to 34.4% from 34.1% and Other's increased to 3.4% from 3.3%, while Skoal's dropped to 16.3% from 16.6%. During the earnings release, MO announced it intends to expand Copenhagen Smooth Wintergreen to 22 states.

WINE: 3Q18's reported and adjusted OCI both fell 19.4% to $29 million from $36 million during 3Q17. The decline was from higher costs and lower shipments, and was partly offset by a favorable premium mix. Revenues, net of excise taxes, were flat at $175 million as a favorable premium mix and higher pricing were partly offset by lower shipment volumes. Overall wine shipment volume decreased 3.5% to approximately 2.2 million cases.

RECENT DEVELOPMENTS:

The FDA Commissioner, Scott Gottlieb, announced proposals to restrict sales of flavored e-cigarettes to minors and pursue a national ban on menthol cigarettes and flavored cigars. He directed the agency's Center for Tobacco Products to revisit its compliance policy that extended the dates for tobacco manufacturers to file marketing applications; August 2012 for combustible tobacco products & August 2022 for electronic nicotine delivery systems (ENDS), known as e-cigs. Additionally, Gottlieb proposed all flavored ENDS products sold should only take place in age-restricted outlets and online sales would be subject to age verification. Given the current appeal of menthol e-cigs to underage users, the FDA intends to pursue a ban on menthol in combustible tobacco products.

MO responded to the FDA's announcement stating, "We welcome FDA's efforts to address the underage use of e-vapor products" and stated Congress should raise the legal purchase for all tobacco products to 21.

On an industry wide basis, sales of most flavored pod-style devices will be removed from convenience stores/gas stations and require strict age verification controls for online sales. Mint, menthol, and tobacco flavored products will still be sold in retail outlets, however, future restrictions may materialize if there is a continued increase of use by underage users.

Due to the developing regulatory environment, and expected financial performance, MO announced it will discontinue the development/distribution of all Mark-Ten, Green Smoke e-vapor products, and VERVE oral nicotine-containing products. Additionally, MO stated it would refocus resources on "more compelling reduced-risk tobacco opportunities."

Seeking alternative revenue opportunities, MO announced it was buying a $1.8 billion stake in the Canadian cannabis company Cronos (CRON-$11.78). MO received warrants which could potentially take its ownership stake to 55%. CRON, ranked 10th in Canadian cannabis producers, recently announced supply agreements with Ontario, British Columbia, Nova Scotia, and Prince Edward Island.

MO recently announced it was making a $12.8 billion investment, or 35% stake, in JUUL Labs, Inc., the leader in e-vapor products in the US. The company will use its retail shelf space for JUUL's products and will apply its logistics/distribution network towards the approximately 230,000 retail locations served by MO.

MO's STOCK TRADING VOLATILITY

A confluence of things merged simultaneously for Altria (MO) causing its stock to drop from the mid-$60s to the high-$40s, or ~25%.

First, 3Q18 earnings results were released by MO and Phillip Morris (PM-$69.50) showing a continuation of the industry wide declines in cigarette smoking levels. The rate of decline had been running about 3%-4% but recent data shows it may be rising towards the 4%-5% level-viewed negatively by Wall Street.

Second, the FDA announced they were moving towards either eliminating, or reducing, use of menthol or other flavors in tobacco products-viewed negatively by Wall Street since about 10% of MO's cigarette sales come from menthol. Also, the FDA wants to reduce teen use of e-cig products & e-vape products.

Third, MO announced it was buying stakes in Canadian Pot company Cronos & in e-cig producer JUUL & adding debt to its balance sheet……Wall Street did not like the addition of debt to MO's balance sheet as the credit markets appear to be growing increasingly leery of corporate debt in what many believe is the late part of the current economic growth cycle. Additionally, there is concern MO overpaid for its stakes in Cronos and JUUL (see below)….debt rating agencies had negative reactions to MO's new debt & Citigroup (C-$55.13) lowered its rating on MO.

NEW DEBT INCURRED BY MO

To finance these acquisitions MO took a $14.6 billion term loan from JPMorgan (JPM-$100.69) , 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 $500 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

The recent sell-off in MO's stock is due to current market volatility as well as news out of the FDA, smoking trends, investments in JUUL & Cronos, and the new debt assumed by Altria from these new investments. The company's cash flow appears to support the common stock dividend. Whereas before, Wall Street was willing to trade MO at a 17x multiple on current earnings, that multiple has now decreased to ~12x given the questioning of the JUUL/CRONOS investment and increase of debt from $13 billion to ~$26.4 billion.

During a recent conference call with MO, management did not quantify its expected ROI on its JUUL investment but said the JUUL/CRONOS investments could be accretive during 2020. 2019 earnings guidance was vague saying MO could grow earnings at the low end of 7%-9%. However, management intends to outline 2019 earnings guidance later this month when it releases 4Q18 earnings results, which may give clarity to the current uncertainty surrounding the stock. We continue to rate MO a HOLD with expectations of the dividend holding at current levels. However, the added annual interest expense (+$500 million-$600 million) may limit MO's ability to raise its dividend and do share repurchases-which had attracted investors to its stock in the past.

Risks

There is no guarantee MO will improve earnings/cash flow. Declining US cigarette consumption/volumes may hurt the company's revenues and profits. Litigation/regulation risks and excise taxes threaten cigarette manufacturers. Rising interest rates, economic recessions, higher tobacco prices, tax issues, or rising operating costs/debt expense 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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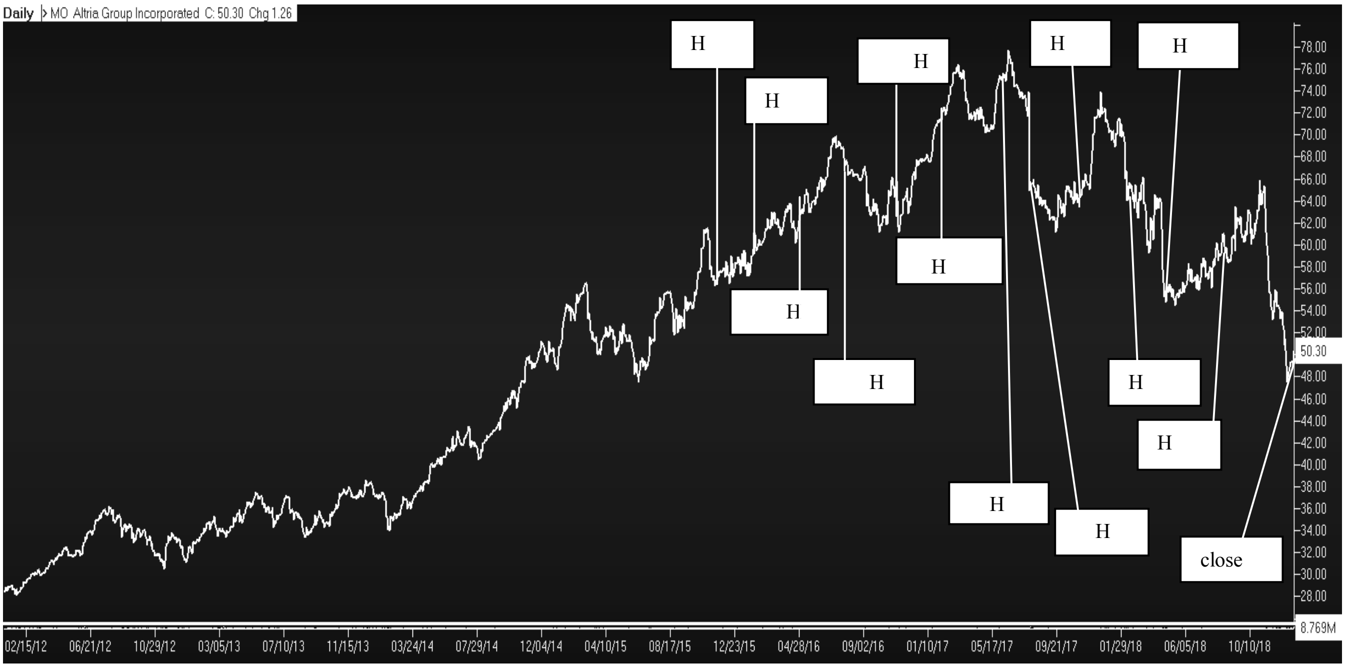
CAPITOL SECURITIES MANAGEMENT, INC.

EQUITY RESEARCH

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

	1Q17	2Q17	3Q17	4Q17	FY17e	1Q18	2Q18	3Q18	4Q18e	FY18e
Net revenues	$6,083	$6,663	$6,729	$6,101	$25,576	$6,108	$6,305	$6,837	$6,246	$25,496
Cost of sales	1,810	1,949	1,940	1,844	7,543	1,734	1,738	2,037	1,874	7,383
Excise taxes on products	1,494	1,595	1,606	1,387	6,082	1,438	1,426	1,545	1,493	5,902
Gross profit	2,779	3,119	3,183	2,870	11,951	2,936	3,141	3,255	2,879	12,211
Marketing, administration, & research costs	477	507	507	623	2,114	567	591	619	523	2,300
Exit cost/asset impairment	4	12	8	9	33	2	2	2	3	9
Operating companies income	2,298	2,600	2,668	2,238	9,804	2,367	2,548	2,638	2,353	9,906
Amortization of intangibles	-5	-5	-5	-6	-21	-5	-5	-20	-5	-35
General corporate expenses	-46	-56	-56	-69	-227	-46	-45	-61	-59	-211
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	2,498	2,557	2,289	9,660
Restructuring charege										
Interest & other debt expense,net	179	177	169	180	705	166	179	159	186	690
Loss on early debt extinguishment										
Earnings from SABMiller equity investment	23	140	169	200	532	342	228	189	196	955
Other Income		408	37		445		9	21		30
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	2,557	2,608	2,299	9,930
Income taxes	689	920	777	2,785	399	571	680	664	552	2,467
Net earnings (continuing ops.)	1,402	1,990	1,867	4,968	10,227	1,895	1,877	1,944	1,747	7,463
Earningns from discontinued ops.										
Earnings attributable to non-controlling interests	-1	-1	-1	-2	-5	-1	-1	-1	-2	-5
Net earnings	$1,401	$1,989	$1,866	$4,966	$10,222	$1,894	$1,876	$1,943	$1,745	$7,458
Net earnings attributable to Altria	$0.72	$1.03	$0.97	$2.60	$5.31	$1.00	$0.99	$1.03	$0.92	$3.94
Earnings per share	$0.73	$0.85	$0.90	$0.91	$3.39	$0.95	$1.01	$1.08	$0.97	$4.01
Continuing operations earnings per share	$0.72	$1.03	$0.97	$2.60	$5.31	$1.00	$0.99	$1.03	$0.92	$3.94

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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