

## **Altria Group Inc.**

**Ticker: MO**

### **Business Description**

Altria Group Inc. through its subsidiaries manufactures and sells cigarettes, other tobacco products, machine-made large cigars and pipe tobacco. It also maintains a portfolio of leveraged and direct finance leases (Morningstar). It is worth noting that Altria completed its spin-off of Phillip Morris International in 2008. Altria shareholders received one share of PMI for every share of Altria they owned. Altria is a non-cyclical and defensive company that derives its revenue from the United States. Tobacco companies are considered defensive because of their products addictive properties and inelasticity of demand. A cigarette smoker will not quit cold turkey because they lost their job and have less or no disposable income. There are studies that show individuals' smoking habits actually intensify after losing a source of income (NCBI). Altria yields a 3.4% dividend and is trading near its all-time highs.

### **Thesis**

My thesis on Altria can be broken down into four parts; A Defensive Play, Cigarettes & Smokeless, E-Cigarettes, Marijuana Market.

#### A Defensive Play

Altria has had 46 years of consecutive dividend increases and has a current dividend payout ratio of 80% and a dividend yield of 3.4%. The payout ratio is calculated as (dividends paid / net income). Generally speaking for non-cyclicals, the lower the payout ratio, the more attractive the company is because investors believe they can increase their dividend which may add value. We can compare this to its International competitor Phillip Morris (PM) who has had 8 year of consecutive dividend increases, a payout ratio of 88.7% and a dividend yield of 4.12%. It is also worth noting that PM's dividend payout ratio exceeded 100% in the 4Q 2015 and 1Q 2016 due to foreign currency translations (strong dollar). I believe Altria will be able to continue to increase its dividend at its annual historical rate of 8.5%. Its dividend seems to be much more stable than its counterpart PM since its sales being almost 100% domestic.

In addition to its dividend, in times of uncertainty investors flee to high dividend paying defensive companies making Altria look especially attractive now since it is off its highs by 6%, the

market trading at historical highs, and volatility has sunk to historical lows. The market has pulled back multiple times in the past 18 months and each time, Altria has outperformed. The historically low bond yields also make Altria look attractive. With the 10-year yields sitting around 1.5%, investors are more willing to take on the risk of equities to obtain a +3% yield. Investors will choose the least risky equities in these cases and with the US being the most stable economy; I believe they will choose Altria opposed to other defensive companies with International exposure. Some events that I believe will push the market lower and increase volatility include the presidential election, tensions in the Middle East, Brexit negotiations, China's slowing economy, and the US's slowing recovery.

### Cigarettes & Smokeless

Altria's core business revolves around its cigarettes and smokeless products. A few brands that Altria manufactures that you probably have heard of include Marlboro, Black & Mild, Copenhagen, and NuMark. Marlboro makes up a majority of Altria's US cigarette market share with 44.1% out of a total of 51.4% in the United States. Altria also controls 26.7% of the cigar market share in the U.S. Altria's total cigarette and cigar shipping volume decreased 5% respectively from 2Q'15 to 2Q'16 (Altria's 2Q'16 Earnings). The decrease in shipping volume was partially offset by higher prices. Even so, Altria's OCI (other comprehensive income) managed to increase 4.6% in the first half of 2016 due to promotions and pricing power. Altria's smokeless products revenue increased 9.2% and OCI increased 2.9% from 2Q'15 to 2Q'16. Below are some notable data from Altria's 2Q'16 earnings release.

**Table 7 - Smokeless Products: Shipment Volume (cans and packs in millions)**

	Second Quarter			Six Months Ended June 30,		
	2016	2015	Change	2016	2015	Change
<i>Copenhagen</i>	134.0	121.2	10.6%	258.8	231.3	11.9%
<i>Skoal</i>	66.6	69.4	(4.0)%	131.1	133.4	(1.7)%
<i>Copenhagen and Skoal</i>	<b>200.6</b>	<b>190.6</b>	<b>5.2%</b>	<b>389.9</b>	<b>364.7</b>	<b>6.9%</b>
Other	17.3	18.4	(6.0)%	34.1	35.4	(3.7)%
<b>Total smokeless products</b>	<b>217.9</b>	<b>209.0</b>	<b>4.3%</b>	<b>424.0</b>	<b>400.1</b>	<b>6.0%</b>

**Table 5 - Smokeable Products: Retail Share (percent)**

	Second Quarter			Six Months Ended June 30,		
	2016	2015	Percentage point change	2016		Percentage point change
				2016	2015	
<b>Cigarettes:</b>						
<i>Marlboro</i>	44.1%	44.2%	(0.1)	44.1%	44.1%	—
Other premium	2.7	2.8	(0.1)	2.7	2.8	(0.1)
Discount	4.6	4.4	0.2	4.6	4.4	0.2
<b>Total cigarettes</b>	<b>51.4%</b>	<b>51.4%</b>	<b>—</b>	<b>51.4%</b>	<b>51.3%</b>	<b>0.1</b>
<b>Cigars:</b>						
<i>Black &amp; Mild</i>	26.3%	27.5%	(1.2)	26.0%	27.1%	(1.1)
Other	0.4	0.3	0.1	0.5	0.3	0.2
<b>Total cigars</b>	<b>26.7%</b>	<b>27.8%</b>	<b>(1.1)</b>	<b>26.5%</b>	<b>27.4%</b>	<b>(0.9)</b>

	2015	2014	2013
Smokeable products	87.4 %	87.2 %	84.5%
Smokeless products	12.8	13.4	12.2
Wine	1.8	1.7	1.4
All other	(2.0)	(2.3)	1.9
<b>Total</b>	<b>100.0 %</b>	<b>100.0 %</b>	<b>100.0%</b>

### E-Cigarettes

Altria entered the e-cig market in 2014 and only held 6% of the US market share at the time. According to a new E-Cigarette & Vaporizer Market Analysis study, the e-cig market is expected to grow to more than \$20 billion by 2025 in the U.S. alone (BIS Research). To compare, the e-cig market had revenue of \$1.6 billion in 2014. At the moment, e-cig is grouped in the “Smokeless Revenue” line item which only accounted for 7% of Altria’s overall sales and a majority of the sales in that category came from snuff and wine. I believe that in the coming years, Altria will find value in the e-cig industry and control a majority of the U.S. market just as they control over 50% of the normal cigarette market. There is also a FDA ruling that took effect on August 8<sup>th</sup> of this year that may actually benefit Altria. We normally see regulations as burdensome and bad for business but this one is very unique. The FDA’s new rule expands the definition of tobacco to include vaporizers, vape pens, hookah pens, e-cigs, and e-pipes. As a result, these products must now be approved by the FDA which can cost companies over a million dollars. In addition, there is a freeze on all new products on the market. With this new rule, small manufacturers of e-cigs will not be able to continue selling their products because they cannot afford to fork out a million dollars for the approval by the FDA. Only the big companies selling e-cig products will survive, i.e. Altria. I believe that this ruling along with the growth in the e-cig’s market over the next decade will increase Altria’s top and bottom line.

### Marijuana Market

There may be another market that Altria can tap into over the next decade that is even larger than the e-cigs. If Altria dominates the cigarette market now, why wouldn’t they be able to dominate the marijuana market in the coming years, assuming it becomes legal on the Federal level? At the moment, the marijuana market is difficult to estimate, but the consensus is anywhere

from \$20 - \$50 billion by 2020 (The Huffington Post). Even if Altria only manages to control half (similar to its U.S. cigarette market share) of the market share, they will add a whopping 50% to their top line. At the moment, 25 states and DC have laws legalizing marijuana in some form. Of these 25, only 4 and DC have legalized it for recreational use. In addition to these legalizations, many States have loosened their laws on the drug. For example, in Maryland possession of under 10 grams will only get you a \$100 fine on the first offense (the fine increases along with the number of offenses), and a maximum of one-year imprisonment or a fine up to \$1,000 for over 10 grams. In the past you could be jailed for years over these same offenses. There are several signs pointing towards the legalization of marijuana in the coming years and I believe this could be a huge opportunity for Altria.

## Valuations

- P/E – 23.1 – Overvalued compared to the sector average of 14.32
- P/S – 6.8 – Overvalued compared to the sector average of 2.63
- P/B – 41.5 – Overvalued compared to the industry average of 5.3
- P/Cash Flow – 23.2 – Overvalued when compared to the industry average of 20.94

As seen by these valuations, Altria is clearly overvalued but I believe its valuation is warranted due to its defensive nature in the current market environment (see **Thesis**).

*Source: Morningstar, Yahoo Biz*

## Income Statement

- Revenue – \$19.11 billion (TTM) – Increased YOY since 2011
- Net Income – \$5.65 billion (TTM) – Increased YOY since 2011

## Balance Sheet

- Cash – \$2.37 billion (2015) – Cash is sitting at its lowest level since 2011. This is because of Altria's stock buyback program and annual dividends. Even so, there should be no immediate cash flow issues. The FCF along with cash on hand is more than enough to finance their

operations including their stock buyback program and dividend. Altria has consistently bought back stock since 2006, reducing their outstanding shares from 2.11B in 2006 to 1.96B in 2015 (VURU, Yahoo Finance). They have paid \$4.34 billion in dividends over the trailing twelve months.

- Long-Term Debt – Has decreased since 2011 from \$13.01 billion to \$12.92 billion in 2015.
  - Altria does carry a significant amount of debt on its balance sheet. Their capital structure is 80.3% debt and 19.7% equity and their debt has coupons ranging from 2.625% - 10.2%. They have paid down \$1 billion of debt over the TTM and not issued any since its \$1 billion issuance in 2014. Below is snipping from their 2015 10-K with a breakdown of their long term debt.

Aggregate maturities of long-term debt are as follows:		
(in millions)		
2016	\$	4
2017		4
2018		867
2019		1,148
2020		1,000
2021		1,500
Thereafter		8,442
		12,965
Less debt discounts		46
	\$	12,919

As you can see, only \$4.5 billion is due prior to 2022. Altria's TTM FCF currently sits at \$5.41 billion (Morningstar) which is more than enough to cover it. Add in the cash on their balance sheet, their ability to refinance, and their future outlook, and we can see that Altria's long term debt isn't so burdensome after all.

- Goodwill/Intangibles – \$5.29 billion - Has remained stable since 2011

*Source: Morningstar*

### Cash Flow Summary

Altria's FCF has increased from \$3.51 billion in 2011 to \$5.52 billion in 2015. CFO has increased 61% to \$5.81 billion since 2011, CFI recently turned negative in 2015 due to purchases of investments and investments in property, and CFF has decreased from (\$3) billion to (\$6.74) billion in 2015 due to

increases in dividends and debt repayments. Altria maintains a healthy free cash flow because of their profitable and stable business operations. We can see in this breakdown of Altria's cash flow that FCF is more than enough to cover both their annual dividend and debt repayments until 2021.

## Ratios

- Gross Profit Margin – 59.53% - Has increased YOY since 2006
- Operating Margin – 45.29% - Has increased YOY since 2006 with the exception of 2011 & 2013
- Dividend Payout Ratio – 78.2% (TTM) – Slightly above average for Altria since 2006 but far off its high in 2011 where it saw a payout ratio of 92.8%. This is also far less than its competitor Phillip Morris International at 97.6% (TTM)
- Return on Assets – 13.3% TTM – Near all-time high of 14.87%
- Return on Equity – 71.36% TTM – Near all-time high of 82.47%

*Source: Morningstar*

## Recent Events

- FDA ruling on the definition of tobacco (FDA.gov)
- Anheuser-Busch merger with SABMiller expected to close in two months. Altria holds a 27% stake in SABMiller so how will this merger help them?
  - Diversification
  - 10% stake in Anheuser-Busch Inbev SA (BUD) that yields 3.18%
  - \$2.5 billion in cash received from the deal which may incur a tax liability

*Source: Value Line, Morningstar*

## Catalysts

- SABMiller merger
- E-cig market
- Continued success in Marlboro & Copenhagen brands
- Marijuana market
- Annual share buyback program

- Dividend growth
- Uncertainty in the global economy

### **Risks**

- Significant portion of its revenue is derived from its Marlboro brand
- Decline in smoker population in the U.S.
- Increased regulation & taxes on products

### **Models & Analyst Price Targets**

- Yahoo Finance Analyst Coverage Average - \$69.25
- Morningstar Fair Value Estimate - \$59

### **Closing Summary**

I recommend we purchase \$6,000 worth of Altria through 2-3 DCAs. I believe the factors contributing to Altria's success warrant its overvaluation and recent run up in stock price. In addition, we need to allocate a portion of our portfolio to non-cyclicals.

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