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SUSS INVESTMENT GROUP

Altria Group, Inc (NYSE: MO)

Sector: Consumer Staples
Industry: Tobacco

Recommendation Buy

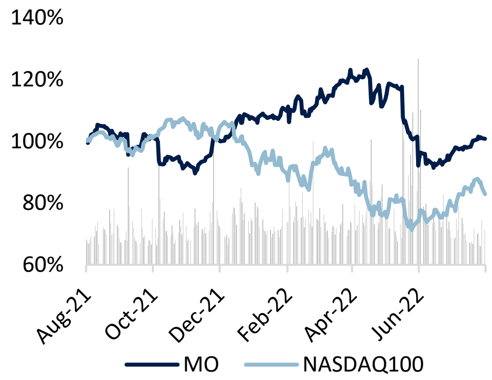
Analysts

Ezekiel Woo	Lead Analyst, Equity Research
Lee Yun Hui	Analyst, Equity Research
Alvin Wang	Analyst, Equity Research

Basic Information

Current Price	$44.10
Target Price	$57.68
+/- Potential	+30.80%
Market Capitalisation	$79.42bn
Shares Outstanding	1.80bn
52-Week Trading	$41.00 – $57.05
Average Volume	12.1mn
Fiscal Year End	31 December 2022

1Y Price vs NASDAQ100



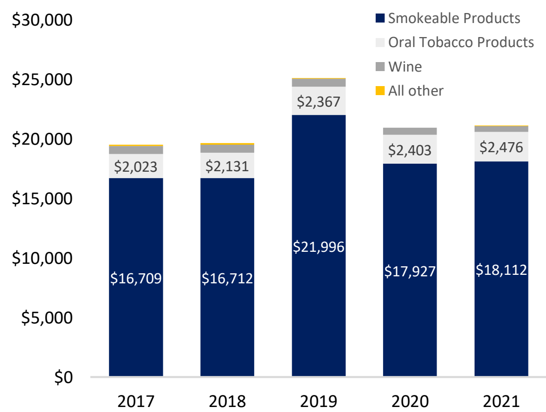
Key Executives

Billy Gifford	VP, COO
Jody Begley	VP, CFO
Sal Mancuso	VP, CFO

Major Shareholders

The Vanguard Group	6.19%
Capital Group Companies	4.82%
Blackrock Fund Advisor	4.82%

Fig 1: Historical Revenue



Source: Company Filings

Altria: Road to a Smoke-free Future

Company Overview

Altria Group, Inc. was founded in 1919 and is headquartered in Richmond, VA. They engage in the manufacture and sale of cigarettes in the United States. Altria Group has a leading portfolio of tobacco products and is diversified between smokeable and smoke-free tobacco brands. The Smokeable Products segment comprised cigarettes, large cigars, and pipe tobacco manufactured and sold by Middleton. The Smokeless products segment is manufactured and sold by USSTC and PM USA. Its business and primarily sell to wholesalers, distributors, retail, and chain stores.

Revenue Breakdown:

The revenue for FY2021 is $21.1bn with smokeable products making up the bulk of it at $18.1b (86%) and the revenue from oral tobacco products makes up $2.5bn (11.7%) while wine products $480m (2.3%).

Industry Outlook

The U.S. tobacco market is expected to grow at a CAGR of 3.4% from 2022 to 2030 to reach USD 102.7bn by 2030, driven by three factors:

Changing Consumer Preferences: The major manufacturers in the US are marketing many novelties like next-generation smokeable products to expand their profit margin by 30 – 50%. As a result, this product segment is expected to grow at a CAGR of 10.0% by 2030 with increased initiation among youths and young adults.

Rampant Teenage E-cigarette Use: The introduction of next-generation smokeable products have caused a huge increase in usage by 1,800% from 2011 to 2020, pushing the tobacco industry into a new customer paradigm shift from adults to teenagers, expanding the Tobacco market to a whole new customer segment where 13% of all teenagers are expected to smoke tobacco by 2025.

From E-cigs to Cigarettes: Studies has shown that youths ranging from middle to high school that vape are 7 times higher to becoming smokers a year later compared to youths who have never vaped. A new opportunity presents itself for the traditional cigarette market as the use of vape from teenagers are at a record high, with a conversion rate of more than 30%.

Porter's 5 Forces

Competition Within Industry – High (4):

This industry is highly competitive as competitors are larger than Altria. The race to produce substitute products will shape the competitive landscape for Altria while balancing R&D and manufacturing of current products.

Threats of New Entrants – Very Low (1)

Altria Group (MO) is unlikely to be threatened nor shifted to new entrants as they hold a large range of products. MO has various products in multiple sectors of the tobacco industry and those brands (Marlboro) are valued

Threat of substitute Products or Services – High (4)

The U.S smoking rate is on a decline now that health is a common topic. This paves the inroad for new products that may replace conventional cigarettes. E-cigarettes, heat-not-burn and E-vapes are more common.

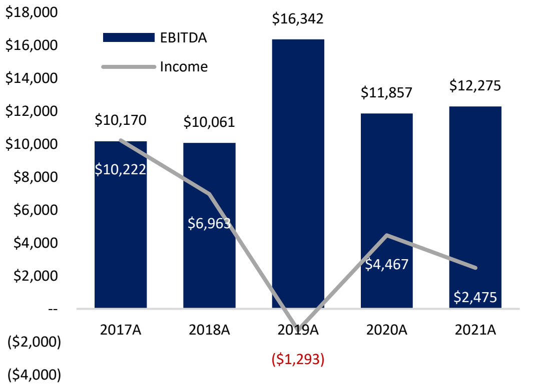
Bargaining Power of suppliers – Very Low (1)

The suppliers for tobacco are highly saturated, leading to low cost of switching. Suppliers are competitive, enabling big companies to have pricing power with the large volume required in this industry.

Bargaining Power of Buyers – Very Low (1)

Currently, Marlboro is the most popular brand in the U.S and seasoned smokers normally stick to this brand. The demand for tobacco is inelastic and buyers will not quit their smoking habits despite price hikes.

Fig 2: Historical EBITDA & Net Income



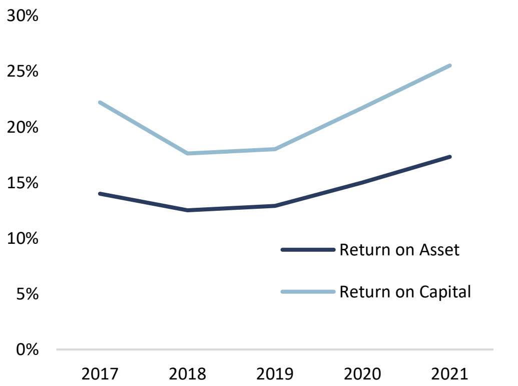
Source: Team analysis

Fig 3: SWOT Analysis

Strengths: - Strong Market share as they hold valuable brands - Resistant to recessions, able to hold up during covid - Largest producer of smokeless tobacco	**Threats:** - Strong competition from companies in different tobacco sectors - Environmental regulations - Declining U.S smoking rate
Opportunities: - Moving to non-combustible products - Sizeable investments in different companies to expand from smokeable products	**Weaknesses:** - Low ESG rating - Not exposed to different tobacco sectors

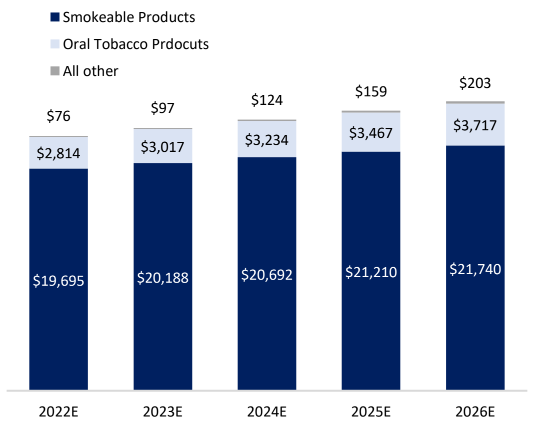
Source: Team Analysis

Fig 4: Historical ROA & ROIC



Source: Company Filings

Fig 5: Forecast Revenue Breakdown



Source: Team Analysis

Investment Thesis

Moving Beyond Smoking

After the US FDA approved IQOS (line of heated tobacco and electronic cigarette products) and HeatSticks as Modified Risk Tobacco Products with a "reduced exposure" claim, Altria is looking to expand in the IQOS market. IQOS is a "heat does not burn" device that is as an alternative to traditional cigarettes. Moreover, the evolving tobacco consumer preferences are continuing to impact the tobacco industry. Their investment in Juul, allows Altria to enter the market without relying on R&D to develop their products. We believe that Juul will achieve an additional USD203m in revenue in 2026, maintaining its dominant market share in the industry.

Sustainable Supply Chain Leader

Altria relies on strong, sustainable partnerships with a network of growers, suppliers, and trade partners. They have 2 distribution and 5 operating companies that are synergized in the value chain. As a result, Altria was named Leader in Sustainable SCM. These efforts led to GPM improvement by c. 6% despite supply chain issues since 2019. We forecast that margins will set to improve further by 2% as supply chain issues stabilize along with their effective value chain, leading to superior NOPAT margins of 25%.

Undying Consumer Loyalty for Marlboro

Historically, the Marlboro brand has dominated retail market share by 40 – 50% for over 45 years in the US with the most recent years hovering around 43%. As a result, this product provides recurring revenue with 32% of profit margins. This household name is often purchased by new smokers due to cultures and consumer preferences. As a result, the Marlboro product line is a cash cow for Altria, supporting their generous dividend pay-out, opex, capex and funding R&D. We forecast that the Marlboro brand is here to stay, providing Altria an avenue of large cashflows for years to come.

Financial Takeaways

Strong Free Cash Flows

While Altria's revenue only grew from $19.4 billion to $21.1 billion from 2017 to 2021, its OCF grew from $4.9 billion to $8.4 billion. Furthermore, the company increased its quarterly dividend pay-out from $0.61 to $0.90 per share. Although Altria's debt for FY2021 is a hefty $28 billion, the consistent and strong cashflow mitigates potential defaults and will not be a threat to dividend payments to shareholders.

Rising ROA and ROIC

Altria's ROA and ROIC is at 17.4% and 25.5% respectively in FY2021. Altria's ROIC has sequentially increased over the last five years, suggesting that it is improving its proficiency at allocating the capital that it is provided. Even though Altria has a $28 billion debt in FY2021, it has effective capital allocation based on its historical ROIC. This suggests that Altria will have favourable long-term returns along with attractive dividend pay-outs.

Valuation

DCF Valuation: We adopted a 5-year DCF as the valuation methodology with Perpetual Growth Method to arrive at a target price of $57.68 (+30.80%). We used a 2% terminal growth rate and a calculated WACC of 5.63% with an implied 8.5x EV/EBITDA exit multiple, which is in line with peers.

Relative Valuation: We used an EV/EBITDA multiple of 11.9x to cross check our perpetual growth method. The market approach is aligned with our perpetual growth hence we emphasise that Altria is undervalued with an EV/EBITDA multiple of 8.5x. This led us to a target price of $65.80 (+49.22%).

We reiterate our BUY recommendation for MO with a target price of $57.68 with an upside of +30.80% supported by our thesis of Leading Innovative Products, Sustainable SCM Leadership, and Consumer Loyalty for Marlboro.

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