BEHIND THE NUMBERS
Quality of Earnings Analysis

June 16, 2022

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BTN Thursday Thoughts

Updates and New Developments on Active BTN Ideas

Companies covered in this issue:

Altria Group, Inc. (MO)- The Feds May Move on Nicotine Levels

MO has seen its stock price hit since our last update on both Wall Street downgrades echoing many of the concerns we have cited in addition to negative news on the regulation front. However, as investors rethink opportunities after recent market events, we think there will be stronger ideas than MO.

When we first wrote our warnings on MO in 2018, we pointed out that the FDA was looking at plans to reduce the nicotine levels in cigarettes to reduce the likelihood of new people getting addicted and to wean current smokers off cigarettes. We considered this a nuclear bomb risk for MO but realized this would take a while to become the federal policy.

Last Friday, it was reported that the Biden Administration may start pursuing this plan. It was in the *WSJ, Fortune,* and *Yahoo* pointed to both. We wrote last month that we believe many people are more addicted to MO's dividend and are ignoring the full level of risks. Here is some quantification of the problems we believe will start being modeled into forecasts soon:

- *The New England Journal of Medicine* said in 2018 that reducing nicotine levels could lead to 5 million smokers quitting in the first year and 13 million within five years. *The Journal of the American Medical Association* has a study showing lower nicotine levels reduced the amount of smoking by 30% over 3 months. The WHO updated research from 2018-21 and found that lower nicotine also meant fewer new smokers or social smokers who would transition into regular smoking, and all groups saw more successful attempts at quitting.

- The CDC defines smokers as people who are 18+ years old and smoke daily or some days. It estimates the total at 30.8 million for 2020 in the U.S. This is 12.5% of the adult population in 2020 – already down from 20.9% in 2005.

- MO has 48.8% of the US cigarette market. We see little chance for MO to avoid a huge problem here if nicotine levels are lowered – even in 5-8 years. It is not a niche player. We will discuss this further below.

- The menthol bomb already appears likely to go off. About one-third of the smoking market is menthol cigarettes. Massachusetts has a menthol ban and so does California. California will vote in November to determine if the ban stays. The FDA said in April it is pursuing a nationwide ban. Studies have shown that menthol makes it easier for people to start smoking, to smoke more often, and inhale more deeply, as well as making it harder to quit. Bulls believe it will take the FDA years to adopt this nationwide. We believe more states will act quickly if California's ban stands. MO is not the number one menthol player, but still has a significant presence and this could quickly wipe out some volume.

- We would remind readers that graphic health warnings about smoking for cigarette packages are coming in early 2023. Covid delayed the roll-out. There are already 120 countries that adopted graphic warnings on cigarette packages and federal law mandates it here. The results where adopted have been people smoking less and fewer people starting smoking. The reasoning is a package of cigarettes is something people carry around frequently and see many times per day. The graphic warnings of health impacts make the risks more obvious. This is already scheduled for the US market in less than one year.

- No sales to people under 21 and inflation are already here too. MO has already been reporting a 7% decline in volume compounded for years, with a reprieve during Covid when more people were at home. Some of that is due to losing youth who aren't starting to smoke and not replacing people who quit or die. Only two or three quarters of higher inflation for gas and food pricing others out of the smoking market has hit MO's reported results so far. MO posted 8% volume declines in 1Q22 and 4Q21 with inflation in effect.

- We believe MO is already addicted to accelerating price hikes to offset volume losses. The more volume is lost, the more MO may price its customers out of the market, especially in light of inflation.

More on a Potential Nicotine Cut

Reducing Nicotine levels is hardly a new idea from left field. The FDA has been working with studies on low-nicotine cigarettes called "Spectrum by 22nd Century" for years. The big tobacco lawsuits of 30+ years ago showed ties between nicotine levels and how addictive cigarettes could become. **Studies from the 1990s focused on reducing nicotine levels to help curb smoking.** Other studies already show that people who smoke lower nicotine cigarettes smoke less and show fewer toxicities in their systems too.

In 2017-18, the FDA was outlining nicotine delivery by risk factors and saw cigarettes as the most dangerous way to get a nicotine buzz. It was looking to avoid getting young people becoming addicted to nicotine via vaping/e-cigarettes and sought ways to transition current smokers into other methods. At that time, the FDA was already talking about reducing nicotine levels in cigarettes citing studies that showed how effective it was in preventing new smokers and causing current smokers to reduce consumption or quit altogether.

We're not medical doctors, but we can read the results of studies and there are few studies that point to anything other than cigarettes being the most dangerous way to get nicotine and add more toxins to people. Section 18.4 of this document is from Australia, but it has links to dozens of studies largely from the United States and is well-footnoted for fast reading of conclusions about the benefits of cutting nicotine levels.

For bulls who see this as something that may take 10-15 years to be enacted in some form, we would point out again that Altria's own website touts that it wants to lead the country away from smoking. Also, it was Altria who was a co-proponent with the FDA of

eliminating smoking for people under 21 only a few years ago. That took about 12 months to become agreed-upon law.

It's not 30-50 years ago when the debate was on whether smoking is addictive or not and health impacts were not well-known. Tobacco companies may seek solutions that take longer to implement and seek to make the transition gradual. However, they may well accept the premise as they did on raising the age to purchase tobacco to 21.

Studies show that both gradual reductions in nicotine and immediately implementing large cuts both reduce smoking rates of current smokers and reduce new smokers from starting. The studies show that large immediate cuts have better results than gradual reductions. We have already seen evidence that MO would rather work with the government than have more court battles. We can see Altria arguing for a compromise to gradually reduce nicotine levels as a best-case scenario and still argue they agree that no one should smoke as they do on their website. An outcome here looks like another gap down in the rates of smoking could be coming sooner than the market believes.

MO Has Accelerated Price Hikes to Offset Volume Losses

This is not news to anyone, but MO's losses have been accelerating, and only during Covid did MO see almost no change in falling cigarette volumes. That has since returned with a vengeance.

Altria Cigarette Vol. Growth	4Q	3Q	2Q	1Q
2022				-8.0%
2021	-8.0%	-7.0%	-4.5%	-3.5%
2020	-1.0%	-1.0%	-2.0%	-3.5%
2019	-6.0%	-7.0%	-7.0%	-7.0%

So far, MO has relied on both boosting prices and having lower excise taxes to remit to various governments because volumes are down. Covid drove the obvious outlier year in 2020. When we look at these primary moving parts, it is scary to see how close MO is to smoking revenue turning negative:

Smoking Results	1Q22	1Q21	2021	2020	2019	2018	2017	2016
Pricing Change	$411	$368	$1,703	$1,152	$1,497	$1,104	$738	$460
Falling Excise Taxes	$77	$157	$408	$4	$419	$342	$320	$176
Volume Change	-$404	-$715	-$1,931	$0	-$1,780	-$1,438	-$1,273	-$577
Chg in Smoking Rev.	$84	-$190	$180	$1,156	$136	$8	-$215	$59

- In 2020, volume change was not quantified in dollars

Now, consider everything that is hurting volume growth now and can slash it even more:

- Higher prices for gas, food, rent, and utilities – MO has only had two to three quarters so far.

- Excise taxes have not been rising much if at all in many years. The average is only up from $1.69 per pack in 2017 to $1.78 in 2022 for state taxes. Here is the change in excise taxes, which are largely following total volumes down:

	2021	2020	2019	2018	2017	2016
Excise Tax Change	-7.9%	0.0%	-7.5%	-5.8%	-5.1%	-2.7%

What if states boost cigarette prices too via higher excise tax rates?

- Menthol bans could hit California in November and may spread to more states than just Massachusetts. Plus, several cities already have banned menthol. The FDA is pursuing a national ban too. This is one-third of cigarette volume at stake.

- Graphic packaging is coming nationwide in 9 months. This has been shown to reduce smoking volumes in other countries already.

- All three of those items – already make it unlikely new people will start smoking or social smokers will increase their volume.

- Now start modeling reduced nicotine in cigarettes causing a 16% drop in volume in one year and 40% over five years. The variable is how soon is year one? Our view is these changes are coming faster now and MO has already endorsed government actions designed to hurt smoking volumes.

We think MO is addicted to accelerating price increases. Here are the recent price hikes per pack for Marlboro:

	2021	2020	2019	2018	2017	2016
Marlboro Price Hike	$0.43	$0.32	$0.25	$0.19	$0.18	$0.15

Some of MO's brands have had even higher price hikes but we wanted to keep this simple. For example, some cigarette brands saw a 51-cent increase in 2021 and others 45 cents in 2019. MO already took a 15-cent price hike on Marlboro for 1Q22. And remember from the first table in this section, MO is not boosting revenue growth with these price hikes. Smoking revenue gains have been slightly positive in most years (except 2020 with Covid) as it offsets growing volume losses.

In 2021, MO sold 4.7 billion packs of cigarettes. To post flat sales growth for smokeable products if the volume declines, MO would need higher price increases. There is some benefit to having excise taxes decline with volume. The volume decay is already accelerating as seen in the table above (-$1.4 billion in 2018 to -$1.8 billion in 2019 to -$1.9 billion in 2021.) All this happened before inflation for food and gas, before menthol bans, before graphic packaging, and some even before the age 21 limit. Even then, price hikes had to grow at an accelerating rate. Now, at a minimum, inflation for food and gas are cutting cigarette demand and the age 21 limit is well in place. Thus, price hikes have to accelerate more even before more negatives to volume continue to be implemented. But, this becomes a vicious cycle – higher price hikes themselves create more losses to volume. When people cannot afford cigarettes today at $6/pack, can they buy the same amount at $6.50 or $7 tomorrow? What if various governments force a 25-cent price hike too with none of that going to MO?

Keurig Dr. Pepper (KDP)- Exposed to Higher Interest Rates

We are maintaining our earnings quality rating of KDP at 2- (Weak).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

Will rising interest rates unravel KDP? The company has only been hitting forecasts despite benefiting from taxes coming in below forecast, reduced marketing, and lower R&D spending. It is guiding to a back-loaded year with coffee brewer and pod sales growth slowing significantly. However, KDP is also uniquely at risk from rising interest rates in our view:

- It has $3.4 billion of its $4.5 billion in payables factored to banks. With total Days Payable at 284 days, we believe that KDP has effectively refinanced normal debt into payables knowing that working capital is often ignored when software calculates debt ratios.

- KDP reports in its SEC documents that when suppliers sell the KDP payables it has no impact on what KDP owes and KDP has no ties to the buyer of the payables. Basically, KDP is saying it can hold its suppliers' cash for over 284 days as an interest-free loan and if the suppliers pay interest expense by discounting the face amount on the sale, it's not KDP's problem.

- With short-term rates at almost 0%, this would have very minimal cost to KDP's suppliers. However, with 3-month LIBOR now 200bp up from 13bp last year and the 3-month SOFR rate now about 90bp up from 5bp last year – the suppliers may be asking KDP to start paying this bill. One way would be to boost what they charge KDP for raw materials and services to cover this which would cut KDP's gross profit margin. Another way would be to build interest costs into invoices that are paid after 30 days.

- Suppliers may require faster payment from KDP. That will effectively push the $3.4 billion in factored payables back onto KDP's bankline. KDP has a $4 billion dollar credit line with a rate between SOFR + 0.875%-1.5% which should be about 1.75%-2.4%. On $3.4 billion that be $59-82 million of additional interest expense or 3.3-4.5 cents in lost annual EPS. Whether suppliers go this route or higher prices to lower gross margin, we think KDP is looking at a headwind here for earnings and it is just meeting forecasts now.

- The problem doesn't stop there on the payables. If they have to move the excess payables back to the revolver, then Debt to EBITDA, which ignores payables, rises from 2.8x to 3.7x overnight. That hurts KDP's deleveraging story. Also, boosting payables has been a huge source of cash flow for KDP. For 2021, cash from operations grew $418 million, but $576 million came from stretching payables which was possible because suppliers sold an additional $616 million of KDP's payables. In 1Q22, cash from operations only grew by $117 million fueled by payables rising by $194 million, but suppliers sold an extra $215 million.

- There are $11.75 billion in notes payable at KDP as well. This is not a company with tons of liquidity laying around with its $590 million in cash. If it had to reduce its payables or finance them for suppliers, they could use up most of the revolver they have in place. It has some sizeable debt maturities coming due fairly quickly: $1 billion due in May 2023, $500 million due in December 2023, and $1.15 billion due in March of 2024. It seems likely at this point that KDP may see interest costs rise on these refinancings too.

- We would also point out that KDP may have longer-term rising cost issues too from all the sale-leaseback style transactions they have completed to generate cash and show a reduced debt to EBITDA figure. The money has been spent and the total lease payments are rising. Lease rollovers may also be happening on higher asset values that KDP's landlord experienced with inflation and at higher imputed interest rates. This could continue boosting their ongoing cost structure too.

The Scotts Miracle-Gro Company (SMG) Investor Day Update

We updated SMG last week after the company significantly reduced its outlook for fiscal 2022 sales and profits. The company presented at the William Blair Growth Stock Conference last Friday where it added some color to its recent order shortfall and its 2022 outlook.

- As we discussed last week, SMG stated that the late spring delayed consumers from starting their early lawn seeding and fertilizer application. However, management had indicated after its 2Q conference call that it was seeing signs of recovery. It offered the following data at the conference showing the fiscal year-to-date growth in point of sale (POS) retail sales of its products through the first few months. Keep in mind these are sales made by retailers to end customers, not sales made by SMG to retailers:

	Point of Sale YTD Growth
March 1	+5%
April 1	-7%
May 1	-12%
June 1	-6%

We see that as of March 1, POS sales were up 5% but by April 1, YTD POS sales were down 7% implying a horrible March result. Results remained weak in April with POS sales falling to -12%. However, May saw a recovery as by June 1, YTD POS sales had recovered to down 6%. Management stated that May POS sales were near a record. Unfortunately, retailers cautious about their own inventories decided to delay replenishment orders to the tune of $300 million which did not allow SMG to participate in the strong POS numbers. Also, data indicates that the weather did not allow homeowners to perform their early spring fertilizing and grass planting as those categories lagged. These revenues are unlikely to be recovered as the window for spring fertilizing has already passed. Also, seed and fertilizer are two of SMG's highest-margin products which further widened the profit shortfall.

- The delay in inventory replenishment despite strong POS sales improved SMG's position for late summer and fall as inventories at retailers should be low on product. However, the company's own inventories have continued to climb:

	4/2/2022	1/1/2022	9/30/2021	7/03/2021
Finished Goods DSI	96.3	251.3	115.5	54.3
Raw Materials DSI	27.8	70.4	35.3	18.0
Work in Porcess DSI	9.0	22.8	13.1	6.3
DSI	133.1	344.6	163.9	78.6

	4/03/2021	1/02/2021	9/30/2020	6/27/2020
Finished Goods DSI	55.1	129.5	55.0	29.0
Raw Materials	18.5	36.4	23.2	11.9
Work in Porcess	5.6	14.2	9.4	5.5
DSI	79.2	180.0	87.6	46.5

	3/28/2020	12/28/2019	9/30/2019	6/29/2019
Finished Goods DSI	56.8	174.0	78.6	43.7
Raw Materials	17.0	50.8	30.0	14.5
Work in Porcess	7.4	22.6	14.5	6.8
DSI	81.2	247.4	123.1	65.0

Remember that the pandemic demand left SMG low on inventories which it struggled to rebuild in 2021. Inventories on a DSI basis are now well above where they would normally be. Management attributed 1/3 of the increase in inventory to higher costs and 2/3 to a buildup in units. The excess units are likely partly a result of disappointing Hawthorne sales as well as the disappointing lawn fertilizer and grass seed.

Management is focusing on how production cutbacks to deal with excess inventory will hurt profitability. However, the company is also continuing to push through price increases. If they stick, it will be able to sell the older inventory at historical costs which should help offset some of the impact of lower production rates. Thus the company's expectations for a 400 bps decline in gross margin may prove to be conservative if the price increases hold.

- We remain somewhat puzzled by a continuing fall in the company's reserve to adjust inventories to net realizable value. This is shown as a percentage of inventory for the last twelve quarters below:

	4/2/2022	1/1/2022	9/30/2021	7/03/2021
Total Inventory	$1,594.1	$1,657.2	$1,126.6	$962.8
Adjustments to reflect inventories at net realizable value	$16.4	$19.4	$22.5	$21.3
% of Net Inventory	1.0%	1.2%	2.0%	2.2%

	4/03/2021	1/02/2021	9/30/2020	6/27/2020
Total Inventory	$1,019.2	$1,068.3	$621.9	$493.1
Adjustments to reflect inventories at net realizable value	$21.4	$23.9	$31.3	$13.9
% of Net Inventory	2.1%	2.2%	5.0%	2.8%

	3/28/2020	12/28/2019	9/30/2019	6/29/2019
Total Inventory	$743.3	$866.1	$540.3	$533.7
Adjustments to reflect inventories at net realizable value	$12.5	$11.4	$8.8	$9.4
% of Net Inventory	1.7%	1.3%	1.6%	1.8%

Despite a 50%+ increase in inventory, the reserve fell by more than 20%. Some of this could be a reflection of the fact that inflation has increased the value of the company's inventories. This effect could be especially true for its fertilizers which have seen a huge runup in price. To that extent, it would add weight to our point that rising prices may help cushion margins from the impact of lower production rates. However, the Hawthorne shortfall has to be constituting a material part of the buildup. Some of these Hawthorne products are soil and nutrients, but also include hardware such as lighting and irrigation equipment which may be more subject to discounting should revenue continue to disappoint. In our view, this remains a relatively small red flag that should be monitored going forward.

- The Hawthorne business which caters to cannabis growers continues to disappoint. This segment should continue to turn in volatile results that swing with the waves in legalization. We see value in the company's legacy lawn and garden business given it is the undisputed leader in the category which is unlikely to be challenged given its tenure and reputation. However, we would prefer to see the company sell the Hawthorne business to distance itself from both the volatility and the potential for negative press. Management seems to be leaving this open as a possibility.

- Free cash flow is expected to be $0 for fiscal 2022 as operating cash flow is being stunted by the inventory build while capex is inflated by the company completing projects to enhance IT and boost manufacturing which will help in the long run. Management's goal of returning cash flow to $1 billion over 2-3 years seems very reasonable at which point it can begin paying down its debt load. It has worked with its banks to increase the leverage limit on its covenants from 4.5x to 6.5x for the next 7 quarters. It sees the high point for leverage hitting in the 4/23 quarter. The company sees its long-term leverage limit as 3.5x.

- Before the pandemic, SMG targeted 0-2% long-term growth for its consumer business. However, it now expects 2-4% growth. The company saw a huge boost to its business during the pandemic as people turned to upgrading their yards and taking up gardening as a stay-at-home hobby. The company claims it picked up 21 million new customers in 2020 as revenue jumped by 24%. In 2021, the company saw those customers continue to garden as sales rose by another 10%. SMG hopes to keep these customers interested and drive revenue at a higher long-term rate although the strange timing of the 2022 season makes it difficult to tell how much of their newfound following they are maintaining this year.

  Management bases its hopes for a higher level of long-term growth on the fact that millennials are at the stage of buying houses and fixing up their yards faster than boomers are leaving the category. Also, millennials are reportedly participating in the lawn and garden category at a higher rate than boomers. This premise seems reasonable to us in the long run although a slowdown in home sales may put a dent in growth in the short run. Inflation may also force homeowners to cut back on lawn care in the near term, but we could see this being offset some by people growing more food at home as prices at the supermarket rise.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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