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Philip Morris (NYSE: MO)

Buy

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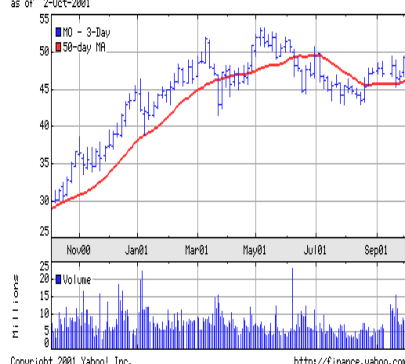
Consumer Staples

Tobacco

MARKET DATA

Price:	\$48.00
Kraft Price:	\$34.70
52 wk range:	\$29.83 - \$53.88
Price Target:	\$61.00
Shares Out:	2,221.0 million
Market Cap:	\$108 billion
5 Yr. EPS Growth:	11.8%
Proj. LT Growth:	10.0%
Dividend Yield:	4.9%
Beta:	.70
Revenue 2000:	\$80,356.0 MM
Net Income 2000:	\$8,510.0 MM
Discretionary CF:	9,436.0 MM

Philip Morris Companies Inc.
as of 2-Oct-2001



COMPANY OVERVIEW

Philip Morris Companies is the leading consumer products company with four major segments: **tobacco** (61% of '00 revenues, 65% of operating profits) including *Marlboro*, *Benson & Hedges*, *Merit*, *Virginia Slims*; **foods** (33%, 29%), including coffee, *Post* cereals, and packaged foods (*Jell-O*, *Kool-Aid*, *Kraft*, *Oscar Mayer*); *Miller beer* (5%, 4%); and financial services/real estate (1%, 2%). MO has a 51% share of the US cigarette market. Acquired Nabisco at the end of 2000. In April 2001 completed a partial IPO of 16% of Kraft Foods for \$8.4 billion. The company has 178,000 employees and their single largest share holder is FMR (Fidelity) with 7.6% of stock outstanding.

INVESTMENT CONCLUSION

- ☐ Recommending purchase of 250 shares of Philip Morris at current market prices. Buy limit order for 150 shares at \$45. Write Jan '02, covered calls with a strike of 42.5 on BUD for \$1.40 (8.34% return for 3 months).

SUMMARY

- ☐ Philip Morris recently increased their dividend to \$2.32 annualized. Current dividend yield now exceeds the 10 year US Treasury Note. This is the 34th increase in the last 32 years. Total dividends approach \$4.8 billion.
- ☐ Share repurchase for 2001 estimated to be \$4.0 to \$4.4 billion. Combined with the dividend payout, MO is returning over \$8.7 billion to their shareholders. This represents > 8% of the total market capitalization of the company making "Big MO" one of the most shareholder friendly companies in existence.
- ☐ The company typically spins off one item every year - free cash flow! And a lot of it. Our free cash flow per share calculations are \$4.25.
- ☐ Potential for weak foreign dollar to actually help MO earnings.
- ☐ Equity provides a lower Beta and lower correlation to growth sectors.
- ☐ Downside risk will always be pending litigation.

INDUSTRY INSIGHT

Earnings throughout the tobacco group have remained very stable and predictable throughout the economic downturn. Historically, the company's stock price has held up well during economic slowdowns. This is a result of the basic nature of their products: food, cigarettes, and beer. All three products continue to be consumed regardless of economics because they satisfy basic consumer needs.

The recent acquisition of Nabisco will give MO unparalleled distribution, pricing, and marketing strength in the food industry.

While it is not possible to know the impact of the terrorist attacks on Philip Morris, we can draw a comparison to how the company's stock reacted during Iraq's invasion of Kuwait. The following page includes a simple price analysis during this past periods following the beginning of the Gulf War.

**HISTORICAL
OBSERVATION****August 2nd, 1990****Operation Desert Storm**

	MO	S&P 500	Performance
1 day after	-0.3%	-1.9%	1.2%
1 week after	-0.3%	-3.3%	2.8%
1 month after	-3.2%	-8.1%	4.8%
3 months after	5.0%	-7.8%	12.9%
1 year after	47.5%	10.2%	37.0%
2 years after	67.6%	20.9%	48.4%

**INVESTMENT
HIGHLIGHTS****Company Strategy & Investment Selection**

Philip Morris has three major product lines - tobacco, food, and beer. Each product division controls either a #1 or #2 market share. As a whole, the company has extremely a cash flow and earning stream that is extremely recession proof. We find each of Philip Morris' divisions equally attractive and summarize our interest as follows:

Food: Kraft foods was the world's 2nd largest food maker after Nestle. Globally, Kraft foods generated \$26.5 billion in revenues and \$4,750mm in operating profits. The \$15 billion acquisition of Nabisco in 2001 will close this gap considerably. In June Philip Morris spun off 16% of Kraft in an IPO valued at \$8.6 billion. Based upon the IPO price, Kraft alone was valued at \$50 billion.

Tobacco: MO is the largest cigarette maker in the world with a 46/54% domestic to international sales mix. In 2000, tobacco generated \$10,561 MM in operating income off of \$49,000 MM in revenues. However, what makes this unit so attractive is that it literally costs pennies to manufacture a pack of cigarettes, they sell to retailers for more than a dollar, and the nicotine is addictive. Huge profit margins and the customer is addicted - that is a profitable combination.

Beer: This unit accounts for \$4,375mm in revenue and \$650mm in operating income. Similarly to the tobacco unit, this division also makes a product that cost pennies to manufacture and sells for huge premiums. Plus, like tobacco, alcohol can be addictive.

INVESTMENT RISKS

On the downside, the stock's 3- to 5-year appreciation potentially could be lackluster given the large litigation risks. Most of the articles that I found regarding outstanding litigation seem to point to two class action suits (Scott and Blankenship) as deserving of focus. Neither of these two suits are expected to be settled in the next six months. Thus, next semesters' portfolio management team should monitor the outcomes of these two cases.

On October 5th a jury ruled in favor of MO in a Florida lawsuit. This is not uncommon, however the rulings in favor of the tobacco companies do not get nearly the publicity as those against the company.

Additional risks are decreases in the restaurant sales of Miller beer due to a slowing economy. The integration of Nabisco and the partial divestiture of Kraft could challenge their management abilities, however, to this point neither concern has been remotely evident.

FINANCIAL SUMMARY**2000 Consolidated Results From 10-K**

	2000	% Change
Revenues	80,356	2.2%
Operating Income	16,228	9.5%
Net Earnings	8,510	10.9%
Diluted Earnings Per Share	3.75	17.6%
<i>Compounded Average Annual Growth Rates</i>	<i>1995-2000</i>	<i>1990-2000</i>
Operating Revenues	4.0%	4.6%
Net Earnings	9.3%	9.2%
Diluted Earnings Per Share	11.8%	11.4%

Results By Business Segment

	2000	% Change
Tobacco		
<i>Domestic</i>		
Operating Revenues	22,658	15.6%
Operating Companies Income	5,350	10.0%
<i>International</i>		
Operating Revenues	26,374	-4.1%
Operating Companies Income	5,211	4.9%
Food		
<i>North American</i>		
Operating Revenues	18,461	3.2%
Operating Companies Income	3,547	11.2%
<i>International</i>		
Operating Revenues	8,071	-9.3%
Operating Companies Income	1,208	13.6%
Beer		
Operating Revenues	4,375	0.8%
Operating Companies Income	650	27.2%
Financial Services		
Operating Revenues	417	17.5%
Operating Companies Income	262	14.9%

**2ND QUARTER
HIGHLIGHTS**

Operating Revenues	23,188	Revenue Breakdown	
Cost of Sales	8,599	Tobacco	57%
Operating Income	4,626	Foods	37%
Net Income	2,288	Beer	5%
Diluted EPS	1.03	Financial Services	1%
Cash Flow From Operations	4,626		
Capital Expenditures	790		
Dividends Paid	2,342		

RECENT EARNINGS

Philip Morris' next earnings call comes after the close on 10/17. Unlike other industries, purchasing ahead of an earnings announcement has not historically been an issue for this company. For the period ended 6/1/01 MO reported earnings of \$1.03 in line with estimates.

Consensus Earnings Estimates	Qtr(9/01)	Qtr(12/01)	FY(12/01)
Average Estimate	1.08	1.00	4.04
High Estimate	1.12	1.01	4.07
Low Estimate	1.05	.98	3.96
Year Ago	.99	.87	3.71
Growth Rate	8.64%	14.51%	8.83%

VALUATION INPUTS

- ☐ All financial data was collected from Philip Morris' website downloading their 2000 10-K and their 2nd quarter 10-Q.
- ☐ The 10-Q data was the first to include the effects of both Nabisco and the 16% divestiture of Kraft.
- ☐ Beta figures were supplied by Value Line and Bloomberg.
- ☐ Growth inputs were comprised from Value Line, First Call, and Zacks. The high/low figures above were used in the sensitivity analysis for the full year 2001.
- ☐ I used a simplified version of the Damodaron DCF model to calculate FCF.

Summary of Relevant Metric Factors

Current Price	\$48.63
Target Price	\$61.00
Stop Price	\$42.00
8 Year Average Est. FCF Growth Rates	7.75%
Low / High Sensitivity	5.0% / 12.0%
Historical 5 Rolling Year Low / High EPS Growth Rate	4.5% / 15.4%
Dividend Growth Rate	7.8%
Share Repurchase + Dividend Payout Ave.	6.0%
Terminal Growth Rate (Historical Inflation)	3.7%
Output Price Ranges	\$57 - \$86

CHARTS

