Philip Morris International Inc. (PM) Q3 2019 Results - Earnings Call Transcript

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Q3: 10-17-19 Earnings Summary

Press Release *10-Q* *Slides*

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Philip Morris International Inc. (NYSE:PM) Q3 2019 Results Conference Call October 17, 2019 9:00 AM ET

Company Participants

Nicholas Rolli - Vice President of Investor Relations and Financial Communications

Martin King - Chief Financial Officer

Conference Call Participants

Chris Growe - Stifel

Michael Lavery - Piper Jaffray

Bonnie Herzog - Wells Fargo

Robert Rampton - UBS

Pamela Kaufman - Morgan Stanley

Adam Spielman - Citi

Vivien Azer - Cowen

Gaurav Jain - Barclays

Owen Bennett - Jefferies

Operator

Good day. And welcome to the Philip Morris International Third Quarter 2019 Earnings Conference Call. Today's call is scheduled to last about one hour, including remarks by Philip Morris International management and the question-and-answer session [Operator Instructions].

I will now turn the call over to Mr. Nick Rolli, Vice President of Investor Relations and Financial Communications. Please go ahead, sir.

Nicholas Rolli

Welcome and thank you for joining us. Earlier today, we issued a news release containing detailed information on our 2019 third quarter results. You may access the release on www.pmi.com, or the PMI’s Investor Relations app. A glossary of terms, including the definition for reduced-risk products, or RRPs, as well as adjustments, other calculations, and reconciliations to the most directly comparable U.S. GAAP measures, are at the end of today's webcast slides, which are posted on our Web site.

Unless otherwise stated, all references to IQOS are to our IQOS heat-not-burn products. Comparisons are presented on a like-for-like basis reflecting pro forma 2018 results, which have been adjusted for the deconsolidation of our Canadian subsidiary, Rothmans Benson & Hedges, Inc. or RBH, effective March 22, 2019.

Today's remarks contain forward-looking statements and projections of future results. I direct your attention to the forward-looking and cautionary statements disclosure in today's presentation and press release for a review of the various factors that could cause actual results to differ materially from projections or forward-looking statements.

It's now my pleasure to introduce Martin King, our Chief Financial Officer. Martin?

Martin King

Thank you, Nick, and welcome ladies and gentlemen. Our third quarter results continued to reflect strong underlying business performance. The results include the better-than-anticipated timing of pricing and costs compared to our previously communicated assumptions for the quarter.

Our reported results in the quarter were impacted by an after-tax charge in Russia of $315 million, related to a final assessment by the Moscow Tax Authorities on excise taxes and VAT for the 2015 to 2017 period. Additional detail on this charge is provided in today's press release.

Total shipment volumes in the third quarter declined by 1.4%. Excluding the net favorable impact of estimated distributor inventory movements due primarily to the heated tobacco unit inventory reduction in Japan during the third quarter of 2018, our total in-market sales volume declined by 3.6%, reflecting lower cigarette volume, partly offset by strong heated tobacco unit volume growth.

Approximately two-thirds of the total in-market sales volume decline was due to three markets, in two of which, the decreases were largely timing related. In Pakistan, our cigarette volume was down by approximately 50%, broadly in line with the industry decline reflecting the timing of excise tax increase announcements compared to last year, as well as the impact of price increases.

In Turkey, our cigarette volume decline was due mainly to the impact of two price increases this year, totaling TRY5 per pack or roughly 44% on a weighted-average basis, which disproportionately impacted our share, given the timing of our price increases vis-à-vis the competition. In Indonesia, our cigarette volume declined, mainly reflected lower share, primarily due to widened price gaps between our brands and the competition’s, as well as a lower total market.

Heated tobacco unit shipment volume reached 16 billion units in the quarter. Excluding the net favorable impact of inventory movements, primarily related to third-quarter 2018 inventory reduction in Japan, our HTU in-market sales volume increased by 28.3%, driven by the EU and Eastern Europe Regions. HTU shipment volume in the quarter was in line with our HTU in-market sales volume of 15.9 billion units.

Third-quarter net revenues increased by 7%, excluding currency, driven by higher HTU shipment volume and favorable pricing for our combustible tobacco portfolio, partly offset by lower cigarette shipment volume. RRP net revenues reached $1.3 billion in the quarter, or over 17% of PMI's total net revenues. It is worth noting that our year-to-date September RRP net revenues of $4.1 billion have essentially reached the full-year 2018 total.

We recorded a strong combustible tobacco pricing variance of 5.9% in the quarter, driven notably by Germany, Indonesia, Mexico, the Philippines, Russia, and Turkey. On a currency-neutral basis, adjusted operating income increased by 8%, while adjusted operating income margin grew by 40 basis points. This margin expansion was achieved despite net incremental investment behind RRPs in the quarter of approximately $170 million and was driven primarily by favorable geographic mix related to HTUs, reflecting the increased contribution of volume from IQOS geographies with relatively high unit margins, notably markets in the EU region.

Our adjusted operating income and margin also benefited from the timing of costs as certain expenditures initially planned for the third quarter were not incurred by quarter-end. Adjusted diluted EPS increased by 5.9% excluding currency. The lower currency neutral growth in adjusted diluted earnings per share compared to adjustable operating income notably reflected the high relative growth contribution in the quarter from markets with sizable non-controlling interest, for example, the Philippines with a non-controlling interest of 50%.

Our total international market share, excluding China and the U.S., was essentially stable in the third quarter, reflecting lower share for cigarettes, offset by higher share for heated tobacco units, which reached 2.3%. Our share of the cigarette category declined by 0.4

points, reflecting continued adult smoker out-switching to IQOS, particularly in the EU region, Japan and Russia, coupled with lower share, notably in Argentina, Indonesia, Korea, Mexico, and Turkey.

Importantly, Marlboro share of the cigarette category increased by 0.2 points to 10.2%, driven by Germany, the Philippines, Russia, Saudi Arabia, and Turkey. The share decline in Indonesia primarily reflects the impact of widened price gaps between Sampoerna A, notably a mild and competitive brand, particularly at the bottom of the market.

As you may recall, we increased our prices in Indonesia late last year in anticipation of a 2019 excise tax increase that ultimately did not materialize. Our competitors largely maintained their prices, particularly following the government's decision to leave cigarette excise taxes unchanged, leading to the widened price gaps with our brands this year.

Although, no formal regulation has yet been issued, the government recently outlined a 2020 cigarette excise tax with an average increase of 23% in exercise and 35% in the minimum band roll price. As the government has not yet announced the increase for each individual tax year, it is difficult to accurately gauge the anticipated volume and share impact in 2020. We do note, however, that while the potential tax pass on is relatively steep in the context of the two-year stack with no excise tax increase in 2019, the average percentage increase is broadly in line with historical levels.

Turning now to a more detailed discussion of RRP performance. We estimate that there were approximately $12.4 million IQOS users as of quarter end. We further estimate that 71% of the total or some 8.8 million IQOS users have stopped smoking and switched to IQOS, with the balance in various stages of conversion.

IQOS is now commercially available in 51 markets, following recent launches in Belarus, the United Arab Emirates and in the United States. We are particularly excited by the launch of IQOS in the U.S. through our commercial arrangement with Altria. The first IQOS retail store has opened in the initial lead market of Atlanta, Georgia, marking a historic milestone in providing better alternatives to the 40 million men and women in the U.S. who smoke. IQOS is currently the only heat-not-burn product on the market authorized through the U.S. food and drug administration's PMTA pathway as, "appropriate for the protection of public health".

As you are aware, the merger discussions with Altria have ended. Although, this chapter is definitively closed, we have an ongoing relationship with Altria, and both companies will focus on maximizing the IQOS opportunity in the U.S. market. Last month, we took another important step in our journey towards a smoke free future with the launch of IQOS 3 DUO. This latest edition to the IQOS family was designed with enhanced features to help adult smokers switch more seamlessly from cigarettes.

IQOS 3 DUO allows two consecutive uses without recharging the holder. While it's charging time is significantly faster compared to IQOS 3, and IQOS 2.4 plus. IQOS 3 DUO is currently available in Japan and will be rolled out in most markets where IQOS is commercially available by the end of this year, further strengthening our smoke free leadership position.

Let me now take you through the performance of IQOS in the quarter. In the markets where IQOS has been commercialized, excluding the U.S., our HTU brands recorded a total combined share of 5.1% despite not yet being nationally distributed in many of them. At this share level, our HTU brands would collectively be the fourth largest tobacco brand in these markets, up from number six in the third quarter of last year.

In the EU region where we are commercializing IQOS in areas representing approximately 57% of total industry volume, share for each more than doubled in the quarter to reach 2.5%. This growth reflects continued strength across a broad range of markets as detailed in the HTU market share appendix included at the end of today's presentation.

On a sequential basis, share increased by 0.1 point compared to the second quarter. Given the impact of higher industry cigarette sales volume reflecting summer seasonality, we believe that this sequential share performance understates the favorable momentum of HEETS. To this point, the end market sales volume for HEETS increased by over 9% sequentially versus the second quarter.

IQOS continued its strong performance in Russia in the quarter with HEETS share up by 2.9 points to reach 4%. On a sequential basis versus the second quarter, HEETS share increased by 1.1 points while in market sales increased by over 40% to reach 2.4 billion units. HEETS share growth in the quarter was consistent with the pace of adult smokers and our geographic expansion. We are now commercializing IQOS in cities, representing approximately half of the market by total industry volume compared to an estimated 40% at the end of the second quarter.

In Japan, our total share for HeatSticks and HEETS increased by 1.5 points to reach 17% in the quarter. The initiatives that we introduced during the second quarter of last year continued to pay off and drove a step up in our share performance. On a sequential basis, the share for our HTU brands was up by 0.4 points or stable after adjusting for the estimated impact of trade loading in advance of the October 1st tax and price increases.

Importantly, our weekly off take share increased sequentially during the quarter, reaching over 18% by the end of September. While we acknowledge that our off take shares toward the end of the period may have been favorably impacted by consumer loading ahead of the October 1st, our share growth continues in the first week of this month.

We are encouraged by our HTU share performance in the face of increased competitive activity as the year has progressed. While the growing number of smoke-free devices and consumables has contributed to competitive churn, IQOS remains the market leader with approximately 73% of HTU category share despite accounting for only around 20% of category SKUs. We believe the launch of IQOS 3 DUO will further reinforce the IQOS family's leadership position. This will be complemented by recent line extensions in our HeatSticks and HEETS line-ups.

In Korea, the heated tobacco category remains highly competitive, particularly in the area of non-menthol flavors and related new taste dimensions that are also present in the cigarette category. HEETS share in the third quarter declined by 1.2 points or by 1 point on an adjusted basis. Share for HEETS was also down sequentially versus the second quarter.

However, we began to see early signs of stabilization in HEETS off take segment share over the course of the third quarter, supported by recent launches that expanded the flavor line-up. While we are encouraged by this trend, we have a lot of work to do to reinforce the heated tobacco category's benefits and build upon IQOS's leadership position. In this regard, we look forward to the upcoming roll-out of IQOS 3 DUO.

Turning now to our full-year outlook. As announced in today's press release, we are revising our 2019 reported diluted EPS guidance at prevailing exchange rates to be at least $4.73. The $0.21 decrease, compared to our prior guidance on July 18th of at least $4.94, was predominantly due to the $315 million after-tax charge in Russia, noted earlier. Our guidance continues to include an unfavorable currency impact, at prevailing exchange rates, of approximately $0.14 per share.

After excluding the reporting adjustments and tax items outlined on this slide, our forecast continues to represent a projected currency-neutral increase of at least 9% versus our pro forma adjusted diluted earnings per share of $4.84 in 2018. Our guidance continues to assume an industry total volume decline in 2019 of approximately 2.5%, excluding China and the U.S.

As a result of recent cigarette price increases in selected markets, notably the Philippines and Turkey, we now assume a full-year total shipment volume decline rate of 1% to 1.5%, versus approximately 1% previously. This revision solely reflects changes to our full-year cigarette shipment volume outlook. We continue to anticipate full-year HTU shipments volume broadly in line with our HTU in-market sales volume with any inventory movements this year in individual markets, essentially offsetting on an aggregate basis.

We are maintaining our full year assumption of currency neutral net revenue growth of at least 6%. This now reflects a higher combustible tobacco pricing variance of approximately 6%, compared to above 5% previously, which is effectively offset by the impact of our revised total shipment volume target. While we continue to anticipate net incremental investments behind RRPs of approximately $400 million, excluding currency, we are refining our currency neutral adjusted operating income margin expansion assumption for the year to approximately 150 basis points from at least 100 basis points previously.

In addition, please note that we now expect the full year contribution of IQOS devices to total RRP net revenues to be approximately 15% compared to below 20% previously. This primarily reflects the favorable geographic mix impact of greater HTU volume in relatively high margin geographies, notably markets in the EU region, the longer lifespan of the latest IQOS devices compared to prior versions, and the impact of IQOS device retail price changes in select markets.

We now anticipate full year operating cash flow of approximately $9.2 billion subject to year-end working capital requirements. The change, compared to our prior assumptions of approximately $9.5 billion, reflects the impact of the after-tax charge in Russia. Separately, we now expect 2019 capital expenditures of approximately $1 billion, compared to approximately $1.1 billion previously.

Dividends remain the primary use of our operating cash flow after capital expenditures. Last month, we increased our quarterly dividend rate by 2.6% to $1.17 per share. This equates to a total quarterly dividend of approximately $1.8 billion, or approximately $7.3 billion annually.

To close on our full year guidance and assumptions, I would like to touch on our anticipated fourth quarter performance. Importantly, we expect currency neutral net revenue and adjusted operating income growth to be in line with our year-to-date September results. However, our currency neutral adjusted diluted EPS growth will be lower than our year-to-date September performance due to the following factors.

An unfavorable income tax rate comparison of roughly 4 percentage points versus the fourth quarter of 2018, during which our three month tax rate benefitted from the full year impact of further clarifications related to the U.S. tax reform. And a continued high relative adjusted operating income growth contribution from markets with sizable non-controlling interest. We expect these two factors to serve as a drag of approximately 9 percentage points on our fourth quarter currency neutral adjusted diluted EPS growth rate compared to our pro forma adjusted diluted earnings per share of $1.17 in the fourth quarter of 2018.

To conclude, we recorded strong underlying business performance in the third quarter, reflecting the quality of our execution against each of the key metrics of net revenues, operating income, margin and diluted EPS on a currency neutral adjusted basis. The fundamentals supporting our strong combustible tobacco portfolio are intact. The favorable momentum for IQOS continues across geographies, further supporting our confidence in our HTU shipment volume target of 90 billion to 100 billion units by 2021. We are excited by the recent launch of IQOS in the U.S. and the global launch of IQOS 3 DUO.

Finally, on a currency neutral basis, we are maintaining our full-year 2019 growth assumption for net revenues of at least 6%, and our anticipated full year 2019 growth rate for adjusted diluted EPS of at least 9%.

Thank you. I'm now happy to take your questions.

Question-and-Answer Session

Operator

Thank you. We will not conduct a question-and-answer portion of conference. [Operator instructions] Our first question comes from the line of Chris Growe of Stifel.

Chris Growe

My first question for you, and I think you did a good job explaining from a high level just that you do have more pricing coming through in the combustible business in relation, and therefore there is a negative volume implication, certainly in this quarter there was. Is that just -- was the timing to tax increases or were there certain markets you'd call out, if you said those I'm sorry I missed them, but . I just want to get a little more color on that to understand the implication to the guidance for year and for volume?

Martin King

Yes, the two markets to call out are Turkey and Philippines. Remember, in Turkey, we had a tax increase back in April, and the pass on was about TRY4.20. And at the time, we took TRY2 shortly thereafter, amidst a lot of scrutiny on inflation from the government. At the time, also, the other competitors did not move immediately and we lost quite a bit of share. And now we've been able to take another TRY3 in August, which the other competitors also followed immediately.

And so, you're seeing basically our opportunity to take pricing in Turkey come with the situation. We're taking it as soon as we can, but we're in fact a little bit late. Now, we've been able to pass the full tax and a little bit more. So, we're on track in turkey after having to delay a bit the pricing from what we would have normally done.

And the second one to call out is the Philippines. There was a tax increase announced to take effect in January 2020. The tax goes from 35 pesos per pack to 45 pesos per pack, and you're seeing us move ahead of that with pricing that started already in August, late August, now that we have clarity on the tax to come, and also because in Philippines, once the tax is clear, the trade will tend to try to buy more volume and take some of the benefits from the tax increase.

So those two are situations where we're taking pricing as we can get it. We were obviously doing very well with volume through the first half of the year. And you see us now in the second half moving a little more with pricing in a couple of markets. But if you look at -- stand back and look at the full year picture, where we're saying volume down 1 to 1.5, pricing at 6%. It's actually a pretty good balance. And our overall share for the year we anticipate to be positive against the industry decline of 2.5.

So when you look at the bigger picture long term, it's a very nice balanced mix between volume, share, and pricing.

Chris Growe

I just had a second question, if I could, in relation to IQOS and RRPs. And you have a -- if my math is right here, if my numbers are right. You have -- you had inventory builds, I'm trying to get to in RRPs year-to-date. Does that come out in the fourth quarter as we think about your inventory that being a factor for your shipments for the year? You did mention that in-market sales should roughly approximate your shipments. So, I just want to put those two numbers. And then just to think about your RRP revenue in the fourth quarter, have you given any color around that sort of the degree to which that should grow, with the degree to which these inventory changes, if they do occur, could weigh on that in the quarter?

Martin King

Let me be crystal clear on RRP HTU inventory. There has been no inventory build and there will be no inventory build for this year. Our in-market sales and our shipments for the full year will be approximately the same, and they were also -- even in the quarter, we had 16 billion of shipments and 15.9 billion of in-market sales.

What you're seeing, Chris, I think maybe there's some confusion, is it last year in the third quarter, we drew inventories down in Japan, in particular, around 4 billion units. So, the reference to ex-inventory is so that you can compare apples-to-apples, what it is essentially saying is add 4 billion back to last year to make the comparisons equal. But this year, our inventories are flat for HTUs and so forth. And in fact, we don't anticipate, by the end of the year, any inventory builds really in HTUs or cigarettes. We should end the year fairly lean on inventory.

Operator

Our next question comes from the line of Michael Lavery of Piper Jaffray.

Michael Lavery

Looking at Indonesia, you've called out the volume headwinds in this quarter, but on a year, you're slightly up. How do you reconcile that with the price gaps that you've cited as a headwind for the quarter? And then just looking ahead, what should we think for the outlook for the market? I know you don’t have some of the tax tier detail yet, but in terms of just where you sit from the category standpoint, can you give a sense of what 2020 might look like?

Martin King

So, for Indonesia, the overall market so far this year is up slightly. As you would expect with no tax increase and very muted pricing, we are losing some share. As we mentioned in the script, the price gap between our premium brands and the low end is hurting our share, but it's also causing some mix erosion as volume trades down. We do have some new initiatives at the lower price tiers that we're doing very well, but within our portfolio, we're being dragged by mix, as well as by the overall share loss. And so our shipments for the year are coming in slightly negative -- year-to-date are coming in slightly negative as well.

Now as far as the situation in Indonesia, going forward, the government has said they're going to increase the tax. They've used the number 23%. It's not final and hasn't been released, particularly by taxed year. They've also said though that the banderole price, minimum price would go by 35%, which would have a very positive effect from the point of view of this mix issue, because it would cause the low end of the market to move up and close some of the gaps that have been the biggest problem for government revenue collection, as well as for our own mix issues.

Now the total volume, it's hard to estimate, going forward, until we see the details, on both the increased the amount but also by individual tiers. But overall when you look at the increase of tax of 23% over two year period and realize that the pass on actual retail price is lower than the full 23%, it's not a disaster from that point of view. Although, we will have the challenge next year of going into the year without a lot of annualization of pricing that we normally have because of the way the Indonesian market works with lots of small price increases.

So Indonesia, I guess the longer term big picture, resetting the gaps, perhaps having a chance to address some of this mixed issue, is net positive. However, the challenge for next year will be the overall lack of annualization on pricing and the potential impact on the volume due to the relatively larger size increase all at once as opposed to coming over a period of time. So we'll wait and see what Indonesia unfolds. But it gives us some opportunities as well.

Michael Lavery

And just on Japan, you've called out some headwinds from down trading as well for the cigarillos. Can you just give a sense of how to think about that segment? And is there more of a headline from that going forward we should anticipate?

Martin King

Yes, there are couple of things to know about the cigarillos segment. One is it's not considered in the cigarettes and HTUs to overall cigarette volume that we've been using as the basis. So as cigarillos grow, we may have some distortions coming from that that we'll have to explain in quarters going forward, and we'll break that out for you.

The cigarillo category benefits from a preferential tax, if you will. We don't know whether this will last. Likely, I think eventually, the government will close this situation, because cigarillos, for example, can be priced below cigarettes at the bottom of the market and still have higher margins. Now, it was initially a category that was opened and JT, when the Class D product separate tax category phased out, they actually transferred some of the Class C brands over into cigarillos.

So we would guesstimate that, probably by the end of this year, it could be $3 billion to $4 billion total year number for cigarillos. So it's starting to get big enough to have an impact on the total market. Obviously, we all think this category should have preferential tax going forward. But we'll have to monitor this situation and decide we ourselves would have to compete in it at some point in order to not be at a disadvantage.

But overall, I think the situation in Japan with our focus being on heated tobacco and IQOS, and the real benefits coming from our gains in those categories, are a net positive right now.

Michael Lavery

One quick last one. You mentioned in duty free some headwinds from China, in particular, having a little bit more enforcement on what people are allowed to bring in to that market. Clearly, there's some consumer interest in that country. Can you give an update on what if any status change you may have had in your negotiations with CNTC to potentially launch with some sort of joint venture, or something in China?

Martin King

I really don't have any news with regards to our cooperations with CNTC. We continue to hope that the RRPs and IQOS in particular is an area for potential cooperation, but we don't have any additional progress on that. You're right. Duty free numbers have been affected by the fact that the allowances, the amount of a product that individual tourists or travellers are allowed to bring back into China, has been reduced and more strictly enforced. And that is having impact on what was a very robust duty free business of HTU, not just to travellers from China but other countries as well.

And you see in the numbers for the Middle East, Africa, duty free that HTU is down this quarter. It's partly because of the comparison whereas last year we were ramping up and building some inventory that deal with higher sales. This year, we're in a reverse situation where we're bringing some of the volume down in order to account for the new situation with the traveller limits. So it's pretty big swing but it's -- in the grand scheme of things, it's not major. And as I said before, the total sales and shipments for our heated tobacco units around the world were equal for the quarter.

Operator

Our next question comes from the line of Bonnie Herzog of Wells Fargo.

Bonnie Herzog

I have a question on your guidance for Q4. You mentioned EPS growth will be below year-to-date trend. So just wondering how much lower? You talked about, I think, a 9 point drive from the factors you mentioned, Martin. But shouldn't that be offset by your expectations for stronger margin expansion? So just trying to get a sense if you're expecting Q4 EPS growth closer to your full year guidance of 9% or below? And I guess I'm really trying to get a sense of how conservative this might be, especially given the momentum you're seeing in your business?

Martin King

The answer is we expect IT to be well below the EPS number, or below where we have been year-to-date. We would expect the operating income and revenues to be in line with where we are year-to-date. But the drop off from operating income to earnings per share is quite steep, driven primarily by this big difference in corporate tax rate. Last year in the fourth quarter, we were catching up on positive news and interpretations of the U.S. tax act, and we have the benefits for the full year hitting in one quarter. So we had a relatively low corporate tax rate in the fourth quarter last year.

This year, it's little bit of a different story that we're slightly behind our 23% projection for the full year so far through the year. So in the fourth quarter, we would expect the tax rate to make up that difference and bring us back to 23%. So the gap between the two years is 4 percentage points, which is pretty big impact. And then on top of that, you have this non-controlling interest line, which is being as effective as it's already even in Q3 you see it, but it's even more pronounced in Q4.

The two markets we called out with significant pricing, just to put it in perspective. In Turkey, the pricing was over 40% and in Philippines, it was just below 40% at 37%. So these two markets with very significant pricing are bringing bigger increases than other markets obviously in operating income et cetera. However, they have non-controlling interest. We called out Philippines with 50% non-controlling interest. So you're sharing some of that big increase with your partners. And therefore, the step down of those two, the tax and the non-controlling interest, we call that as a 9 percentage point drag versus the number last year, which was $1.17 on the adjusted pro forma basis. So it's a very large gap between the OI and the EPS number, Bonnie.

Bonnie Herzog

And then actually I wanted to ask you about the deal talks with Altria, if I may. I know they've ended. But I'd be curious to hear why you considered merging with Altria to begin with? And then why the timing was right? And I guess when the talks started, I'd like to hear from you how you were thinking about the U.S. market, and then how that in fact maybe changed given of course, the talks have ended? And then just in terms of talking with some of the investors over the last month, month and half. There was a fair amount of concern that maybe you were seeing something in your business that made you feel compelled to maybe seek a deal. So if you could just touch on that, I think that would be really helpful. Thank you.

Martin King

So Altria discussions were a natural outgrowth. The fact that we were launching IQOS in the U.S., we had PMTA approval. So it's natural, I think, for the two companies to sit down and discuss whether that's the best arrangement or whether there was other alternatives, for example, a merger. And whenever you're looking at a merger between two companies the first thing you start to look for are our strategic benefits, primarily synergies around revenue. And in our case, obviously, it was about RRP portfolios and having the right product mix for the future of a combined company potentially, having a better opportunity with wider range of products. We were looking at the U.S. market being very profitable, very large, 20 billion profitability in that market, with growing profitability over time.

Obviously, you look at cost synergies, although, that wasn't really a key driver here. And then regulatory synergies, because from our perspective the U.S. market has pretty big role in setting the regulatory framework for the world. So we looked at all these different categories and then we put it also into the larger context. And one of the big things was the environment was developing rather rapidly as we were in these discussions with all the news around e-vapor and the regulatory approach from FDA, et cetera.

We also got pretty clear feedback from our shareholders. We have lot of questions about whether this would make sense. And shareholders feeling that they could, if they wanted to, be exposed to the U.S. market by Altria separately, they didn't need PMI to do that. So we obviously heard quite a bit from shareholders. And then of course, you have the distraction, the management that would come with overcoming the environment, the shareholder feedback, and so forth.

So in the end, both management teams decided that the best path was for us to collectively focus on IQOS success in the U.S., which incidentally as this was developing became even more of an opportunity, because we felt that the environments gave IQOS even more of a chance since it's the only heated tobacco market with FDA, PMTA authorization. And so we've chosen this path. We are definitively done with merger discussions. We've chosen the path of working with Altria on IQOS. The merger is off the table. And we're going down a path, which is very promising and we're very happy with.

Now as far as concerns about whether this was some way to offset results. I think this quarter's numbers in our picture for the full year I think should give people some confidence on that. I mean, if you step back from the big picture, we've got a very positive situation. We have -- the total industry, they were predicting the down 2.5%, which is at the better end of the range that we've seen long-term for total tobacco industry, ex-U.S. and China.

Our volume, we're predicting to come in between 1 and 1.5, meaning we're gaining share, pricing at about 6%. So there's a nice healthy mix between the two. Revenues, we're seeing at least 6% ex-currency adjusted. We're seeing good growth on RRPs and HTUs, particularly coming from markets with high margins like the EU and managing our costs and investments. So you see the margin expanding 150 basis points we're estimating for the full year. And then you see our EPS guidance at least 9% despite the non-controlling interest issue, and so forth.

So I think that's a pretty good indication of a very well shaped P&L and a good overall positive business momentum. So I hope people take that as the true picture of a situation, and realize that there was no merit to the idea that the discussion with Altria had anything to do with our base business.

Operator

Our next question comes from Robert Rampton of UBS.

Robert Rampton

Three questions for me, if I may. The first is on Japan. I'm interested to know what the cap rate, in particular versus 2Q. I mean, I can see that your share has improved and you've had competitive launches over the same period and there are more coming. So some color on the overall category will be great.

Martin King

Okay, do you want to take one at a time, or…?

Robert Rampton

Yes, that would be great.

Martin King

So overall heat-not-burn category for Japan continues to grow. From the end of last year till now, it's up about 2 percentage points. We're at about 25% for the total category. We've gained most of that. So we're maintaining, in fact, improving a little bit our segments share. But sequentially, it's not quite so smooth. There was a bigger step up in Q1. It continues to grow. But I think if you look at it more from the beginning of the year, you can see the overall picture with of course, as you mentioned, additional product launches coming from various other competitors.

So we're gratified by the category growth and our ability to grow within the category is intact as well. Our segments share is solid and you see that from our exit shares from C-stores at over 18% for this quarter. So I think we're on a on a steady trend of Japan continuing to grow. It's not as fast as, say our Russia, which is growing spectacularly right now. But its good solid growth given the total size of the category and our share, are already very substantial in Japan.

And we're also gratified by the DUO. I think the launcher DUO can be underestimated. This product is very positive from the point of view of consumer experience. Those that have been using it, we're surprised at how much of a difference it made, being that you have the tubes experience as anytime you want and the very fast charging time to come back to the first experience. It just makes it seamless. And you don't have to worry about the charging, or waiting, or the device. It's really a very nice step forward as far as the overall consumer experience.

So we have high hopes for DUO, particularly in Japan and Korea, where we will focus the first of volumes as we ramp up production.

Robert Rampton

On East Asia and Australia Asia more broadly, so per pack revenue for the region declined a lot kind of sequentially and year-on-year. Trying to understand what's driven that? You flagged some price right downs and inventory right downs, you have -- it’s been kind of there and specifically what the run rate is in that market?

Martin King

Well, we did have some device price adjustments in the quarter. In Japan, we used to have a pricing ladder. There was more or less ¥1,198,000 for three multi and 2.4 plus. Now in Japan, 2.4 Plus is almost gone very, few people buy it. It's doing very well in other markets. But in Japan, we now have DUO coming in at 10,000 essentially and then multi three and multi fill out the pricing ladder down from there.

And one of the consequences of reducing the pricing for the existing inventories of three and multi and a little bit of 2.4 Plus is yes, we did have to revalue the inventories in Japan. So you see that one time effect hitting the quarter. So it's probably disproportionate to what's really happening with pricing, because you're taking an inventory and revaluing it as opposed to just having the effect of the sales that you actually made in the quarter. Does that make sense?

Robert Rampton

It does, yes. And can you just give us -- if you could quantify that number?

Martin King

No, I mean I think you see it in the pricing line and in that line there if you can try to pick out the effect. So we haven't given individual inventory revaluation type numbers.

Robert Rampton

And my last question. Just can we get a color market share in the UK and specifically London? I mean, just anecdotally. I've seen a lot of it around and obviously, the market where e-cigarette use is very high and we've also cut prices. So I'm curious to hear how IQOS is doing in this market?

Martin King

Yes, IQOS is doing better in London and the UK, admittedly from a relatively small base.

But it's up itself over 1% in London, depending on how you define the city, right? But it's doing much better. It's grown at a much faster rate in the last few months than it was before. And we're encouraged by the pickup that we're seeing in the UK and in London, in particular. Now it's from a small base and we have obviously many other markets where the share is much higher. But it's very good to see it moving and we anticipate better results coming forward.

Operator

Our next question comes from the line of Pamela Kaufman of Morgan Stanley.

Pamela Kaufman

I have a follow up question on your discussions with Altria. Were there any changes to your agreement with Altria on IQOS that emerged from the merger discussions that more closely align each of your interests? And is there sufficient incentive for Altria to invest behind and push the product?

Martin King

Yes. I mean, I think one of the benefits of the merger discussions and going through all the discussions about how we would align et cetera, is that we came out of this period with better understanding of each other and better alignment, both regulatory and how we would go about IQOS et cetera. The current agreement is the one we had before that we're continuing to commercialize under. But I think we did come out of this whole thing with better alignment, better understanding better push for IQOS in the U.S.

And I think given the news flow around the e-vapor and everything else, I think we both agree that there is even more of an opportunity for IQOS in the U.S. than we might have understood a few months ago. And if there were any doubts about Altria's alignment and interest behind IQOS, I think it's very clear they are fully focused on it. They were before but even more so perhaps now that IQOS has even bigger opportunity in the U.S., given the news flow and the whole situation around e-vapor.

Now, I mean, we haven't disclose the terms of the agreement. But Altria has very good incentives to make sure that IQOS does very well. And we're very happy with the arrangement, the agreement, their execution in Atlanta, so far has been excellent. And we look forward to some good success coming out of that.

Pamela Kaufman

And just related to that. Are you seeing any impact from the healthcare around vaping in the U.S. on consumer attitudes towards our view outside of the U.S, given the potential for this issue creates confusion among consumers? Do you want to see any impact on IQOS's performance?

Martin King

We don't. Although, we are working hard to make sure that IQOS is distinguished from the issues in the U.S.; making sure it's understood that this is not an e-cigarette, this is a heated tobacco product; making sure it's understood our track record. We have 12 million plus users now. We have very good conversion practices to make sure that we're focused on adult smokers. We have lots of experience in over 50 markets, with making sure that the people that convert to IQOS are former adult smokers. We also emphasize that this is scientifically substantiated product. We've got the FDA authorization. So we're able to really make sure that the IQOS heat-not-burn is in a different category.

At the same time, when we're engaging with regulators and others, we're very clear to say that the issues that they're hearing about in the U.S. are not coming from authentic properly manufactured close system e-cigarettes. In other words, it would be unfortunate for a properly manufactured, properly regulated e-cigarette to be caught up in this issue around the unfortunate illnesses and very unfortunate deaths that have been reported in the U.S. We understand that is a different issue from a properly done e-cigarette, like we will have or do have already, but we'll have better versions of with our MESH.

And so we have worked hard to both make sure that it's understood what e-cigarettes are and how they can be properly regulated to make sure these issues don't evolve. But also to make sure that they understand the heat-not-burn and IQOS are truly a different category and shouldn't be even in the discussion around the issues they're hearing about from the U.S. I mean when it comes to the youth access issue, this is where we focus on our good conversion practices and are very stringent focus on adult smokers.

Pamela Kaufman

And should we expect you to file any PMTA applications next year, maybe related to IQOS MESH?

Martin King

With regard to IQOS MESH, as you know we have the improved device. We are working very hard to ramp up our production. We are on track to be able to launch in a market this year. And we are very much focused on expanding production and capacity so that we can satisfy a number of international markets next year. So our full focus with MESH is in international markets. Obviously, we're focused in the U.S. on IQOS heat-not-burn and the agreement with Altria.

Now, with regard to MESH, we are putting together a package of scientific substantiation, which we could use in the future with a number of different regulators and that work needs to happen regardless. So that's our plan for MESH is to get it into as many markets internationally as we can. At the end of this year starting, but really next year is the big ramp up.

Operator

Our next question comes from Adam Spielman of Citi.

Adam Spielman

I want to ask you sort of more general question, because this is not I didn't understand about these results. The first thing was that the margin was substantially better than certainly I was expecting. Are the two key results you said you'd be investing much more heavily in the first quarter but that you said that didn't seem to come through, and I was just wondering why? You also said that part of the reason for the good margin growth was that you've actually done very well in high margin markets for RRP, specifically the EU.

And yet at the same time, the market share growth in the EU, as you said yourself, was a little bit disappointing. So I'm wanting if you can sort of bring all those things together. Why was the margin so strong? When frankly, you said it probably wouldn't be in 3Q. And if you can give a little bit more color about what you sort of think the underlying market share for such a thing in the EU is for IQOS? Thank you. That would be the first question.

Martin King

First of all, with regard to why the margin was better, it's two things. One is additional pricing, which we called it out for Philippines, Turkey, as two examples. The other piece is costs were lower into third quarter shifting to the fourth quarter. You're right, the $170 million for RRP related investment compares to the $200 million that we have said and planned. But there are also some additional costs throughout various areas of the company that shifted.

The total impact is probably about $30 million for the RRPs and about $40 million or $50 million for all the other costs netted together. So when you move that from one quarter to the other, it has a pretty significant impact. And I would emphasize, this isn't spending lower spending, primarily it's just movement from one quarter to the next, hence the fourth quarter impact.

Now as far as talking about when we called out the EU impact of higher margin volume coming from HTUs that was more of a total year picture when we were explaining the device wait in the margin, I mean, in the RRP revenues being around 15% to help folks with their modeling and so forth. Now for EU, growth during the quarter, you're right. Sequentially, the share growth was about 0.1, which was not as much as you might expect, especially since the end market sales we're up 9%.

So you have a seasonality impact where cigarette volume sales are higher in the summer. And that obscured the fact that HTUs were actually up very nicely at 9%. And if you look at the year-over-year, the share was up more than doubled from 1.2 to 2.5. So the EU growth rate is continuing at a very nice cliff. It's obscured a bit just when you look sequentially in the quarter. And we always said share, in particular, tends to be a little bit lumpy.

When we look at user acquisition, we look at in market sales, those are more direct leading indicators of where it's going. And the momentum in the EU is very solid, very good. And that will eventually of course lead to continued improvement in margin as the volumes in the EU are already very significant by the way. If you look at the number of units shipped but they're growing at a very nice pace. And of course, they're coming with substantially higher margins than the average elsewhere.

Adam Spielman

I mean, certainly, the 40 or 50 movements in 4Q does I mean this is very minor and perhaps I shouldn't waste your time even asking it. A quick follow up questions is it's in my look. I mean why seasonality affects cigarettes more than the HTUs in the EU, it appears to me? But there's -- the more important point is if you can try and give some color about Russia, because in Russia things are clearly going well. But again, it seems very volatile. You had I thought excellent growth sequentially in Q1 and it went backwards in Q2 than even more surprising, but very sharp growth sequentially in Q3. How should we think about the passing of this? And how, I guess -- also congratulate EU. I mean, should we think or if you're modeling this. Should we just assume, I don't know 20 or 30 bps of market share expansion a quarter, I don't average it will have work out and equally in Russia. How should we think about it given the volatility in market shares you're reporting?

Martin King

So first just quickly the seasonality topic, because it does also affect Russia. What we're seeing is that heated tobacco units' seasonality is different from combustible cigarettes. And one of the reasons is because people are more likely to use it indoors. So the cigarette consumption in Europe, for example, increases as people have more time outdoors during the summer months. But for HTUs, it doesn't seem to move as much, because people can use it more into their houses et cetera without bothering others. And so they feel much less constrained about their cigarette -- their consumption of HTUs depending on how the weather is.

And this also partly is your answer on Russia. If you remember in the first quarter, we called out that the share for HTUs in Russia was flattered by the fact that the consumption of cigarettes was much lower during the super cold weather. And that's because you don't want to go outside to use one. And so it's on the other way in a slightly different quarter in Russia, and help to explain some of that difference in share. And we topped down the share in Russia in first quarter, and we were right. It came back in and showed exactly where we were in the second quarter.

And here you have the opposite effect going on in the EU, because of the warm summer months' seasonality impact. And we saw that also, by the way, in Korea and elsewhere that these seasonality impacts are part of explaining the reason why the share tends to come a bit lumpy. Again, we have underlying view on how fast we're acquiring consumers, and that's really our focus and our biggest forward looking number. We've been giving that number on an aggregate basis, and you see it and the step up this quarter to over 12 million. And casing we've given it broken to regions, but that's probably our best way of having a look forward on what's coming this year.

Adam Spielman

And you can't give us a year of sort of underline -- so in Japan, you sort of talked about underlying market share was essentially flat. You can't talk about something like that in the EU, or in Russia but it's just somehow an adjusted figure, but try to exclude some of the volatility practice?

Martin King

I mean, we went down that path in Japan, because of the heightened concerns and because of the issues we'd had about shares and being impacted by competitor inventories and so forth. I mean, I hesitate to get into that sort of reporting everywhere in the world. We've done it sort of on a temporary basis to try to give people more transparency on the Japan situation, given where we were last year. But I don't think we need to go into that with EU.

We're growing very nicely. We're delivering the results. We see this strong year-over-year. There's no slowdown in momentum in the EU. So I think we will stick with what we got. And eventually even in Japan and other places, we may stop doing that extra transparency once it's no longer needed.

Operator

Our next question comes from line of Vivien Azer of Cowen.

Vivien Azer

So I wanted to touch on IQOS in the U.S. please. In looking at the introductory bundle that's being sold, it seems like it's a very attractive proposition for the consumer at $80 for carton of consumables plus advice. Would you be able to comment at all on who is funding that promo? Because it seems like the implied price of the device is $25, which is far lower than what I've seen even on a promoted basis in international markets.

Martin King

Yes, I think I'm going to leave those sorts of questions to Altria who is commercializing IQOS in the U.S. The answer is funding it. I mean, they are responsible for the commercial expenditures around the launch. And so the answer would be, it would be their program and their funding, and their decision on how to approach the consumer in the U.S.

Obviously, we've shared with them and continue to share with them all of our experiences from around the world, and what we've seen in the many markets we've launched in. But it's their program and their decision on it. And I think I'll leave it to them to answer those specific questions like that.

Vivien Azer

And then my second question also on IQOS in the U.S., I can certainly appreciate the optimism that you're expressing on the call today, in particular in light of growing concerns around potential health effects with liquid e-vapor, but as I reflect back on some of the pre marketing consumer work that you guys did in the U.S. relative to some of the other countries where you were running similar consumer trials. If I recall correctly, U.S. trial and conversion looks closer to Italy, or Switzerland than it did, even in Germany but certainly not a Japan, or South Korea. But if you could just remind us why you have so much confidence? Because yes, like Italy certainly, at this point in a 4.6% share, is clearly a success story, but it was five years in the making. Thanks.

Martin King

I think we've said in the past that if you look at consumer readiness for reduced risk products and the openness to switching out of smoking that we see a lot of receptivity. We said in the U.S. the ability to communicate with consumers is actually very good. There are rules around how we need to report and do it with the FDA, given the pre market authorization. But compared to other countries around the world, the ability to communicate with consumers is very good.

Now, as far as any studies you might be referring to, Vivien, I would imagine they're very old by now, if you're talking about studies done back when we were looking at Italy and Japan. They would be about five years old, or more by now. And you have a tremendous fee change in the U.S. with regard to people's receptivity to reduce risk products, understanding of the issues around smoking, et cetera. So

So we have high confidence that the U.S. will perform well.

And we've always said it's probably somewhere in between where the EU has taken time and energy, because of the consumer receptiveness and the ability to communicate. And it probably won't be as quick as say Japan or Korea started out, where they were -- it was a phenomenon and it kind of took off on us. So we'll see, right, it's early days. But we have heightened expectations given the news flow that's happening to U.S., if you're a smoker and considering alternatives.

And this is the only product with PMTA authorization in the heated tobacco space, and it's got your taste and performance very, very well. I mean, I think it's got to be very high consideration, maybe even higher than it would have been a couple of months ago. So I think that's where we are on the U.S.

Operator

Our next question comes from the line of Gaurav Jain of Barclays.

Gaurav Jain

So on the CapEx decline of $100 million for this year. Is it because it shifted to us by '20, or there is a change to growth expectations?

Martin King

Neither. We've sharpened our pencils. We are better and better at getting more capacity out of the existing assets, particularly when it comes to production of heated tobacco units. Our uptimes keep improving. Our waste rates keep declining. Our ability of our factories to produce efficiently continues to improve beyond our initial expectations. And so we've been able to scale back some of the investments.

And usually at the beginning of the year, we put our capacity plans down as best we can. But there is a probably a little bit of opportunities to sharpen the pencil and cleanup the estimates, and come to a closer number and we're near the end of the year now. So we've been able to revise and refine our numbers and come to the billion. But it's not shifting to next year nor is it an indication of not needing the capacity. If anything, our capacity is in line with our $90 billion to $100 billion estimate that we have for -- by 2021. We're well on track to hit that and that's the capacity number we're focused on for heated tobacco units, as well as of course preparing for MESH and the e-cigarette platform for ramp up that I mentioned earlier.

Gaurav Jain

Now coming to the new product categories, so there is a lot of discussion around modern oral. Do you have any plans in that category?

Martin King

Around which category?

Gaurav Jain

Around the modern oral category?

Martin King

I mean we continue to monitor. We look at it very closely. But yes, right now, we don't have a modern oral product on the market. But we certainly have studied it and looked at it. And most of our markets right now today, we don't have huge oral category. But we are interested in that product, because it is reduced risk product category and we think it may play a role in the future.

Gaurav Jain

And my last question is just on the stock price, so you know your stock is where it was in 2011. Can you do something to change the trajectory? Like launch a share buyback, such as Progressive. Now that your balance sheet is more under control, you're not planning M&A. There doesn't seem to be any obvious escalation for you out there.

Martin King

Well, with regard to stock buybacks. We've said that our focus in the interim time next 18 months or so is to get into the leverage ratios that go with our mid-single A credit rating, and we are committed to that. And you see us slowly deleveraging over the last period, and we'll continue to do that. Once we get into the range for the mid-single A, then the board would be able to reconsider starting stock buybacks. I'd share with you that perhaps the underlying feeling that our stock is a good buy, but we aren't ready yet to be able to -- to start a buyback program until we get our leverage ratios to the range as it goes with our mid-single A rating.

Operator

And ladies and gentlemen, we have time for one more question [Operator instructions]. Our final question will come from the one line of Owen Bennett of Jefferies.

Owen Bennett

Just one question for me then, so on the earnings guidance you called out the higher growth in market to sizable non-controlling interest. I was just hoping you could provide a bit more specifics here in terms of which markets they are, what sort of growth you're actually seeing in operating income and also what is driving the strong growth? Thank you.

Martin King

The one we called out and it's probably the best explanation for this, is Philippines with 50% non-controlling interest in the Philippines. And we haven't given the specific market profitability. But you can see from the pricing and from the fact that our Marlboro share, for example, is way up as we get up trading. Marlboro has now hit 40% share this quarter. So you can see in the Philippines, I think, or you can sense in the Philippines that the profitability is up substantially. Obviously, we share that with our partners with 50%.

So when your overall growth in the operating income line is being boosted by an affiliate like the Philippines and then half of it goes to the non-controlling interest, when you go to the EPS, that growth there is not obviously as pronounced. Turkey is another example where there is a non-controlling interest. And there are others, I'm not going to go through the whole list. But you can see, I believe in the P&L, you see the non-controlling interest line and you see this been growing.

And it's pretty substantial on third quarter and we expect it to take another significant step up in the fourth quarter as the full impact of the pricing in countries like and affiliates like Philippines and Turkey kick in since their pricing only started partway through the second quarter, I mean, the third quarter. In the case of the Philippines, it was the end of August. In the case of Turkey, it was in August as well. So the fourth quarter will see another step up in non-controlling interest.

Operator

And that was our final question. I would now like to turn the floor back over to management for any additional or closing remarks.

A - Martin King

Yes, I mean, I think I just like to close with the thought that our overall year is showing very good momentum. We pointed a little bit to the fourth quarter, and that we expect the currency neutral growth of net revenues and adjusted operating income to be in line with our year-to-date. However, the impact of the non-controlling interest and the tax rate differential leads us to about a 9% drag at the EPS line.

Nevertheless, I think if you stand back and look at the big picture, we have a very positive year with good momentum going forward with nice balance between volume, share, pricing, margin expansion and the growth of heated tobacco units, especially coming from some higher margin locations like EU. We're seeing broad geographic success of heated tobacco units, and our smoke free future strategy is paying off throughout the results of the company as well.

So I think that would close it. And thank you all very much for listening.

Operator

Thank you, ladies and gentlemen. This does conclude Philip Morris International's third quarter 2019 earnings conference call. You may now disconnect. And have a wonderful day.