

# Imperial Brands PLC IMBBY (PINX) | ★★★

Last Price	Fair Value	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
46.17 USD	48.00 USD	Low	Wide	Stable	Standard	Tobacco Products

## Imperial Undershoots in 1H, but Improvement Priced Into Valuation

Updated Forecasts and Estimates from 04 May 2017

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The primary analyst covering this company does not own its stock.

Research as of 04 May 2017  
Estimates as of 04 May 2017  
Pricing data through 29 Jun 2017  
Rating updated as of 29 Jun 2017

Currency amounts expressed with "\$" are in U.S. dollars (USD) unless otherwise denoted.

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### Investment Thesis 04 May 2017

Imperial Brands generates the highest tobacco operating margins among the large-cap manufacturers, but we think a multiple discount is still appropriate for the stock due to the firm's weaker volume trends, slightly lower brand equity, and its absence from the promising heated tobacco segment. Nevertheless, we believe Imperial's pricing power, largely driven by the addictive nature of the product, give it a wide economic moat, and we would own the stock at an appropriate margin of safety.

Imperial's strategy to maximise shareholders returns revolves around cost optimisation and disciplined capital allocation. Despite generating best-in-class tobacco margins (although the profitability of Philip Morris International has been negatively affected by currency in recent years), Imperial has an opportunity to expand margins via rationalisation of stock-keeping units, or SKUs. So far, execution has been strong, with a 95% retention rate in the migration of consumers from small, low-margin brands to core brands. Management has restructured the company to differentiate "Growth" from "Returns" markets, and investment is concentrated on those markets that offer growth. This focused investment should allow for both continued dividend growth and debt repayment, and we forecast the firm to sustain a 10% dividend growth rate until 2020 and to deleverage to 2.0 net debt/EBITDA by 2020, from 3.7 times at the end of fiscal 2016.

We believe Imperial's widening multiple discount in recent months is largely linked to its absence from the heated tobacco category. Philip Morris International has invested heavily in this emerging adjacency, and has reported strong uptake in some markets, most notably Japan. With competitive products from British American and Japan Tobacco now in the early sages of commercialisation, Imperial appears to have been left behind in heated tobacco, preferring to make investments in vaping. However, we are sceptical that any first-mover advantage has been ceded, and we believe Imperial could step into the category within months if growth is replicated in markets outside of Japan.

### Vital Statistics

Market Cap (USD Mil)	42,978
52-Week High (USD)	54.91
52-Week Low (USD)	41.90
52-Week Total Return %	-8.5
YTD Total Return %	8.3
Last Fiscal Year End	30 Sep 2016
5-Yr Forward Revenue CAGR %	3.5
5-Yr Forward EPS CAGR %	32.0
Price/Fair Value	0.96

### Valuation Summary and Forecasts

	Fiscal Year:	2015	2016	2017(E)	2018(E)
Price/Earnings		23.5	66.8	17.6	16.0
EV/EBITDA		15.0	15.2	12.1	11.9
EV/EBIT		21.5	23.6	16.3	14.3
Free Cash Flow Yield %		7.7	7.8	8.7	10.2
Dividend Yield %		3.9	3.6	5.5	5.2

### Financial Summary and Forecasts (GBP Mil)

	Fiscal Year:	2015	2016	2017(E)	2018(E)
Revenue		7,000	7,976	8,432	8,597
Revenue YoY %		-5.6	13.9	5.7	2.0
EBIT		1,959	2,201	2,870	3,275
EBIT YoY %		-0.6	12.4	30.4	14.1
Net Income, Adjusted		1,633	575	1,952	2,136
Net Income YoY %		23.3	-64.8	239.4	9.5
Diluted EPS		2.20	0.77	2.63	2.88
Diluted EPS YoY %		23.9	-64.8	239.4	9.5
Free Cash Flow		-1,856	3,816	3,588	3,285
Free Cash Flow YoY %		-169.6	-305.5	-6.0	-8.4

Historical/forecast data sources are Morningstar Estimates and may reflect adjustments.

### Profile

Imperial Brands is the world's fourth-largest international tobacco company (excluding China National Tobacco) with total fiscal 2016 volume of 277 billion cigarettes sold in more than 160 countries. The firm holds a leading global position in the fine-cut tobacco and hand-rolling paper categories and is a leading seller of cigars in several countries. Recent acquisitions in the United States make Imperial the third-largest manufacturer in that market. Through its acquisition of Altadis, the firm has a logistics platform in Western Europe.

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## Morningstar Analysis

### Imperial Undershoots in 1H, but Improvement Priced Into Valuation 04 May 2017

Imperial Brands narrowly undershot our volume forecast in the first half of its fiscal year, and we are lowering our near-term organic growth assumptions. This is immaterial to our valuation, however, and we are maintaining our GBX 3,900 fair value estimate for the London-traded ordinary shares. Although Imperial has suffered below-market declines in several markets in recent quarters, the company's scale provides it with a cost advantage over regional manufacturers that should give it the financial flexibility to execute on its strategy and invest behind its brands. For this reason, along with the pricing power evident in the Specialist Brand portfolio, we are reiterating our wide moat rating.

First-half revenue declined 5.5%, driven entirely by a volume drop of 5.5%. Imperial's inability to mitigate the volume drop with price increases was disappointing, particularly in light of the 6% pricing currently being achieved by Philip Morris International and British American Tobacco. The firm's mature market footprint is behind the weakness, with revenue in the Returns markets, which represented 56% of sales, falling by 7.7% on an underlying basis. Revenue in the Growth markets, on the other hand (23% of sales), grew by 1.7% on a 3.1% volume decline. This highlights the portfolio limitations of Imperial's pricing power, which appears to be concentrated in emerging markets and premium categories.

Operating leverage was partly responsible for a 440-basis-point year-over-year decline in the reported operating margin to 21.7%. Even in the absence of a volume recovery, we expect this headwind to ease somewhat throughout the year as Imperial accelerates its cost optimisation program.

Our valuation assumes improvement in volume trends and profitability. While this depends to a large degree on execution, we still believe Imperial Tobacco possesses

competitive advantages that should allow it to make progress on both metrics in emerging markets, where its competition is often from smaller local manufacturers. We think consensus estimates and the market valuation also price in such expectations, however, and we would wait for a more attractive margin of safety before investing.

### Valuation, Growth and Profitability 04 May 2017

Our fair value estimate for Imperial's ADRs is \$48. Our valuation implies fiscal 2017 multiples of 14.8 times earnings and 11.3 times enterprise value/adjusted EBITDA, with a dividend yield of 4.4%. These implied multiples represent a lower valuation than competitors Philip Morris and British American, which we think is justified given that Imperial's weaker long-term competitive positioning is likely to lead to a slower growth profile. In addition, we think Imperial's reported results may be temporarily boosted by the impact of the weaker pound sterling this year, and that the earnings power of the business will be slightly lower in a normalised environment.

Our valuation is based on three key drivers: volume, pricing, and margins. We assume revenue growth of over 8% in fiscal 2017, boosted by currency. On an organic basis, we expect revenue to decline slightly due to weak volumes and below-par price/mix this year. Our mid-cycle estimate of sales growth is 3%, driven entirely by pricing offsetting volume declines in line with the global market. This is slightly below our estimates for both British American and Philip Morris International, due to lower pricing power.

The U.S. deals are likely to be margin-accretive. Imperial generates impressive EBIT margins of around 55% in the U.S. Much of the benefit is likely to be accrued at the gross margin, and we forecast a medium-term margin of 78%, some 4 percentage points higher than the margin the firm generated before the acquisitions. Further margin opportunity exists through the improvement of operating efficiency, though, and we forecast Imperial's EBIT margin to grow to 36% by 2021 as a result of its greater presence

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in the high-margin U.S. market, its cost-saving program, and more efficient operations as a result of lowering trade inventories. This margin implies some reversal in the recent severe weakness in the pound sterling. This would represent a peak margin, but we think it is achievable, given the return of pricing power and management's focus on cost savings.

We think mid-single-digit EPS growth is achievable from fiscal 2020 onward, driven by pricing-led organic growth.

### Scenario Analysis

The primary variable in our scenario analysis is foreign exchange, because the relative strength of the pound will have a major influence on reported growth and margins over the next few years. We also flex Imperial's volume trajectory and pricing power, as well as the outcomes of its cost optimisation program. We see greater upside than downside risk. Our bull case yields a valuation of \$63 per ADR, and our bear case yields a valuation of \$44. The fairly narrow range of outcomes for Imperial leads us to award a low uncertainty rating, and, therefore, a relatively narrow margin of safety.

In our bull case, we assume that current exchange rates represent the "new normal" for sterling, a plausible scenario in the aftermath of Brexit. We assume sustained EBIT margins of close to 40%. This level of profitability also implies that more of the cost optimisation savings flow through to the EBIT line than we forecast in our base-case scenario. We retain our 3% midcycle growth forecast in this scenario.

In our bear case, we assume an almost full reversal of Imperial's recent currency benefit. Our midcycle EBIT margin assumption is 34.6%, still around a percentage point higher than the previous peak margin, thanks to the accretive impact of the U.S. business, but 150 basis points below the margin achieved in our base case. We also assume weaker organic revenue growth, and use 2% as our midcycle growth rate. This implies industrylike volume declines of 1% to 2% per year, offset by low- to mid-single-digit price/mix, a level we think Imperial can continue to achieve even in this less optimistic scenario.

### Economic Moat

Strong intangible assets at the premium end of its portfolio are at the core of Imperial Brands' wide economic moat. In addition, the company's broad platform of tobacco products, which is being extended to include e-cigarettes, gives the firm economies of scope and scale that make it difficult for new entrants to overcome. Finally, the addictive nature of tobacco products makes demand fairly price-inelastic, and with few substitute products outside the portfolios of the Big Tobacco firms, a favourable industry structure exists for the largest players in which pricing, for the most part, is rational.

Tobacco brands' intellectual property has created a loyalty among tobacco users toward the brands they enjoy. Despite the advertising ban on tobacco products in many developed markets, brand identity through product differentiation and trademarks allows manufacturers to charge premium prices

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for their products. In fact, it is the bans on advertising that help to keep market shares stable and new entrants out. As the fourth-largest cigarette manufacturer behind Philip Morris International, British American Tobacco, and Japan Tobacco, Imperial holds 9% of the global market (excluding China), a share that has remained organically fairly flat since 2008. It is in loose tobacco that Imperial Tobacco holds the most brand loyalty, particularly through Golden Virginia, the global leader in roll-your-own tobacco, and Rizla, the number-one paper brand, but its cigarette labels also contribute to its intangible assets.

Historical returns on invested capital lend support to our wide moat rating. Imperial has generated returns on invested capital of 15% on average over the past five years, and we forecast returns to remain in the mid- to high teens over the next five years, comfortably ahead of our 7.7% estimate of the firm's weighted average cost of capital.

## Moat Trend

We think Imperial's moat trend is stable. We do not expect the firm's moat to contract in the short term as the company's vast distribution system, market share, and brand strength are all relatively secure. Regulation is one of the omnipresent fat-tail risks to the tobacco industry, but we believe that some of the options open to governments could actually widen the pricing power and the economic moat of the large cigarette manufacturers. The most severe of these measures would be an outright ban on tobacco sales, but we doubt that any government will implement a tobacco ban in the medium term, given their reliance on tobacco as a revenue stream and many national and local governments' struggle to balance the books. In addition, a ban would create a black market for cigarettes, removing regulatory control from the grip of governments.

Of the other options open to regulators, the prevention of in-store displays of tobacco products has been rolled out in

some small markets. The experience of Scotland, however, suggests that the ban had little impact on industry volume. In fact, we think such a move actually increases pricing power because the elimination of packages from display also eliminates the communication of price, making it less likely that customers will make a purchase decision based on price and more likely that they will remain loyal to their favourite brand. This is likely to damp competitive pricing strategies.

We are more concerned about the impact of plain packaging on moats. The evidence from Australia suggests that some trading down is occurring, and we believe this is due to the impairment of the brand identity of the premium brands. If similar measures were taken in other larger markets, we may reconsider our stable moat trend ratings for the tobacco firms, but in Europe, such a move would probably be favourable to Imperial Brands, whose portfolio includes some strong value brands such as JPS. Indeed, Imperial gained share after the introduction of plain packs in Australia, and we think the firm could also be a beneficiary when plain packs hit the shelves in the U.K. in May 2017. On balance, however, we think that the legal systems of most countries would allow a powerful challenge by the tobacco manufacturers to such regulation on intellectual property grounds. In addition, any trading down on flat volume would reduce the industry value, which would, in turn, reduce government tax revenue on an ad valorem basis.

The evolution of e-cigs may also have a near-term impact on our view of moat trends in tobacco. We believe heated tobacco is the category most likely to win share over time, given its close replication of the smoking experience, and Imperial is currently absent from this category. We do not believe, however, that Imperial faces significant barriers to entry in the category, and it could step into the category if continued growth in heat-not-burn threatens the company's long-term competitive positioning and growth opportunities.

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## Morningstar Analysis

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## Bulls Say/Bears Say

### Bulls Say

- ▶ Although emerging markets account for 60% of Imperial's volumes, they represent just 20% of EBIT. As a result, Imperial has heavy exposure to some of the largest and highest margin profit pools in the world, and can manage most of its business for cash.
- ▶ Imperial is the number-one player in Cuban cigars, and could benefit from the thawing of relations between Cuba and the U.S.
- ▶ If plain packaging legislation spreads, Imperial, through its value portfolio, may be the manufacturer best positioned to benefit.

### Bears Say

- ▶ By not investing in heated tobacco, Imperial risks being left behind in the race to win share in the emerging noncombustible categories.
- ▶ Brand loyalty to Imperial's value brands is weaker than that to British American and particularly to Philip Morris International, which owns Marlboro, the only truly global cigarette brand.
- ▶ We believe price elasticity stays roughly unchanged in the event of steady excise tax hikes, but one-time large tax increases can disrupt volume and elasticity temporarily.

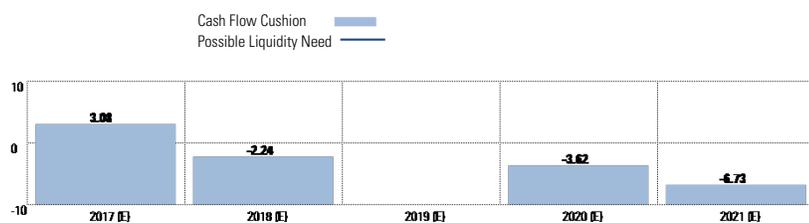
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## Five Year Adjusted Cash Flow Forecast (GBP Mil)

	2017(E)	2018(E)	2019(E)	2020(E)	2021(E)
Cash and Equivalents (beginning of period)	1,274	2,374	2,793	3,226	3,435
Adjusted Available Cash Flow	2,488	1,737	1,279	1,394	1,088
Total Cash Available before Debt Service	3,762	4,111	4,072	4,620	4,524
Principal Payments	—	2,484	871	1,898	1,295
Interest Payments	-1,221	-652	-647	-623	-623
Other Cash Obligations and Commitments	—	—	—	—	—
Total Cash Obligations and Commitments	-1,221	1,832	224	1,275	673

## Cumulative Annual Cash Flow Cushion



## Adjusted Cash Flow Summary

	GBP Millions	% of Commitments
Beginning Cash Balance	1,274	-45.8
Sum of 5-Year Adjusted Free Cash Flow	7,987	-287.1
Sum of Cash and 5-Year Cash Generation	9,261	-332.9
Revolver Availability	—	—
Asset Adjusted Borrowings (Repayment)	-6,548	235.4
Sum of Cash, 5-Year Cash Generation, Revolver and Adjustments	2,713	-97.5
Sum of 5-Year Cash Commitments	2,782	—

## Financial Health

With net debt/EBITDA standing at 3.7 times at the end of fiscal 2016, Imperial is more highly levered than its peers, primarily due to the 2015 acquisitions of U.S. assets from Reynolds American and Lorillard. However, Imperial's presence in developed markets makes it a cash-generating machine, even more so since the U.S. acquisitions. The firm has been operating in recent years on a strongly negative cash conversion cycle, and cash conversion has been up there with the best-in-class performers across the global consumer staples space. We expect cash conversion (defined as operating cash flow divided by operating income) to run close to 100% over our five-year explicit forecast period. This cash flow generation should allow the company to pay down the acquisition debt fairly quickly, and we expect Imperial to return to a more normalised leverage position of 2 times net debt/EBITDA by 2020. Management has guided to dividend growth of 10% in the medium term. We think this is achievable, and we forecast three years of 10% dividend growth. At a payout ratio close to 90%, however, we expect dividend growth to mimic earnings growth, which we forecast in the midsingle digits from 2019 onwards.

## Enterprise Risk

Our uncertainty rating for Imperial Brands is low. Evidence from the recent economic volatility suggests that industry fundamentals--and, therefore, manufacturers' cash flows--remain stable. With pricing power intact, the greatest operational risks, in our view, are plain-packaging legislation and the growth of e-cig categories, in which Imperial does not have a strong presence. Any investor owning tobacco stocks should have the stomach for fat-tail risk. Although the businesses are generally stable, government intervention is an omnipresent threat. Litigation risk is substantially lower for the European players because most countries do not have a class-action legal process. Nevertheless, we regard government and legal risks as low-probability events

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with high potential impact that investors should be aware of. In general, we believe regulation does little to affect the economic moat or the cash flows of tobacco manufacturers, and in some cases, regulation actually limits competition, lowers cost, and strengthens pricing power. Plain packaging is different, though, because we believe that it could facilitate trading down, which would erode pricing power. Australia, where Imperial holds a share of about 20%, has taken the lead on plain packaging, and the British and Irish governments have also introduced plain packs. Although we think Imperial's strong presence in value categories could lead to increased market share in the event of trading down, we would be concerned about the global industry profit pool if plain packaging is introduced in other major markets. The continued emergence of heated tobacco as a major e-cigarette subcategory would present a risk to Imperial insofar as the company currently has no presence in the space. We believe Imperial could enter the market fairly quickly if the category does continue to grow, in a fairly low-risk way. However, it may have to do so at lower margin than its competitors, in order to recapture lost share.

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## Management & Ownership

### Management Activity

Name	Position	Shares Held	Report Date*	InsiderActivity
MS. ALISON JANE COOPER	Chief Executive Officer, Director	248,229	17 Feb 2017	—
MR. MATTHEW ROBERT PHILLIPS	Chief Development Officer, Director	72,437	17 Feb 2017	—
MR. OLIVER TANT	Chief Financial Officer, Director	40,349	15 Dec 2016	—
STEVEN P. STANBROOK	Director	18,059	15 Dec 2016	—
MR. MARK DAVID WILLIAMSON	Chairman, Director	10,190	03 Apr 2017	—
DR. PIERRE JEAN MARIE HENRI JUNGELS CBE	Director	6,012	10 Aug 2011	—
MR. MALCOLM IAN WYMAN	Director	3,984	03 Apr 2017	—

\*Represents the date on which the owner's name, position, and common shares held were reported by the holder or issuer.

### Fund Ownership

Top Owners	% of Shares Held	% of Fund Assets	Change (k)	Portfolio Date
Vanguard Windsor™ II Fund	1.75	1.71	-929	31 Mar 2017
American Beacon Large Cap Value Fund	0.12	0.70	-34	30 Apr 2017
Vanguard VIF Diversified Val	0.08	3.34	—	31 Mar 2017
Glenmede Fund International Portfolio	0.01	1.46	-30	31 Mar 2017
Nuveen Tax Advantaged Total Return Strat	0.01	2.16	7	31 May 2017

#### Concentrated Holders

Forester Discovery Fund	—	3.80	—	31 Mar 2017
Vanguard VIF Diversified Val	0.08	3.34	—	31 Mar 2017
Catalyst/MAP Global Capital Apprec Fd	—	3.32	—	31 Mar 2017
Catalyst/MAP Global Total Return Inc Fd	—	2.76	—	31 Mar 2017
Nuveen Tax Advantaged Total Return Strat	0.01	2.16	7	31 May 2017

### Institutional Transactions

Top 5 Buyers	% of Shares Held	% of Fund Assets	Shares Bought/Sold (k)	Portfolio Date
Parametric Portfolio Associates LLC	0.05	0.03	76	31 Mar 2017
Ferguson Wellman Capital Management, Inc	0.01	0.22	39	31 Mar 2017
Schafer Cullen Capital Management Inc	0.10	0.59	26	31 Mar 2017
Nuveen Fund Advisors, LLC	0.01	0.75	16	31 May 2017
NWQ Investment Management Co LLC	0.02	1.36	10	31 May 2017

#### Top 5 Sellers

Barrow Hanley Mewhinney & Strauss LLC	1.83	1.75	-929	31 Mar 2017
Glenmede Trust Co NA	0.01	0.03	-39	31 Mar 2017
American Beacon Advisors Inc	0.12	0.69	-34	30 Apr 2017
Logan Capital Management Inc	—	0.09	-3	31 Mar 2017
FTB Advisors, Inc	—	0.01	-1	31 Mar 2017

### Management 02 Apr 2017

We believe Imperial Brands' management team have been Standard stewards of shareholder capital. The firm has been fairly acquisitive over the past decade, with mixed results. We believe the less than 9 times enterprise value/EBITDA paid for select U.S. assets of Lorillard and Reynolds American is value-creative and gives Imperial financial flexibility to reposition its acquired brands. The 2007 acquisition of Altadis, on the other hand, appeared rich, at 14 times EBITDA, a valuation at the high end of historical tobacco transactions. Reemtsma, bought in 2002 for 12.7 times EBITDA, was also acquired at an above-historical valuation for the industry, but Tobaccor at 1.5 times sales was a value-enhancing deal. These deals predate Alison Cooper's appointment to the chief executive position in 2010, however, and we are impressed by her focus on cutting costs and repositioning the firm's structure to manage mature markets for cash and developing markets for volume growth.

We suspect that the high gearing on the balance sheet could limit management's ability to be opportunistic in buying back shares. Nevertheless, with a payout ratio at around 65% of this year's earnings, the dividend has headroom to grow, and we expect Imperial to remain in the top quartile of its consumer defensive peer group for returning capital to shareholders.

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Operating deleverage was partly responsible for a 440-basis-point year-over-year decline in the reported operating margin to 21.7%. Even in the absence of a volume recovery, we expect this headwind to ease somewhat throughout the year as Imperial accelerates its cost optimisation program.

Our valuation assumes improvement in volume trends and profitability. While this depends to a large degree on

execution, we still believe Imperial Tobacco possesses competitive advantages that should allow it to make progress on both metrics in emerging markets, where its competition is often from smaller local manufacturers. We think consensus estimates and the market valuation also price in such expectations, however, and we would wait for a more attractive margin of safety before investing.

### Imperial's Preclose Update Indicates Firm Is on Track in 1H; Shares Fairly Valued 02 Apr 2017

Imperial Brand's preclose update shed little light on the company's recent trading performance, but noted that it is in line to meet expectations for the first half of the fiscal year, which closed on March 31. As we forecast revenue growth only slightly below that of consensus, we do not plan to make any adjustments to our estimates or of our GBX 3,900 and \$50 fair value estimates for the ordinary shares and ADRs, respectively. With the rest of the Big Tobacco industry trading above our fair value estimates, Imperial may appear to offer the most compelling valuation, but we believe the shares are fairly valued and would wait for a wider margin of safety before investing. Our wide moat rating also remains intact.

The preclose update contained few details, but stated that foreign exchange would be a 13%-14% tailwind to reported revenue and profit, in line with our estimate. We expect volumes to be down in the mid- to high-single-digit range and price/mix to be flat in the first half. Facing headwinds from the brand migration program, some very weak markets in the Middle East and the loss of a distribution contract, Imperial is likely to continue to undershoot its larger competitors over the last six months. Nevertheless, the acquired U.S. business will be margin accretive, however, with a reported 55% EBIT margin last year. Imperial's GBP 300 million in brand investments, intended to save GBP 300 million per year by 2020, is likely to be skewed to the first half of the year, further weighing on near-term results.

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## Analyst Notes

Plain packs will be compulsory in the United Kingdom by May of this year, and we believe there may be upside to our medium-term estimates of 3% revenue growth if the policy were to spread to other markets. Imperial is the best-positioned player, in our opinion, to benefit from trading down that could occur as a result of the introduction of plain packs.

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## Morningstar Analyst Forecasts

### Financial Summary and Forecasts

Fiscal Year Ends in September

	3-Year Hist. CAGR	Forecast					5-Year Proj. CAGR
		2014	2015	2016	2017	2018	
Growth (% YoY)							
Revenue	-11.2	-34.9	-5.6	13.9	5.7	2.0	3.5
EBIT	-16.3	-47.5	-0.6	12.4	30.4	14.1	9.2
EBITDA	-7.9	-36.0	0.9	20.8	13.3	2.2	3.7
Net Income	-34.8	-36.0	23.3	-64.8	239.4	9.5	32.0
Diluted EPS	-34.3	-34.9	23.9	-64.8	239.4	9.5	32.0
Earnings Before Interest, after Tax	-1.6	-31.4	-7.5	50.2	-18.7	2.8	-2.9
Free Cash Flow	2.3	-25.2	-169.6	-305.5	-6.0	-8.4	-3.8

	3-Year Hist. Avg	Forecast					5-Year Proj. Avg
		2014	2015	2016	2017	2018	
Profitability							
Operating Margin %	27.4	26.6	28.0	27.6	34.0	38.1	35.9
EBITDA Margin %	40.3	37.7	40.3	42.7	45.8	45.9	44.0
Net Margin %	16.1	17.9	23.3	7.2	23.2	24.9	23.8
Free Cash Flow Margin %	19.1	36.0	-26.5	47.8	42.6	38.2	36.6
ROIC %	13.1	13.2	12.6	13.4	15.0	17.2	17.5
Adjusted ROIC %	49.4	61.4	43.6	43.3	64.4	92.4	124.5
Return on Assets %	4.1	4.8	5.8	1.8	6.1	6.8	6.7
Return on Equity %	22.4	24.9	31.4	10.8	35.8	36.8	35.5

	3-Year Hist. Avg	Forecast					5-Year Proj. Avg
		2014	2015	2016	2017	2018	
Leverage							
Debt/Capital	0.70	0.66	0.73	0.72	0.71	0.68	0.67
Total Debt/EBITDA	4.22	3.54	5.04	4.09	3.49	3.22	3.19
EBITDA/Interest Expense	2.23	2.64	2.33	1.72	3.16	6.05	5.58

### Valuation Summary and Forecasts

	2015	2016	2017(E)	2018(E)
Price/Fair Value	1.11	1.03	—	—
Price/Earnings	23.5	66.8	17.6	16.0
EV/EBITDA	15.0	15.2	12.1	11.9
EV/EBIT	21.5	23.6	16.3	14.3
Free Cash Flow Yield %	7.7	7.8	8.7	10.2
Dividend Yield %	3.9	3.6	5.5	5.2

### Key Valuation Drivers

Cost of Equity %	9.0
Pre-Tax Cost of Debt %	5.8
Weighted Average Cost of Capital %	7.7
Long-Run Tax Rate %	25.0
Stage II EBI Growth Rate %	3.0
Stage II Investment Rate %	12.0
Perpetuity Year	20

Additional estimates and scenarios available for download at <http://select.morningstar.com>.

### Discounted Cash Flow Valuation

	GBP Mil	Firm Value (%)	Per Share Value
Present Value Stage I	13,113	26.9	13.71
Present Value Stage II	20,674	42.5	21.61
Present Value Stage III	14,914	30.6	15.59
<b>Total Firm Value</b>	<b>48,701</b>	<b>100.0</b>	<b>50.90</b>
Cash and Equivalents	1,274	—	1.33
Debt	-13,938	—	-14.57
Preferred Stock	—	—	—
Other Adjustments	-613	—	-0.64
<b>Equity Value</b>	<b>35,424</b>	<b>—</b>	<b>37.03</b>
Projected Diluted Shares	957		
<b>Fair Value per Share (USD)</b>	<b>48.00</b>		

The data in the table above represent base-case forecasts in the company's reporting currency as of the beginning of the current year. Our fair value estimate may differ from the equity value per share shown above due to our time value of money adjustment and in cases where probability-weighted scenario analysis is performed.

# Imperial Brands PLC IMBBY (PINX) | ★★★

Last Price	Fair Value	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
46.17 USD	48.00 USD	Low	Wide	Stable	Standard	Tobacco Products

## Morningstar Analyst Forecasts

### Income Statement (GBP Mil)

Fiscal Year Ends in September

	2014	2015	2016	Forecast	
				2017	2018
<b>Revenue</b>	<b>7,411</b>	<b>7,000</b>	<b>7,976</b>	<b>8,432</b>	<b>8,597</b>
Cost of Goods Sold	2,230	1,829	2,020	1,877	1,805
<b>Gross Profit</b>	<b>5,181</b>	<b>5,171</b>	<b>5,956</b>	<b>6,555</b>	<b>6,792</b>
Selling, General & Administrative Expenses	2,335	2,321	2,520	2,659	2,809
Other Operating Expense (Income)	—	—	—	—	—
Income from Equity Investments	49	29	28	34	35
Depreciation & Amortization (if reported separately)	827	862	1,207	992	672
<b>Operating Income (ex charges)</b>	<b>1,970</b>	<b>1,959</b>	<b>2,201</b>	<b>2,870</b>	<b>3,275</b>
Restructuring & Other Cash Charges	—	—	—	—	—
Impairment Charges (if reported separately)	—	—	—	—	—
Other Non-Cash (Income)/Charges	—	—	—	—	—
<b>Operating Income (incl charges)</b>	<b>1,970</b>	<b>1,959</b>	<b>2,201</b>	<b>2,870</b>	<b>3,275</b>
Interest Expense	1,059	1,209	1,984	1,221	652
Interest Income	516	948	634	805	132
<b>Pre-Tax Income</b>	<b>1,427</b>	<b>1,698</b>	<b>851</b>	<b>2,454</b>	<b>2,755</b>
Income Tax Expense	80	33	238	458	570
Other After-Tax Cash Gains (Losses)	—	—	—	—	—
Other After-Tax Non-Cash Gains (Losses)	—	—	—	—	—
(Minority Interest)	-23	-32	-38	-45	-49
(Preferred Dividends)	—	—	—	—	—
<b>Net Income</b>	<b>1,324</b>	<b>1,633</b>	<b>575</b>	<b>1,952</b>	<b>2,136</b>
Weighted Average Diluted Shares Outstanding	960	956	957	957	957
<b>Diluted Earnings Per Share</b>	<b>1.38</b>	<b>1.71</b>	<b>0.60</b>	<b>2.04</b>	<b>2.23</b>
Adjusted Net Income	1,324	1,633	575	1,952	2,136
<b>Diluted Earnings Per Share (Adjusted)</b>	<b>1.38</b>	<b>1.71</b>	<b>0.60</b>	<b>2.04</b>	<b>2.23</b>
Dividends Per Common Share	1.54	1.70	1.87	2.44	2.31
<b>EBITDA</b>	<b>2,797</b>	<b>2,821</b>	<b>3,408</b>	<b>3,862</b>	<b>3,947</b>
<b>Adjusted EBITDA</b>	<b>2,797</b>	<b>2,821</b>	<b>3,408</b>	<b>3,862</b>	<b>3,947</b>

# Imperial Brands PLC IMBBY (PINX) | ★★★

Last Price	Fair Value	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
46.17 USD	48.00 USD	Low	Wide	Stable	Standard	Tobacco Products

## Morningstar Analyst Forecasts

### Balance Sheet (GBP Mil)

Fiscal Year Ends in September

	2014	2015	2016	Forecast	
				2017	2018
Cash and Equivalents	1,413	2,042	1,274	2,374	2,793
Investments	—	—	—	—	—
Accounts Receivable	2,761	2,454	2,671	2,201	2,245
Inventory	2,875	2,842	3,498	3,653	3,557
Deferred Tax Assets (Current)	96	56	45	46	46
Other Short Term Assets	38	74	46	—	—
<b>Current Assets</b>	<b>7,183</b>	<b>7,468</b>	<b>7,534</b>	<b>8,274</b>	<b>8,641</b>
Net Property Plant, and Equipment	1,854	1,768	1,959	1,964	1,995
Goodwill	11,675	11,698	13,631	13,631	13,631
Other Intangibles	3,659	6,992	7,073	6,269	5,769
Deferred Tax Assets (Long-Term)	241	533	631	557	557
Other Long-Term Operating Assets	718	1,077	1,157	105	105
Long-Term Non-Operating Assets	561	598	744	744	744
<b>Total Assets</b>	<b>25,891</b>	<b>30,134</b>	<b>32,729</b>	<b>31,544</b>	<b>31,441</b>
Accounts Payable	6,957	6,795	7,991	7,871	8,041
Short-Term Debt	429	1,957	1,544	2,984	1,371
Deferred Tax Liabilities (Current)	128	167	284	169	169
Other Short-Term Liabilities	221	222	306	273	277
<b>Current Liabilities</b>	<b>7,735</b>	<b>9,141</b>	<b>10,125</b>	<b>11,297</b>	<b>9,858</b>
Long-Term Debt	9,462	12,250	12,394	10,490	11,346
Deferred Tax Liabilities (Long-Term)	1,430	1,170	1,034	946	946
Other Long-Term Operating Liabilities	1,801	1,877	3,434	2,763	2,763
Long-Term Non-Operating Liabilities	—	—	—	—	—
<b>Total Liabilities</b>	<b>20,428</b>	<b>24,438</b>	<b>26,987</b>	<b>25,496</b>	<b>24,913</b>
Preferred Stock	—	—	—	—	—
Common Stock	104	104	104	104	104
Additional Paid-in Capital	5,836	5,836	5,836	5,836	5,836
Retained Earnings (Deficit)	-756	-315	-1,525	-1,387	-966
(Treasury Stock)	—	—	—	—	—
Other Equity	-119	-298	896	1,037	1,037
<b>Shareholder's Equity</b>	<b>5,065</b>	<b>5,327</b>	<b>5,311</b>	<b>5,590</b>	<b>6,011</b>
Minority Interest	398	369	431	459	518
<b>Total Equity</b>	<b>5,463</b>	<b>5,696</b>	<b>5,742</b>	<b>6,049</b>	<b>6,529</b>

# Imperial Brands PLC IMBBY (PINX) | ★★★

Last Price	Fair Value	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
46.17 USD	48.00 USD	Low	Wide	Stable	Standard	Tobacco Products

## Morningstar Analyst Forecasts

### Cash Flow (GBP Mil)

Fiscal Year Ends in September	2014	2015	2016	Forecast	
				2017	2018
Net Income	1,445	1,723	669	1,997	2,185
Depreciation	159	142	163	188	172
Amortization	668	720	1,044	804	500
Stock-Based Compensation	22	25	29	13	13
Impairment of Goodwill	—	—	—	—	—
Impairment of Other Intangibles	92	78	37	—	—
Deferred Taxes	—	—	—	-130	—
Other Non-Cash Adjustments	-5	-293	1,058	—	—
(Increase) Decrease in Accounts Receivable	-29	218	171	470	-43
(Increase) Decrease in Inventory	121	21	-149	-155	96
Change in Other Short-Term Assets	—	—	—	46	—
Increase (Decrease) in Accounts Payable	29	89	116	-120	170
Change in Other Short-Term Liabilities	—	—	—	-33	5
<b>Cash From Operations</b>	<b>2,502</b>	<b>2,723</b>	<b>3,138</b>	<b>3,078</b>	<b>3,098</b>
(Capital Expenditures)	-255	-194	-164	-192	-203
Net (Acquisitions), Asset Sales, and Disposals	-28	-4,603	-25	—	—
Net Sales (Purchases) of Investments	—	—	—	—	—
Other Investing Cash Flows	10	10	7	381	—
<b>Cash From Investing</b>	<b>-273</b>	<b>-4,787</b>	<b>-182</b>	<b>189</b>	<b>-203</b>
Common Stock Issuance (or Repurchase)	-341	—	—	—	—
Common Stock (Dividends)	-1,149	-1,259	-1,386	-1,814	-1,715
Short-Term Debt Issuance (or Retirement)	—	—	—	1,440	-1,613
Long-Term Debt Issuance (or Retirement)	-897	4,340	-1,740	-1,904	856
Other Financing Cash Flows	-229	-355	-805	-30	-3
<b>Cash From Financing</b>	<b>-2,616</b>	<b>2,726</b>	<b>-3,931</b>	<b>-2,308</b>	<b>-2,476</b>
Exchange Rates, Discontinued Ops, etc. (net)	7	-57	188	141	—
<b>Net Change in Cash</b>	<b>-380</b>	<b>605</b>	<b>-787</b>	<b>1,100</b>	<b>419</b>

# Imperial Brands PLC IMBBY (PINX) | ★★★

Last Price	Fair Value	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
46.17 USD	48.00 USD	Low	Wide	Stable	Standard	Tobacco Products

## Comparable Company Analysis

These companies are chosen by the analyst and the data are shown by nearest calendar year in descending market capitalization order.

### Valuation Analysis

Company/Ticker	Price/Fair Value	Price/Earnings			EV/EBITDA			Price/Free Cash Flow			Price/Book			Price/Sales		
		2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)
Philip Morris International Inc PM USA	1.23	20.4	24.0	23.1	14.3	16.5	15.7	20.6	29.3	24.0	NM	NM	NM	5.3	6.6	6.2
Altria Group Inc MO USA	1.26	9.1	22.5	20.8	16.0	15.4	14.9	36.6	25.5	24.2	10.3	11.1	11.1	6.8	7.1	7.0
British American Tobacco PLC BATS	1.09	18.5	21.3	17.5	13.9	13.1	10.9	21.4	14.9	11.3	10.5	9.6	7.6	5.8	5.3	3.7
Reynolds American Inc RAI USA	0.99	32.0	24.6	22.6	15.5	15.4	14.3	74.4	25.7	23.9	3.7	4.2	4.2	6.4	7.1	6.6
Average		20.0	23.1	21.0	14.9	15.1	14.0	38.3	23.9	20.9	8.2	8.3	7.6	6.1	6.5	5.9
<b>Imperial Brands PLC IMBBY US</b>	<b>0.96</b>	<b>66.8</b>	<b>17.6</b>	<b>16.0</b>	<b>15.2</b>	<b>12.1</b>	<b>11.9</b>	<b>12.8</b>	<b>11.5</b>	<b>11.5</b>	<b>7.2</b>	<b>5.9</b>	<b>5.5</b>	<b>4.8</b>	<b>3.9</b>	<b>3.9</b>

### Returns Analysis

Company/Ticker	Last Historical Year Total Assets (Mil)	ROIC %			Adjusted ROIC %			Return on Equity %			Return on Assets %			Dividend Yield %		
		2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)
Philip Morris International Inc PM USA	36,851 USD	42.4	35.7	44.9	69.9	58.2	73.9	-53.7	-64.9	-72.1	19.7	19.9	19.2	4.5	3.6	3.6
Altria Group Inc MO USA	45,932 USD	64.6	48.8	50.1	98.1	74.0	75.8	175.4	52.5	56.2	35.0	14.6	15.7	3.4	3.6	3.8
British American Tobacco PLC BATS	39,773 GBP	25.2	19.7	19.3	44.6	26.7	23.2	71.1	58.9	57.1	13.0	9.4	8.4	3.4	3.5	4.0
Reynolds American Inc RAI USA	51,095 USD	9.0	9.1	9.7	14.0	14.1	15.1	30.4	17.3	18.5	11.6	7.3	7.9	3.0	3.0	3.3
Average		35.3	28.3	31.0	56.7	43.3	47.0	55.8	16.0	14.9	19.8	12.8	12.8	3.6	3.4	3.7
<b>Imperial Brands PLC IMBBY US</b>	<b>32,729 GBP</b>	<b>13.4</b>	<b>15.0</b>	<b>17.2</b>	<b>43.3</b>	<b>64.4</b>	<b>92.4</b>	<b>10.8</b>	<b>35.8</b>	<b>36.8</b>	<b>1.8</b>	<b>6.1</b>	<b>6.8</b>	<b>3.6</b>	<b>5.5</b>	<b>5.2</b>

### Growth Analysis

Company/Ticker	Last Historical Year Revenue (Mil)	Revenue Growth %			EBIT Growth %			EPS Growth %			Free Cash Flow Growth %			Dividend/Share Growth %		
		2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)
Philip Morris International Inc PM USA	26,685 USD	-0.4	4.0	5.3	1.1	7.9	4.9	1.3	8.7	4.1	1.3	-13.5	20.0	1.9	2.4	1.9
Altria Group Inc MO USA	19,337 USD	2.6	4.6	1.9	4.8	10.6	3.4	164.6	-55.3	8.0	-115.1	-782.6	4.7	8.3	12.7	8.0
British American Tobacco PLC BATS	14,751 GBP	12.6	25.8	43.7	18.9	18.0	20.6	8.2	-1.3	21.5	874.9	-372.1	-181.7	5.0	-0.6	15.0
Reynolds American Inc RAI USA	12,503 USD	17.1	5.0	7.2	29.8	12.3	7.3	-11.3	50.5	9.2	-166.7	-40.6	6.7	26.6	12.5	9.2
Average		8.0	9.9	14.5	13.7	12.2	9.1	40.7	0.7	10.7	148.6	-302.2	-37.6	10.5	6.8	8.5
<b>Imperial Brands PLC IMBBY US</b>	<b>7,976 GBP</b>	<b>13.9</b>	<b>5.7</b>	<b>2.0</b>	<b>12.4</b>	<b>30.4</b>	<b>14.1</b>	<b>-64.8</b>	<b>239.4</b>	<b>9.5</b>	<b>-305.5</b>	<b>-6.0</b>	<b>-8.4</b>	<b>10.0</b>	<b>30.9</b>	<b>-5.4</b>

# Imperial Brands PLC IMBBY (PINX) | ★★★

Last Price	Fair Value	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
46.17 USD	48.00 USD	Low	Wide	Stable	Standard	Tobacco Products

## Comparable Company Analysis

These companies are chosen by the analyst and the data are shown by nearest calendar year in descending market capitalization order.

### Profitability Analysis

Company/Ticker	Last Historical Year Net Income (Mil)	Gross Margin %			EBITDA Margin %			Operating Margin %			Net Margin %			Free Cash Flow Margin %		
		2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)
Philip Morris International Inc PM USA	6,948 USD	64.8	65.2	66.0	43.7	45.4	45.3	40.9	42.4	42.3	26.0	27.3	26.7	25.9	22.3	25.9
Altria Group Inc MO USA	14,531 USD	59.9	59.0	59.0	46.4	48.8	49.5	45.3	47.9	48.6	75.2	31.8	33.3	18.6	27.8	28.8
British American Tobacco PLC BATS	4,648 GBP	74.7	74.6	75.3	50.8	47.2	39.6	46.8	43.9	36.8	31.5	29.1	24.6	27.3	35.2	32.4
Reynolds American Inc RAI USA	2,509 USD	61.3	61.0	61.0	47.1	50.9	51.0	46.1	49.3	49.4	20.1	28.6	28.8	8.6	27.5	27.6
Average		65.2	65.0	65.3	47.0	48.1	46.4	44.8	45.9	44.3	38.2	29.2	28.4	20.1	28.2	28.7
<b>Imperial Brands PLC IMBBY US</b>	<b>575 GBP</b>	<b>74.7</b>	<b>77.7</b>	<b>79.0</b>	<b>42.7</b>	<b>45.8</b>	<b>45.9</b>	<b>27.6</b>	<b>34.0</b>	<b>38.1</b>	<b>7.2</b>	<b>23.2</b>	<b>24.9</b>	<b>37.3</b>	<b>34.2</b>	<b>33.7</b>

### Leverage Analysis

Company/Ticker	Last Historical Year Total Debt (Mil)	Debt/Equity %			Debt/Total Cap %			EBITDA/Interest Exp.			Total Debt/EBITDA			Assets/Equity		
		2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)
Philip Morris International Inc PM USA	29,617 USD	-233.4	-297.5	-316.6	175.0	150.6	146.2	10.9	11.5	10.0	2.5	2.5	2.6	-2.9	-3.7	-3.8
Altria Group Inc MO USA	13,881 USD	108.7	107.7	107.4	52.1	51.9	51.8	12.0	11.8	12.3	1.5	1.4	1.4	3.6	3.6	3.6
British American Tobacco PLC BATS	19,495 GBP	238.3	512.2	412.5	70.4	83.7	80.5	11.0	8.8	6.5	2.6	6.0	5.0	4.9	7.4	6.3
Reynolds American Inc RAI USA	13,165 USD	60.6	60.2	59.8	37.8	37.6	37.4	9.4	11.5	12.4	2.2	2.0	1.8	2.4	2.3	2.3
Average		43.6	95.7	65.8	83.8	81.0	79.0	10.8	10.9	10.3	2.2	3.0	2.7	2.0	2.4	2.1
<b>Imperial Brands PLC IMBBY US</b>	<b>13,938 GBP</b>	<b>262.4</b>	<b>241.0</b>	<b>211.6</b>	<b>72.4</b>	<b>70.7</b>	<b>67.9</b>	<b>1.7</b>	<b>3.2</b>	<b>6.1</b>	<b>4.1</b>	<b>3.5</b>	<b>3.2</b>	<b>6.2</b>	<b>5.6</b>	<b>5.2</b>

### Liquidity Analysis

Company/Ticker	Market Cap (Mil)	Cash per Share			Current Ratio			Quick Ratio			Cash/Short-Term Debt			Payout Ratio %		
		2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)	2016	2017(E)	2018(E)
Philip Morris International Inc PM USA	181,842 USD	2.73	4.69	6.39	1.07	1.56	1.39	0.52	0.92	0.88	1.32	7.59	2.20	91.6	86.5	84.6
Altria Group Inc MO USA	143,714 USD	2.33	2.35	2.38	0.98	1.00	1.01	0.71	0.70	0.70	—	—	—	33.6	76.5	75.8
British American Tobacco PLC BATS	97,604 GBP	1.18	8.67	11.17	1.04	2.35	2.30	0.55	1.81	1.85	0.73	6.67	7.12	62.6	63.0	59.6
Reynolds American Inc RAI USA	92,732 USD	1.43	1.44	1.46	0.85	0.87	0.89	0.52	0.52	0.52	4.09	4.09	4.09	41.4	75.0	75.0
Average		1.92	4.29	5.35	0.99	1.45	1.40	0.58	0.99	0.99	2.05	6.12	4.47	57.3	75.3	73.8
<b>Imperial Brands PLC IMBBY US</b>	<b>42,978 USD</b>	<b>1.33</b>	<b>2.48</b>	<b>2.92</b>	<b>0.74</b>	<b>0.73</b>	<b>0.88</b>	<b>0.40</b>	<b>0.41</b>	<b>0.52</b>	<b>0.83</b>	<b>0.80</b>	<b>2.04</b>	<b>241.0</b>	<b>92.9</b>	<b>80.3</b>

# Research Methodology for Valuing Companies

## Overview

At the heart of our valuation system is a detailed projection of a company's future cash flows, resulting from our analysts' research. Analysts create custom industry and company assumptions to feed income statement, balance sheet, and capital investment assumptions into our globally standardized, proprietary discounted cash flow, or DCF, modeling templates. We use scenario analysis, in-depth competitive advantage analysis, and a variety of other analytical tools to augment this process. Moreover, we think analyzing valuation through discounted cash flows presents a better lens for viewing cyclical companies, high-growth firms, businesses with finite lives (e.g., mines), or companies expected to generate negative earnings over the next few years. That said, we don't dismiss multiples altogether but rather use them as supporting cross-checks for our DCF-based fair value estimates. We also acknowledge that DCF models offer their own challenges (including a potential proliferation of estimated inputs and the possibility that the method may miss short-term market-price movements), but we believe these negatives are mitigated by deep analysis and our long-term approach.

Morningstar's equity research group ("we", "our") believes that a company's intrinsic worth results from the future cash flows it can generate. The Morningstar Rating for stocks identifies stocks trading at a discount or premium to their intrinsic worth—or fair value estimate, in Morningstar terminology. Five-star stocks sell for the biggest risk-adjusted discount to their fair values, whereas 1-star stocks trade at premiums to their intrinsic worth.

Four key components drive the Morningstar rating: (1) our assessment of the firm's economic moat, (2) our estimate of the stock's fair value, (3) our uncertainty around that fair value estimate

and (4) the current market price. This process ultimately culminates in our single-point star rating.

## 1. Economic Moat

The concept of an economic moat plays a vital role not only in our qualitative assessment of a firm's long-term investment potential, but also in the actual calculation of our fair value estimates. An economic moat is a structural feature that allows a firm to sustain excess profits over a long period of time. We define economic profits as returns on invested capital (or ROIC) over and above our estimate of a firm's cost of capital, or weighted average cost of capital (or WACC). Without a moat, profits are more susceptible to competition. We have identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

Companies with a narrow moat are those we believe are more likely than not to achieve normalized excess returns for at least the next 10 years. Wide-moat companies are those in which we have very high confidence that excess returns will remain for 10 years, with excess returns more likely than not to remain for at least 20 years. The longer a firm generates economic profits, the higher its intrinsic value. We believe low-quality, no-moat companies will see their normalized returns gravitate toward the firm's cost of capital more quickly than companies with moats.

To assess the sustainability of excess profits, analysts perform ongoing assessments of the moat trend. A firm's moat trend is positive in cases where we think its sources of competitive advantage are growing stronger; stable where we don't anticipate changes to competitive advantages over the next several years; or negative when we see signs of deterioration.

## 2. Estimated Fair Value

Combining our analysts' financial forecasts with the firm's economic moat helps us assess how long returns on invested capital are likely to exceed the firm's cost of

capital. Returns of firms with a wide economic moat rating are assumed to fade to the perpetuity period over a longer period of time than the returns of narrow-moat firms, and both will fade slower than no-moat firms, increasing our estimate of their intrinsic value.

Our model is divided into three distinct stages:

### Stage I: Explicit Forecast

In this stage, which can last five to 10 years, analysts make full financial statement forecasts, including items such as revenue, profit margins, tax rates, changes in working-capital accounts, and capital spending. Based on these projections, we calculate earnings before interest, after taxes (EBI) and the net new investment (NNI) to derive our annual free cash flow forecast.

### Stage II: Fade

The second stage of our model is the period it will take the company's return on new invested capital—the return on capital of the next dollar invested ("RONIC")—to decline (or rise) to its cost of capital. During the Stage II period, we use a formula to approximate cash flows in lieu of explicitly modeling the income statement, balance sheet, and cash flow statement as we do in Stage I. The length of the second stage depends on the strength of the company's economic moat. We forecast this period to last anywhere from one year (for companies with no economic moat) to 10–15 years or more (for wide-moat companies). During this period, cash flows are forecast using four assumptions: an average growth rate for EBI over the period, a normalized investment rate, average return on new invested capital (RONIC), and the number of years until perpetuity, when excess returns cease. The investment rate and return on new invested capital decline until a perpetuity value is calculated. In the case of firms that do not earn their cost of capital, we assume marginal ROICs rise to the firm's cost of capital (usually attributable to less reinvestment), and we may truncate the second stage.

### Stage III: Perpetuity

Once a company's marginal ROIC hits its cost of capital, we calculate a continuing value, using a standard perpetuity formula. At perpetuity, we assume that any growth or decline or investment in the business neither creates nor destroys value and that any new investment provides a return in line with estimated WACC.

Because a dollar earned today is worth more than a dollar earned tomorrow, we discount our projections of cash flows in stages I, II, and III to arrive at a total pres-

## Morningstar Research Methodology for Valuing Companies



# Research Methodology for Valuing Companies

ent value of expected future cash flows. Because we are modeling free cash flow to the firm—representing cash available to provide a return to all capital providers—we discount future cash flows using the WACC, which is a weighted average of the costs of equity, debt, and preferred stock (and any other funding sources), using expected future proportionate long-term, market-value weights.

### 3. Uncertainty around that fair value estimate

Morningstar’s Uncertainty Rating captures a range of likely potential intrinsic values for a company and uses it to assign the margin of safety required before investing, which in turn explicitly drives our stock star rating system. The Uncertainty Rating represents the analysts’ ability to bound the estimated value of the shares in a company around the Fair Value Estimate, based on the characteristics of the business underlying the stock, including operating and financial leverage, sales sensitivity to the overall economy, product concentration, pricing power, and other company-specific factors.

Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case, and a 25% probability that the company will perform worse than the bear case. The distance between the bull and bear cases is an important indicator of the uncertainty underlying the fair value estimate.

Our recommended margin of safety widens as our uncertainty of the estimated value of the equity increases. The more uncertain we are about the estimated value of the equity, the greater the discount we require relative to our estimate of the value of the firm before we would recommend the purchase of the shares. In addition, the uncertainty rating provides guidance in portfolio construction based on risk tolerance.

Our uncertainty ratings for our qualitative analysis are low, medium, high, very high, and extreme.

► **Low:** margin of safety for 5-star rating is a 20% discount and for 1-star rating is 25% premium.

- **Medium:** margin of safety for 5-star rating is a 30% discount and for 1-star rating is 35% premium.
- **High:** margin of safety for 5-star rating is a 40% discount and for 1-star rating is 55% premium.
- **Very High:** margin of safety for 5-star rating is a 50% discount and for 1-star rating is 75% premium.
- **Extreme:** Stock’s uncertainty exceeds the parameters we have set for assigning the appropriate margin of safety.

### 4. Market Price

The market prices used in this analysis and noted in the report come from exchange on which the stock is listed which we believe is a reliable source.

For more detail information about our methodology, please go to <http://global.morningstar.com/equitydisclosures>

### Morningstar Star Rating for Stocks

Once we determine the fair value estimate of a stock, we compare it with the stock’s current market price on a daily basis, and the star rating is automatically recalculated at the market close on every day the market on which the stock is listed is open. Our analysts keep close tabs on the companies they follow, and, based on thorough and ongoing analysis, raise or lower their fair value estimates as warranted.

Please note, there is no predefined distribution of stars. That is, the percentage of stocks that earn 5 stars can fluctuate daily, so the star ratings, in the aggregate, can serve as a gauge of the broader market’s valuation. When there are many 5-star stocks, the stock market as

a whole is more undervalued, in our opinion, than when very few companies garner our highest rating.

We expect that if our base-case assumptions are true the market price will converge on our fair value estimate over time, generally within three years (although it is impossible to predict the exact time frame in which market prices may adjust).

Our star ratings are guideposts to a broad audience and individuals must consider their own specific investment goals, risk tolerance, tax situation, time horizon, income needs, and complete investment portfolio, among other factors.

The Morningstar Star Ratings for stocks are defined below:

### Five Stars ★★★★★

We believe appreciation beyond a fair risk-adjusted return is highly likely over a multiyear time frame. Scenario analysis developed by our analysts indicates that the current market price represents an excessively pessimistic outlook, limiting downside risk and maximizing upside potential.

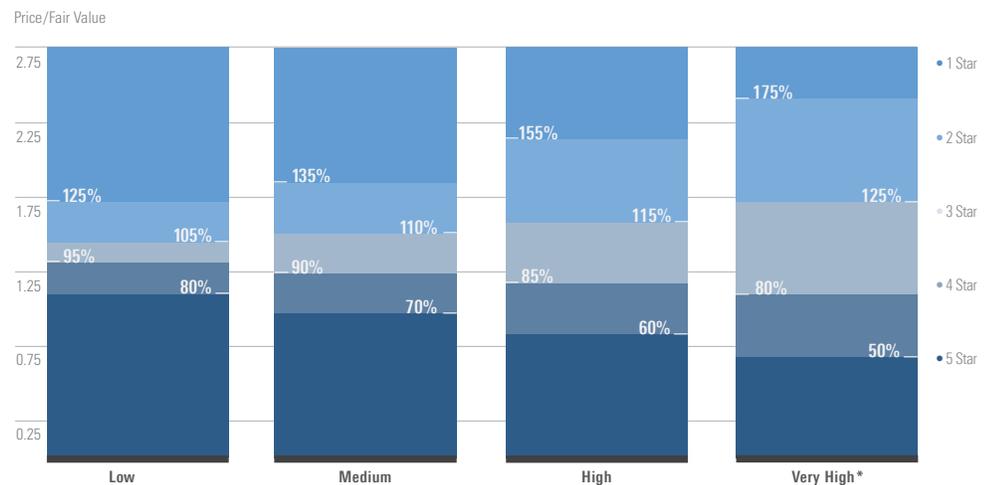
### Four Stars ★★★★

We believe appreciation beyond a fair risk-adjusted return is likely.

### Three Stars ★★★

Indicates our belief that investors are likely to receive a fair risk-adjusted return (approximately cost of equity).

## Morningstar Research Methodology for Valuing Companies



\* Occasionally a stock’s uncertainty will be too high for us to estimate, in which case we label it Extreme.

# Research Methodology for Valuing Companies

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## Two Stars ★★

We believe investors are likely to receive a less than fair risk-adjusted return.

## One Star ★

Indicates a high probability of undesirable risk-adjusted returns from the current market price over a multiyear time frame, based on our analysis. Scenario analysis by our analysts indicates that the market is pricing in an excessively optimistic outlook, limiting upside potential and leaving the investor exposed to Capital loss.

Other Definitions:

**Last Price:** Price of the stock as of the close of the market of the last trading day before date of the report.

**Stewardship Rating:** Represents our assessment of management's stewardship of shareholder capital, with particular emphasis on capital allocation decisions. Analysts consider companies' investment strategy and valuation, financial leverage, dividend and share buyback policies, execution, compensation, related party transactions, and accounting practices. Corporate governance practices are only considered if they've had a demonstrated impact on shareholder value. Analysts assign one of three ratings: "Exemplary," "Standard," and "Poor." Analysts judge stewardship from an equity holder's perspective. Ratings are determined on an absolute basis. Most companies will receive a Standard rating, and this is the default rating in the absence of evidence that managers have made exceptionally strong or poor capital allocation decisions.

**Quantitative Valuation:** Using the below terms, intended to denote the relationship between the security's Last Price and Morningstar's quantitative fair value estimate for that security.

- ▶ **Undervalued:** Last Price is below Morningstar's quantitative fair value estimate.
- ▶ **Fairly Valued:** Last Price is in line with Morningstar's quantitative fair value estimate.
- ▶ **Overvalued:** Last Price is above Morningstar's quantitative fair value estimate.

## Risk Warning

Please note that investments in securities are subject to market and other risks and there is no assurance or guarantee that the intended investment objectives will be achieved. Past performance of a security may or may not be sustained in future and is no indication of future performance. A security investment return and an investor's principal value will fluctuate so that, when redeemed, an investor's shares may be worth more or less than their original cost. A security's current investment performance may be lower or higher than the investment performance noted within the report. Morningstar's Uncertainty Rating serves as a useful data point with respect to sensitivity analysis of the assumptions used in our determining a fair value price.

# Imperial Brands PLC IMBBY (PINX) | ★★★

Last Price	Fair Value	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
46.17 USD	48.00 USD	Low	Wide	Stable	Standard	Tobacco Products



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# Imperial Brands PLC IMBBY (PINX) | ★★★

Last Price	Fair Value	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
46.17 USD	48.00 USD	Low	Wide	Stable	Standard	Tobacco Products

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