Imperial Tobacco Group PLC ITYBY (PINX) | ★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
102.09 USD	92.00 USD	73.60 USD	115.00 USD	Low	Wide	Stable	Standard	Tobacco Products

Imperial Holds Its Own in 1H15; Attention Now Turns to U.S. Regulatory Developments

See Page 2 for the full Analyst Note from 06 May 2015

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

Research as of 06 May 2015
Estimates as of 06 May 2015
Pricing data through 20 May 2015
Rating updated as of 20 May 2015

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

Contents

Investment Thesis 06 May 2015

Under CEO Alison Cooper, Imperial Tobacco is slowly transforming from an also-ran--albeit a highly profitable one--to a significant player and potential consolidator in the global tobacco industry. But despite recent value-creating acquisitions in the United States, we think there is more work to do, and of the three wide-moat European cigarette manufacturers we cover, we prefer the competitive positioning of Philip Morris International and British American Tobacco due to their superior scale.

We attribute a portion of Imperial's lower returns on invested capital (averaging almost 17% over the past five years, lower than peers) to the firm's capital-intensive logistics business, which is a drag on ROIC and masks the highly profitable tobacco business, with margins in line with those of its larger competitors. Therefore we approved when last year the firm announced that it was to partially sell Logista through an initial public offering. We would prefer to see a full disposal because we see little strategic or financial benefit from owning distribution assets in the tobacco industry.

Imperial's margins are driven by its footprint in superpremium categories, and it remains at a cost disadvantage to its larger rivals. Imperial's operating costs per pack were GBP 0.37 in fiscal 2014, above the GBP 0.27 of Philip Morris and GBP 0.28 of British American. About 40% of total operating costs in cigarette manufacturing are fixed, so scale delivers operating leverage and lowers average cost and creates a cost advantage through procurement pricing power. Although a clear number four (excluding China) in terms of cost advantages, its overlap with its larger competitors is essentially restricted to the European Union, Ukraine, and Australia. In developing markets (about 60% of volume), the firm competes with local players and holds a clear cost advantage through its superior scale.

Given that Imperial is at a structural disadvantage to its bigger rivals, we think a valuation discount to Philip Morris and British American is appropriate. However, the firm has strong competitive advantages, and we recommend owning the stock when that multiple gap grows too wide.

Vital Statistics

Market Cap (USD Mil)	48,855
52-Week High (USD)	102.82
52-Week Low (USD)	80.07
52-Week Total Return %	18.2
YTD Total Return %	19.9
Last Fiscal Year End	30 Sep 2014
5-Yr Forward Revenue CAGR %	3.9
5-Yr Forward EPS CAGR %	11.0
Price/Fair Value	1.11

Valuation Summary and Forecasts

Fiscal Year:	2013	2014	2015(E)	2016(E)
Price/Earnings	25.4	19.2	*14.5*	*15.2*
EV/EBITDA	12.4	11.8	*13.6*	*12.7*
EV/EBIT	16.0	16.5	*17.4*	*14.9*
Free Cash Flow Yield %	9.4	9.0	*9.0*	*4.6*
Dividend Yield %	4.8	4.5	*4.0*	*4.4*

Financial Summary and Forecasts (GBP Mil)

Fiscal Year:	2013	2014	2015(E)	2016(E)
Revenue	7,857	7,424	*7,959*	*8,362*
Revenue YoY %	-0.3	-5.5	*7.2*	*5.1*
EBIT	1,958	2,064	*2,357*	*2,758*
EBIT YoY %	29.0	5.4	*14.2*	*17.0*
Net Income, Adjusted	937	1,422	*2,215*	*2,114*
Net Income YoY %	38.2	51.8	*55.8*	*-4.6*
Diluted EPS	2.92	4.51	*7.05*	*6.73*
Diluted EPS YoY %	41.3	54.4	*56.5*	*-4.6*
Free Cash Flow	2,579	2,807	*-400*	*1,762*
Free Cash Flow YoY %	24.5	8.8	*-114.2*	*-541.0*

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

Profile

Imperial Tobacco is the world's fourth-largest international tobacco company (excluding China National Tobacco) with total 2014 volume of 294 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. Through its acquisition of Altadis, the firm has a logistics platform in Western Europe.

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Morningstar Analysis

Imperial Holds Its Own in 1H15; Attention Now Turns to U.S. Regulatory Developments 06 May 2015

Imperial Tobacco's first-half results put the firm on track to meet our forecasts for full-year underlying performance. We are raising our fair value estimates to GBX 3,000 from 2,900 for the ordinary shares and to $92 from $90 for the ADRs to account for the time value of money since our last update. These results demonstrate that Imperial is holding its own against larger competitors British American Tobacco and Philip Morris International and support our belief that Imperial is a strong business with sustainable competitive advantages. Our wide economic moat and stable moat trend ratings remain in place.

Reported revenue fell 4%, slightly below our forecast and a sequential deceleration after an above-par first quarter. Foreign exchange had a negative 7% impact on revenue, a headwind that could continue in the second half of the year as a result of the recent strengthening of the British pound against several currencies. Volume declined 3% excluding Iraq and after adjusting for the effects of last year's stock optimization program, a slightly slower rate than the industry, and modestly better than the 3.6% decline reported by British American in the same period. Including Iraq, however, volumes declined 5%.

With the business chugging along as expected, investors' attention is likely to switch to Imperial's pending acquisitions of cigarette brands from Reynolds American and blu e-cigarettes from Lorillard. We believe the firm has entered into the deals at a value-creating price, which will be accretive to returns on invested capital immediately upon closure. Although we generally regard the deal favorably, we have concerns that the lack of pricing power of the acquired brands could create some unattractive strategic alternatives: Expand the brand by cutting prices and margins, or maximize cash generation with volume continuing to underperform in a declining industry.

Valuation, Growth and Profitability 06 May 2015

Following Imperial's half-year update, we are raising our fair value estimate to $92 from $90 to account for the time value of money. Our new valuation assumes a sterling/U.S. dollar exchange rate of 1.52, the spot rate on May 6, and implies fiscal 2015 multiples of 13.4 times earnings, 12.3 times enterprise value/adjusted EBITDA, and a 2015 dividend yield of 5.1%. These implied multiples represent a lower fair value estimate 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. Still, we think the recent brand acquisitions at around 7 times EBITDA are accretive to the firm's intrinsic value.

Our valuation is based on three key drivers: volume, pricing, and margins. We assume revenue growth of almost 8% in fiscal 2015, boosted by a full half year of the U.S. acquisitions, and implying low single-digit organic growth. Longer term, we forecast a growth rate of 2.4%, below that of Philip Morris and British American due to weaker pricing power. Driving our revenue assumptions are mid- to high-single-digit volume declines in mature markets, fading to 3% declines in the long term, and pricing marginally in excess of volume declines in all three reporting segments. We expect pricing in return markets to exceed that in the growth markets in the long term.

We believe there could be upside to the gross margin after the expansion in the U.S., and we assume a long-term gross margin of just over 71%, modestly above that achieved in fiscal 2014. Further margin opportunity exists through the improvement of operating efficiency, though, and we forecast Imperial's EBIT margin to grow a further 730 basis points by 2019 to 35.1% as a result of its greater presence in the high-margin U.S. market, its cost-saving program, and more efficient operations as a result of lowering trade inventories. This would represent a peak margin, but we

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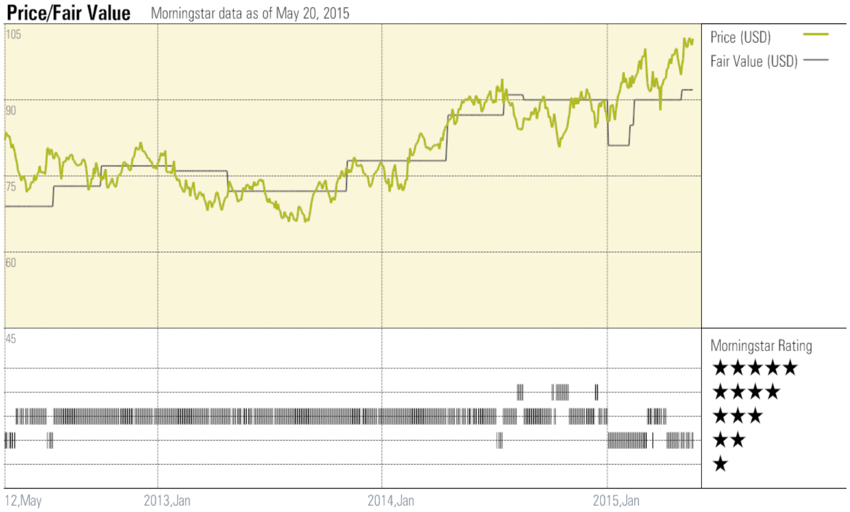
Price/Fair Value Morningstar data as of May 20, 2015



think it is achievable given the return of pricing power and management's focus on cost savings.

We think mid- to high-single-digit EPS growth is achievable from fiscal 2016 onward after the U.S. assets have been consolidated, driven by margin expansion and share repurchases.

Scenario Analysis

The two major valuation drivers that we vary in our scenario analysis are pricing and cost efficiencies. In our bull-case scenario, we assume that Imperial takes more pricing than in our base case. Between fiscal 2015 and 2017, we assume 4.3% average annual organic (ex-U.S. acquisitions) revenue growth (above the 2.8% revenue CAGR in our base case) and 4.0% growth in our final forecast year in 2018 (versus 2.5% in our base case). These top-line assumptions would represent an acceleration in revenue growth from current levels, but are similar to our broader industry assumptions. We also make more aggressive assumptions on fixed operating costs. We assume that from 2015, Imperial generates an incremental 75 basis points of margin expansion from manufacturing efficiencies, including head count reduction and production consolidation. This implies an average operating margin of 36.7% over our five-year forecast period and 37.0% in the long term. Although these margins are still around 200 basis points below our base-case assumptions for Philip Morris International, Imperial's logistics business is a drag that is likely to prevent Imperial from generating similar levels of profitability. We think exceeding historical peak margins is possible in the event of stronger pricing power and significant reductions in fixed costs. Our bull case yields a hypothetical valuation of $117 per ADR, or 27% above our fair value estimate and 15.3 times our bull-case 2015.

In our bear case, we damp our growth and cost assumptions. We assume 0.3% annualized organic revenue declines between 2015 and 2018. This is below the 2.0% base-case assumption and implies that our thesis that pricing power is improving in Europe does not play out. We also assume some margin headwinds. If competition intensifies in the European Union over innovation (particularly in relation to e-cigs), research and development expense could reach historical highs. In our bear case, we assume that higher research and development as well as marketing expenses weigh on the operating margin, which falls to an average of 37.6% throughout the first four years of our forecast period and normalizes at 38.1%. This is essentially in line with British American's profitability and behind that of Philip Morris International. This scenario yields a valuation of $80, 13% below our fair value estimate and 11.3 times our 2015 bear-case EPS estimate of GBX 213.

Economic Moat

Strong intangible assets at the premium end of its portfolio are at the core of Imperial Tobacco's wide economic moat. In addition, the company's platform of total 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 compete with. Finally, the addictive nature of tobacco products makes demand fairly

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price inelastic, and with few substitute products outside the portfolios of the Big Tobacco firms, a favorable 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 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 roughly 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 17% on average over the past five years, and we forecast returns to remain in the mid- to high teens over the next five, comfortably ahead of our 8% estimate of the firm's weighted average cost of capital.

Moat Trend

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 favorite brand. This is likely to damp competitive pricing strategies.

We are more concerned about the impact of plain packaging on moats. Early evidence from Australia suggests that industry volume has not been affected, with a low- to mid-single digit volume decline in 2014, in line with other developed markets. However, 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 favorable to Imperial Tobacco, whose portfolio includes some strong value brands such as JPS. 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.

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Morningstar Analysis

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Bulls Say/Bears Say

Bulls Say

- With a product portfolio concentrated at both high and low price points, Imperial is well positioned to exploit the emerging trends of trading up in developing regions and trading down in some of its more mature markets.
- We believe Imperial is making brand acquisitions in the U.S. that give it the financial flexibility to reposition the brands and attempt to gain market share.
- If plain packaging legislation spreads, Imperial, through its value portfolio, may be the manufacturer best positioned to benefit.

Bears Say

- With 25% of revenue and 60% of EBIT generated in the EU in 2014, Imperial has significant exposure to mature markets, many of which are experiencing meaningful volume declines amid recessionary pressures.
- 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.

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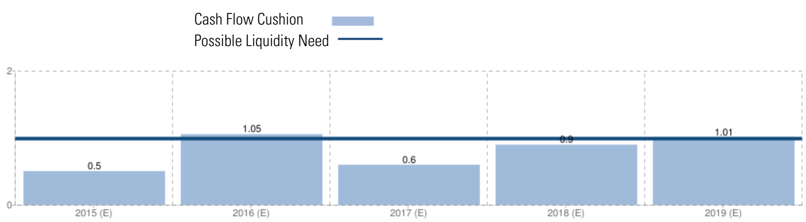
Five Year Adjusted Cash Flow Forecast (GBP Mil)

	2015(E)	2016(E)	2017(E)	2018(E)	2019(E)
Cash and Equivalents (beginning of period)	1,431	178	669	120	431
Adjusted Available Cash Flow	-833	500	791	1,178	1,204
Total Cash Available before Debt Service	598	677	1,460	1,297	1,634
Principal Payments	—	—	-1,789	-773	-947
Interest Payments	-1,192	-643	-654	-674	-672
Other Cash Obligations and Commitments	—	—	—	—	—
Total Cash Obligations and Commitments	-1,192	-643	-2,443	-1,447	-1,619

Cumulative Annual Cash Flow Cushion



Adjusted Cash Flow Summary

	GBP Millions	% of Commitments
Beginning Cash Balance	1,431	19.5
Sum of 5-Year Adjusted Free Cash Flow	2,839	38.7
Sum of Cash and 5-Year Cash Generation	4,270	58.2
Revolver Availability	—	—
Asset Adjusted Borrowings (Repayment)	—	—
Sum of Cash, 5-Year Cash Generation, Revolver and Adjustments	4,270	58.2
Sum of 5-Year Cash Commitments	-7,344	—

Financial Health

Imperial Tobacco has a significantly more geared capital structure than its rivals, but from a cash flow perspective it is in solid financial shape. With GBP 10 billion in debt on its balance sheet and a net debt/adjusted EBITDA ratio of 2.9 times, Imperial has around double the leverage of its rivals British American and Philip Morris (at 1.7 times and 1.9 times, respectively). This is primarily as a result of the GBP 9 billion in debt incurred when acquiring Altadis in 2007. EBITDA covers interest expense by 2.5 times (well below the low-teen coverage ratios of its competitors) and this does not leave much financial flexibility. Nevertheless, management was focused on debt reduction in 2014 ahead of the planned US acquisitions, which we believe will increase net debt/adjusted EBITDA to over 4 times by 2016. Debt maturities are quite well laddered, though, and higher interest rate notes mature before the lower rate debt, so we expect the current debt load to be manageable, absent a deterioration in industry fundamentals. In fact, we forecast the EBITDA/interest expense coverage ratio to rise to 3.9 times over our explicit forecast period, from 2.5 times in 2014, with net debt/adjusted EBITDA rising to 3.7 times.

Imperial's limited financial flexibility could put the company at a competitive disadvantage to its rivals in the market for small strategic acquisitions. We think British American Tobacco and Philip Morris International could much more comfortably absorb bolt-on deals that will help generate further economies of scale. Strategic targets remain in the Southern Europe and North Africa region, and we regard Imperial to be a much less likely acquirer until it reduces the gearing in its balance sheet.

From a cash flow standpoint, the firm is in healthier shape. Its conversion of sales to free cash flow at just over 30% is not only at the high end of the consumer defensive sector, but also leads the international tobacco industry, thanks to its efficient use of working capital. With a dividend payout

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ratio in the mid-60s (excluding extraordinary items), Imperial is roughly in line with its European competitors but below the 75%-80% payout ratio targeted by its U.S. counterparts. In the long term and as developing markets mature, we expect significant growth in the company's dividend.

Enterprise Risk

Our uncertainty rating for Imperial 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 foreign exchange. 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 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 government has put forward legislation to introduce plain packs, while in Ireland, such legislation has already been approved. 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.Imperial's reporting currency is sterling, but Britain represents just 6% of revenue and 19% of EBIT. The firm is also exposed to currencies that cannot be hedged in large quantities. Britain is not a major supplier of raw tobacco, so very little of the company's input costs are denominated in sterling, meaning it is highly exposed to an appreciation of the British pound.

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Management & Ownership

Management Activity

Name	Position	Shares Held	Report Date*	InsiderActivity
MS. ALISON JANE COOPER	Chief Executive Officer,Director	168,858	18 Dec 2014	—
MR. MATTHEW ROBERT PHILLIPS	Corporate Affairs Director,Director	43,870	18 Dec 2014	—
MR. MARK D WILLIAMSON	Chairman,Director	8,241	15 Dec 2014	—
DR PIERRE JEAN MARIE HENRI JUNGELS CBE	Director	6,012	10 Aug 2011	—
MR. MICHAEL HUGH CREEDON HERLIHY	Director	4,758	04 Mar 2015	—
MR. MALCOLM IAN WYMAN	Director	3,581	04 Mar 2015	—

*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	1.83	1.54	—	31 Mar 2015
American Beacon Large Cap Value Fund	0.19	0.68	—	31 Mar 2015
Vanguard VIF Diversified Val	0.07	2.57	—	31 Mar 2015
Foreign & Colonial Investment Trust	0.01	0.10	—	31 Dec 2014
Nuveen Tax Advantaged Total Return Strat	0.01	1.50	31	31 Jan 2015
Concentrated Holders				
Forester Discovery Fund	—	3.35	—	31 Mar 2015
Vanguard VIF Diversified Val	0.07	2.57	—	31 Mar 2015
Catalyst/MAP Global Total Return Inc Fd	—	1.84	—	31 Dec 2014
MSSPR- International Portfolio I	—	1.78	2	30 Jun 2014
Vanguard Windsor™ II Fund	1.83	1.54	—	31 Mar 2015

Institutional Transactions

Top 5 Buyers	% of Shares Held	% of Fund Assets	Shares Bought/ Sold (k)	Portfolio Date
Schafer Cullen Capital Management Inc	0.29	1.21	567	31 Mar 2015
Nuveen Fund Advisors, LLC.	0.01	0.89	33	31 Jan 2015
MFS Investment Management	—	0.20	22	31 Mar 2015
Bricklayers & Trowel Trades International Pension Fund	—	0.07	14	31 Dec 2008
Parametric Portfolio Associates LLC	0.02	0.02	11	31 Dec 2014
Top 5 Sellers				
Barrow, Hanley, Mewhinney & Strauss LLC.	2.27	1.30	-75	31 Mar 2015
Philadelphia Contributionship Ins Houses	—	0.19	-2	31 Dec 2014
NORCAL Mutual Insurance Company	—	0.03	-2	31 Dec 2014
World Asset Management Inc	0.01	0.07	0	31 Mar 2015
MFS	—	0.20	0	31 Mar 2015

Management 23 Mar 2015

We believe Imperial Tobacco's management team has been standard stewards of shareholder capital. The firm has been fairly acquisitive over the past decade, often at generous valuations. The 2007 acquisition of Altadis was rich, in our opinion. At 14 times EBITDA, the deal was at the high end of historical tobacco transactions and saddled the firm with an additional GBP 9 billion in debt that still leaves Imperial hamstrung in the market for acquisitions. 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 also believe the less than 9 times EV/EBITDA paid for select U.S. assets of Lorillard and Reynolds American is modestly value-creative, and gives Imperial financial flexibility to reposition its acquired brands.

Although Imperial has lowered its share count before the stock rerated during the economic recovery, we suspect that the high gearing on the balance sheet could limit management's ability to be opportunistic in buying back shares. This is a legacy of the former senior management, but we believe it could lead to Imperial's continued underperformance of its tobacco rivals. Nevertheless, with a payout ratio north of 60%, we expect Imperial to remain in the top quartile of its consumer defensive peer group for returning capital to shareholders.

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Imperial Tobacco Group PLC ITYBY (PINX) | ★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
102.09 USD	92.00 USD	73.60 USD	115.00 USD	Low	Wide	Stable	Standard	Tobacco Products

Analyst Notes

Imperial Holds Its Own in 1H15; Attention Now Turns to U.S. Regulatory Developments 06 May 2015

Imperial Tobacco's first-half results put the firm on track to meet our forecasts for full-year underlying performance. We are raising our fair value estimates to GBX 3,000 from 2,900 for the ordinary shares and to $92 from $90 for the ADRs to account for the time value of money since our last update. These results demonstrate that Imperial is holding its own against larger competitors British American Tobacco and Philip Morris International and support our belief that Imperial is a strong business with sustainable competitive advantages. Our wide economic moat and stable moat trend ratings remain in place.

Reported revenue fell 4%, slightly below our forecast and a sequential deceleration after an above-par first quarter. Foreign exchange had a negative 7% impact on revenue, a headwind that could continue in the second half of the year as a result of the recent strengthening of the British pound against several currencies. Volume declined 3% excluding Iraq and after adjusting for the effects of last year's stock optimization program, a slightly slower rate than the industry, and modestly better than the 3.6% decline reported by British American in the same period. Including Iraq, however, volumes declined 5%.

With the business chugging along as expected, investors' attention is likely to switch to Imperial's pending acquisitions of cigarette brands from Reynolds American and blu e-cigarettes from Lorillard. We believe the firm has entered into the deals at a value-creating price, which will be accretive to returns on invested capital immediately upon closure. Although we generally regard the deal favorably, we have concerns that the lack of pricing power of the acquired brands could create some unattractive strategic alternatives: Expand the brand by cutting prices and margins, or maximize cash generation with volume continuing to underperform in a declining industry.

We Expect U.S. Tobacco Transactions to be Permitted With Further Divestitures 07 Apr 2015

Amid conflicting reports in the media on whether regulatory approval will be granted for the proposed U.S. tobacco transactions involving Lorillard, Reynolds American and Imperial Tobacco, we are reiterating our view that the deals will be permitted, but that further divestitures by Reynolds may be necessary. If the deals close, they will transform the competitive landscape of the U.S. tobacco industry, enhancing the wide economic moat of Imperial Tobacco, and giving narrow-moat Reynolds American a stronger brand portfolio. We expect a decision by regulators by the end of June.

In July 2014, Reynolds American announced that it was to acquire Lorillard for $27 billion. As part of the deal, Reynolds intends to sell the Kool, Salem, Winston and Maverick (currently owned by Lorillard) cigarette brands, as well as the Blu eCig brand to Imperial Tobacco for $7 billion. As proposed, Imperial's market share in the United States will rise from 3% to 10%, while Reynolds' will rise from 27% to around 36%. We estimate that the deal will increase the concentration of the U.S. tobacco industry as measured by the Herfindahl-Hirschmann Index (HHI) by 400 points to around 4,000, a level that has inevitably attracted antitrust scrutiny. The FTC and the U.S. Department of Justice examine proposed mergers if they increase the HHI by 200 points or more in an already highly concentrated industry.

Despite investors' legitimate skepticism over whether the deals will be permitted (Lorillard's stock has consistently traded at a wide discount to its proposed acquisition price), we believe the deals will be approved, albeit with some restructuring. Not included in the deal are Doral and some other very small brands including Misty and Capri, which we estimate have a combined market share of 2%. Selling

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those brands to Imperial would increase the tobacco industry's HHI by just 200 points to 3,800, a level that, under their own guidelines, would make regulators more likely to approve the deals.

Based on the acquisition valuation of Kool, Winston, Salem and Maverick, we believe the sale price of Reynolds' remaining noncore brands is likely to be less than $2 billion, and that Imperial would be willing and able buyers. At a similar headline valuation of 8.8 times EV/EBITDA, we estimate that Imperial's debt/EBITDA would rise from 3.5 times in fiscal 2014 to 4.6 times under the deal as it is currently proposed, and 4.8 times if it were to acquire Reynolds' remaining noncore brands. Although this is at least double the leverage of its peers, it is well below its peak level of leverage of 6.5 times debt/EBITDA reached after the Altadis acquisition, and manageable given that Imperial's free cash flow generation is almost 40% of revenue.

On balance, if the deals are restructured in this manner with Imperial picking up Doral, Misty and Capri, and possibly Santa Fe, we believe they will be approved by regulators. Imperial will be a significant third player in the industry, and will have acquired as part of the deal Lorillard's salesforce with a stellar track record of gaining volume share and shelf space. Furthermore, the revitalization of Winston could increase price competition across the industry. Four decades ago, Winston was the leading brand in the U.S. until its market share under Reynolds' stewardship was overtaken in 1975 by Marlboro. Since then, it has dropped to number seven in the U.S. with a retail share of just 2% (and falling), and with Reynolds having provided little funding for the brand in recent years, its core consumer is the legacy smoker from the 1970s and it commands a premium price, even to Marlboro. Price sensitivity is greatest at the value end of the cigarette market, and if Imperial repositions Winston as a value brand, it could potentially gain share from brands such as Reynolds' Pall Mall.

Another wildcard in the negotiations is Reynolds' treatment of the Newport brand when it assumes control. Newport is a premium brand, trading roughly in line with Marlboro Red, but Reynolds could opt to bring it under its every day low price strategy, a move that could trigger a higher level of price competition, particularly in menthol. We doubt that Reynolds would want to jeopardise the pricing power of Newport, which will become one of the jewels in its crown, but we estimate that the HHI of the menthol category will increase by around 1,000 points and even the transfer of additional brands to Imperial will not materially mitigate that issue. Therefore, menthol could be the stumbling block if the FTC chooses to look at the tobacco industry by category, and regulators may wish to see more competitive practices in that segment before rubber stamping these transformative deals.

Plain Packs a Step Closer in the U.K.; Trading Down Likely and a Risk to Industry Profitability 11 Mar 2015

As we had expected, the U.K. government passed a bill in the House of Commons that would introduce standardized packaging in the U.K. from 2016. The bill will now move to the House of Lords for final ratification next week. While we believe this development in isolation will have limited impact on the names under our coverage, we are concerned that the spread of plain pack legislation could be a significant negative for the industry, and we would probably revise our pricing assumptions for the global players if similar legislation spreads to other markets. Until we gain more visibility into governments' strategies, however, we are retaining our wide moat and stable moat trend ratings for the tobacco multinationals we cover.

Following around two years of consultation, culminating in last year's Chantler report that concluded that the introduction of plain packs would accelerate the decline of smoking rates, the U.K. government put this plain packs bill

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Analyst Notes

to Parliament. Although there was something of a rebellion amongst the coalition ranks--113 MPs voted against it--we do not anticipate any significant challenges to the passage of the bill in the Lords, given its broad cross-party appeal. Plain packs could be a reality in the U.K. by May 2016.

We believe plain packs are a threat to the profitability of the tobacco industry because they could cause trading down by smokers and/or erode the pricing power of premium brands over lower-priced competitors. In an industry that already has limited opportunities to communicate with its core consumer, plain packs would eliminate trademarks and packaging branding, some of the few remaining marketing tools available to cigarette manufacturers. In turn, we believe this could lead to trading down to cheaper brands by consumers less able to differentiate among brands. Differences in taste and perceived quality are likely to offset trading down, however, particularly at the higher end where smokers tend to be more brand-loyal.

Evidence on the impact of standardized packaging from Australia, the only other market to have introduced the legislation, is mixed. Retail World supermarket sales data showed that the volume of mainstream and premium brands fell 8%-9% in 2013, but value brands increased 12.9%, indicating that trading down is occurring. Plain packs were introduced in 2012, along with a large excise tax increases of 12.5% every year for four years. This has muddied the waters for measuring the impact of plain packs, as Australia is already one of the highest-price-point cigarette markets in the world, and the change in consumption patterns could be driven by the increasing price points rather than economizing.

In the U.K., the major manufacturers have well-laddered product portfolios, and all have lower-priced brands that could capture market share in the event of trading down. However, we think the migration of consumers to lower price points represents a risk for those with the largest market share. Imperial Tobacco is the market leader in the U.K., with a volume share of around 45%. Its product portfolio ranges from Davidoff and Embassy at the high end of the pricing spectrum to Lambert & Butler and JPS at below-average price points. Japan Tobacco (not covered) has a share of around 40% and could have the most to lose. Through Benson & Hedges and Silk Cut, the firm has a heavy presence in premium price categories. For British American Tobacco and Philip Morris International, however, the U.K. is a relatively small market. Both firms possess volume shares in the high single digits and will be less affected than Imperial and Japan Tobacco. Nevertheless, the Marlboro brand is positioned at the premium end in the U.K. and Philip Morris International could suffer share losses as a result.

In-Line 1Q for Imperial Tobacco; Shares Fully Priced as Investors' Attention Turns to M&A 12 Feb 2015

Imperial Tobacco's first-quarter trading update indicated that the firm is on track to meet our full-year expectations. We may slightly increase our near-term volume assumptions, but we do not expect to make a change to our GBX 2,900 fair value estimate. This trading update supports our belief that Imperial is a strong business with sustainable competitive advantages, and our wide economic moat and stable moat trend ratings remain in place.

Reported revenue fell 2%, in line with our forecast. Foreign exchange had a negative 4% impact on revenue, a headwind that could continue for the rest of the year as a result of the recent strengthening of the British pound against several currencies. Volume declined 4%, a slightly faster rate than the industry, in line with historical trends.

With the business chugging along as expected, investors' attention is likely to switch to Imperial's pending acquisitions of cigarette brands from Reynolds American and blu e-cigs from Lorillard. We believe the firm has

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entered into the deals at a value-creating price, which will be accretive to returns on invested capital immediately upon closure. Although we generally regard the deal favorably, we have concerns that the lack of pricing power of the acquired brands could create some unattractive strategic alternatives: Expand the brand by cutting prices and margins, or maximize cash generation with volume continuing to underperform in a declining industry.

With Imperial and British American Tobacco now trading at or above our fair value estimates, we regard the space as being fairly valued. For a high-quality name in our global tobacco coverage universe at a relatively attractive valuation, we continue to recommend Philip Morris, whose scale gives it a cost advantage over local competitors and loyalty to the Marlboro brand creates a strong intangible asset competitive advantage.

Plain Pack Legislation Likely to Cause Trading Down, but Tobacco Firms Well Laddered in U.K. 26 Jan 2015

We believe the announcement by the U.K. government that it will press ahead with legislation to introduce plain cigarette packs in England will have limited impact on the names under our coverage. However, we regard the spread of plain pack legislation as a significant negative for the industry, and we would probably revise our pricing assumptions for the global players if similar legislation spreads to other markets. Until we gain more visibility into governments' strategies, however, we are retaining our wide moat and stable moat trend ratings for the tobacco multinationals we cover.

Following around two years of consultation, culminating in last year's Chantler report that recommended the introduction of plain packs, the U.K. government has announced that it will put legislation to Parliament by May that will propose the introduction of standardized packaging on tobacco products in England. We believe the bill has a strong chance of passing. A poll by Cancer Research UK (admittedly an organization with a vested interest) indicates that 72% of U.K. voters favor such legislation. The largest opposition party also takes a firmly anti-tobacco stance, which should tip the balance toward enactment.

We believe plain packs would be a significant negative for the industry because the legislation could cause trading down by smokers and/or erode the pricing power of premium brands over lower-priced competitors. In an industry that already has limited opportunities to communicate with its core consumer, plain packs would eliminate trademarks and packaging branding, some of the few remaining marketing tools available to cigarette manufacturers. In turn, we believe this could lead to trading down to cheaper brands by consumers less able to differentiate among brands. Differences in taste and perceived quality are likely to offset trading down, however, particularly at the higher end where smokers tend to be more brand loyal.

Evidence on the impact of standardized packaging from Australia, the only other market to have introduced the legislation, is mixed. Retail World supermarket sales data showed that volume of mainstream and premium brands fell 8%-9% in 2013, but value brands increased 12.9%, indicating that trading down is occurring. Plain packs were introduced in 2012, along with a large excise tax increases of 12.5% every year for four years. This has muddied the waters for measuring the impact of plain packs, as Australia is already one of the highest-price-point cigarette markets in the world, and the change in consumption patterns could be driven by the increasing price points rather than economizing.

In the United Kingdom, the major manufacturers have well-laddered product portfolios, and all have lower-priced brands that could capture market share in the event of

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trading down. However, we think the migration of consumers to lower price points represents a risk for those with the largest market share. Imperial Tobacco is the market leader in the U.K., with a volume share of around 45%. Its product portfolio ranges from Davidoff and Embassy at the high end of the pricing spectrum to Lambert & Butler and JPS at below-average price points. Japan Tobacco (not covered) has a share of around 40% and could have the most to lose. Through Benson & Hedges and Silk Cut, the firm has a heavy presence in premium price categories. For British American Tobacco and Philip Morris International, however, the U.K. is a relatively small market. Both firms possess volume shares in the high single digits and will be less affected than Imperial and Japan Tobacco. Nevertheless, the Marlboro brand is positioned at the premium end in the U.K. and Philip Morris International could suffer share losses as a result.

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Morningstar Analyst Forecasts

Financial Summary and Forecasts

Fiscal Year Ends in September

Growth (% YoY)	3-Year Hist. CAGR	2012	2013	2014	*2015* (Forecast)	*2016* (Forecast)	*5-Year Proj. CAGR*
Revenue	*-1.8*	0.4	-0.3	-5.5	*7.2*	*5.1*	*3.9*
EBIT	*-7.9*	-42.5	29.0	5.4	*14.2*	*17.0*	*8.8*
EBITDA	*-3.4*	-36.0	22.4	15.0	*4.1*	*7.4*	*4.6*
Net Income	*-7.5*	-62.3	38.2	51.8	*55.8*	*-4.6*	*10.2*
Diluted EPS	*-5.7*	-61.6	41.3	54.4	*56.5*	*-4.6*	*11.0*
Earnings Before Interest, after Tax	*0.2*	-2.2	3.6	-0.8	*-21.7*	*6.4*	*-2.2*
Free Cash Flow	*2.6*	-20.2	24.5	8.8	*-114.2*	*-541.0*	*-2.0*

Profitability	3-Year Hist. Avg	2012	2013	2014	*2015*	*2016*	*5-Year Proj. Avg*
Operating Margin %	*24.0*	19.3	24.9	27.8	*29.6*	*33.0*	*33.4*
EBITDA Margin %	*32.4*	26.1	32.0	39.0	*37.8*	*38.7*	*39.3*
Net Margin %	*13.2*	8.6	11.9	19.2	*27.8*	*25.3*	*26.1*
Free Cash Flow Margin %	*32.3*	26.3	32.8	37.8	*-5.0*	*21.1*	*19.3*
ROIC %	—	—	—	—	—	—	—
Adjusted ROIC %	*37.7*	23.8	36.9	52.3	*79.4*	*149.4*	*146.4*
Return on Assets %	*3.6*	2.3	3.3	5.2	*6.2*	*5.6*	*6.1*
Return on Equity %	*17.6*	9.9	16.1	26.7	*32.4*	*29.6*	*31.0*

Leverage	3-Year Hist. Avg	2012	2013	2014	*2015*	*2016*	*5-Year Proj. Avg*
Debt/Capital	*0.65*	0.61	0.67	0.66	*0.67*	*0.67*	*0.65*
Total Debt/EBITDA	*4.18*	4.67	4.43	3.43	*3.54*	*3.46*	*3.17*
EBITDA/Interest Expense	*1.87*	1.39	1.72	2.49	*2.52*	*5.03*	*4.67*

Valuation Summary and Forecasts

	2013	2014	*2015(E)*	*2016(E)*
Price/Fair Value	1.03	0.96	—	—
Price/Earnings	25.4	19.2	*14.5*	*15.2*
EV/EBITDA	12.4	11.8	*13.6*	*12.7*
EV/EBIT	16.0	16.5	*17.4*	*14.9*
Free Cash Flow Yield %	9.4	9.0	*9.0*	*4.6*
Dividend Yield %	4.8	4.5	*4.0*	*4.4*

Key Valuation Drivers

Cost of Equity %	10.0
Pre-Tax Cost of Debt %	5.3
Weighted Average Cost of Capital %	8.4
Long-Run Tax Rate %	30.0
Stage II EBI Growth Rate %	5.0
Stage II Investment Rate %	6.7
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	6,243	16.7	6.50
Present Value Stage II	18,275	48.9	19.04
Present Value Stage III	12,886	34.5	13.42
Total Firm Value	**37,404**	**100.0**	**38.97**
Cash and Equivalents	1,431	—	1.49
Debt	-9,932	—	-10.35
Preferred Stock	—	—	—
Other Adjustments	-780	—	-0.81
Equity Value	**28,123**	**—**	**29.30**
Projected Diluted Shares	960		
Fair Value per Share (USD)	—		

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.

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Morningstar Analyst Forecasts

Income Statement (GBP Mil)
Fiscal Year Ends in September

				Forecast	
	2012	2013	2014	*2015*	*2016*
Revenue	**7,877**	**7,857**	**7,424**	***7,959***	***8,362***
Cost of Goods Sold	2,383	2,328	2,149	*2,305*	*2,492*
Gross Profit	**5,494**	**5,529**	**5,275**	***5,654***	***5,870***
Selling, General & Administrative Expenses	3,440	3,014	2,383	*2,644*	*2,636*
Other Operating Expense (Income)	—	—	—	—	—
Other Operating Expense (Income)	—	—	—	—	—
Depreciation & Amortization (if reported separately)	536	557	828	*653*	*476*
Operating Income (ex charges)	**1,518**	**1,958**	**2,064**	***2,357***	***2,758***
Restructuring & Other Cash Charges	—	—	—	—	—
Impairment Charges (if reported separately)	—	—	—	—	—
Other Non-Cash (Income)/Charges	—	—	—	—	—
Operating Income (incl charges)	**1,518**	**1,958**	**2,064**	***2,357***	***2,758***
Interest Expense	1,473	1,463	1,160	*1,192*	*643*
Interest Income	1,036	766	616	*1,024*	*149*
Pre-Tax Income	**1,081**	**1,261**	**1,520**	***2,189***	***2,264***
Income Tax Expense	382	300	69	*474*	*622*
Other After-Tax Cash Gains (Losses)	—	—	—	—	—
Other After-Tax Non-Cash Gains (Losses)	—	—	—	—	—
(Minority Interest)	-21	-24	-29	*-29*	*-28*
(Preferred Dividends)	—	—	—	—	—
Net Income	**678**	**937**	**1,422**	***1,685***	***1,614***
Weighted Average Diluted Shares Outstanding	998	977	960	*955*	*955*
Diluted Earnings Per Share	**0.68**	**0.96**	**1.48**	***1.76***	***1.69***
Adjusted Net Income	678	937	1,422	*2,215*	*2,114*
Diluted Earnings Per Share (Adjusted)	**0.68**	**0.96**	**1.48**	***2.32***	***2.21***
Dividends Per Common Share	3.00	3.32	3.64	*4.02*	*4.45*
EBITDA	**2,054**	**2,515**	**2,892**	***3,010***	***3,234***
Adjusted EBITDA	**2,054**	**2,515**	**2,892**	***3,010***	***3,234***

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Imperial Tobacco Group PLC ITYBY (PINX) | ★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
102.09 USD	92.00 USD	73.60 USD	115.00 USD	Low	Wide	Stable	Standard	Tobacco Products

Morningstar Analyst Forecasts

Balance Sheet (GBP Mil)

Fiscal Year Ends in September	2012	2013	2014	Forecast 2015	Forecast 2016
Cash and Equivalents	631	1,809	1,431	*178*	*669*
Investments	—	—	—	—	—
Accounts Receivable	3,029	2,966	2,806	*3,047*	*3,204*
Inventory	3,132	3,296	2,935	*3,215*	*3,484*
Deferred Tax Assets (Current)	55	72	96	*34*	*34*
Other Short Term Assets	266	245	38	—	—
Current Assets	**7,113**	**8,388**	**7,306**	***6,473***	***7,391***
Net Property Plant, and Equipment	2,025	2,080	1,862	*1,880*	*1,955*
Goodwill	12,178	12,697	11,954	*16,164*	*16,164*
Other Intangibles	5,431	4,685	3,905	*3,448*	*3,148*
Deferred Tax Assets (Long-Term)	142	153	241	*233*	*233*
Other Long-Term Operating Assets	734	398	724	*206*	*206*
Long-Term Non-Operating Assets	16	17	17	*17*	*17*
Total Assets	**27,639**	**28,418**	**26,009**	***28,421***	***29,114***
Accounts Payable	7,231	7,354	6,990	*8,347*	*8,292*
Short-Term Debt	1,254	3,276	468	*500*	*2,764*
Deferred Tax Liabilities (Current)	372	141	133	*105*	*105*
Other Short-Term Liabilities	285	311	222	*162*	*161*
Current Liabilities	**9,142**	**11,082**	**7,813**	***9,114***	***11,322***
Long-Term Debt	8,333	7,858	9,464	*10,162*	*8,414*
Deferred Tax Liabilities (Long-Term)	1,877	1,820	1,453	*1,267*	*1,267*
Other Long-Term Operating Liabilities	2,203	2,010	1,802	*2,114*	*2,111*
Long-Term Non-Operating Liabilities	—	—	—	—	—
Total Liabilities	**21,555**	**22,770**	**20,532**	***22,657***	***23,113***
Preferred Stock	—	—	—	—	—
Common Stock	107	107	104	*104*	*104*
Additional Paid-in Capital	5,833	5,833	5,836	*5,836*	*5,836*
Retained Earnings (Deficit)	-150	-795	-756	*-333*	*-116*
(Treasury Stock)	—	—	—	—	—
Other Equity	245	447	-119	*-256*	*-256*
Shareholder's Equity	**6,035**	**5,592**	**5,065**	***5,351***	***5,568***
Minority Interest	49	56	412	*414*	*433*
Total Equity	**6,084**	**5,648**	**5,477**	***5,765***	***6,001***

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Morningstar Analyst Forecasts

Cash Flow (GBP Mil)
Fiscal Year Ends in September

				Forecast	
	2012	2013	2014	*2015*	*2016*
Net Income	699	961	1,451	*1,714*	*1,642*
Depreciation	150	163	160	*196*	*176*
Amortization	386	394	668	*457*	*300*
Stock-Based Compensation	20	18	22	*13*	*13*
Impairment of Goodwill	—	—	—	—	—
Impairment of Other Intangibles	1,226	658	92	—	—
Deferred Taxes	—	—	—	*-144*	—
Other Non-Cash Adjustments	143	240	25	—	—
(Increase) Decrease in Accounts Receivable	-285	151	-33	*-241*	*-158*
(Increase) Decrease in Inventory	-305	-93	119	*-280*	*-269*
Change in Other Short-Term Assets	—	—	—	*38*	—
Increase (Decrease) in Accounts Payable	85	-140	44	*1,357*	*-55*
Change in Other Short-Term Liabilities	—	—	—	*-60*	*-1*
Cash From Operations	**2,119**	**2,352**	**2,548**	***3,051***	***1,648***
(Capital Expenditures)	-300	-269	-256	*-214*	*-251*
Net (Acquisitions), Asset Sales, and Disposals	-3	-56	-28	*-4,210*	—
Net Sales (Purchases) of Investments	—	—	—	—	—
Other Investing Cash Flows	15	9	10	*830*	*-3*
Cash From Investing	**-288**	**-316**	**-274**	***-3,594***	***-254***
Common Stock Issuance (or Repurchase)	-528	-500	-341	—	—
Common Stock (Dividends)	-983	-1,065	-1,149	*-1,262*	*-1,397*
Short-Term Debt Issuance (or Retirement)	—	—	—	*32*	*2,264*
Long-Term Debt Issuance (or Retirement)	-153	1,421	-876	*698*	*-1,748*
Other Financing Cash Flows	-605	-569	-293	*-41*	*-22*
Cash From Financing	**-2,269**	**-713**	**-2,659**	***-573***	***-903***
Exchange Rates, Discontinued Ops, etc. (net)	-102	-145	7	*-137*	—
Net Change in Cash	**-540**	**1,178**	**-378**	***-1,253***	***491***

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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

		Price/Earnings			EV/EBITDA			Price/Free Cash Flow			Price/Book			Price/Sales		
Company/Ticker	Price/Fair Value	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)
Philip Morris International Inc PM USA	0.93	17.0	19.1	18.7	11.6	13.1	12.6	19.1	19.0	18.1	NM	NM	NM	4.2	4.6	4.5
British American Tobacco PLC BTI USA	0.98	21.4	18.6	16.7	14.7	13.6	12.3	20.2	22.1	20.2	11.7	16.5	15.3	4.6	4.8	4.5
Altria Group Inc MO USA	1.02	—	18.5	17.3	—	13.7	13.0	—	23.1	21.4	—	24.5	24.8	—	5.6	5.4
Average		19.2	18.7	17.6	13.2	13.5	12.6	19.7	21.4	19.9	11.7	20.5	20.1	4.4	5.0	4.8
Imperial Tobacco Group PLC ITYBY	**1.11**	**19.2**	**14.5**	**15.2**	**11.8**	**13.6**	**12.7**	**11.2**	**11.1**	**22.5**	**5.1**	**5.9**	**5.7**	**3.5**	**4.0**	**3.8**

Returns Analysis

		ROIC %			Adjusted ROIC %			Return on Equity %			Return on Assets %			Dividend Yield %		
Company/Ticker	Last Historical Year Total Assets (Mil)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)
Philip Morris International Inc PM USA	35,187 USD	—	—	—	63.6	67.8	62.9	-78.7	-55.0	-53.1	21.9	19.6	18.5	4.8	4.9	4.8
British American Tobacco PLC BTI USA	26,167 GBP	—	—	—	80.6	106.4	115.1	39.5	59.4	71.7	9.0	10.2	9.5	4.2	5.8	4.1
Altria Group Inc MO USA	— USD	—	—	—	47.6	48.3	50.7	122.8	132.7	140.9	14.5	15.7	16.6	—	4.2	4.6
Average		—	—	—	63.9	74.2	76.2	27.9	45.7	53.2	15.1	15.2	14.9	4.5	5.0	4.5
Imperial Tobacco Group PLC ITYBY	**26,009** GBP	**—**	**—**	**—**	**52.3**	**79.4**	**149.4**	**26.7**	**32.4**	**29.6**	**5.2**	**6.2**	**5.6**	**4.5**	**4.0**	**4.4**

Growth Analysis

		Revenue Growth %			EBIT Growth %			EPS Growth %			Free Cash Flow Growth %			Dividend/Share Growth %		
Company/Ticker	Last Historical Year Revenue (Mil)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)
Philip Morris International Inc PM USA	29,767 USD	-4.6	-3.3	1.5	-10.6	-7.3	4.0	-9.5	-6.5	2.0	4.6	-5.6	9.9	9.3	7.8	-1.1
British American Tobacco PLC BTI USA	13,971 GBP	-8.5	1.1	7.4	-17.7	16.2	12.0	-18.6	21.2	11.2	-23.8	-157.8	-330.6	6.0	46.1	-30.5
Altria Group Inc MO USA	17,945 USD	1.6	2.1	2.4	-5.7	1.3	5.0	6.4	9.4	7.1	-9.4	9.3	6.5	15.1	3.4	11.7
Average		-3.8	0.0	3.8	-11.3	3.4	7.0	-7.2	8.0	6.8	-9.5	-51.4	-104.7	10.1	19.1	-6.6
Imperial Tobacco Group PLC ITYBY	**7,424** GBP	**-5.5**	**7.2**	**5.1**	**5.4**	**14.2**	**17.0**	**54.4**	**56.5**	**-4.6**	**8.8**	**-114.2**	**-541.0**	**9.8**	**10.4**	**10.7**

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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 %		
		2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)
Philip Morris International Inc PM USA	7,493 USD	64.9	63.8	65.0	44.5	42.7	43.7	41.5	39.7	40.7	25.2	24.4	24.2	22.1	24.2	25.0
British American Tobacco PLC BTI USA	3,115 GBP	78.3	77.7	77.6	36.3	40.7	42.0	32.5	37.4	39.0	22.3	26.7	27.7	22.8	21.9	22.2
Altria Group Inc MO USA	5,070 USD	56.6	57.5	57.5	45.1	44.7	46.0	43.9	43.6	44.7	28.3	30.1	31.1	23.1	24.1	25.3
Average		66.6	66.3	66.7	42.0	42.7	43.9	39.3	40.2	41.5	25.3	27.1	27.7	22.7	23.4	24.2
Imperial Tobacco Group PLC ITYBY	**1,422** GBP	**71.1**	**71.0**	**70.2**	**39.0**	**37.8**	**38.7**	**27.8**	**29.6**	**33.0**	**19.2**	**27.8**	**25.3**	**30.9**	**35.6**	**16.7**

Leverage Analysis

Company/Ticker	Last Historical Year Total Debt (Mil)	Debt/Equity %			Debt/Total Cap %			EBITDA/Interest Exp.			Total Debt/EBITDA			Assets/Equity		
		2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)
Philip Morris International Inc PM USA	29,455 USD	-233.2	-247.5	-259.8	175.1	167.8	162.6	11.3	9.1	8.1	2.2	2.6	2.8	-2.8	-2.8	-2.9
British American Tobacco PLC BTI USA	12,258 GBP	222.5	414.7	475.7	69.0	80.6	82.6	7.9	8.4	7.0	2.4	3.0	3.3	4.7	7.3	7.8
Altria Group Inc MO USA	14,517 USD	351.0	348.6	353.2	77.8	77.7	77.9	10.0	9.6	10.2	1.8	1.8	1.7	8.5	8.4	8.5
Average		113.4	171.9	189.7	107.3	108.7	107.7	9.7	9.0	8.4	2.1	2.5	2.6	3.5	4.3	4.5
Imperial Tobacco Group PLC ITYBY	**9,932** GBP	**196.1**	**199.3**	**200.8**	**66.2**	**66.6**	**66.8**	**2.5**	**2.5**	**5.0**	**3.4**	**3.5**	**3.5**	**5.1**	**5.3**	**5.2**

Liquidity Analysis

Company/Ticker	Market Cap (Mil)	Cash per Share			Current Ratio			Quick Ratio			Cash/Short-Term Debt			Payout Ratio %		
		2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)	2014	2015(E)	2016(E)
Philip Morris International Inc PM USA	132,313 USD	1.07	2.10	4.18	1.02	1.05	1.11	0.46	0.53	0.64	0.67	0.81	1.14	75.2	92.9	90.0
British American Tobacco PLC BTI USA	105,575 USD	0.97	0.22	2.57	1.04	0.84	1.50	0.57	0.38	0.98	0.73	0.14	3.20	113.2	138.3	89.4
Altria Group Inc MO USA	101,868 USD	1.65	1.67	1.69	0.98	0.98	0.98	0.69	0.69	0.69	6.23	6.23	6.23	81.2	76.7	80.0
Average		1.23	1.33	2.81	1.01	0.96	1.20	0.57	0.53	0.77	2.54	2.39	3.52	89.9	102.6	86.5
Imperial Tobacco Group PLC ITYBY	**48,855** USD	**1.49**	**0.19**	**0.70**	**0.94**	**0.71**	**0.65**	**0.56**	**0.36**	**0.35**	**3.06**	**0.36**	**0.24**	**80.8**	**74.9**	**86.6**

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Research Methodology for Valuing Companies

Components of Our Methodology

- Economic Moat™ Rating
- Moat Trend™ Rating
- Moat Valuation
- Three-Stage Discounted Cash Flow
- Weighted Average Cost of Capital
- Fair Value Estimate
- Scenario Analysis
- Uncertainty Ratings
- Margin of Safety
- Consider Buying/Selling
- Stewardship Rating

The Morningstar Rating for stocks identifies companies trading at a discount or premium to our analysts' assessment of their fair value. A number of components drive this rating: (1) our assessment of the firm's economic moat, (2) our estimate of the stock's intrinsic value based on a discounted cash-flow model, (3) the margin of safety bands we apply to our Fair Value Estimate, and (4) the current stock price relative to our fair value estimate.

The concept of the Morningstar Economic Moat™ Rating plays a vital role not only in our qualitative assessment of a firm's investment potential, but also in our valuation process. We assign three moat ratings—none, narrow, or wide—as well as the Morningstar Moat Trend™ Rating—positive, stable, or negative—to each company we cover. There are two major requirements for firms to earn either a narrow or wide moat rating: (1) the prospect of earning above-average returns on capital; and (2) some competitive edge that prevents these returns from quickly eroding. The assumptions we make about a firm's moat determine the length of "economic outperformance" that we assume in the latter stages of our valuation model. We also quantify the value of each firm's moat, which represents the difference between a firm's enterprise value and the value of the firm if no future net investment were to occur. Said differently, moat value identifies the value generated by the firm as a result of any future net new investment. Our Moat Trend Rating reflects our assessment of whether each firm's competitive advantage is either getting stronger or weaker, since we think of moats as dynamic, rather than static.

At the heart of our valuation system is a detailed projection of a company's future cash flows. The first stage of our three-stage discounted cash flow model can last from 5 to 10 years and contains numerous detailed assumptions about various financial and operating items. The second stage of our model—where a firm's return on new invested capital (RONIC) and earnings growth rate implicitly fade until the perpetuity year—can last anywhere from 0 years (for no-moat firms) to 20 years (for wide-moat companies). In our third stage, we assume the firm's RONIC equals its weighted average cost of capital, and we calculate a continuing value using a standard

Morningstar Research Methodology for Valuing Companies

Analyst conducts company and industry research: ► Financial statement analysis ► Channel checks ► Trade-show visits ► Industry and company reports and journals ► Conference calls ► Management and site visits	Strength of competitive advantage is rated: None, Narrow, or Wide Advantages that confer an economic moat: **High Switching Costs** (Microsoft) **Cost advantage** (Wal-Mart) **Intangible assets** (Johnson & Johnson) **Network Effect** (Mastercard) **Efficient Scale** (Lockheed Martin)	Analyst considers past financial results and focuses on competitive position and future prospects to forecast future cash flows. Assumptions are entered into Morningstar's proprietary discounted cash-flow model.	Analyst uses a discounted cash-flow model to develop a Fair Value Estimate, which serves as the foundation for the Morningstar Rating for stocks.	The analyst then evaluates the range of potential intrinsic values for the company and assigns an Uncertainty Rating: Low, Medium, High, Very High, or Extreme. The Uncertainty Rating determines the margin of safety required before we would recommend the stock. The higher the uncertainty, the wider the margin of safety.	The current stock price relative to Morningstar's Fair Value Estimate, adjusted for uncertainty, determines the Morningstar Rating for stocks. The Morningstar Rating for stocks is updated each evening after the market closes.

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Research Methodology for Valuing Companies

Detailed Methodology Documents and Materials*

- Comprehensive Equity Research Methodology
- Uncertainty Methodology
- Cost of Equity Methodology
- Morningstar DCF Valuation Model
- Stewardship Rating Methodology

* Please contact a sales representative for more information.

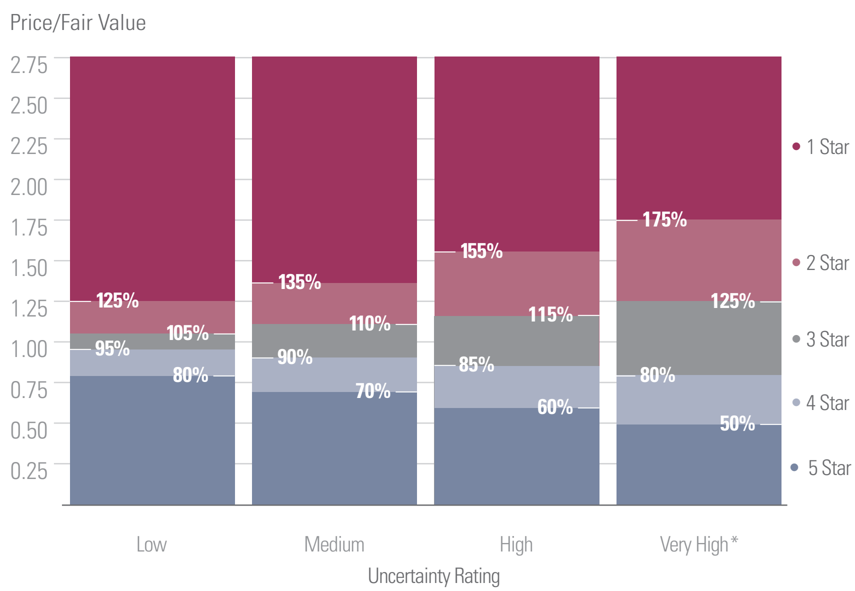
perpetuity formula. In deciding on the rate at which to discount future cash flows, we ignore stock-price volatility. Instead, we rely on a system that measures the estimated volatility of a firm's underlying future free cash flows, taking into account fundamental factors such as the diversity of revenue sources and the firm's fixed cost structure.

We also employ a number of other tools to augment our valuation process, including scenario analysis, where we assess the likelihood and performance of a business under different economic and firm-specific conditions. Our analysts typically model three to five scenarios for each company we cover, stress-testing the model and examining the distribution of resulting fair values.

The Morningstar Uncertainty Rating captures the range of these potential fair values, based on an assessment of a company's future sales range, the firm's operating and financial leverage, and any other contingent events that may impact the business. Our analysts use this range to assign an appropriate margin of safety—or the discount/premium to a fair value we apply in setting our consider buying/consider selling prices. Firms trading below our consider-buying prices receive our highest rating of five stars, whereas firms trading above our consider-selling prices receive our lowest rating of one star.

Our corporate 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.

Morningstar Margin of Safety and Star Rating Bands



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

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Imperial Tobacco Group PLC ITYBY (PINX) | ★★

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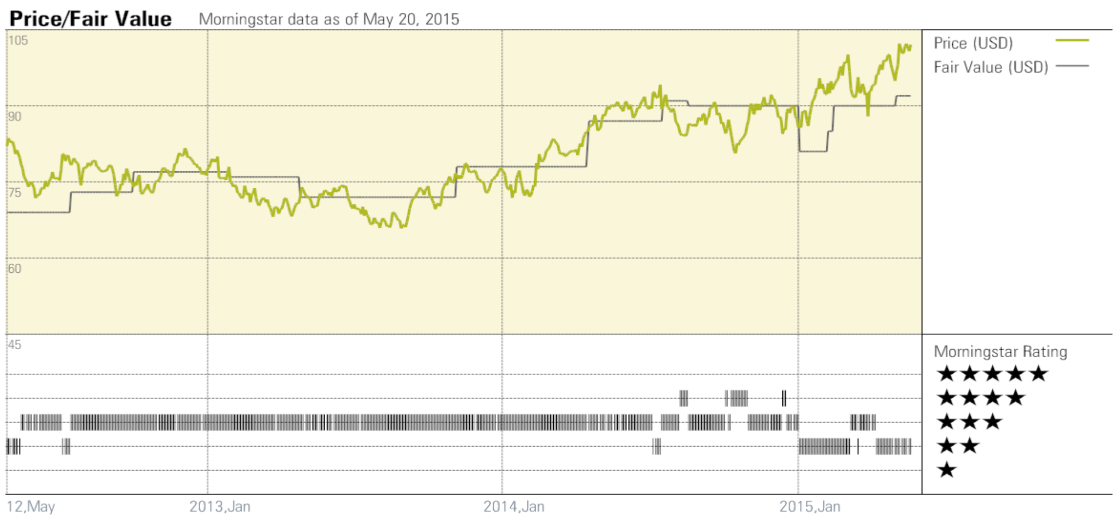
102.09 USD	92.00 USD	73.60 USD	115.00 USD	Low	Wide	Stable	Standard	Tobacco Products



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