Lorillard Inc LO (NYSE) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
59.95 USD	69.00 USD	48.30 USD	93.15 USD	Medium	Wide	Stable	Standard	UR-	Tobacco Products

Lorillard's 2Q Demonstrates Why Newport Is Attractive Asset, but Lack of Moat Evident in eCigs

See Page 2 for the full Analyst Note from 30 Jul 2014

R.J. Hottovy, CFA
Director
rj.hottovy@morningstar.com
+1 (312) 244-7060

Philip Gorham, CFA, FRM
Senior Equity Analyst
philip.gorham@morningstar.com
+31 (0) 20 560 2962

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

Research as of 30 Jul 2014
Estimates as of 14 May 2014
Pricing data through 26 Sep 2014
Rating updated as of 26 Sep 2014

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

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Investment Thesis 23 Oct 2013

Even though the U.S. cigarette market has continually shrunk, Lorillard has been able to grow cigarette volumes over the past five years thanks to menthol becoming a larger piece of the overall tobacco market, the Newport brand gaining share of the menthol market, the recent launches of Newport Red and Newport Gold, and robust growth of its value-priced Maverick brand. We view the possibility of significant restrictions by the U.S. Food and Drug Administration on the menthol cigarette market extremely unlikely given the high probability of meaningful negative unintended consequences. Income investors may also find the company's dividend yield an attractive alternative to bonds.

We think that Lorillard enjoys a wide economic moat because of the extraordinary strength of Newport, its flagship brand. However, with roughly 90% of its volume generated from the menthol category and the threat of increased FDA regulation, the firm is vulnerable to unfavorable regulatory developments.

Lorillard's Newport brand is the leader in the menthol category, possessing 37% of the American menthol market and 12.5% of the overall domestic cigarette market. Although Lorillard, which sells 40.7 billion cigarettes per year, is significantly smaller than rivals Altria (135 billion cigarettes per year) and Reynolds American (73 billion cigarettes per year), it has been able to maintain volumes against a backdrop of waning demand. Since 2007 cigarette demand in the U.S. has dropped by roughly 20%, with Altria's volumes falling by 40 billion sticks and Reynolds' volume decreasing by 25 billion cigarettes. Despite this, Lorillard's volumes actually grew from 36.6 billion cigarettes in 2007 to 40.7 billion in 2012 as consumers increasingly opted for menthol cigarettes and Lorillard's value brand Maverick steadily gained share.

Lorillard's Blu and SKYCIG brands will play a critical role in expanding the company's exposure to the fast growing e-cigarette category.

Vital Statistics

Market Cap (USD Mil)	21,583
52-Week High (USD)	67.46
52-Week Low (USD)	44.12
52-Week Total Return %	39.1
YTD Total Return %	21.9
Last Fiscal Year End	31 Dec 2013
5-Yr Forward Revenue CAGR %	5.4
5-Yr Forward EPS CAGR %	9.3
Price/Fair Value	0.87

Valuation Summary and Forecasts

Fiscal Year:	2012	2013	*2014(E)*	*2015(E)*
Price/Earnings	14.0	16.4	*16.5*	*15.3*
EV/EBITDA	8.6	9.9	*10.5*	*10.0*
EV/EBIT	8.8	10.2	*10.7*	*10.2*
Free Cash Flow Yield %	7.4	6.1	*5.6*	*6.1*
Dividend Yield %	5.4	4.5	*4.1*	*4.3*

Financial Summary and Forecasts (USD Mil)

Fiscal Year:	2012	2013	*2014(E)*	*2015(E)*
Revenue	4,636	4,972	*5,508*	*5,806*
Revenue YoY %	4.1	7.3	*10.8*	*5.4*
EBIT	1,853	2,010	*2,270*	*2,377*
EBIT YoY %	-0.8	8.5	*13.0*	*4.7*
Net Income, Adjusted	1,081	1,156	*1,316*	*1,377*
Net Income YoY %	-1.6	6.9	*13.8*	*4.7*
Diluted EPS	2.77	3.09	*3.64*	*3.93*
Diluted EPS YoY %	5.5	11.6	*17.7*	*7.9*
Free Cash Flow	1,047	1,185	*1,298*	*1,424*
Free Cash Flow YoY %	-12.1	13.2	*9.5*	*9.7*

Historical/forecast data sources are Morningstar Estimates and may reflect adjustments.
Analyst Note: Revenue estimate excludes excise taxes

Profile

Lorillard is the third-largest manufacturer of cigarettes in the United States. Its flagship brand, Newport, claims an almost 15% share of the total U.S. cigarette market and a 40% share of the menthol category. The firm's other full-price brands include Kent, True, and Max. Its leading discount cigarette brands are Maverick and Old Gold. In 2012, the company acquired Blu to enter the electronic cigarette category.

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Morningstar Analysis

Lorillard's 2Q Demonstrates Why Newport Is Attractive Asset, but Lack of Moat Evident in eCigs 30 Jul 2014

Lorillard missed consensus estimates for its second-quarter earnings, but we think there was plenty in the results to demonstrate the competitive advantages that justify our wide economic moat rating and make Lorillard an attractive acquisition for Reynolds American. By contrast, we are concerned with the decline in blu's volumes, and we harbor concerns about the long-term leadership of the brand in the U.S. eCigs category.

Although Lorillard's revenue declined by 0.3%, the cigarette business performed in line with expectations, growing revenue by almost 1.0% and outperforming the broader U. S. market. Newport's share of the cigarette market was 12.8%, 0.3 percentage points above a year-ago level. Newport operates in a segment of the market--full-flavor menthol--that is declining at a slower rate than the rest of the industry. With the U.S. cigarette market declining 4%-5% annually, Newport volumes declined just 1.2% after adjusting for trade inventory movements in the second quarter. Although the reported EBIT margin declined by 40 basis points, it increased by 10 basis points when adjusted for the costs of rebranding SKYCIG to blu in the U.K. Lorillard took pricing of 3.6% year over year, and it is this pricing power, its superior growth runway, and the ability to leverage price increases to increase profitability that make Lorillard an attractive asset for Reynolds.

The performance of blu, however, the eCig asset being acquired by Imperial Tobacco, is concerning. With the category in its infancy, and with consumers still in trial mode, the eCig category possesses none of the wide moat characteristics of cigarettes, and we are concerned that today's market leader could be usurped by one of the emerging technologies. This was evident in the second quarter, with sales declining 35% and retail share falling 1.1 percentage point to 40.9%. We think the conversion to lower-priced rechargeable kits demonstrates that eCigs is a price-competitive category.

While Lorillard's operating performance is now very much of interest to Reynolds American and Imperial Tobacco shareholders, for Lorillard investors, the critical decision is whether to cash out now at a discount to the takeout valuation or wait for the acquisition to close. If the deal is approved by antitrust regulators, Lorillard shareholders should receive a final valuation of around $68 per share, or 10% above yesterday's close. We still think that the deal is more likely than not to clear antitrust hurdles. Although the deal would trigger further scrutiny under the Department of Justice's Herfindahl Index measure of industry concentration, there are several reasons why the deal should close. Reynolds' net share will only increase by around 7 percentage points, Imperial will likely be forced to be aggressive on price if it is to turn around its acquired brands, and both state and the federal governments have a strong financial incentive to preserve the tobacco industry profit pool. In addition, Reynolds still has some dry powder to get the deal past the regulators. For example, it could sell Doral or Natural American Spirit in order to shave a percentage point or two from its market share.

Valuation, Growth and Profitability 15 Jul 2014

We are raising our fair value estimate to $69 from $49 in light of the announcement that the firm is to be acquired by Reynolds American at that price. The valuation represents 12 times 2013 EBITDA, a value in line with recent deals in mature tobacco markets. While the acquisition must still pass scrutiny by the Federal Trade Commission and the Department of Justice, we believe it will meet antitrust requirements given the material asset disposals made by Reynolds American.

We forecast the company to grow revenue by over 8% during 2013 and to generate operating margins of almost 41%. Longer term, we expect that the company will continue to gain share at the expense of Altria and Reynolds, and to grow revenue by around 5% and EPS in the high single digits.

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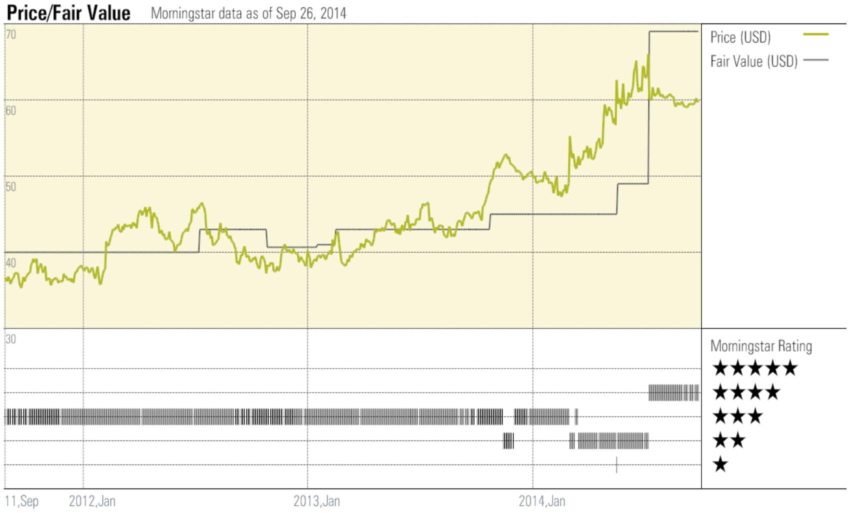
Price/Fair Value Morningstar data as of Sep 26, 2014



Our fair value estimate does not incorporate any meaningful FDA restrictions limiting the sale of menthol cigarettes. But it does include a slight contribution from the firm's Blu e-cigs division.

Scenario Analysis

If the FDA significantly restricts, or outright bans, menthol cigarettes it would be disastrous for the company's shares. However, we believe there is only a remote chance that would occur and our downside scenario does not take such draconian actions into account. Rather, our downside scenario assumes a greater-than-expected reduction in smoking in the U.S., a competitive environment that remains intense, gradually decaying volumes for Newport menthol products, and the company pulling the plug on Newport Red. Should this scenario play out, we expect the company's shares to be worth $40, the firm's long-term revenue growth to be 2.4%, and long-term operating margins of 40%, roughly 150 basis points lower than our base-case scenario.

On the other hand, Lorillard's shares could be worth $59 should our upside scenario occur. In this case, the company continues to grow cigarette volumes through 2017 as it successfully grows the Newport brand west of the Mississippi and into the nonmenthol segment. Additionally, this scenario would include a more meaningful contribution from the company's electronic cigarette division. Should this occur, Lorillard's long-term revenue growth could reach 8% per year and operating margins would be 150 basis points greater than our base-case scenario.

Economic Moat

The addictive nature of cigarettes, barriers to entry facing new tobacco players, and the loyalty of Newport smokers give Lorillard a wide moat in our opinion. Scale is critical to Lorillard's wide operating margins and high returns on invested capital, but tobacco marketing restrictions make it very challenging for new competitors to steal share at the expense of well-known brands. Even powerful incumbents such as Altria (Marlboro) and Reynolds (Camel) have found it very difficult to erode Newport's share of the menthol market. Lorillard's operating margins are the widest in the industry: In 2013, the company's cigarette business generated operating margins of over 40%, notably above Altria's 38% segment operating margin, and Reynolds' cigarette segment's 27% operating margin. Consequently, we expect the firm to continue to generate returns on invested capital in excess of 80% for years to come.

Moat Trend

Lorillard's wide moat is stable, in our opinion. U.S. smokers tend to exhibit a great deal of brand loyalty, and Newport smokers possess a strong affinity for the leading full-flavor menthol brand. We do not see an imminent threat to Newport's dominance in the menthol segment, and believe that marketing restrictions in the U.S. make it improbable for new entrants to emerge. However, should the FDA impose significant restrictions on menthol cigarettes (which we believe is a low-probability event), we would likely look to downgrade Lorillard's moat and moat trend ratings.

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Bulls Say/Bears Say

Bulls Say

- Newport is the dominant menthol cigarette brand, controlling 37% of the menthol category and 12.5% of the overall U.S. cigarette market.
- The overall menthol category has been gaining share and Newport volumes actually increased from 2007 to 2012, while the overall cigarette market in the U. S. was in a state of decline.
- Menthol cigarettes now make up 31.4% of the total market compared with 26.0% in 2002.

Bears Say

- Lorillard generates roughly 90% of its revenue from Newport, leaving it highly undiversified and vulnerable to any negative regulatory developments in the menthol category.
- Having sold the international rights to its brands in 1977, Lorillard cannot profit from the Newport brand in overseas markets.
- Competitors Salem and Kool once enjoyed commanding share of the menthol category in the 1950s and 1960s, but meaningfully lost share as consumers' tastes changed. Should consumers no longer take pleasure in Newport, Lorillard's financial results will suffer.

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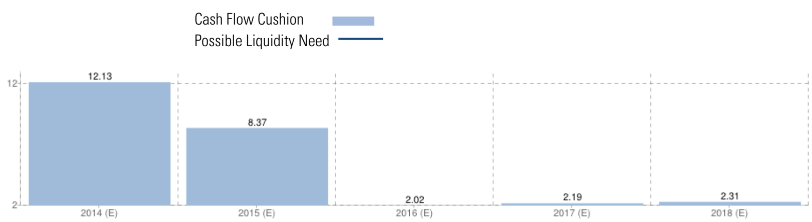
Credit Analysis

Five Year Adjusted Cash Flow Forecast (USD Mil)

	2014(E)	2015(E)	2016(E)	2017(E)	2018(E)
Cash and Equivalents (beginning of period)	1,611	916	801	888	944
Adjusted Available Cash Flow	423	509	553	581	604
Total Cash Available before Debt Service	2,034	1,424	1,353	1,469	1,549
Principal Payments	—	—	-500	-500	-500
Interest Payments	-168	-170	-170	-170	-170
Other Cash Obligations and Commitments	—	—	—	—	—
Total Cash Obligations and Commitments	-168	-170	-670	-670	-670

Cumulative Annual Cash Flow Cushion



Adjusted Cash Flow Summary

	USD Millions	% of Commitments
Beginning Cash Balance	1,611	68.6
Sum of 5-Year Adjusted Free Cash Flow	2,670	113.7
Sum of Cash and 5-Year Cash Generation	4,281	182.3
Revolver Availability	—	—
Asset Adjusted Borrowings (Repayment)	—	—
Sum of Cash, 5-Year Cash Generation, Revolver and Adjustments	4,281	182.3
Sum of 5-Year Cash Commitments	-2,348	—

Credit Rating Pillars–Peer Group Comparison

	LO	Sector	Universe
Business Risk	4	4.3	5.1
Cash Flow Cushion	5	6.4	6.0
Solvency Score	3	4.6	4.7
Distance to Default	3	2.9	3.8
Credit Rating	UR-	A	BBB+

Source: Morningstar Estimates

Note: Scoring is on a scale 1-10, 1 being Best, 10 being Worst

Financial Health & Capital Structure

We have placed our rating for Lorillard under review for downgrade as Reynolds has announced its proposal to acquire Lorillard. Reynolds will pay $68.88 per share, consisting of $50.50 in cash and 0.2909 share of RAI stock, resulting in an enterprise value of $27.4 billion. We estimate that Reynolds is paying approximately a 12 times enterprise value/EBITDA multiple. As part of the transaction, Reynolds will sell several of its brands and Lorillard will sell its blu e-cigs to Imperial Tobacco. Pro forma for the acquisition, British American Tobacco will maintain its 42% ownership in Reynolds through a $4.7 billion equity investment and Lorillard shareholders will own 15%.

Reynolds expects to maintain its investment grade rating following the transaction; however, we are placed our BBB rating under review for downgrade due to the heightened debt leverage that will be used to conduct the acquisition. We expect pro forma debt leverage for the combined entity following the acquisition and asset sales will be approximately 3.6 times. We also expect the firm will need to commit to the agencies that it will use a significant portion of its free cash flow to quickly deleverage its balance sheet and will halt its share-repurchase program (beyond offsetting share issuances). We will also likely reconsider our narrow moat rating for Reynolds, as this deal would be transformative for the company's competitive positioning.

Enterprise Risk

We are lowering our uncertainty rating for Lorillard to medium from high. Fundamentals in the oligopolistic tobacco industry are fairly sound, leading to revenue and profit growth that is among the most stable in our coverage universe. However, the threat of significant actions by the U.S. Food and Drug Administration against menthol cigarettes, which we view to be slight, is the most meaningful risk for Lorillard. For this reason, we believe an uncertainty rating above its domestic tobacco peers is

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Credit Analysis

justified. The Newport brand, which is predominantly menthol, represents almost 90% of the company's sales. Should the FDA choose to meaningfully restrict or ban menthol cigarettes, Lorillard's financial performance would probably collapse catastrophically. Nonetheless, we believe that this risk is minor because the FDA must also weigh the impact of the unintended consequences, including increased black-market sales, increased youth access, and more than $10 billion of lost government revenue related to taxes on menthol cigarettes.The firm faces thousands of lawsuits, which results in an unpredictable level of legal liabilities. Also, Lorillard is keenly focused on the cigarette market and lacks a presence in the cigar and smokeless tobacco markets. Per-capita cigarette consumption in the U.S. has been falling since the 1970s, and is likely to continue to fall during the next decade. Falling volumes will likely have an impact on the company's capacity utilization rate at its lone manufacturing facility and could result in a profitability headwind.

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Management & Ownership

Management Activity

Name	Position	Shares Held	Report Date*	InsiderActivity
MURRAY S. KESSLER	CEO/Director/President/Chairman of the Board,Director	381,864	19 Feb 2014	—
MR. RONALD S. MILSTEIN	Executive VP, Divisional/General Counsel/Secretary	91,960	19 Feb 2014	—
MR. RANDY B. SPELL	Executive VP, Divisional	91,272	19 Feb 2014	—
MR. CHARLES E. HENNIGHAUSEN	Executive VP, Divisional	74,980	29 Apr 2014	—
MR. DAVID H. TAYLOR	Executive VP, Divisional/CFO	67,430	19 Feb 2014	—
ANTHONY B. PETITT	Chief Accounting Officer/ Controller/Vice President	26,042	19 Feb 2014	—
DAVID E. R. DANGOOR	Director	24,576	01 Jan 2014	—

*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
VA CollegeAmerica Cap Income Builder	1.96	0.47	-1,558	30 Jun 2014
MFS® Value Fund	1.62	1.05	-591	31 Jul 2014
Vanguard Total Stock Mkt Idx	1.64	0.10	66	31 Aug 2014
Franklin Mutual Global Discovery Fund	1.48	1.25	—	30 Jun 2014
SunAmerica Focused Dividend Strategy Por	1.42	3.76	-55	31 Jul 2014
Concentrated Holders				
Carne Hedged Equity Fund	0.02	9.05	39	31 Jul 2014
USA Mutuals Barrier Fund	0.10	6.99	—	31 Aug 2014
MHAM/SWIP Foreign High Div Equity MF	0.01	6.39	0	12 May 2014
USA Mutuals Generation Wave Growth Fund	—	6.31	—	31 Aug 2014
Catalyst Event Arbitrage Fund	—	5.91	10	30 Jun 2014

Institutional Transactions

Top 5 Buyers	% of Shares Held	% of Fund Assets	Shares Bought/ Sold (k)	Portfolio Date
Pioneer Investment Management Inc	1.06	0.89	3,622	30 Jun 2014
Mason Capital Management LLC	0.96	2.52	3,473	30 Jun 2014
J.P.Morgan Securities Inc.	0.48	0.20	971	30 Jun 2014
Jennison Associates LLC	0.27	0.05	957	30 Jun 2014
Susquehanna Financial Group, LLLP	0.26	0.03	901	30 Jun 2014
Top 5 Sellers				
Columbia Mangmt Investment Advisers, LLC	1.75	0.26	-3,009	30 Jun 2014
MFS Investment Management K.K.	4.63	0.53	-2,928	30 Jun 2014
Grantham, Mayo, Van Otterloo & Co., LLC	0.06	0.03	-1,650	30 Jun 2014
T. Rowe Price Associates, Inc.	0.24	0.01	-1,581	30 Jun 2014
Credit Suisse First Boston (CSFB)	0.24	0.04	-1,462	30 Jun 2014

Management 14 May 2014

We believe that Lorillard's management team has been a standard steward of shareholders' capital. We applaud the company's laser focus on the menthol category and for steadily growing the Newport brand. Given the lack of acquisitions available for domestic cigarette companies we believe the firm's dividend policy is an efficient use of capital and approve of management's decision to lever up the balance sheet following the company's 2008 emergence as an independent, publicly traded company.

CEO Murray Kessler, who took the reins in 2010, was the former CEO of smokeless tobacco manufacturer UST until its 2009 acquisition by Altria. He has extensive experience in the consumer staples industry. We believe that Kessler's strategy of expanding Newport's marketing efforts west of the Mississippi and into the nonmenthol category should benefit the company over the long term.

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Analyst Notes

Reynolds-Lorillard Synergies Cloudy, but Imperial's Purchase of Blu Is an Unexpected Positive 15 Jul 2014

We are raising our fair value estimate for Lorillard to $69 per share after the announcement that it is to be acquired by Reynolds American at that price. In connection with the deal, Imperial Tobacco will acquire cigarette and electronic cigarette assets from the combined Reynolds-Lorillard entity for $7.1 billion. Strategically, we believe this is a sound move, although at 12 times EBITDA, Reynolds has paid a full price to grab Newport, one of the crown jewels of the U.S. tobacco industry. We are maintaining our narrow moat rating for Reynolds at this time, but may consider revising it as we think this deal significantly improves Reynolds' competitive positioning. The deal is also transformative for Imperial Tobacco, and although we will review the assumptions in our model, we doubt the deal will have a material impact on our valuation. British American will retain its 42% holding of Reynolds by providing $4.7 billion of funding for the deal, an investment we do not expect to move the needle on our fair value estimate.

The deal values Lorillard at $27.4 billion, or 12 times 2013 EBITDA, although given that we believe Reynolds stock, which will make up 27% of the funding, is currently 50% overvalued, we estimate the underlying valuation to be 11.2 times EBITDA. The headline valuation is in line with historical deals in mature tobacco markets, which have averaged 12.5 times since Imperial acquired Reemstma for 12.7 times EBITDA in 2002, and we think it represents solid value for Lorillard shareholders. Although we are skeptical that the use of menthol will be banned by the U.S. Food and Drug Administration, and view the menthol risk factor as minimal, the risk still exists and we believe this valuation prices Lorillard at a level that overlooks that risk.

For Reynolds, this is a strong strategic move, in our opinion. Around 90% of the firm's cigarette portfolio will now consist of Pall Mall, Camel, and Newport, with the remaining 10% taken up by smaller brands such as American Spirit and Doral. Imperial Tobacco will purchase the Kool, Salem, Winston, and Maverick brands, and will become the third-largest player in the U.S. industry, with a share of about 10%. While we expect regulators to take a close look at the deal, we think the announced divestitures will be sufficient to allow the deal to pass, particularly as we estimate Reynolds' market share will increase only by around 7% to 36%.

Management estimated synergies in the deal of $800 million over two years, above our $400 million-$500 million estimate. We are skeptical that the combined Reynolds-Lorillard company can achieve this, though, since Lorillard's 2013 selling, general, and administrative expenses were only $709 million in total, and we estimate total noninput costs amount to little more than $1 billion.

The biggest surprise in today's announcement, in our opinion, was the acquisition by Imperial of Lorillard's Blu e-cig business. Blu is the market leader in the U.S., with a share of around 50% of the market in convenience stores, and has established intellectual property in a fast-emerging category in which customers are still in trial mode. We regard this acquisition as a positive for Imperial, which we believe lagged competitors in establishing a footprint in e-cigs, but we believe Blu was the sweetener to persuade Imperial to take the cigarette brands Reynolds wanted to dispose of rather than one of its marquee brands Camel or Pall Mall.

While we believe the acquisition of Blu is a positive for Imperial, we are also impressed that the firm is assuming the infrastructure of Lorillard, which will give it a much stronger presence in the U.S. However, the brands it is acquiring are third-tier and lack the brand loyalty and pricing power of leaders Marlboro (Altria) and Newport (Reynolds-

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Analyst Notes

Lorillard) and even second-tier brands such as Camel and Pall Mall. Although, at an EBITDA multiple of less than 9 times, we believe the firm has picked up these brands at an attractive valuation, we suspect Imperial will be the clear price taker and that the U.S. industry will operate more as a duopoly. We recommend long-term investors take long positions in the tobacco names with the strongest competitive advantages, including Philip Morris International, which is currently trading at a modest discount to our fair value estimate.

Reynolds and Lorillard in Talks; Deal Makes Sense, but We're Less Enthusiastic About Imperial's Role 11 Jul 2014

Following months of speculation, Reynolds American and Lorillard confirmed Friday that they--the second- and third-largest U.S. tobacco companies, respectively--have held talks with regard to a merger. A deal has not been confirmed, but it appears that Reynolds is likely to acquire Lorillard at a price that has been agreed upon but not disclosed. The news followed quickly after Imperial Tobacco confirmed that it is also in talks with Reynolds to acquire assets that would become available following the acquisition of Lorillard. Valuation details are slim thus far, so we're maintaining our fair value estimates for all three firms, though we note that at current market prices, Reynolds appears to be paying a decent premium for Lorillard. We do not think this deal would affect our wide moat rating for Imperial, but we may reconsider our narrow moat rating for Reynolds, as this deal, if confirmed, would be transformative for the latter firm's competitive positioning.

We think this is a sound strategic deal for Reynolds. Lorillard owns Newport, a premium menthol brand with one of the most loyal customer bases in the consumer staples industry. It operates in a niche of the market that is declining at a slower rate (flat to slightly down year over year) than the rest of the U.S. industry (down around 4% per year). Loyalty to the Newport brand and scale in a niche market are the sources of Lorillard's wide economic moat and make the firm one of the strongest in our consumer defensive coverage universe, in our opinion. Despite the well-publicized studies of the use of menthol in cigarettes, we are highly skeptical that it will be banned by the Food and Drug Administration and view the menthol risk factor as minimal.

In addition to its strong positioning in cigarettes, Lorillard owns Blu, an e-cigarette business that commands around 50% market share in convenience stores in the U.S. This proven intellectual property and established distribution platform should strengthen Reynolds' positioning in the emerging e-cig category, and provide it with a hedge against share loss by its core business to next-generation products.

We estimate that by acquiring Lorillard, Reynolds American could generate $400 million-$500 million in annual cost savings, primarily from the elimination of duplicate back-office functions, but also from improved capacity utilization and distribution efficiencies. Until the deal is confirmed and valuation is revealed, we do not know if this would be a value-creating acquisition for shareholders, but we do think the deal makes sense strategically.

Although a Reynolds-Lorillard combination would create a powerful industry number two, we think the deal would probably be a net positive for Altria. Post merger, the industry would essentially be a duopoly, with Altria still the leader with a 50% share and Reynolds-Lorillard second with around 38%. We believe this industry structure would be more likely to be rational, with fewer price skirmishes and temporary price discounts, which would be healthy for the industry profit pool. However, the anticompetitive industry structure would probably raise eyebrows at the Federal Trade Commission and Department of Justice, which we expect to closely examine the deal. We believe the deal will ultimately get past antitrust issues because higher prices

Analyst Notes

as a result of lower competition could have positive public health benefits if volume declines accelerate. Nevertheless, we expect Reynolds to have to dispose of some of its existing brands in order to receive the green light from regulators.

Imperial Tobacco is the most likely buyer of any assets that are put up for sale as a result of the Reynolds-Lorillard merger. The firm will receive around $640 million in proceeds from the initial public offering of its distribution business, Logista, and management has previously identified the U.S. as a potential market for growth. It currently holds a share of just 3% in the U.S., and adding scale in this profitable market should allow it to increase margins. However, we doubt that any of Reynolds' crown jewels, namely the Pall Mall and Camel brands, will be available as a result of the deal with Lorillard. It seems more likely on antitrust grounds that Reynolds will dispose of Kool, its menthol brand that has failed to gain significant pricing power against key competitor Newport. Given that Reynolds' management has tried and failed to strengthen the positioning of Kool on several occasions, we doubt that there is anything different that Imperial can do. Like the Reynolds-Lorillard deal, the value extraction from the deal would depend on the price paid, so we will reserve judgement until a deal is announced. At this point, however, we have reservations about the strategic rationale of Imperial picking up third-tier brands in a market in which it has little presence. With most of the shares in the space fairly valued, we recommend long-term investors avoid this risk and take long positions in the tobacco names with the strongest competitive advantages, including Philip Morris International, which is currently trading at a modest discount to our fair value estimate.

Tobacco Stocks Jump on M&A Rumors; We Think Deal Makes Sense, and Would Be Approved 22 May 2014

Rumors of advanced merger talks sent Lorillard's shares up 10% late on Wednesday, with shares of Reynolds American advancing around 4%. Assuming the rumors are true, we place a high probability on the deal being done. However, because our valuations for both are based on the cash flows of the standalone businesses, we won't make any changes to our fair value estimates for either name until a firm offer materializes.

The stocks for both Lorillard and Reynolds are now trading at material premia to our fair value estimates (30% and 40%, respectively). With the caveat that any final deal price could exceed Lorillard's current $63 per share valuation, we regard this as an opportunity for shareholders to take profits on both stocks.

A Reynolds-Lorillard combination would have a U.S. market share of around 42%, and would essentially create a duopoly with industry leader Altria, with its 50% share. We believe this would be beneficial to the industry profit pool, and we would expect the two market leaders to generate higher revenue per pack as a result. Nevertheless, we doubt that regulators would prohibit any deal on antitrust grounds. We believe the government will take a broad perspective, and because higher cigarette prices are likely to lead to lower consumption (U.S. price elasticity has been a fairly constant -0.35 over the last two decades) we believe the government will allow the deal to go through.

Mature market tobacco acquisitions in the last decade have hovered around 12x EBITDA, although Imperial's acquisition of Altadis at over 14x EBITDA was the exception. We think a valuation of 12x 2014 EBITDA is reasonable for Lorillard, with its strong e-cigarette presence offset by its menthol risk, implying a takeout valuation of $65 per share.

Lorillard CEO Murray Kessler has a track record of maximizing value for shareholders in strategic merger talks. In 2008, he sold UST to Altria for 12x EBITDA, despite the lack of funding availability during the financial crisis. If a deal for Lorillard materializes, we expect it would be at a

Lorillard Inc LO (NYSE) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
59.95 USD	69.00 USD	48.30 USD	93.15 USD	Medium	Wide	Stable	Standard	UR-	Tobacco Products

Analyst Notes

similar level. Given that Reynolds' stock is trading above our fair value estimate, any deal could be weighted towards stock. However, the valuation could go higher if other suitors emerge.

This is one of the few remaining transformative deals left in tobacco. With its best-in-class capital structure, Japan Tobacco has the financial flexibility to execute a deal, and could also be interested in Lorillard's e-cigarette technology.

British American (BAT) holds a 42% stake in Reynolds, and will be the power behind the throne in any merger talks. We believe Lorillard's Blu e-cigarette business, with established intellectual property and an approximate 50% share of the U.S. e-cigarette market, is the attractive asset to British American. We expect the firm would attempt to introduce the product into international markets. It is possible that British American could acquire the remaining 58% of the equity it does not hold in the combined Reynolds-Lorillard entity in the future, but we do not see this as a near-term development, as BAT would probably want some visibility into global consumer acceptance of the Blu brand. If an offer is forthcoming, we think it would indicate the high level of confidence that tobacco executives have that menthol will not be banned in the United States by the Food and Drug Administration.

Newport Drives Solid 1Q for Lorillard; E-Cig Outlook Positive Despite Increased FDA Regulation 24 Apr 2014

Lorillard's first-quarter update echoed much of what we've seen from the rest of the tobacco names, with strong pricing among core full-price cigarette brands helping to negate volume declines as well as continued e-cigarette investments. Newport, which saw volumes decline just 1.5% but market share gain 40 basis points to 13%, helped to offset total cigarette segment volume declines of 2.9%. Factoring in strong pricing trends, Lorillard's cigarette segment posted top-line growth of 2.9% and adjusted operating income growth of 4.9%. Our long-term revenue growth forecast in the low- to midsingle digits assumes that Lorillard will continue to gain share in the shrinking U.S. cigarette market as menthol grows in popularity and the firm continues to expand into the western U.S.

Management also discussed its e-cigarette business, which remains the domestic market leader, with 45% of all-outlet e-cigarette dollars spent, according to Nielsen. Unit volumes increased, but total e-cig segment revenue remains pressured by a lower-priced rechargeable kit. We remain constructive about Lorillard's potential to defend market share in this category, particularly as new product advances are rolled out over the next six months (including battery strength and vapor production) to better compete with personal vaporizers. We also don't expect many near-term regulatory changes after the April 24 announcement that the U.S. Food and Drug Administration has proposed to extend its authority to cover e-cigarettes, since we've anticipated that for some time.

There is no change to our $45 fair value estimate or wide moat rating, and we remain comfortable with model assumptions calling for high-single-digit free cash flow growth the next several years (despite continuing e-cigarette investments). Although we remain optimistic about Lorillard and its competitive position, we currently find better investment options in the tobacco industry, including Philip Morris or British American.

Lorillard Inc LO (NYSE) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
59.95 USD	69.00 USD	48.30 USD	93.15 USD	Medium	Wide	Stable	Standard	UR-	Tobacco Products

Morningstar Analyst Forecasts

Financial Summary and Forecasts

Fiscal Year Ends in December

Growth (% YoY)	3-Year Hist. CAGR	2011	2012	2013	2014 (Forecast)	2015 (Forecast)	5-Year Proj. CAGR
Revenue	7.1	9.8	4.1	7.3	10.8	5.4	5.4
EBIT	5.2	8.2	-0.8	8.5	13.0	4.7	6.0
EBITDA	5.4	8.2	-0.6	8.9	12.3	4.7	5.9
Net Income	4.0	6.7	-1.6	6.9	13.8	4.7	6.4
Diluted EPS	11.0	16.2	5.5	11.6	17.7	7.9	9.3
Earnings Before Interest, after Tax	4.5	7.3	1.8	4.4	14.8	4.7	6.3
Free Cash Flow	2.5	8.2	-12.1	13.2	9.5	9.7	6.9

Profitability	3-Year Hist. Avg	2011	2012	2013	2014	2015	5-Year Proj. Avg
Operating Margin %	40.8	41.9	40.0	40.4	41.2	40.9	41.2
EBITDA Margin %	41.7	42.8	40.8	41.4	42.0	41.7	42.0
Net Margin %	23.7	24.7	23.3	23.3	23.9	23.7	24.0
Free Cash Flow Margin %	24.4	26.8	22.6	23.8	23.6	24.5	24.8
ROIC %	71.9	79.2	68.0	68.7	115.7	126.7	118.7
Adjusted ROIC %	74.2	79.2	70.5	72.8	126.2	138.7	128.7
Return on Assets %	34.6	35.4	34.3	34.1	40.5	47.0	47.1
Return on Equity %	-85.6	-128.4	-66.8	-61.4	-61.4	-61.3	-68.0

Leverage	3-Year Hist. Avg	2011	2012	2013	2014	2015	5-Year Proj. Avg
Debt/Capital	2.37	2.40	2.33	2.38	3.42	3.63	3.15
Total Debt/EBITDA	1.58	1.36	1.64	1.73	1.36	1.30	1.24
EBITDA/Interest Expense	13.16	15.23	12.29	11.98	13.80	14.25	14.98

Valuation Summary and Forecasts

	2012	2013	2014(E)	2015(E)
Price/Fair Value	0.96	1.13	—	—
Price/Earnings	14.0	16.4	16.5	15.3
EV/EBITDA	8.6	9.9	10.5	10.0
EV/EBIT	8.8	10.2	10.7	10.2
Free Cash Flow Yield %	7.4	6.1	5.6	6.1
Dividend Yield %	5.4	4.5	4.1	4.3

Key Valuation Drivers

Cost of Equity %	9.0
Pre-Tax Cost of Debt %	5.5
Weighted Average Cost of Capital %	8.4
Long-Run Tax Rate %	37.5
Stage II EBI Growth Rate %	2.0
Stage II Investment Rate %	4.0
Perpetuity Year	10

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

Discounted Cash Flow Valuation

	USD Mil	Firm Value (%)	Per Share Value
Present Value Stage I	5,860	28.8	16.49
Present Value Stage II	4,494	22.1	12.65
Present Value Stage III	9,969	49.1	28.06
Total Firm Value	**20,323**	**100.0**	**57.19**
Cash and Equivalents	1,611	—	4.53
Debt	-3,560	—	-10.02
Preferred Stock	—	—	—
Other Adjustments	-1,076	—	-3.03
Equity Value	**17,298**	**—**	**48.68**
Projected Diluted Shares	355		
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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59.95 USD	69.00 USD	48.30 USD	93.15 USD	Medium	Wide	Stable	Standard	UR-	Tobacco Products

Morningstar Analyst Forecasts

Income Statement (USD Mil) Fiscal Year Ends in December	2011	2012	2013	*Forecast* 2014	*Forecast* 2015
Revenue	**4,452**	**4,636**	**4,972**	***5,508***	***5,806***
Cost of Goods Sold	2,134	2,279	2,253	*2,688*	*2,833*
Gross Profit	**2,318**	**2,357**	**2,719**	***2,820***	***2,973***
Selling, General & Administrative Expenses	451	504	709	*550*	*596*
Other Operating Expense (Income)	—	—	—	—	—
Other Operating Expense (Income)	—	—	—	—	—
Depreciation & Amortization (if reported separately)	—	—	—	—	—
Operating Income (ex charges)	**1,867**	**1,853**	**2,010**	***2,270***	***2,377***
Restructuring & Other Cash Charges	—	—	—	—	—
Impairment Charges (if reported separately)	—	—	—	—	—
Other Non-Cash (Income)/Charges	-25	-25	-44	—	—
Operating Income (incl charges)	**1,892**	**1,878**	**2,054**	***2,270***	***2,377***
Interest Expense	125	154	172	*168*	*170*
Interest Income	3	4	2	*5*	*5*
Pre-Tax Income	**1,770**	**1,728**	**1,884**	***2,107***	***2,212***
Income Tax Expense	654	629	704	*790*	*829*
Other After-Tax Cash Gains (Losses)	—	—	—	—	—
Other After-Tax Non-Cash Gains (Losses)	—	—	—	—	—
(Minority Interest)	—	—	—	—	—
(Preferred Dividends)	—	—	—	—	—
Net Income	**1,116**	**1,099**	**1,180**	***1,317***	***1,382***
Weighted Average Diluted Shares Outstanding	418	390	374	*361*	*350*
Diluted Earnings Per Share	**2.67**	**2.82**	**3.16**	***3.65***	***3.94***
Adjusted Net Income	1,098	1,081	1,156	*1,316*	*1,377*
Diluted Earnings Per Share (Adjusted)	**2.63**	**2.77**	**3.09**	***3.64***	***3.93***
Dividends Per Common Share	1.73	2.07	2.20	*2.44*	*2.63*
EBITDA	**1,929**	**1,917**	**2,104**	***2,314***	***2,423***
Adjusted EBITDA	**1,904**	**1,892**	**2,060**	***2,314***	***2,423***

Lorillard Inc LO (NYSE) | ★★★★

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59.95 USD	69.00 USD	48.30 USD	93.15 USD	Medium	Wide	Stable	Standard	UR-	Tobacco Products

Morningstar Analyst Forecasts

Balance Sheet (USD Mil)

Fiscal Year Ends in December

				Forecast	
	2011	2012	2013	*2014*	*2015*
Cash and Equivalents	1,634	1,720	1,611	*916*	*801*
Investments	—	—	—	—	—
Accounts Receivable	93	70	48	*53*	*56*
Inventory	277	410	499	*595*	*628*
Deferred Tax Assets (Current)	535	557	555	*555*	*555*
Other Short Term Assets	25	20	23	*23*	*23*
Current Assets	**2,564**	**2,777**	**2,736**	***2,142***	***2,062***
Net Property Plant, and Equipment	262	298	316	*344*	*373*
Goodwill	—	64	102	*102*	*102*
Other Intangibles	—	57	87	*87*	*87*
Deferred Tax Assets (Long-Term)	54	48	51	*51*	*51*
Other Long-Term Operating Assets	128	152	244	*244*	*244*
Long-Term Non-Operating Assets	—	—	—	—	—
Total Assets	**3,008**	**3,396**	**3,536**	***2,970***	***2,919***
Accounts Payable	32	39	42	*50*	*53*
Short-Term Debt	—	—	—	—	—
Deferred Tax Liabilities (Current)	6	23	8	*8*	*8*
Other Short-Term Liabilities	1,447	1,539	1,601	*1,601*	*1,601*
Current Liabilities	**1,485**	**1,601**	**1,651**	***1,659***	***1,662***
Long-Term Debt	2,595	3,111	3,560	*3,150*	*3,150*
Deferred Tax Liabilities (Long-Term)	—	—	—	—	—
Other Long-Term Operating Liabilities	53	52	84	*84*	*84*
Long-Term Non-Operating Liabilities	388	409	305	*305*	*305*
Total Liabilities	**4,521**	**5,173**	**5,600**	***5,198***	***5,201***
Preferred Stock	—	—	—	—	—
Common Stock	2	5	4	*4*	*4*
Additional Paid-in Capital	266	298	256	*256*	*256*
Retained Earnings (Deficit)	2,059	2,351	-1,438	*-1,002*	*-543*
(Treasury Stock)	-3,612	-4,190	-756	*-1,356*	*-1,869*
Other Equity	-228	-241	-130	*-130*	*-130*
Shareholder's Equity	**-1,513**	**-1,777**	**-2,064**	***-2,228***	***-2,282***
Minority Interest	—	—	—	—	—
Total Equity	**-1,513**	**-1,777**	**-2,064**	***-2,228***	***-2,282***

Lorillard Inc LO (NYSE) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
59.95 USD	69.00 USD	48.30 USD	93.15 USD	Medium	Wide	Stable	Standard	UR-	Tobacco Products

Morningstar Analyst Forecasts

Cash Flow (USD Mil)

Fiscal Year Ends in December	2011	2012	2013	*Forecast 2014*	*2015*
Net Income	1,116	1,099	1,180	*1,317*	*1,382*
Depreciation	37	39	50	*44*	*46*
Amortization	—	—	—	—	—
Stock-Based Compensation	12	9	5	*4*	*4*
Impairment of Goodwill	—	—	—	—	—
Impairment of Other Intangibles	—	—	—	—	—
Deferred Taxes	-15	-11	-42	—	—
Other Non-Cash Adjustments	-14	1	-8	—	—
(Increase) Decrease in Accounts Receivable	1	-8	-7	*-5*	*-3*
(Increase) Decrease in Inventory	—	-118	-89	*-96*	*-32*
Change in Other Short-Term Assets	—	—	—	—	—
Increase (Decrease) in Accounts Payable	-33	64	20	*8*	*3*
Change in Other Short-Term Liabilities	79	95	83	—	—
Cash From Operations	**1,183**	**1,170**	**1,192**	***1,272***	***1,401***
(Capital Expenditures)	-56	-74	-62	*-72*	*-75*
Net (Acquisitions), Asset Sales, and Disposals	—	-135	-46	—	—
Net Sales (Purchases) of Investments	—	—	-250	—	—
Other Investing Cash Flows	—	—	—	—	—
Cash From Investing	**-56**	**-209**	**-358**	***-72***	***-75***
Common Stock Issuance (or Repurchase)	-1,586	-578	-795	*-600*	*-513*
Common Stock (Dividends)	-723	-807	-823	*-881*	*-923*
Short-Term Debt Issuance (or Retirement)	—	—	—	—	—
Long-Term Debt Issuance (or Retirement)	741	495	496	*-410*	—
Other Financing Cash Flows	12	15	22	*-4*	*-4*
Cash From Financing	**-1,556**	**-875**	**-1,100**	***-1,895***	***-1,440***
Exchange Rates, Discontinued Ops, etc. (net)	—	—	—	—	—
Net Change in Cash	**-429**	**86**	**-266**	***-695***	***-115***

Lorillard Inc LO (NYSE) | ★★★★

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59.95 USD	69.00 USD	48.30 USD	93.15 USD	Medium	Wide	Stable	Standard	UR-	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

		Price/Earnings			EV/EBITDA			Price/Free Cash Flow			Price/Book			Price/Sales		
Company/Ticker	Price/Fair Value	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)
Altria Group Inc MO USA	1.17	15.9	*17.8*	*17.1*	10.6	*13.5*	*13.8*	18.0	*22.6*	*21.4*	18.6	*20.9*	*21.3*	4.3	*5.1*	*5.0*
Imperial Tobacco Group PLC ITYBY USA	0.96	23.1	*72.1*	*40.8*	12.4	*11.2*	*10.3*	10.7	*12.0*	*11.6*	4.0	*4.9*	*4.5*	2.8	*3.3*	*3.0*
Reynolds American Inc RAI USA	1.39	15.7	*17.3*	*16.2*	9.8	*10.8*	*10.4*	26.1	*18.5*	*17.3*	5.2	*5.9*	*5.8*	3.3	*3.6*	*3.6*
Average		18.2	*35.7*	*24.7*	10.9	*11.8*	*11.5*	18.3	*17.7*	*16.8*	9.3	*10.6*	*10.5*	3.5	*4.0*	*3.9*
Lorillard Inc LO US	**0.87**	**16.4**	***16.5***	***15.3***	**9.9**	***10.5***	***10.0***	**16.4**	***18.0***	***16.3***	**NM**	***NM***	***NM***	**3.7**	***3.9***	***3.7***

Returns Analysis

		ROIC %			Adjusted ROIC %			Return on Equity %			Return on Assets %			Dividend Yield %		
Company/Ticker	Last Historical Year Total Assets (Mil)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)
Altria Group Inc MO USA	34,859 USD	49.5	*45.6*	*45.8*	84.2	*76.6*	*77.4*	124.4	*121.0*	*122.5*	12.9	*14.6*	*15.0*	4.7	*4.5*	*4.6*
Imperial Tobacco Group PLC ITYBY USA	28,418 GBP	16.5	*11.9*	*10.0*	16.5	*13.0*	*14.7*	16.1	*23.3*	*30.4*	3.3	*4.5*	*5.3*	4.8	*4.5*	*4.9*
Reynolds American Inc RAI USA	15,402 USD	19.4	*16.4*	*17.0*	64.1	*53.0*	*54.3*	33.0	*34.2*	*35.1*	10.8	*11.5*	*12.0*	5.0	*4.7*	*4.9*
Average		28.5	*24.6*	*24.3*	54.9	*47.5*	*48.8*	57.8	*59.5*	*62.7*	9.0	*10.2*	*10.8*	4.8	*4.6*	*4.8*
Lorillard Inc LO US	**3,536** USD	**68.7**	***115.7***	***126.7***	**72.8**	***126.2***	***138.7***	**-61.4**	***-61.4***	***-61.3***	**34.1**	***40.5***	***47.0***	**4.5**	***4.1***	***4.3***

Growth Analysis

		Revenue Growth %			EBIT Growth %			EPS Growth %			Free Cash Flow Growth %			Dividend/Share Growth %		
Company/Ticker	Last Historical Year Revenue (Mil)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)	2013	2014(E)	2015(E)
Altria Group Inc MO USA	17,663 USD	0.9	*0.5*	*1.7*	8.5	*-7.8*	*-2.2*	9.2	*6.7*	*4.6*	5.0	*-7.5*	*2.2*	7.6	*13.7*	*4.6*
Imperial Tobacco Group PLC ITYBY USA	7,857 GBP	-0.3	*-1.3*	*8.6*	29.0	*28.8*	*21.2*	41.3	*-62.7*	*77.3*	21.8	*-2.2*	*-173.7*	10.8	*7.6*	*10.7*
Reynolds American Inc RAI USA	8,236 USD	-0.8	*3.1*	*1.2*	5.5	*4.6*	*4.0*	7.4	*5.6*	*6.6*	-32.2	*42.6*	*6.9*	6.1	*10.3*	*6.6*
Average		-0.1	*0.8*	*3.8*	14.3	*8.5*	*7.7*	19.3	*-16.8*	*29.5*	-1.8	*11.0*	*-54.9*	8.2	*10.5*	*7.3*
Lorillard Inc LO US	**4,972** USD	**7.3**	***10.8***	***5.4***	**8.5**	***13.0***	***4.7***	**11.6**	***17.7***	***7.9***	**13.2**	***9.5***	***9.7***	**6.5**	***10.8***	***7.9***

Lorillard Inc LO (NYSE) | ★★★★

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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 % 2013	Gross Margin % 2014(E)	Gross Margin % 2015(E)	EBITDA Margin % 2013	EBITDA Margin % 2014(E)	EBITDA Margin % 2015(E)	Operating Margin % 2013	Operating Margin % 2014(E)	Operating Margin % 2015(E)	Net Margin % 2013	Net Margin % 2014(E)	Net Margin % 2015(E)	Free Cash Flow Margin % 2013	Free Cash Flow Margin % 2014(E)	Free Cash Flow Margin % 2015(E)
Altria Group Inc MO USA	4,812 USD	59.2	55.7	55.8	47.0	43.2	41.7	45.8	42.0	40.4	27.2	28.8	29.2	24.0	22.6	23.5
Imperial Tobacco Group PLC ITYBY USA	937 GBP	70.4	70.8	70.7	32.0	41.8	42.0	24.9	32.5	36.3	11.9	4.5	7.3	26.5	27.9	26.2
Reynolds American Inc RAI USA	1,744 USD	55.3	53.4	52.4	37.9	38.8	39.8	36.7	37.2	38.2	21.2	21.4	22.3	12.5	19.7	20.9
Average		61.6	60.0	59.6	39.0	41.3	41.2	35.8	37.2	38.3	20.1	18.2	19.6	21.0	23.4	23.5
Lorillard Inc LO US	**1,156** USD	**54.7**	**51.2**	**51.2**	**41.4**	**42.0**	**41.7**	**40.4**	**41.2**	**40.9**	**23.3**	**23.9**	**23.7**	**22.7**	**21.8**	**22.8**

Leverage Analysis

Company/Ticker	Last Historical Year Total Debt (Mil)	Debt/Equity % 2013	Debt/Equity % 2014(E)	Debt/Equity % 2015(E)	Debt/Total Cap % 2013	Debt/Total Cap % 2014(E)	Debt/Total Cap % 2015(E)	EBITDA/Interest Exp. 2013	EBITDA/Interest Exp. 2014(E)	EBITDA/Interest Exp. 2015(E)	Total Debt/EBITDA 2013	Total Debt/EBITDA 2014(E)	Total Debt/EBITDA 2015(E)	Assets/Equity 2013	Assets/Equity 2014(E)	Assets/Equity 2015(E)
Altria Group Inc MO USA	14,517 USD	352.4	334.3	340.7	77.9	77.0	77.3	7.9	7.0	8.9	1.7	1.9	1.9	8.5	8.1	8.2
Imperial Tobacco Group PLC ITYBY USA	11,134 GBP	199.1	211.8	274.4	66.6	67.9	73.3	1.7	3.4	4.3	4.4	3.4	4.4	5.1	5.4	6.1
Reynolds American Inc RAI USA	5,099 USD	98.7	96.8	95.5	49.7	49.2	48.9	12.1	12.9	13.4	1.6	1.5	1.5	3.0	2.9	2.9
Average		216.7	214.3	236.9	64.7	64.7	66.5	7.2	7.8	8.9	2.6	2.3	2.6	5.5	5.5	5.7
Lorillard Inc LO US	**3,560** USD	**-172.5**	**-141.4**	**-138.0**	**238.0**	**341.8**	**363.0**	**12.0**	**13.8**	**14.2**	**1.7**	**1.4**	**1.3**	**-1.7**	**-1.3**	**-1.3**

Liquidity Analysis

Company/Ticker	Market Cap (Mil)	Cash per Share 2013	Cash per Share 2014(E)	Cash per Share 2015(E)	Current Ratio 2013	Current Ratio 2014(E)	Current Ratio 2015(E)	Quick Ratio 2013	Quick Ratio 2014(E)	Quick Ratio 2015(E)	Cash/Short-Term Debt 2013	Cash/Short-Term Debt 2014(E)	Cash/Short-Term Debt 2015(E)	Payout Ratio % 2013	Payout Ratio % 2014(E)	Payout Ratio % 2015(E)
Altria Group Inc MO USA	90,862 USD	1.59	1.68	1.71	0.93	0.98	0.98	0.67	0.69	0.69	6.05	6.38	6.38	79.7	80.0	80.0
Imperial Tobacco Group PLC ITYBY USA	41,391 USD	1.85	2.53	3.70	0.93	0.93	0.99	0.57	0.57	0.63	1.55	1.63	1.92	113.7	89.6	76.0
Reynolds American Inc RAI USA	30,979 USD	2.74	2.76	2.79	1.19	1.21	1.22	0.82	0.82	0.82	—	—	—	77.7	81.4	82.2
Average		2.06	2.32	2.73	1.02	1.04	1.06	0.69	0.69	0.71	3.80	4.01	4.15	90.4	83.7	79.4
Lorillard Inc LO US	**21,583** USD	**4.31**	**2.53**	**2.28**	**1.66**	**1.29**	**1.24**	**1.35**	**0.93**	**0.86**	**—**	**—**	**—**	**69.8**	**66.9**	**66.8**

Research Methodology for Valuing Companies

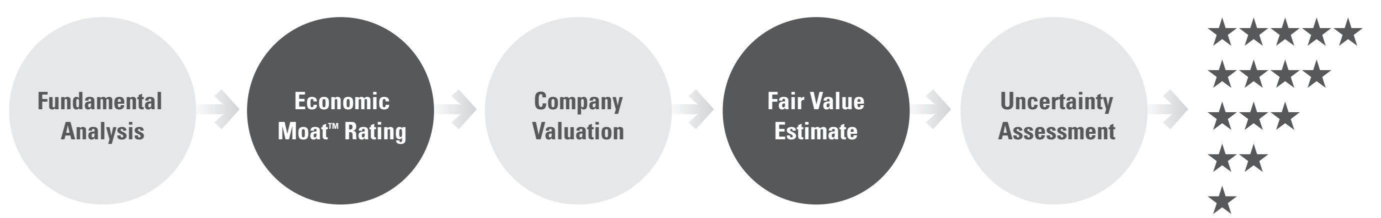
Components of Our Methodology
- Economic Moat™ Rating
- Moat Trend™ Rating
- Moat Valuation
- Three-Stage Discounted Cash Flow
- Weighted Average Cost of Capital
- Fair Value Estimate
- Scenario Analysis
- Uncertainty Ratings
- Margin of Safety
- Consider Buying/Selling
- Stewardship Rating

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.

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.

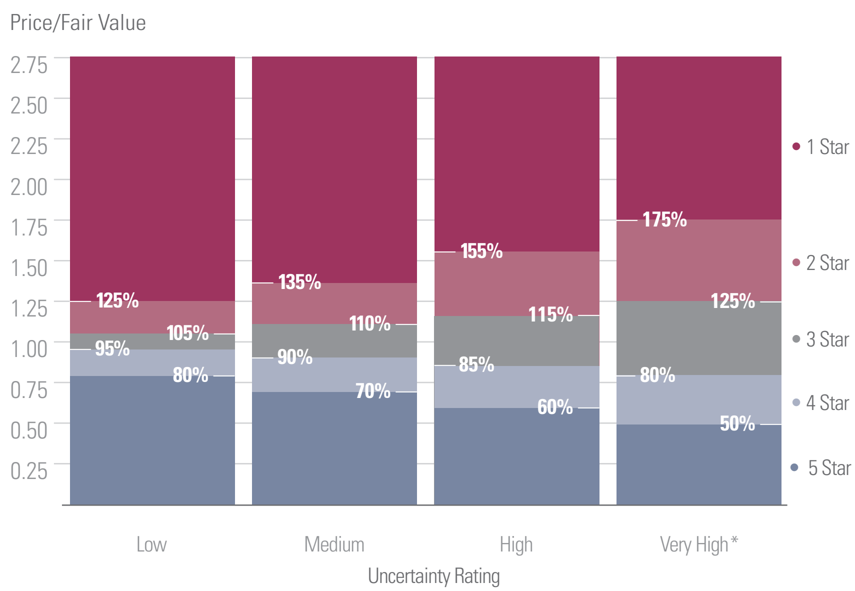
perpetuity formula. In deciding on the rate at which to discount future cash flows, we ignore stock-price volatility. Instead, we rely on a system that measures the estimated volatility of a firm's underlying future free cash flows, taking into account fundamental factors such as the diversity of revenue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

Morningstar's Approach to Rating Corporate Credit

- Offers a proprietary measure of the credit quality of companies on our coverage list.
- Encapsulates our in-depth modeling and quantitative work in one letter grade.
- Allows investors to rank companies by each of the four underlying components of our credit ratings, including both analyst-driven and quantitative measures.
- Provides access to all the underlying forecasts that go into the rating, available through our institutional service.

Purpose

The Morningstar Corporate Credit Rating measures the ability of a firm to satisfy its debt and debt-like obligations. The higher the rating, the less likely we think the company is to default on these obligations.

The Morningstar Corporate Credit Rating builds on the modeling expertise of our securities research team. For each company, we publish:

- Five years of detailed pro-forma financial statements
- Annual estimates of free cash flow
- Annual forecasts of return on invested capital
- Scenario analyses, including upside and downside cases
- Forecasts of leverage, coverage, and liquidity ratios for five years
- Estimates of off balance sheet liabilities

These forecasts are key inputs into the Morningstar Corporate Credit Rating and are available to subscribers at select.morningstar.com.

Methodology

We feel it's important to perform credit analysis through different lenses—qualitative and quantitative, as well as fundamental and market-driven. We therefore evaluate each company in four broad categories.

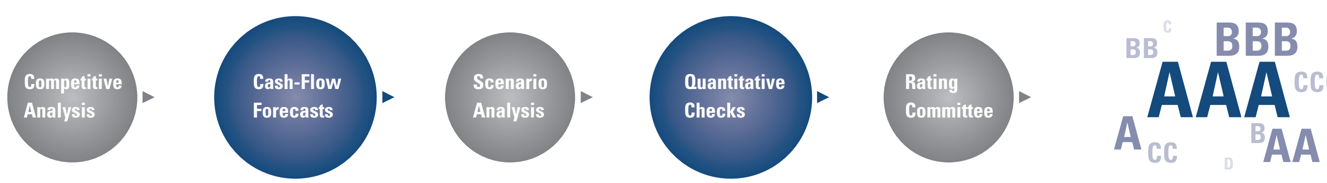
Business Risk

Business Risk captures the fundamental uncertainty around a firm's business operations and the cash flow generated by those operations. Key components of the Business Risk rating include the Morningstar Economic Moat™ Rating and the Morningstar Uncertainty Rating.

Cash Flow Cushion™

Morningstar's proprietary Cash Flow Cushion™ ratio is a fundamental indicator of a firm's future financial health The measure reveals how many times a company's internal cash generation plus total excess liquid cash will cover its debt-like contractual commitments over the next five years. The Cash Flow Cushion acts as a predictor of financial distress, bringing to light potential refinancing, operational, and liquidity risks inherent to the firm.

Morningstar Research Methodology for Determining Corporate Credit Ratings



Analyst conducts company and industry research:

- Management interviews
- Conference calls
- Trade show visits
- Competitor, supplier, distributor, and customer interviews
- Assign Economic Moat™ Rating

Analyst considers company financial statements and competitive dynamics to forecast future free cash flows to the firm.

Analyst derives estimate of Cash-Flow Cushion™.

Analysts run bull and bear cases through the model to derive alternate estimates of enterprise value.

Based on competitive analysis, cash-flow forecasts, and scenario analysis, the analyst assigns Business Risk.

We gauge a firm's health using quantitative tools supported by our own backtesting and academic research.

- Morningstar Solvency Score™
- Distance to Default

Senior personnel review each company to determine the appropriate final credit rating.

- Review modeling assumptions
- Approve company-specific adjustments

AAA	Extremely Low Default Risk
AA	Very Low Default Risk
A	Low Default Risk
BBB	Moderate Default Risk
BB	Above Average Default Risk
B	High Default Risk
CCC	Currently Very High Default Risk
CC	Currently Extreme Default Risk
C	Imminent Payment Default
D	Payment Default
UR	Under Review
UR+	Positive Credit Implication
UR-	Negative Credit Implication

Morningstar's Approach to Rating Corporate Credit

The advantage of the Cash Flow Cushion ratio relative to other fundamental indicators of credit health is that the measure focuses on the future cash-generating performance of the firm derived from Morningstar's proprietary discounted cash flow model. By making standardized adjustments for certain expenses to reflect their debt-like characteristics, we can compare future projected free cash flows with debt-like cash commitments coming due in any particular year. The forward-looking nature of this metric allows us to anticipate changes in a firm's financial health and pinpoint periods where cash shortfalls are likely to occur.

Morningstar Solvency Score™

The Morningstar Solvency Score™ is a quantitative score derived from both historical and forecasted financial ratios. It includes ratios that focus on liquidity (a company's ability to meet short term cash outflows), profitability (a company's ability to generate profit per unit of input), capital structure (how does the company finance its operations), and interest coverage (how much of profit is used up by interest payments).

Distance to Default

Morningstar's quantitative Distance to Default measure ranks companies on the likelihood that they will tumble into financial distress. The measure is a linear model of the percentile of a firm's leverage (ratio of Enterprise Value to Market Value), the percentile of a firm's equity volatility relative to the rest of the universe and the interaction of these two percentiles. This is a proxy methodology for the common definition of Distance to Default which relies on option-based pricing models. The proxy has the benefit of increased breadth of coverage, greater simplicity of calculation, and more predictive power.

For each of these four categories, we assign a score, which we then translate into a descriptive rating along the scale of Very Good / Good / Fair / Poor / Very Poor.

Overall Credit Rating

The four component ratings roll up into a single preliminary credit rating. To determine the final credit rating, a credit committee of at least five senior research personnel reviews each preliminary rating.

We review credit ratings on a regular basis and as events warrant. Any change in rating must be approved by the Credit Rating Committee.

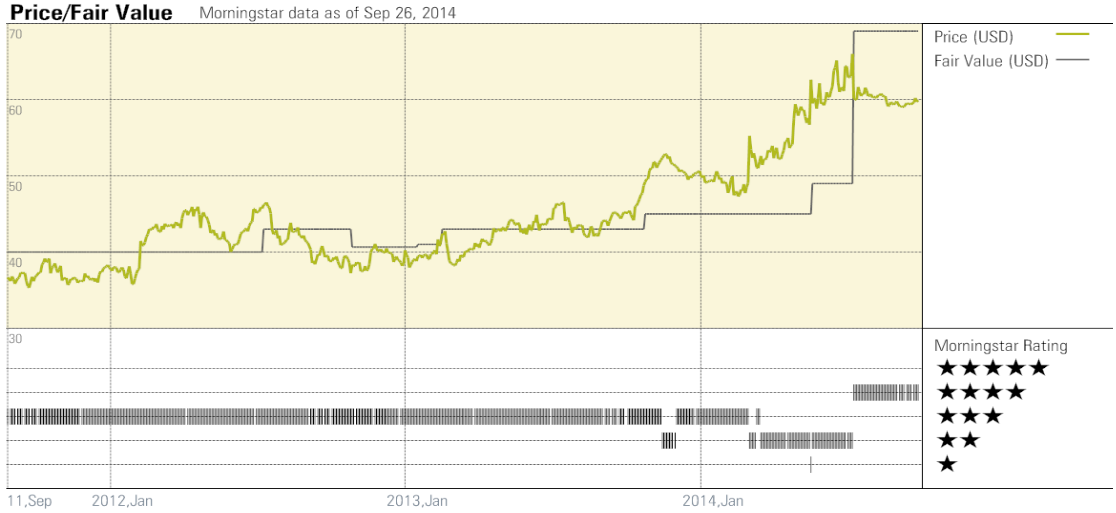
Investor Access

Morningstar Corporate Credit Ratings are available on Morningstar.com. Our credit research, including detailed cash-flow models that contain all of the components of the Morningstar Corporate Credit Rating, is available to subscribers at select.morningstar.com.

Lorillard Inc LO (NYSE) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Morningstar Credit Rating	Industry Group
59.95 USD	69.00 USD	48.30 USD	93.15 USD	Medium	Wide	Stable	Standard	UR-	Tobacco Products

Price/Fair Value Morningstar data as of Sep 26, 2014



The Morningstar Rating for stocks identifies stocks trading at a discount or premium to their intrinsic value. Five-star stocks sell for the biggest risk-adjusted discount whereas one-star stocks trade at premiums to their intrinsic value. Based on a fundamentally focused methodology and a robust, standardized set of procedures and core valuation tools used by Morningstar's Equity Analysts, four key components drive the Morningstar Rating: 1. Assessment of the firm's economic moat, 2. Estimate of the stock's fair value, 3. Uncertainty around that fair value estimate and 4. Current market price. Further information on Morningstar's methodology is available from http://global.morningstar.com/equitydisclosures.

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