Philip Morris International Inc PM (NYSE) | ★★★★

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

Philip Morris On Track to Meet Our Above-Consensus Full-Year Projections; Still Value in Stock

See Page 2 for the full Analyst Note from 16 Apr 2015

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

Research as of 16 Apr 2015
Estimates as of 24 Feb 2015
Pricing data through 20 Apr 2015
Rating updated as of 20 Apr 2015

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

Contents

Investment Thesis 24 Feb 2015

Philip Morris International is one of the strongest businesses in our consumer defensive coverage. The company generates industry-leading normalized operating margins in the low- to mid-40% range and boasts a wide economic moat with strong brand loyalty and cost advantages at its core. Nevertheless, we see room for execution improvement and we think margins could go even higher.

Philip Morris' profitability in emerging markets is a key differentiator against its competitors, and it has a strong presence in Asia. The advantage of selling in emerging markets is that volumes are in some cases, increasing. Indonesia (where Philip Morris has about a 31% share), Turkey (about 45%), and the Philippines (about 90%) are all growing in volume at a low- to mid-single-digit rate as a more lax regulatory environment in those regions has led to higher levels of smoking initiation. This should help to slow the firm's decline in volumes over the next decade. The disadvantage of emerging markets is that on the whole, they are less profitable than developed markets. This is less true for Philip Morris International than it is for its competitors. It generated a 2014 EBIT margin (excluding unfavorable foreign exchange movements) of 40% in Asia, in line with the group EBIT margin and above that of British American. The Asia segment margin is skewed by the firm's strong presence in the profitable Japanese market, but it also reflects Philip Morris' positioning in premium categories.

An opportunity for margin expansion lies in improving its operational efficiency, and we would like to see management focus on optimizing its manufacturing processes. Since its creation in 2008, the firm has consistently operated with less efficient asset turnover and cash conversion ratios than its competitors, despite its greater scale. We believe there is some fat to trim in the firm's cost structure, including consolidating manufacturing plants, which by bringing the firm's asset turnover ratios in line with competitors, we estimate could add a further $800 million or 200 basis points to the EBIT margin.

Vital Statistics

Market Cap (USD Mil)	131,458
52-Week High (USD)	91.63
52-Week Low (USD)	75.27
52-Week Total Return %	6.9
YTD Total Return %	5.6
Last Fiscal Year End	31 Dec 2014
5-Yr Forward Revenue CAGR %	3.3
5-Yr Forward EPS CAGR %	3.2
Price/Fair Value	0.92

Valuation Summary and Forecasts

Fiscal Year:	2013	2014	*2015(E)*	*2016(E)*
Price/Earnings	16.5	15.9	*19.7*	*18.5*
EV/EBITDA	11.2	11.6	*13.3*	*12.4*
EV/EBIT	11.9	12.5	*14.3*	*13.3*
Free Cash Flow Yield %	6.5	5.7	*4.6*	*5.3*
Dividend Yield %	4.1	4.8	*4.9*	*4.9*

Financial Summary and Forecasts (USD Mil)

Fiscal Year:	2013	2014	*2015(E)*	*2016(E)*
Revenue	31,217	29,767	*28,898*	*29,502*
Revenue YoY %	-0.5	-4.6	*-2.9*	*2.1*
EBIT	13,802	12,342	*11,155*	*11,972*
EBIT YoY %	-0.9	-10.6	*-9.6*	*7.3*
Net Income, Adjusted	8,576	8,028	*6,778*	*7,146*
Net Income YoY %	-2.6	-6.4	*-15.6*	*5.4*
Diluted EPS	5.29	5.13	*4.32*	*4.60*
Diluted EPS YoY %	1.7	-3.0	*-15.8*	*6.6*
Free Cash Flow	7,517	7,863	*7,095*	*7,736*
Free Cash Flow YoY %	-14.3	4.6	*-9.8*	*9.0*

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

Profile

Philip Morris International is the world's second-largest tobacco company, behind China National Tobacco, and holds 28% of the global market, excluding China. The firm owns seven of the leading 15 international brands. Marlboro, the company's flagship brand, accounted for about one third of total volume in 2014. Other key brands include L&M, Philip Morris, Bond Street, Chesterfield, Parliament, and Lark.

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Morningstar Analysis

Philip Morris On Track to Meet Our Above-Consensus Full-Year Projections; Still Value in Stock 16 Apr 2015

Philip Morris International comfortably beat consensus on the top line, but first-quarter results put the firm on track to meet our full-year projections. Management modestly raised its full-year guidance to $4.32-$4.42 in earnings per share from $4.27-$4.37, and although our estimate is now at the lower end of that range, we are unlikely to make material changes to our forecasts. We are reiterating our $92 fair value estimate and our wide economic moat and stable trend ratings. We continue to view Philip Morris as a high-quality business that is temporarily hampered by foreign exchange headwinds. As we stated in our fourth-quarter earnings note, looking through the reported numbers and stripping out the impact of foreign exchange, the business is performing quite well.

First-quarter revenue of $6.6 billion was 4.4% lower than last year on a reported basis, but 9.2% higher on a currency-adjusted basis. The upside was healthy and broad-based, with every region contributing positive growth. Particularly encouraging was the rebound in the European Union, which delivered 7.8% currency-neutral growth. While favorable trade inventory movements boosted volume around 1% in some key markets by our estimation, sell-through to the consumer accelerated in the first quarter in Europe, and Philip Morris made modest share gains in most major EU markets.

Only currency spoiled another strong performance in the Eastern Europe and Latin America segments. Despite strong performances last year, with both segments generating double-digit currency-neutral revenue growth, sales accelerated to 13.9% and 14.2%, respectively, mostly driven by pricing. It is this pricing power in a still fairly challenging environment that gives us confidence that the business model and competitive advantages of Philip Morris International remain firmly in place.

The first quarter is the smallest for Philip Morris, and we temper our enthusiasm for these results with some caution that risks relating to the macroeconomic environment and regulatory environment remain. Nevertheless, with the headwinds in Europe beginning to subside, we believe there is value in Philip Morris stock, and we continue to recommend it to value investors looking to hold high-quality businesses.

Valuation, Growth and Profitability 24 Feb 2015

After a solid fourth quarter that was in line with our expectations, we are raising our fair value estimate for Philip Morris to $92 from $90, due to the impact of the time value of money, mitigated by further unfavorable foreign exchange movements. Our valuation implies a 2015 P/E multiple of 21.6 times and a 2015 EV/EBITDA multiple of 14.6 times. It also implies a 2015 dividend yield of 4.4%, which is around the middle of the pack for the international tobacco manufacturers. These multiples are higher than the historical average for tobacco companies, but when adjusting for the reduction in EPS of $0.80 next year caused by currency movements, the 2015 earnings multiple is 16 times.

Our fair value estimate is based on three key valuation drivers: volume, pricing, and margins. We have lowered our 2015 estimates to account for the strengthening U.S. dollar, and now expect revenue to fall by 2.9% and operating income by 9.6% this year. Beyond 2016, we hold revenue growth in the mid-single digits for the remainder of our explicit forecast period. Our revenue assumptions are driven primarily by pricing, as global volumes continue to decline. We assume a long-term gross margin of 66%. Revenue growth is being driven by pricing, not volume, so the procurement advantage of growing scale is limited. In the absence of acquisitions, and given that raw tobacco prices are fairly stable, we see little opportunity for Philip Morris to expand its gross margin on a sustained basis. However, we do believe there is an opportunity at the operating margin for greater profitability. We forecast Philip Morris' operating

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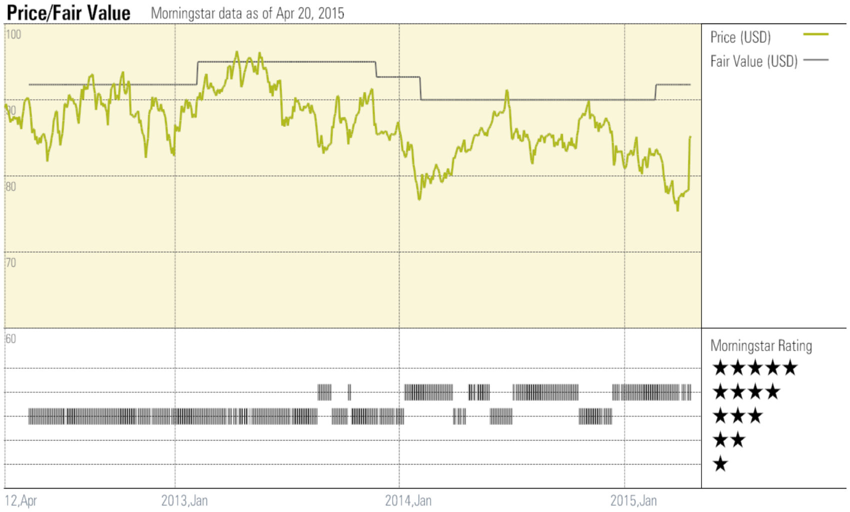
Price/Fair Value Morningstar data as of Apr 20, 2015



margin to grow by 280 basis points over the 2014 margin of 41.5% (to 10 basis points belowits 2012 peak of 44.4%), mainly driven by cost leverage from pricing, but also because we believe there is some operational fat to trim. This is a key variable in our scenario analysis.

Despite higher costs of borrowing in the later years in our forecast period, we model an average of 8.1% EPS growth (after a 16% drop this year on currency) driven by earnings growth with some support from share buybacks.

Scenario Analysis

With industry fundamentals fairly stable and exchange rates currently being the key hindrance to cash flow generation, the critical variable in our scenario analysis is the value of the euro against a basket of currencies that Philip Morris International has the most exposure to. Our base case assumes that the ECB's asset purchasing program draws to a close as expected in September 2016, and that the euro strengthens, providing Philip Morris with a low single-digit tailwind from currency from the fourth quarter of that year through to the end of 2018. In our bull-case scenario, however, we assume that the eurozone recovery gathers pace in early 2016, with the ECB pulling back from quantitative easing and allowing the euro to recover against PM's major currency exposures--the U.S. dollar, the Japanese yen, the Swiss franc, and the pound sterling. In this scenario, PM's top line grows at 7% in 2016, fading to 5% by 2019. The faster growing top line allows for a further 240 basis points of margin expansion in 2016, with margins fading to being in line with the base-case assumption of 44% by 2019. In 2016, the year of the greatest impact of favorable currency movements in our bull-case scenario, our assumptions lead to an extra $0.54 in EPS over the base case scenario. Our valuation under these circumstances is $98 per share.

Conversely, in our bear case, we assume a prolonged period of quantitative easing, with the euro remaining weak throughout our forecast period. Revenue grows at 3% per year, a level we believe is an achievable organic medium-term rate. This leads to margin degradation of 100 basis points versus the base-case scenario, and a 2019 operating margin of 43.3%. Our valuation under these circumstances would be $86 per share.

Economic Moat

Powerful intangible assets are at the core of Philip Morris International's wide economic moat. In addition, the company's platform of total tobacco products and e-cigarettes gives it economies of scope and scale that make it difficult for new entrants to gain the critical mass of volume necessary to compete. Finally, the addictive nature of tobacco products makes demand fairly price inelastic, and with few substitute products outside the portfolios of the Big Tobacco firms, a 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. Philip Morris has an impressive brand portfolio that is quite evenly

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balanced across price points. In spite of 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. Philip Morris' leading brands include Parliament, Virginia Slims, and Chesterfield, and the firm also offers the only truly global and highest-volume brand, Marlboro. The company is the largest cigarette manufacturer outside of China and is the only one of the largest four players (excluding China National Tobacco) to increase its market share (by 30 basis points to 16%) since 2008.

Historical returns on invested capital lend support to our wide moat rating. Philip Morris has generated returns on invested capital in excess of 30% since splitting from Altria in 2008, and ROIC has increased steadily over that time to around 45% in 2013. We forecast returns to remain at 45% over the next decade, comfortably ahead of our 9% estimate of the firm's weighted average cost of capital.

Moat Trend

Philip Morris' moat trend is stable. We do not expect the firm's moat to contract in the short term, since the company's vast distribution system, market share, and brand strength are all relatively secure. Increased regulation is one of the omnipresent fat-tail risks facing 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 that many national and local governments are struggling to balance the books. In addition, a ban would create a black market for cigarettes, removing regulatory control from the grip of governments, which would be undesirable.

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 volumes. In fact, we think such a move actually increases pricing power because the elimination of packs 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 dampen competitive pricing strategies.

We are more concerned about the impact of plain packaging on moats, however, and we think that of the international manufacturers, Philip Morris has the most to lose. Early evidence from Australia suggests that industry volumes have not been affected, with 2013 volume declines of around 2%, and the market is actually outperforming most 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. With Philip Morris being heavily overindexed in premium categories both in developed and emerging markets, we believe that brands such as Parliament, Philip Morris, and Virginia Slims could lose share to competitive brands at lower prices. If similar measures were taken in other larger markets, we may reconsider our stable moat trend rating for Philip Morris. 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 volumes would reduce the industry value, which would, in turn, reduce government tax revenue on an ad valorem basis.

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Bulls Say/Bears Say

Bulls Say

- With 28% global market share (excluding the U.S. and China), PMI is the largest publicly traded tobacco company in the world. This unmatched scale, customer loyalty to Marlboro, and its addictive products give the firm meaningful pricing power.

- PMI owns the international rights to Marlboro, the iconic global cigarette brand, and the strength of its product portfolio makes the firm the price leader in many international markets.

- There is a long-term trend of trading up in emerging markets, and Philip Morris is the best-placed of the international manufacturers to benefit.

Bears Say

- Plain packaging legislation is one of the few legitimate regulatory threats to Philip Morris' wide economic moat.

- With its revenue derived in foreign currencies and about one quarter of its input costs in dollars, a strengthening of the U.S. dollar can have a material impact on earnings growth.

- Although Marlboro is the only truly global cigarette brand, differences in tastes and preferences across geographies limit the economies of scale the firm can derive from the brand.

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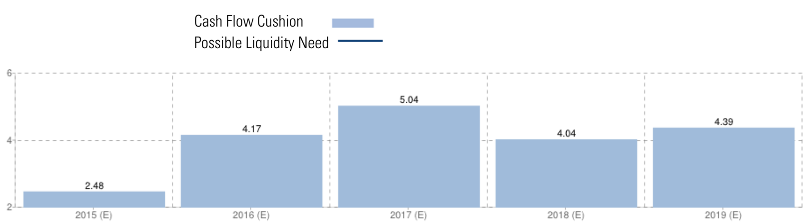
Five Year Adjusted Cash Flow Forecast (USD Mil)

	2015(E)	2016(E)	2017(E)	2018(E)	2019(E)
Cash and Equivalents (beginning of period)	1,682	9,914	13,287	14,695	14,663
Adjusted Available Cash Flow	7,925	3,001	3,247	3,612	4,036
Total Cash Available before Debt Service	9,607	12,915	16,533	18,307	18,698
Principal Payments	-2,170	-1,357	-1,300	-2,500	-2,009
Interest Payments	-1,447	-1,543	-1,842	-2,061	-2,316
Other Cash Obligations and Commitments	-251	-196	-137	28	63
Total Cash Obligations and Commitments	-3,868	-3,096	-3,279	-4,533	-4,262

Cumulative Annual Cash Flow Cushion



Adjusted Cash Flow Summary

	USD Millions	% of Commitments
Beginning Cash Balance	1,682	8.8
Sum of 5-Year Adjusted Free Cash Flow	21,821	114.6
Sum of Cash and 5-Year Cash Generation	23,503	123.5
Revolver Availability	8,000	42.0
Asset Adjusted Borrowings (Repayment)	—	—
Sum of Cash, 5-Year Cash Generation, Revolver and Adjustments	31,503	165.5
Sum of 5-Year Cash Commitments	-19,038	—

Financial Health

Philip Morris is in sound financial shape. With a net debt/EBITDA ratio of 2.10 times and EBITDA/interest expense of 11.3 times at the end of 2014, Philip Morris International can comfortably meet its debt-repayment schedule and interest payments. With the firm generating free cash flow at or above 30% of revenue, the highest in its peer group, it should remain in robust financial health. Our credit rating is A-, implying low default risk.

There are probably only one or two transformative deals left in global tobacco, but given the leverage in its balance sheet, we doubt that Philip Morris would be able to execute a large deal in cash. In addition, we expect the firm's share repurchase rate to slow going forward. Philip Morris has spent an aggregate $38 billion on repurchases between its spin off in May 2008 and the end of 2014, but we forecast no repurchases in 2015 (in line with guidance) and the annual rate to slow to around $2 billion in annual repurchases from 2016 onwards, from $5.4 billion to 2014. We expect the firm to grow the dividend at a mid-to-high single digit rate, in line with EPS growth. This, too, is a modest slowdown from the double digit rate of dividend growth to 2014.

Enterprise Risk

Our uncertainty rating for Philip Morris International 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 the risk of plain packaging measures in large markets and foreign exchange risk.Any investor owning tobacco stocks should have the stomach for fat-tail risk. Although the businesses are stable, the threat of government intervention through large excise tax increases, for example, is omnipresent. Litigation risk is substantially lower for the European players as most countries do not have a class-action legal process.

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Nevertheless, we regard government and legal risks as low-probability events with high potential impacts that investors should be aware of.In general, we believe government 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 and be detrimental to moats in the industry. The most likely large market to follow Australia in introducing plain packaging is the U.K., where Philip Morris has only a small presence, but if plain packages are introduced in any other major EU market, this could be materially detrimental to the firm, given its positioning in premium categories.Philip Morris' functional currency is the euro, but it reports in U.S. dollars. It also has exposure to currencies too small to hedge in large amounts on the open market. Although it has something of a natural hedge, with about 26% of its costs in euros almost offsetting the 32% of its revenue denominated in euros, strength in the U.S. dollar can have a significant and detrimental impact on Philip Morris' earnings.

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Management & Ownership

Management Activity

Name	Position	Shares Held	Report Date*	InsiderActivity
LOUIS C. CAMILLERI	Director	952,814	31 Dec 2014	—
ANDRE CALANTZOPOULOS	CEO/Director	760,492	18 Feb 2015	30,000
CHARLES R. WALL		588,087	30 Jun 2010	—
MATTEO PELLEGRINI	President, Geographical	268,888	18 Feb 2015	—
JACEK OLCZAK	CFO	223,792	18 Feb 2015	—
JEAN-CLAUDE KUNZ		222,344	12 Feb 2010	—
MIROSLAW ZIELINSKI	President, Divisional	208,672	18 Feb 2015	—
MR. MARC S. FIRESTONE	General Counsel/Senior VP	207,080	05 Feb 2015	—
JOACHIM PSOTTA	Controller/Vice President	164,489	18 Feb 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
VA CollegeAmerica Cap Income Builder	2.19	2.82	1,414	31 Mar 2015
Vanguard Total Stock Mkt Idx	1.76	0.51	211	31 Mar 2015
VA CollegeAmerica Fundamental Investors	1.65	2.79	5,765	31 Mar 2015
VA CollegeAmerica American Balanced	1.57	2.33	9,600	31 Mar 2015
VA CollegeAmerica Invmt Co of America	1.55	2.56	-500	31 Mar 2015
Concentrated Holders				
GMO Alpha Only Fund	0.07	15.75	9	30 Nov 2014
Stratégie Indice Alimentation	—	8.65	-2	31 Dec 2014
Independent Franchise Part Equity Fund	0.06	8.54	156	31 Dec 2014
Consumer Staples Select Sector SPDR® Fd	0.51	7.32	21	17 Apr 2015
First Trust Morningstar Dividend Leaders	0.06	7.11	—	17 Apr 2015

Institutional Transactions

Top 5 Buyers	% of Shares Held	% of Fund Assets	Shares Bought/ Sold (k)	Portfolio Date
Capital World Investors	4.08	1.39	5,090	31 Dec 2014
Invesco Advisers, Inc	0.34	0.27	3,220	31 Dec 2014
State Street Corp	4.00	0.50	3,207	31 Dec 2014
Cedar Rock Capital Ltd	0.37	14.53	3,012	31 Dec 2014
Vanguard Group, Inc.	5.56	0.50	2,418	31 Dec 2014
Top 5 Sellers				
BB&T SECURITIES, LLC	0.04	1.21	-5,816	31 Dec 2014
Arrowstreet Capital Limited Partnership	0.05	0.38	-4,261	31 Dec 2014
Wellington Management Company LLP	1.02	0.34	-4,130	31 Dec 2014
Capital Research Global Investors	5.72	2.50	-3,819	31 Dec 2014
J.P. Morgan Investment Management Inc.	0.52	0.28	-2,911	31 Dec 2014

Management 24 Feb 2015

Our stewardship rating of Philip Morris is Standard. Since its separation from Altria, Philip Morris has delivered total returns in the top half of its peer group, driven by top decile share repurchases and dividend growth in the consumer universe. We hold Chairman and former CEO Louis Camilleri in high regard, since we believe he created significant value for shareholders by reshaping Altria from a consumer packaged goods conglomerate into two pure-play tobacco powerhouses. However, Camilleri stepped aside from the CEO position at Philip Morris International in May 2013, making way for Andre Calantzopoulos, the former COO. This followed the retirement of CFO Hermann Waldemer a year earlier. Although foreign exchange has weighed on profitability and cash flow generation in the last two years, Philip Morris has a strong track record of double-digit annual returns to shareholders since its creation in 2008. While we continue to believe that the strength of the business will allow Philip Morris to continue to deliver strong returns on capital, we believe the jury is out on the new management team until major decisions on capital allocation have to be made.

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Analyst Notes

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 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.

Philip Morris Misses in 4Q; Upside Potential to Conservative Guidance Could Be Catalyst for Stock 05

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Analyst Notes

Feb 2015

The headline numbers from Philip Morris' fourth quarter do not offer investors much encouragement. The firm narrowly undershot our forecasts, entirely as a result of weaker-than-expected volumes in Eastern Europe, and missed consensus EPS estimates by $0.03. Management has provided 2015 guidance well below consensus, our forecasts and 2014 earnings. Looking through the reported numbers and stripping out the impact of foreign exchange, however, reveals that the business is performing quite well. We will lower our near-term assumptions, but our $90 fair value estimate remains in place for now, and we think there is upside to the current market price. We believe this earnings report shows that pricing power remains intact, and we are reiterating our wide economic moat and stable moat trend ratings.

Philip Morris International narrowly missed our full year 2014 forecasts by $0.03 in EPS, driven by volumes in the Eastern Europe, the Middle East, and the Africa segment that lagged our forecast. Demand remains weak in Russia, where the industry contracted by over 9% last year, Ukraine and Kazakhstan, and we expect the steep decline in currencies and the price of oil to continue to cause some revenue volatility for consumer goods companies in the region for some time. Asia remains very weak, although it is encouraging that volumes did not deteriorate further. Australia is the primary culprit, and with double-digit excise tax increases again scheduled for 2015, we believe Asia will be a drag on Philip Morris' top line next year as well.

Beyond Asia and the CIS region, however, we see reasons for optimism, particularly from the firm's ability to raise prices at a rate above volume declines in many markets. Revenue growth in the European Union, although weak, remains positive. Excluding currency movements and acquisitions, EU revenue grew by 1.3%, a sequential improvement on the 0.5% growth in the third quarter. Growth is being driven by pricing, notably in Germany and Poland.

Guidance for 2015 EPS of $4.27 to $4.37 is also alarmingly low on the surface. However, after stripping out the effect of heavily unfavorable foreign exchange movements, the guidance implies 4% to 6% higher revenue, 6% to 8% EBIT growth, and 8% to 10% adjusted EPS growth. This is slightly above our long-term estimates of the firm's growth algorithm, an indication of the momentum of the business in some markets, in our opinion. Furthermore, this guidance includes higher SG&A spending on the roll-out of iQOS next year, and assumes no share repurchases, a conservative assumption that could provide upside to earnings per share next year.

With business momentum improving in some geographies and a stock trading at a 10% discount to our fair value estimate, Philip Morris remains our pick in the international tobacco space. Guidance for next year could prove to be conservative, negative currency movements aside, and any improvement in Eastern Europe or Asia could trigger the modest upside to our valuation. While we are wary of the risk of contagion in standardized packaging legislation, we think Philip Morris' entrenchment with strong brands in markets with high barriers to entry makes it a high quality business with a wide economic moat.

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

Philip Morris International Inc PM (NYSE) | ★★★★

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

Analyst Notes

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 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.

Philip Morris International Inc PM (NYSE) | ★★★★

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Morningstar Analyst Forecasts

Financial Summary and Forecasts

Fiscal Year Ends in December

Growth (% YoY)	3-Year Hist. CAGR	2012	2013	2014	Forecast 2015	2016	5-Year Proj. CAGR
Revenue	-1.5	0.9	-0.5	-4.6	-2.9	2.1	3.3
EBIT	-2.8	3.6	-0.9	-10.6	-9.6	7.3	4.7
EBITDA	-2.9	2.7	-1.0	-9.9	-9.5	7.0	4.5
Net Income	-2.2	2.4	-2.6	-6.4	-15.6	5.4	2.0
Diluted EPS	1.7	6.6	1.7	-3.0	-15.8	6.6	3.2
Earnings Before Interest, after Tax	-0.7	5.1	7.2	-13.0	-14.4	7.3	3.1
Free Cash Flow	-7.3	-11.0	-14.3	4.6	-9.8	9.0	5.4

Profitability	3-Year Hist. Avg	2012	2013	2014	2015	2016	5-Year Proj. Avg
Operating Margin %	43.4	44.4	44.2	41.5	38.6	40.6	42.2
EBITDA Margin %	46.3	47.3	47.0	44.5	41.4	43.4	44.9
Net Margin %	27.5	28.1	27.5	27.0	23.5	24.2	24.8
Free Cash Flow Margin %	26.2	28.0	24.1	26.4	24.6	26.2	27.5
ROIC %	—	—	—	—	—	—	—
Adjusted ROIC %	80.9	89.7	81.1	71.9	66.6	71.1	77.6
Return on Assets %	23.2	24.3	23.4	21.9	19.1	19.1	20.1
Return on Equity %	-261.3	-547.2	-158.1	-78.7	-56.2	-59.9	-59.8

Leverage	3-Year Hist. Avg	2012	2013	2014	2015	2016	5-Year Proj. Avg
Debt/Capital	1.44	1.18	1.39	1.75	1.57	1.55	1.60
Total Debt/EBITDA	1.88	1.54	1.88	2.23	2.64	2.74	2.53
EBITDA/Interest Expense	13.11	14.72	13.30	11.31	8.27	8.29	7.83

Valuation Summary and Forecasts

	2013	2014	2015(E)	2016(E)
Price/Fair Value	0.94	0.91	—	—
Price/Earnings	16.5	15.9	19.7	18.5
EV/EBITDA	11.2	11.6	13.3	12.4
EV/EBIT	11.9	12.5	14.3	13.3
Free Cash Flow Yield %	6.5	5.7	4.6	5.3
Dividend Yield %	4.1	4.8	4.9	4.9

Key Valuation Drivers

Cost of Equity %	8.5
Pre-Tax Cost of Debt %	5.8
Weighted Average Cost of Capital %	8.0
Long-Run Tax Rate %	35.0
Stage II EBI Growth Rate %	4.0
Stage II Investment Rate %	3.2
Perpetuity Year	25

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	34,390	20.0	21.90
Present Value Stage II	94,640	55.0	60.26
Present Value Stage III	43,106	25.0	27.45
Total Firm Value	**172,136**	**100.0**	**109.60**
Cash and Equivalents	1,682	—	1.07
Debt	-29,455	—	-18.76
Preferred Stock	—	—	—
Other Adjustments	-954	—	-0.61
Equity Value	**143,409**	**—**	**91.31**
Projected Diluted Shares	1,571		
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.

Philip Morris International Inc PM (NYSE) | ★★★★

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

Morningstar Analyst Forecasts

Income Statement (USD Mil)

Fiscal Year Ends in December

				Forecast	
	2012	2013	2014	*2015*	*2016*
Revenue	**31,377**	**31,217**	**29,767**	***28,898***	***29,502***
Cost of Goods Sold	10,373	10,410	10,436	*10,692*	*10,326*
Gross Profit	**21,004**	**20,807**	**19,331**	***18,205***	***19,176***
Selling, General & Administrative Expenses	6,177	6,123	6,205	*6,345*	*6,490*
Other Operating Expense (Income)	—	—	—	—	—
Income from Equity Investments	—	—	-105	*-110*	*-116*
Depreciation & Amortization (if reported separately)	898	882	889	*815*	*831*
Operating Income (ex charges)	**13,929**	**13,802**	**12,342**	***11,155***	***11,972***
Restructuring & Other Cash Charges	—	—	—	—	—
Impairment Charges (if reported separately)	—	—	—	—	—
Other Non-Cash (Income)/Charges	—	—	—	—	—
Operating Income (incl charges)	**13,929**	**13,802**	**12,342**	***11,155***	***11,972***
Interest Expense	1,007	1,104	1,170	*1,447*	*1,544*
Interest Income	148	131	118	*142*	*150*
Pre-Tax Income	**13,070**	**12,829**	**11,290**	***9,850***	***10,578***
Income Tax Expense	3,833	3,670	3,097	*2,922*	*3,271*
Other After-Tax Cash Gains (Losses)	—	—	—	—	—
Other After-Tax Non-Cash Gains (Losses)	—	—	—	—	—
(Minority Interest)	-354	-274	-165	*-149*	*-161*
(Preferred Dividends)	—	—	—	—	—
Net Income	**8,883**	**8,885**	**8,028**	***6,778***	***7,146***
Weighted Average Diluted Shares Outstanding	1,692	1,622	1,566	*1,571*	*1,553*
Diluted Earnings Per Share	**5.25**	**5.48**	**5.13**	***4.32***	***4.60***
Adjusted Net Income	8,800	8,576	8,028	*6,778*	*7,146*
Diluted Earnings Per Share (Adjusted)	**5.20**	**5.29**	**5.13**	***4.32***	***4.60***
Dividends Per Common Share	3.19	3.53	3.85	*4.10*	*4.14*
EBITDA	**14,827**	**14,684**	**13,231**	***11,970***	***12,802***
Adjusted EBITDA	**14,827**	**14,684**	**13,231**	***11,970***	***12,802***

Philip Morris International Inc PM (NYSE) | ★★★★

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

Morningstar Analyst Forecasts

Balance Sheet (USD Mil)

Fiscal Year Ends in December	2012	2013	2014	Forecast 2015	2016
Cash and Equivalents	2,983	2,154	1,682	*2,921*	*5,127*
Investments	—	—	—	—	—
Accounts Receivable	3,589	3,853	4,004	*3,522*	*3,653*
Inventory	8,949	9,846	8,592	*8,868*	*9,205*
Deferred Tax Assets (Current)	450	502	533	*533*	*533*
Other Short Term Assets	619	497	673	*515*	*536*
Current Assets	**16,590**	**16,852**	**15,484**	***16,360***	***19,053***
Net Property Plant, and Equipment	6,645	6,755	6,071	*6,519*	*6,961*
Goodwill	9,900	8,893	8,388	*8,388*	*8,388*
Other Intangibles	3,619	3,193	2,985	*2,892*	*2,799*
Deferred Tax Assets (Long-Term)	—	—	—	—	—
Other Long-Term Operating Assets	916	2,475	2,259	*1,716*	*1,786*
Long-Term Non-Operating Assets	—	—	—	—	—
Total Assets	**37,670**	**38,168**	**35,187**	***35,875***	***38,987***
Accounts Payable	1,103	1,274	1,242	*1,144*	*1,187*
Short-Term Debt	5,200	3,655	2,526	*2,061*	*3,171*
Deferred Tax Liabilities (Current)	1,456	1,192	1,078	*973*	*1,012*
Other Short-Term Liabilities	9,257	10,945	10,266	*9,684*	*10,038*
Current Liabilities	**17,016**	**17,066**	**15,112**	***13,862***	***15,407***
Long-Term Debt	17,639	24,023	26,929	*29,523*	*31,877*
Deferred Tax Liabilities (Long-Term)	1,875	1,477	1,549	*1,549*	*1,549*
Other Long-Term Operating Liabilities	2,993	1,876	2,800	*2,432*	*2,530*
Long-Term Non-Operating Liabilities	—	—	—	—	—
Total Liabilities	**39,523**	**44,442**	**46,390**	***47,365***	***51,363***
Preferred Stock	—	—	—	—	—
Common Stock	—	—	—	—	—
Additional Paid-in Capital	1,334	723	710	*1,110*	*1,110*
Retained Earnings (Deficit)	25,076	27,843	29,249	*29,588*	*30,302*
(Treasury Stock)	-26,282	-32,142	-35,762	*-35,762*	*-37,362*
Other Equity	-3,604	-4,190	-6,826	*-6,426*	*-6,426*
Shareholder's Equity	**-3,476**	**-7,766**	**-12,629**	***-11,490***	***-12,376***
Minority Interest	1,623	1,492	1,426	—	—
Total Equity	**-1,853**	**-6,274**	**-11,203**	***-11,490***	***-12,376***

Philip Morris International Inc PM (NYSE) | ★★★★

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

Morningstar Analyst Forecasts

Cash Flow (USD Mil)

Fiscal Year Ends in December				*Forecast*	
	2012	2013	2014	*2015*	*2016*
Net Income	9,154	8,850	8,193	*6,928*	*7,306*
Depreciation	801	789	796	*722*	*737*
Amortization	97	93	93	*93*	*93*
Stock-Based Compensation	—	—	—	—	—
Impairment of Goodwill	—	—	—	—	—
Impairment of Other Intangibles	26	288	175	—	—
Deferred Taxes	—	—	—	*-105*	*39*
Other Non-Cash Adjustments	4	325	-65	—	—
(Increase) Decrease in Accounts Receivable	-398	-449	-463	*482*	*-131*
(Increase) Decrease in Inventory	-728	-1,413	105	*-276*	*-336*
Change in Other Short-Term Assets	—	—	—	*158*	*-21*
Increase (Decrease) in Accounts Payable	10	103	177	*-98*	*42*
Change in Other Short-Term Liabilities	455	1,549	-737	*-582*	*353*
Cash From Operations	**9,421**	**10,135**	**8,274**	***7,322***	***8,084***
(Capital Expenditures)	-1,056	-1,200	-1,153	*-1,170*	*-1,179*
Net (Acquisitions), Asset Sales, and Disposals	—	-2,121	-139	—	—
Net Sales (Purchases) of Investments	—	—	—	—	—
Other Investing Cash Flows	64	-62	296	*174*	*29*
Cash From Investing	**-992**	**-3,383**	**-996**	***-996***	***-1,150***
Common Stock Issuance (or Repurchase)	-6,524	-5,963	-3,833	*400*	*-1,600*
Common Stock (Dividends)	-5,404	-5,720	-6,035	*-6,440*	*-6,431*
Short-Term Debt Issuance (or Retirement)	898	52	-1,080	*-465*	*1,110*
Long-Term Debt Issuance (or Retirement)	3,279	4,443	4,351	*2,594*	*2,354*
Other Financing Cash Flows	-349	-324	-242	*-1,575*	*-161*
Cash From Financing	**-8,100**	**-7,512**	**-6,839**	***-5,486***	***-4,728***
Exchange Rates, Discontinued Ops, etc. (net)	104	-69	-376	*400*	—
Net Change in Cash	**433**	**-829**	**63**	***1,239***	***2,206***

Philip Morris International Inc PM (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.

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)
British American Tobacco PLC BTI USA	0.96	21.1	18.6	17.2	14.7	13.9	12.5	20.2	22.2	20.1	11.7	16.1	14.1	4.6	4.9	4.6
Imperial Tobacco Group PLC ITYBY USA	1.08	—	13.5	14.2	—	11.2	11.4	—	19.8	17.6	—	5.3	5.0	—	3.6	3.5
Average		21.1	16.1	15.7	14.7	12.6	12.0	20.2	21.0	18.9	11.7	10.7	9.6	4.6	4.3	4.1
Philip Morris International Inc PM	**0.92**	**15.9**	**19.7**	**18.5**	**11.6**	**13.3**	**12.4**	**17.7**	**21.8**	**18.8**	**NM**	**NM**	**NM**	**4.2**	**4.5**	**4.5**

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)
British American Tobacco PLC BTI USA	26,167 GBP	—	—	—	80.6	106.2	115.0	39.5	59.5	69.2	9.0	10.4	9.8	4.2	5.5	3.7
Imperial Tobacco Group PLC ITYBY USA	— GBP	—	—	—	83.6	135.4	128.2	28.3	31.0	27.3	5.3	5.3	4.7	—	4.1	4.2
Average		—	—	—	82.1	120.8	121.6	33.9	45.3	48.3	7.2	7.9	7.3	4.2	4.8	4.0
Philip Morris International Inc PM	**35,187** USD	**—**	**—**	**—**	**71.9**	**66.6**	**71.1**	**-78.7**	**-56.2**	**-59.9**	**21.9**	**19.1**	**19.1**	**4.8**	**4.9**	**4.9**

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)
British American Tobacco PLC BTI USA	13,971 GBP	-8.5	1.1	7.4	-17.7	16.2	12.0	-18.6	17.3	7.9	-23.8	16.5	-135.3	6.0	41.5	-32.6
Imperial Tobacco Group PLC ITYBY USA	7,995 GBP	7.7	8.5	2.4	27.7	15.6	1.3	41.0	11.3	-4.4	-116.5	364.4	-203.4	2.1	9.2	2.1
Average		-0.4	4.8	4.9	5.0	15.9	6.7	11.2	14.3	1.8	-70.2	190.5	-169.4	4.1	25.4	-15.3
Philip Morris International Inc PM	**29,767** USD	**-4.6**	**-2.9**	**2.1**	**-10.6**	**-9.6**	**7.3**	**-3.0**	**-15.8**	**6.6**	**4.6**	**-9.8**	**9.0**	**9.3**	**6.4**	**1.0**

Philip Morris International Inc PM (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 % 2014	2015(E)	2016(E)	EBITDA Margin % 2014	2015(E)	2016(E)	Operating Margin % 2014	2015(E)	2016(E)	Net Margin % 2014	2015(E)	2016(E)	Free Cash Flow Margin % 2014	2015(E)	2016(E)
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	25.9	26.0	22.8	22.2	22.8
Imperial Tobacco Group PLC ITYBY USA	2,006 GBP	71.0	71.1	71.2	38.8	40.6	39.2	33.0	35.1	34.7	25.1	25.7	24.0	31.9	18.1	19.8
Average		74.7	74.4	74.4	37.6	40.7	40.6	32.8	36.3	36.9	23.7	25.8	25.0	27.4	20.2	21.3
Philip Morris International Inc PM	**8,028** USD	**64.9**	**63.0**	**65.0**	**44.5**	**41.4**	**43.4**	**41.5**	**38.6**	**40.6**	**27.0**	**23.5**	**24.2**	**23.9**	**21.3**	**23.4**

Leverage Analysis

Company/Ticker	Last Historical Year Total Debt (Mil)	Debt/Equity % 2014	2015(E)	2016(E)	Debt/Total Cap % 2014	2015(E)	2016(E)	EBITDA/Interest Exp. 2014	2015(E)	2016(E)	Total Debt/EBITDA 2014	2015(E)	2016(E)	Assets/Equity 2014	2015(E)	2016(E)
British American Tobacco PLC BTI USA	12,258 GBP	222.5	397.1	430.0	69.0	79.9	81.1	7.9	8.4	7.0	2.4	3.0	3.3	4.7	7.0	7.1
Imperial Tobacco Group PLC ITYBY USA	12,415 GBP	231.3	296.5	268.1	69.8	74.8	72.8	4.2	3.9	3.7	4.0	4.9	4.7	5.6	6.1	5.7
Average		226.9	346.8	349.1	69.4	77.4	77.0	6.1	6.2	5.4	3.2	4.0	4.0	5.2	6.6	6.4
Philip Morris International Inc PM	**29,455** USD	**-233.2**	**-274.9**	**-283.2**	**175.1**	**157.2**	**154.6**	**11.3**	**8.3**	**8.3**	**2.2**	**2.6**	**2.7**	**-2.8**	**-3.1**	**-3.2**

Liquidity Analysis

Company/Ticker	Market Cap (Mil)	Cash per Share 2014	2015(E)	2016(E)	Current Ratio 2014	2015(E)	2016(E)	Quick Ratio 2014	2015(E)	2016(E)	Cash/Short-Term Debt 2014	2015(E)	2016(E)	Payout Ratio % 2014	2015(E)	2016(E)
British American Tobacco PLC BTI USA	104,149 USD	0.97	2.85	2.82	1.04	1.36	1.56	0.57	0.90	1.04	0.73	1.86	3.51	113.2	131.3	80.7
Imperial Tobacco Group PLC ITYBY USA	46,419 USD	1.90	2.78	2.38	0.90	0.83	0.88	0.55	0.53	0.55	3.64	0.97	1.23	79.5	73.9	80.0
Average		1.44	2.82	2.60	0.97	1.10	1.22	0.56	0.72	0.80	2.19	1.42	2.37	96.4	102.6	80.4
Philip Morris International Inc PM	**131,458** USD	**1.07**	**1.86**	**3.30**	**1.02**	**1.18**	**1.24**	**0.46**	**0.54**	**0.64**	**0.67**	**1.42**	**1.62**	**75.2**	**95.0**	**90.0**

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

Fundamental Analysis	Economic Moat™ Rating	Company Valuation	Fair Value Estimate	Uncertainty Assessment	★★★★★ ★★★★ ★★★ ★★ ★
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.

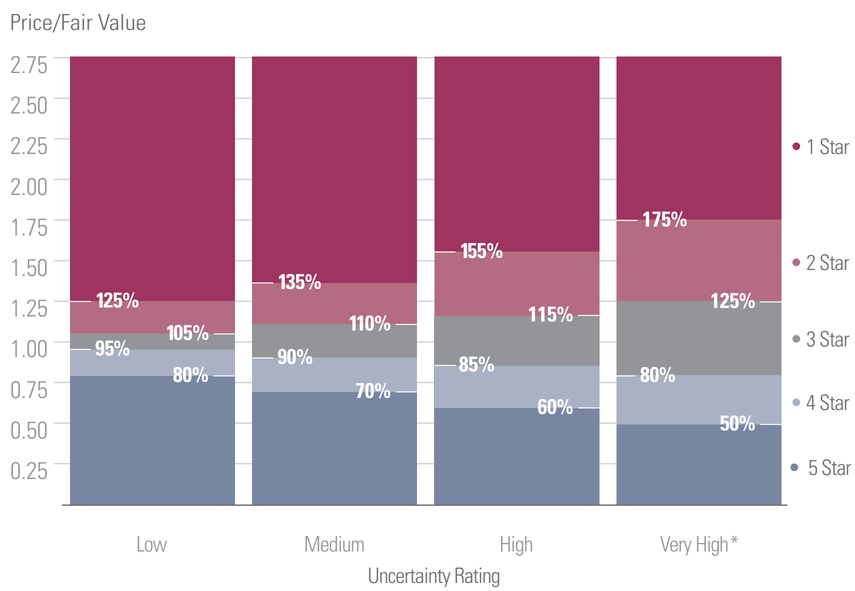
perpetuity formula. In deciding on the rate at which to discount future cash flows, we ignore stock-price volatility. Instead, we rely on a system that measures the estimated volatility of a firm's underlying future free cash flows, taking into account fundamental factors such as the diversity of revenue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

Philip Morris International Inc PM (NYSE) | ★★★★

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

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Philip Morris International Inc PM (NYSE) | ★★★★

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