

Wall Street Tobacco Industry Update

NATO Education Seminar – February 11, 2019

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All estimates/forecasts are as of 2/8/19 unless otherwise stated.

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Discussion Topics

➤ Overview of Current Tobacco Industry Trends

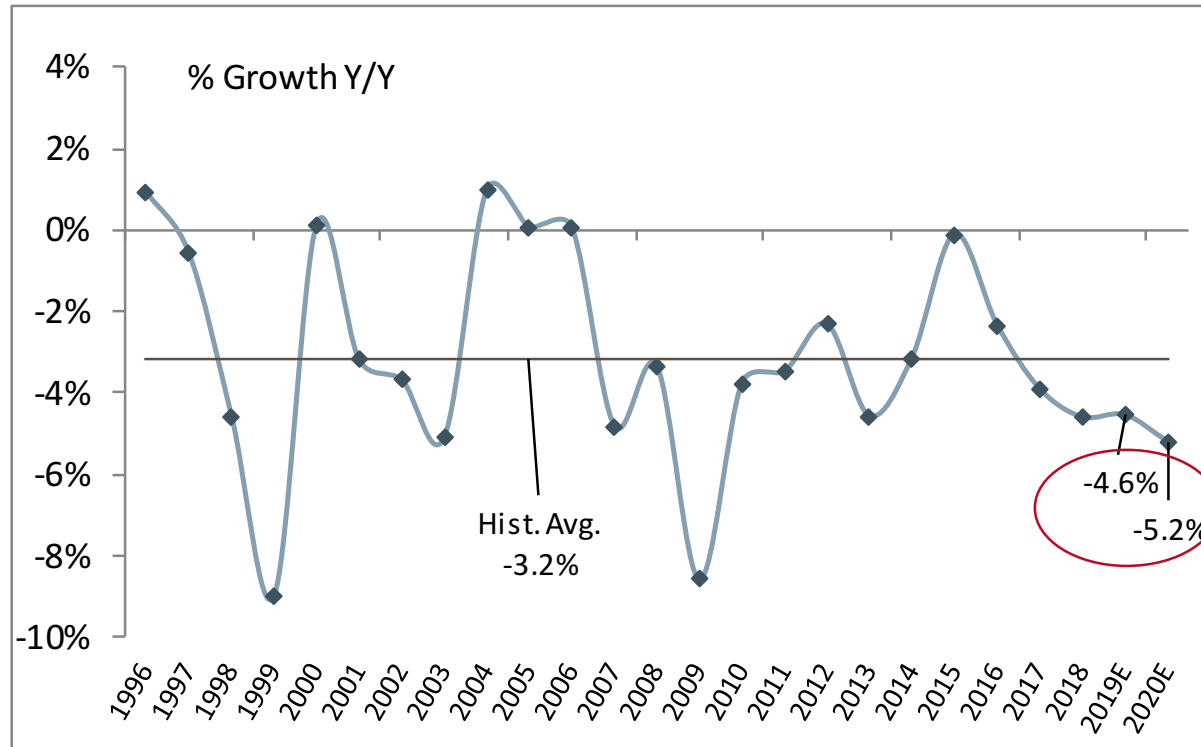
- **Combustible Cig Vol Deceleration Accelerates**
- **JUUL Leads E-Cigs/Vapor Renaissance**
- **FDA Cracks Down on E-Cig Youth Access While Advocating “Continuum of Risk” Approach & New Nicotine Strategy**
 - Removes Certain E-Cig Flavors From C-Store Channel
 - Encourages Long-Term Shift in Adult Cig Consumption to RRP
 - Premarket Tobacco Product Application (PMTA) Deadline for Marketing Newly Regulated Non-Combustible Products is **August 8, 2022**

➤ Notable Industry Developments

- **Altria Takes 35% Equity Stake in JUUL, Exits Own E-Cig Biz**
- **Total U.S. Nicotine Pool Set To Grow as New Users, RRP Dual-Usage, & Per Caps Increase**
- **Expect Consumption of RRP to Exceed Combustibles in Next Decade**

Combustible Cig Volume Deceleration Accelerates

U.S. Combustible Cig Volume Growth



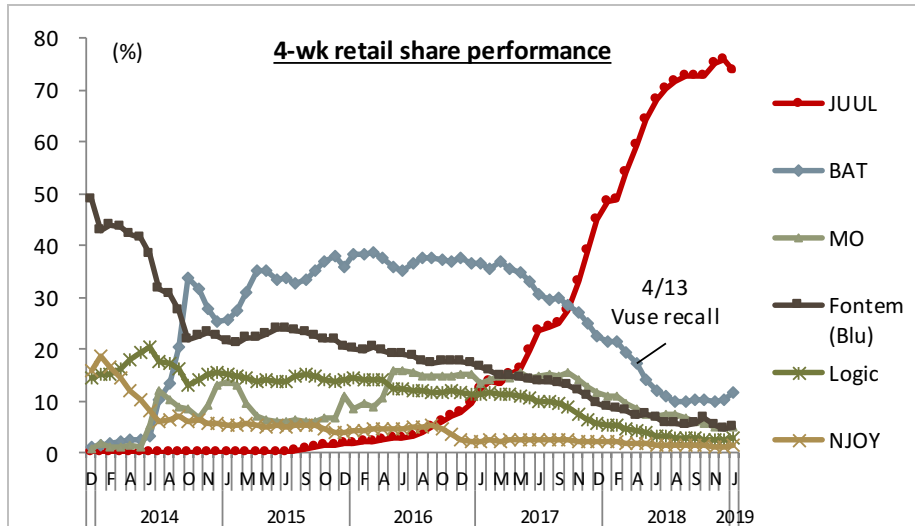
Source : Company Reports and Wells Fargo Securities, LLC estimates

- Combustible Cig Volumes Decelerate Below Historical Average Declines
- E-Vapor Resurgence & State Excise Tax Increases Impact Cig Industry Vol
- Net Price Realization, However, Remains Robust, Up ~5%

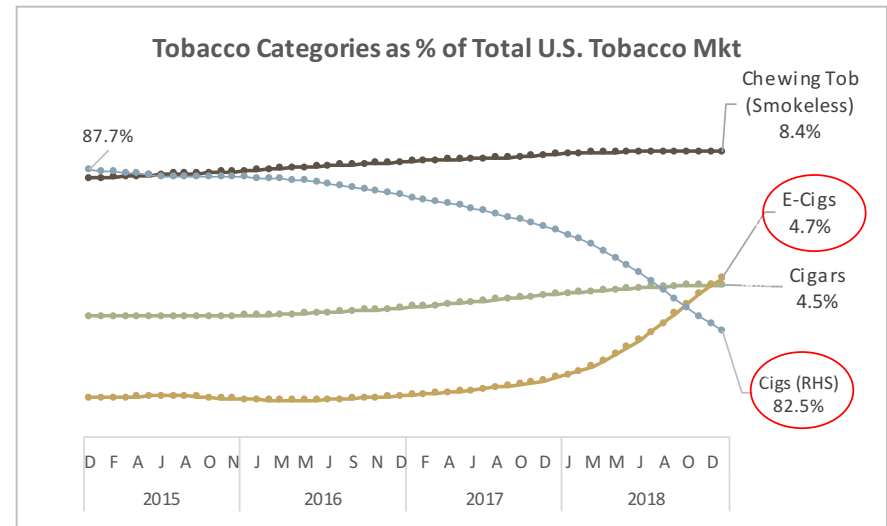
JUUL Leads E-Cig Resurgence

Nielsen All Channel Scanner Data Thru 1/26/19

E-Cig \$ Share Performance Thru Nielsen 4-wk period ended 1/26



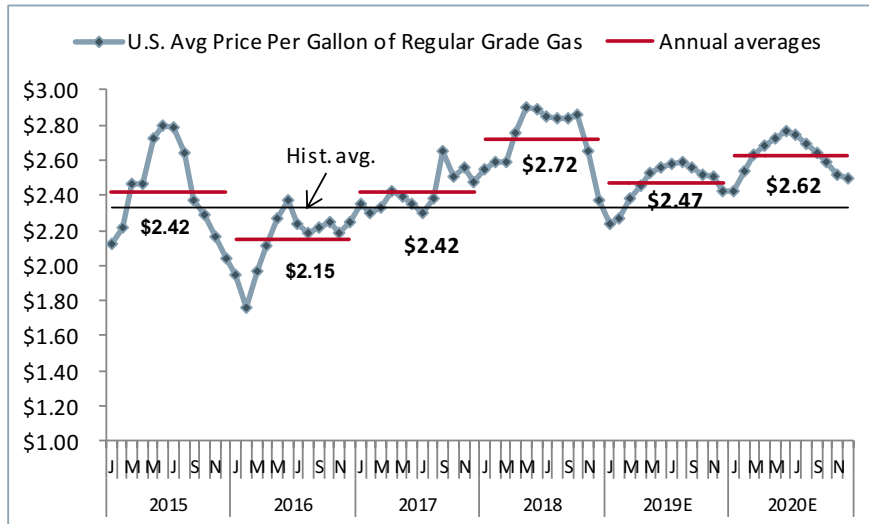
E-Cigs' Share of Total Nicotine Pool is Still Small, But Growing



- JUUL has re-ignited U.S. e-vapor category growth, accounting for nearly all of the category's growth to date
- JUUL represents >30% share of the overall e-vapor category, across open/closed systems and all trade classes
- U.S. e-vapor volume is expected to grow at a +15-20% CAGR thru 2023

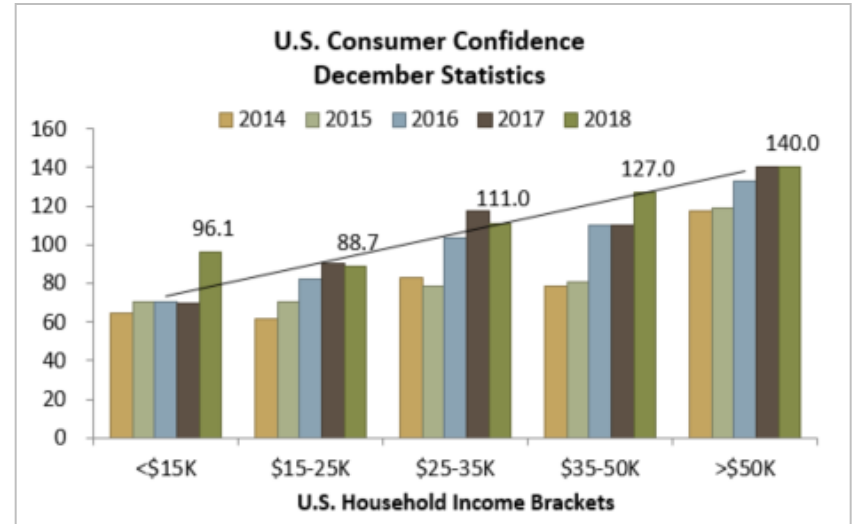
U.S. Adult Tobacco Consumer In Good Shape

U.S. Pump Prices Normalizing Avg Price Per Gallon of Regular Gas



Source: U.S. Energy Information Administration (EIA), Wells Fargo Securities, LLC

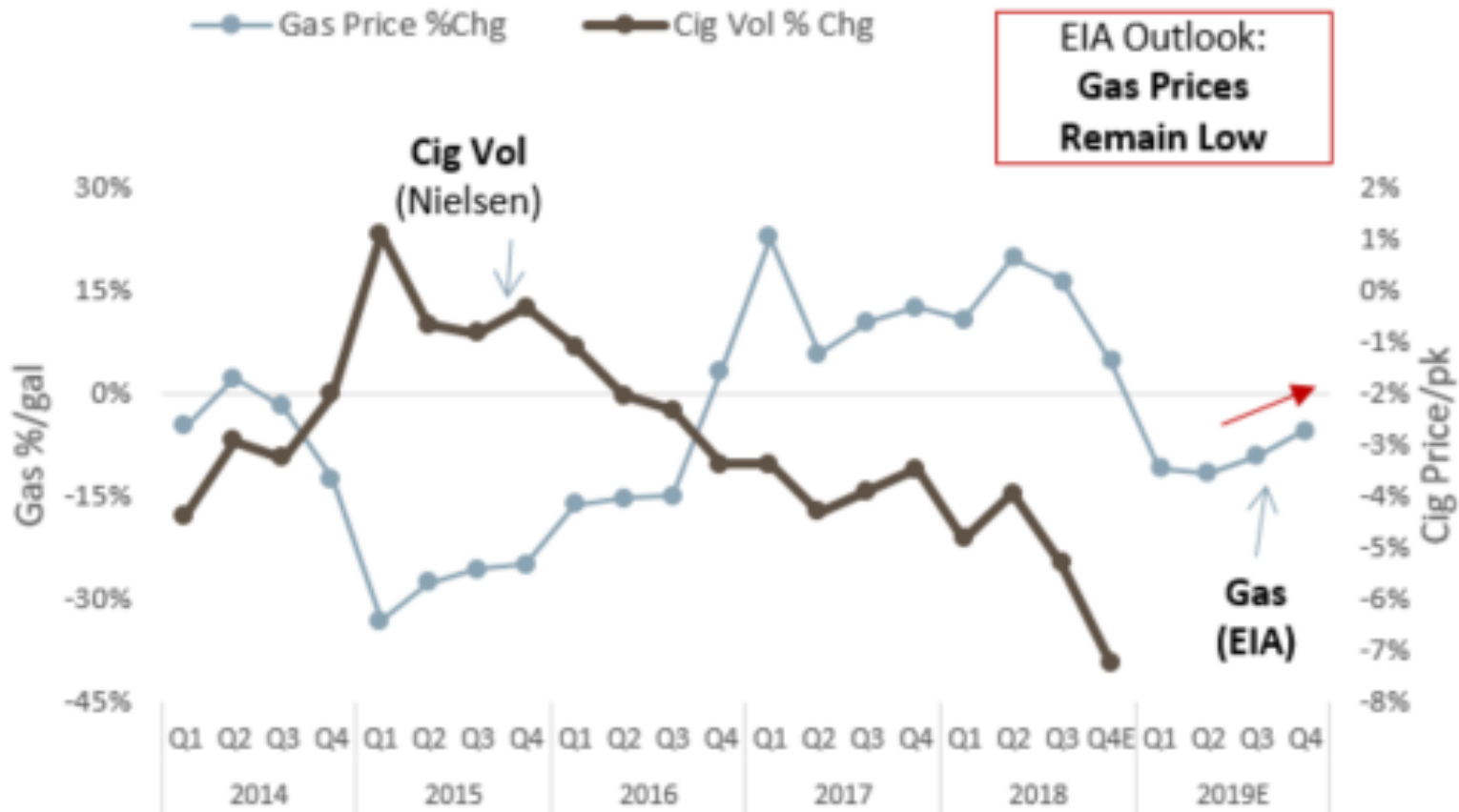
U.S. Consumer Confidence Up Generally, But Unevenly Spread



Source: FactSet, The Conference Board, Wells Fargo Securities, LLC

- Gas Prices Remain Relatively Low & Consumer Confidence Is At Highest Level Since 2001
- Supports Strong U.S. Adult Tobacco Consumer
- Favorable Macro Trends Favor Premium Brands

Cig Vols Strongly Correlated to Gas Price Trends

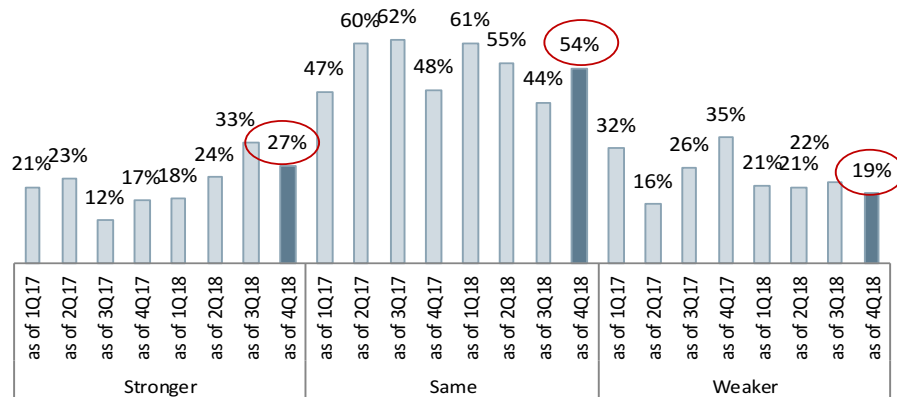


Sources: U.S. Energy Information Administration (EIA) for gas prices; Nielsen

U.S. Adult Tobacco Consumer In Good Shape

U.S. Adult Tobacco Consumer Responding Well to Loyalty Programs

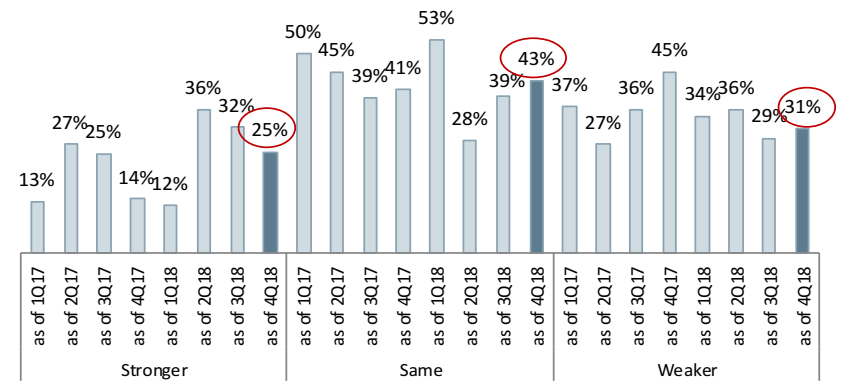
What do you think about the state of the U.S. adult tobacco consumer?



Source: 4Q18 "Tobacco Talk" Survey

Overall Traffic Trends Largely Unchanged But Warmer Weather & Promos Helped

What are you seeing in terms of overall traffic trends in your stores?

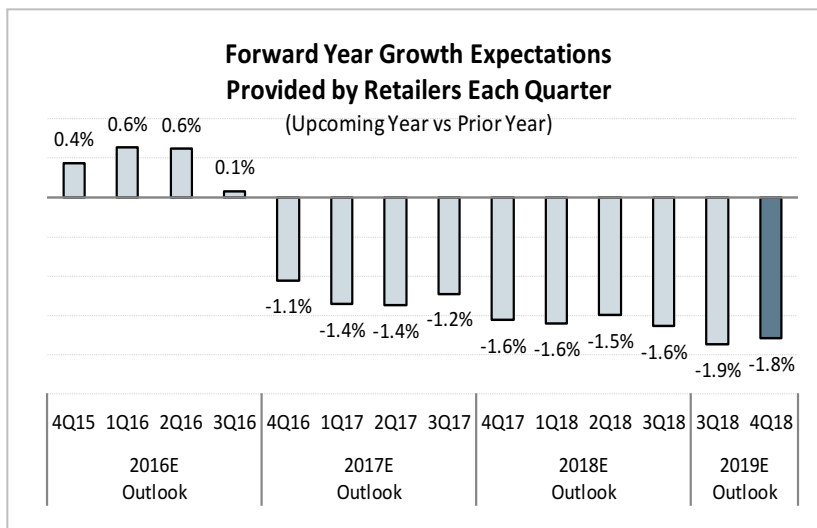


Source: 4Q18 "Tobacco Talk" Survey

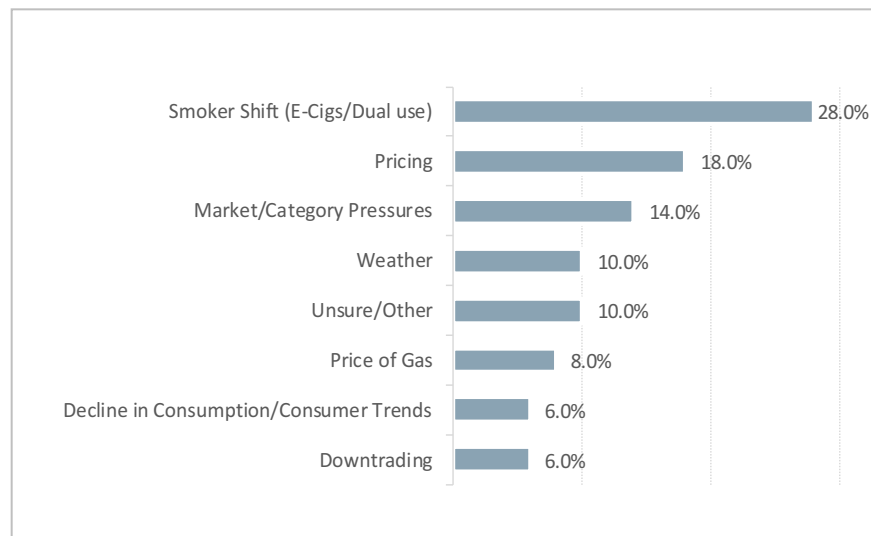
- "Customer counts in general are decreasing as we are seeing in cigarettes as well fortunately overall sales are up--so average purchase has increased in Q4, we started to see cigarette units go negative."
- "2018 proved to be a good year in Tobacco. Customers tend to purchase more traditional cigs than we saw in RYO, and foot traffic was up."
- "With the warmer weather we experienced, traffic/customers were slightly up over the past 4-8 weeks."

But Traffic Pressure Continues.....

Retailers Expect Slightly More Cig Vol Pressure in 2019



~30% of Retailers Attribute Cig Vol Softness to E-Cig Conversions & Dual Use



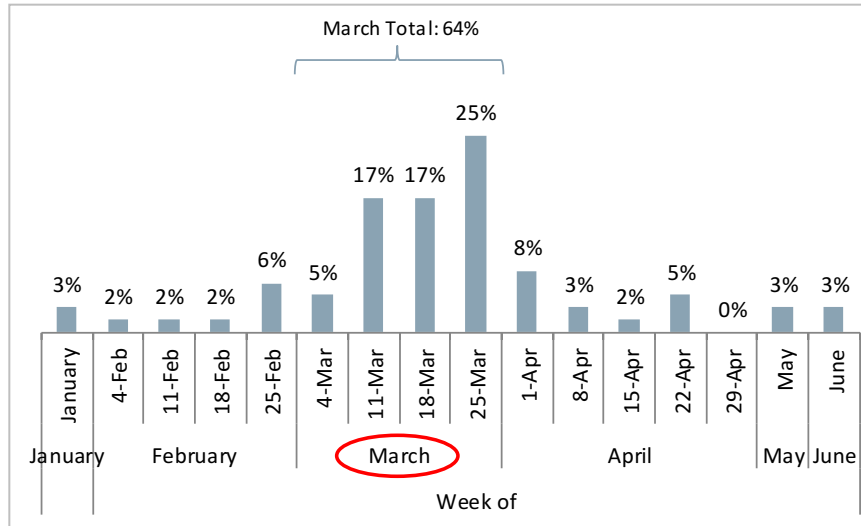
- JUUL & Dual-Use Contributing to Pressure, but Cig Mfr Pricing, Strong Loyalty Programs & Promos Are Expected to Be Key Offsets
- “More alternatives to combustibles + higher cigarette prices = slower sales”
- “We are not sure that gas prices will stay low as projected, which could result in customers trading down”
- “Gen Z is not smoking, retails are too high (pricing power is dead), and people are moving to vape, just as the FDA moves to suppress vape”

Source for both graphs: 4Q18 & Ad Hoc “Tobacco Talk” Surveys published in Feb 2019 and Nov 2018, respectively; Wells Fargo Securities, LLC estimates

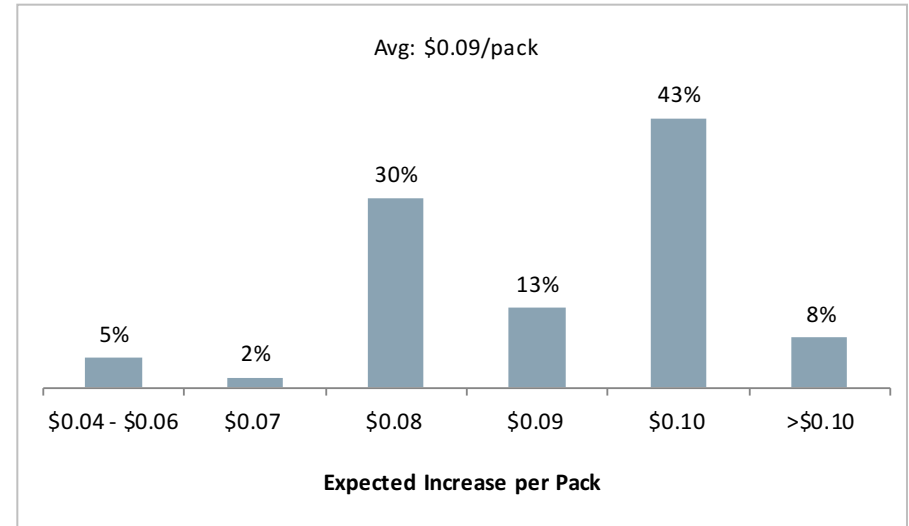
Next Cig List Price Increase Expected Late March

"Tobacco Talk" Survey – February 2019

Expected Date
of Next Cig List Price Increase



Expected Amount (per pack)
Of Next Manufacturer List Price Increase

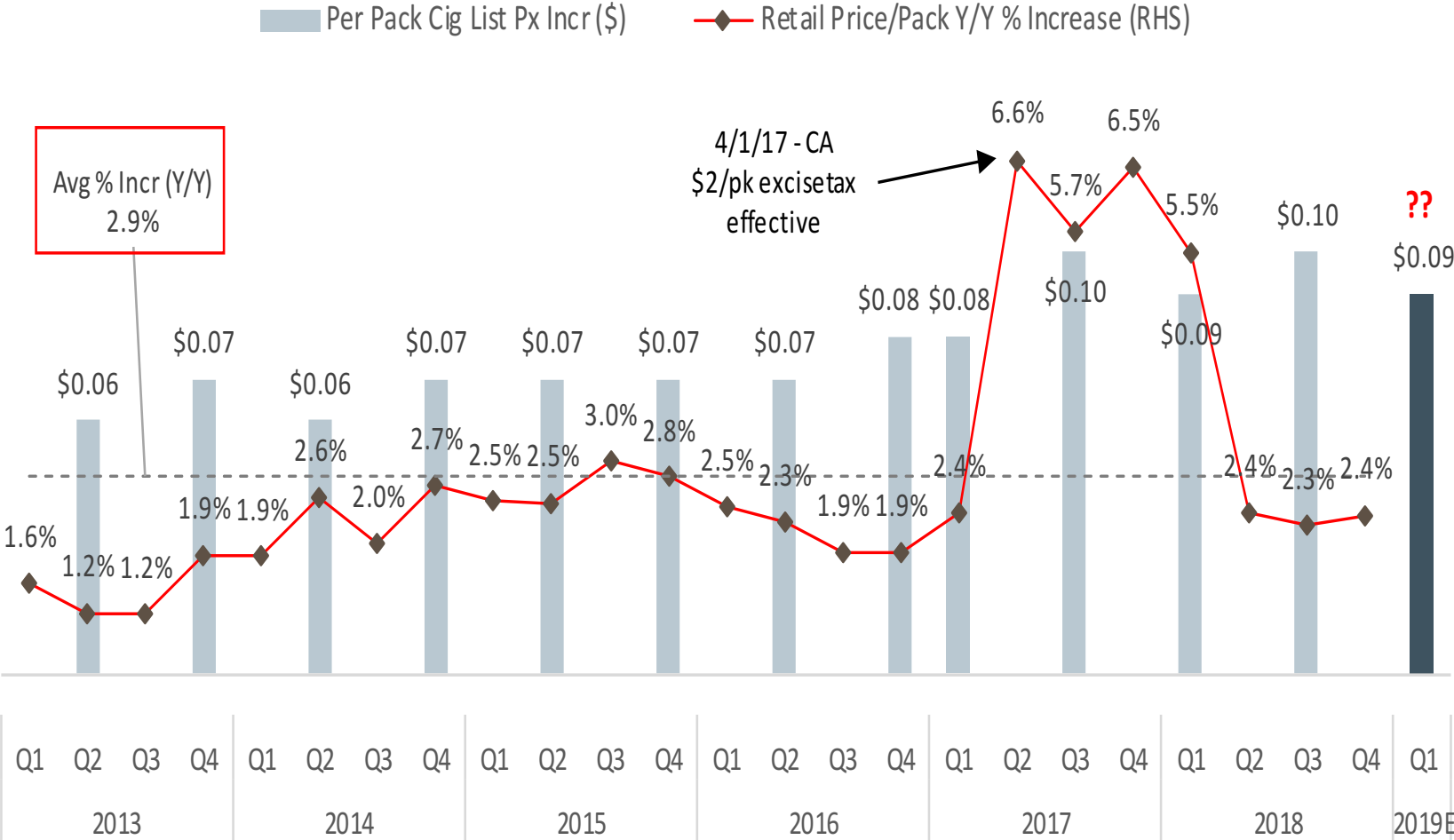


- \$0.09/Pk Cig List Price Increase (+2-3%) Expected in Late March
 - To Be Led By PM USA (as usual)
 - Over 55% of Retailers/Wholesalers Predict \$0.09-\$0.10 Per Pack
- **Bottom line** – Reflects Industry's Confidence/Ability To Price Through Vol Weakness

Source for both graphs: "Tobacco Talk" Survey; Wells Fargo Securities, LLC estimates

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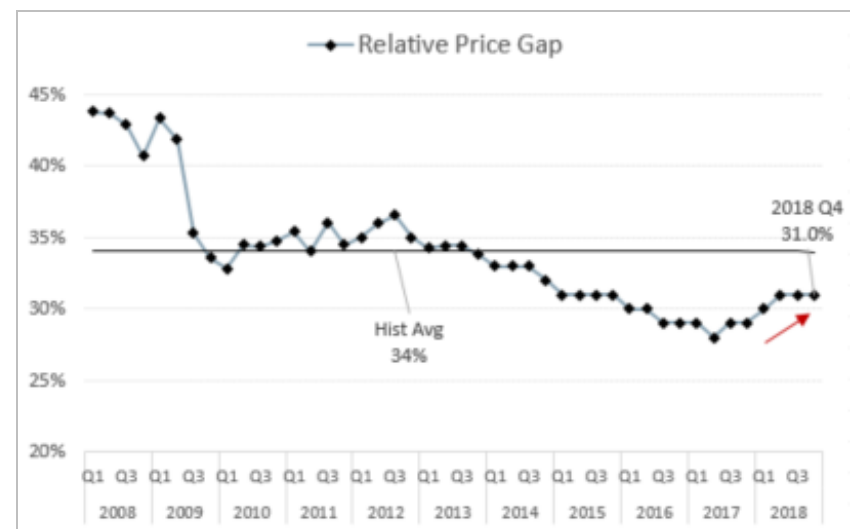
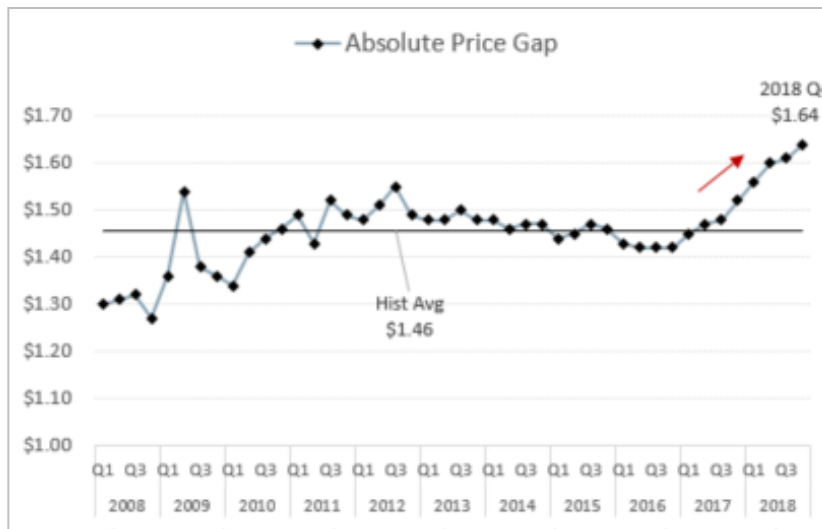
History of Cig List Price Increases



Source: Company data; Wells Fargo Securities, LLC estimates

Cig Price Gaps Relatively Steady

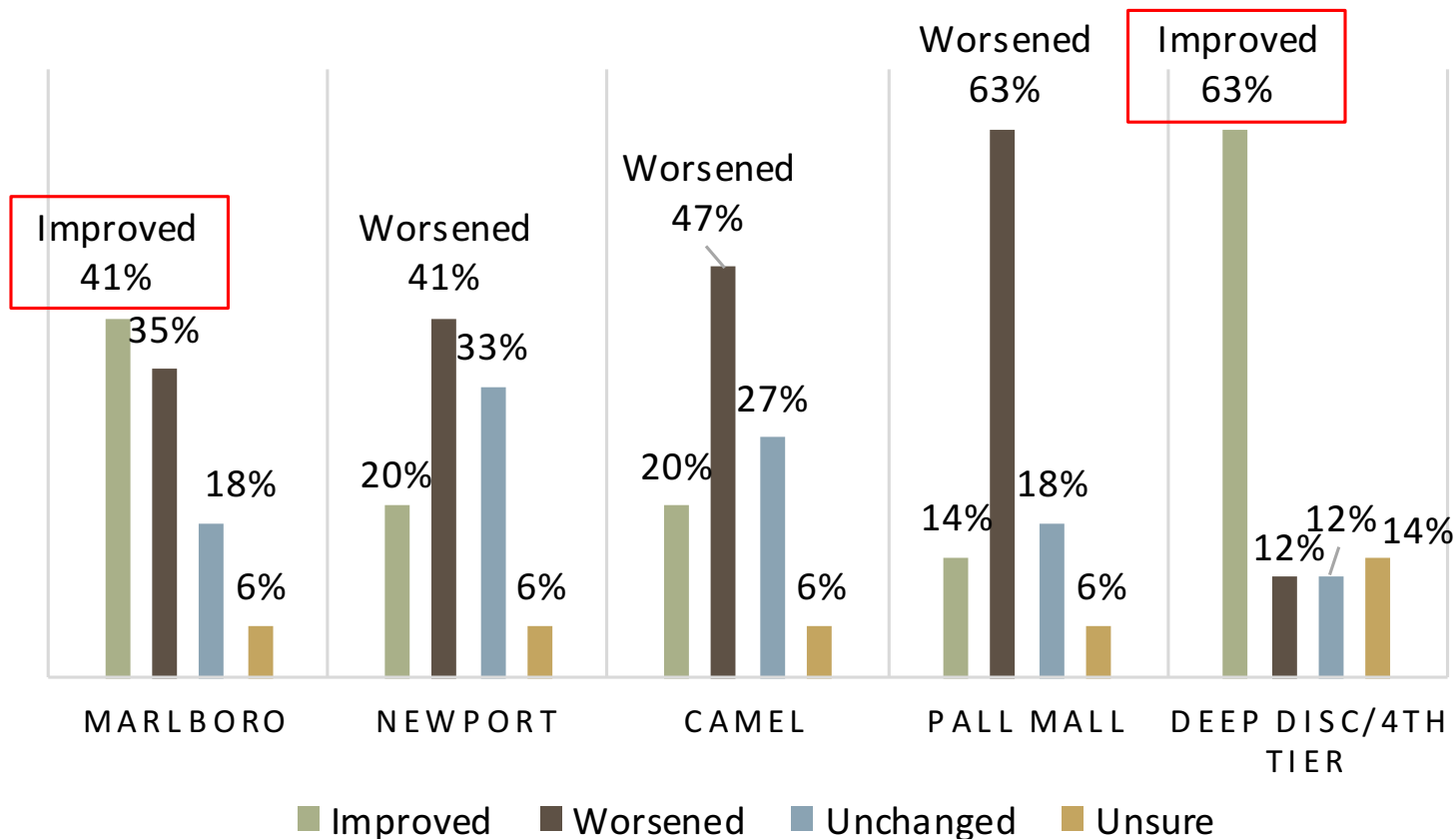
Absolute & Relative Price Gap Between Premium (Marlboro) & Deep Discount Cigarettes (Q/Q)



- Absolute Price Gap Widening to a record high \$1.64/pk but....
- Relative Price Gap Relatively Stable at 31%
- Retailers See Vape As "Big Winner" Given Lower Price Points Relative to Cigs
- Altria Notes Continued Churn Within Deep Discount From Branded to Non-Branded

Key Brand Trends in Q4

Marlboro & Deep Discount Share Improving

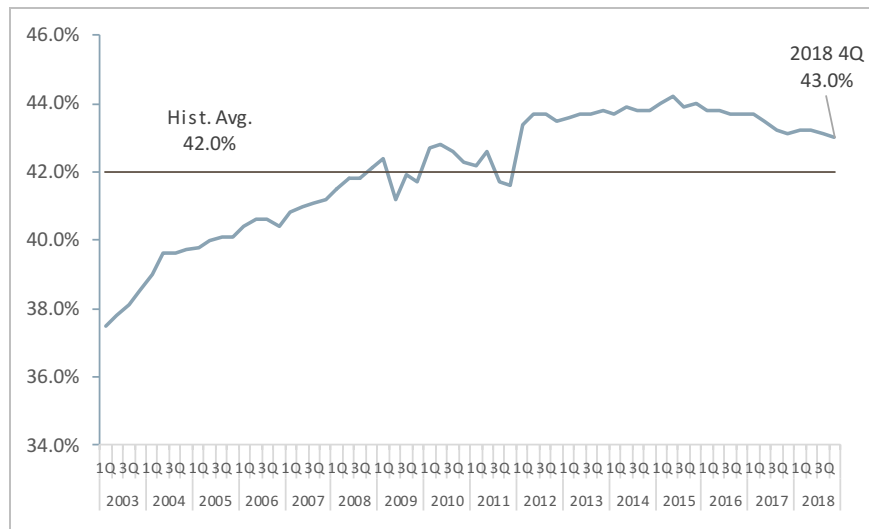


- “Marlboro volume started to stabilize and return.”
- “As the category shrinks, the most price sensitive people in the economy are making up a larger share of the category.”

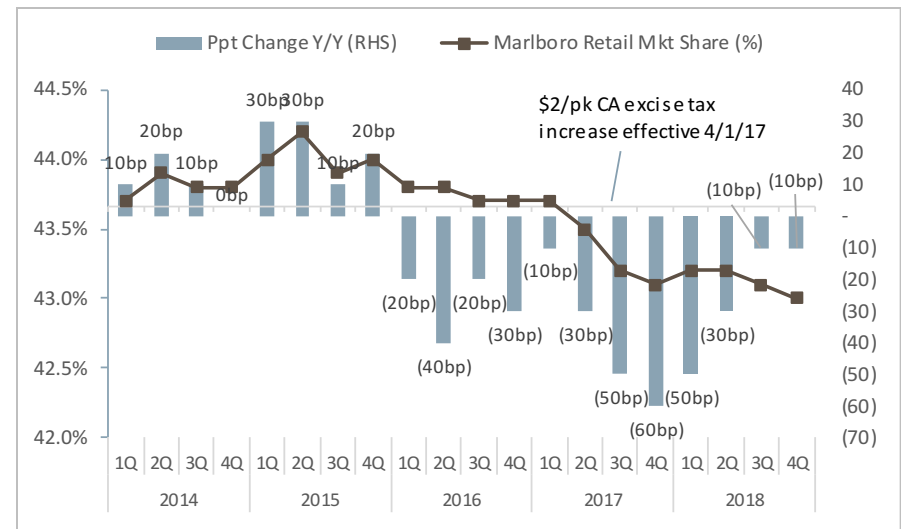
Source: 4Q18 “Tobacco Talk” survey

PM USA: Marlboro Share Pressure Receding

Marlboro U.S. Market Share Performance



Marlboro Showing Signs of Stabilization



➤ The Marlboro Brand Franchise

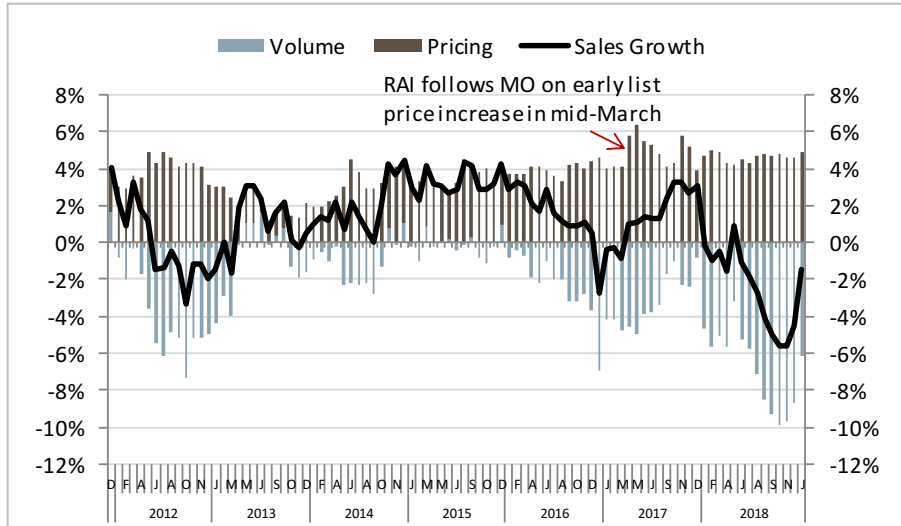
- Among the Strongest & Most Recognizable Consumer Brands Worldwide, In Our View
- Strong Loyalty Program & Effective Promo Strategy Making Positive Impact
- We Expect Marlboro to Continue to Outperform the Overall Cig Industry

Source for both graphs: Company data and Wells Fargo Securities, LLC

RJR & ITG Also Seeing Some Improvement in Nielsen Data

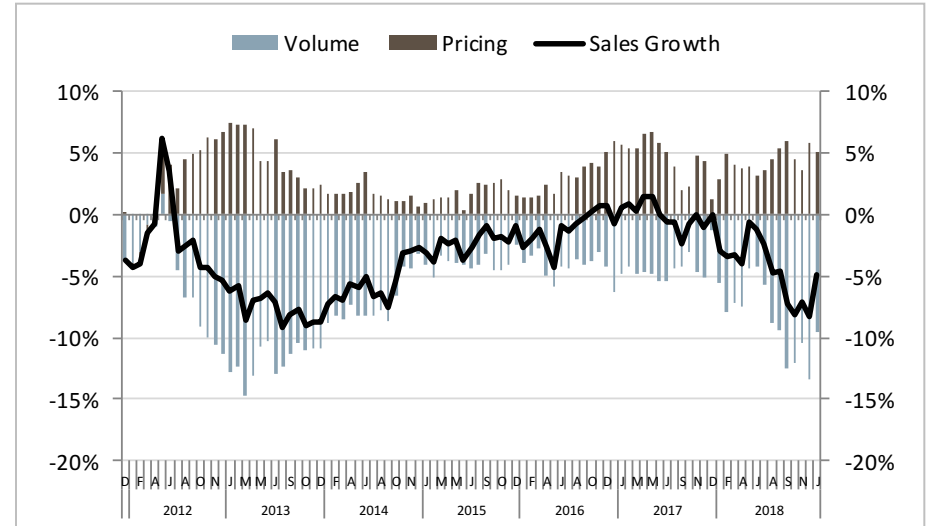
BAT/RJ Reynolds

Nielsen All-Channel Scanner Data Thru 1/26



Imperial Tobacco

Nielsen All-Channel Scanner Data Thru 1/26



Latest Nielsen 4-Wk Scanner Data:

- Volume Pressure Easing Led By **Newport** at -2.6% for 4-wks ended 1/26 (vs -7.4% for 12-wks)
- **Camel** Vol Also Improving at -5.1% (vs -6.6% for 12-wks), Albeit Still Weak
- **Natural American Spirit** Growth Continues With Vol Increasing +2.7% (vs +1.0% for 12-wks)
- ITG Performance Remains Alarming With **Winston** Vol Down -15.3%, Albeit Better Than In Recent Periods

Source for graphs: Nielsen; Wells Fargo Securities, LLC

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View on FDA's Recent Decisions

FDA's New "Continuum of Risk" Is Positive For U.S. Vapor

- Embraces "Continuum of Risk" (i.e., Relative Risk) vs Abstinence
- Encourages Innovation At the Lower, Less Harmful End of the Continuum
- Extends Deadline for Submission of Deeming Reg Applications for Newly Regulated Tobacco Products in Market as of 8/6/16
 - Deadline for Newly Regulated Combustible Products (Cigars, Pipe Tobacco & Hookah Tobacco): **August 8, 2021**
 - Deadline for Newly Regulated Non-Combustible Products (e-cigs or ENDS): **August 8, 2022**
- **Bottom Line - We Think The FDA's New Approach Will Encourage Consumers To Shift More Rapidly to Vapor/RRPs**

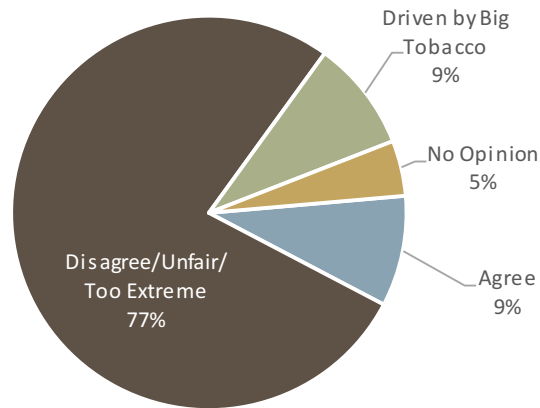
FDA Announces E-Cig Action Plan

- **On 11/15, the FDA Announced a 5-Pt Action Plan To Address the E-Cig Youth “Epidemic”**
 1. **C-store restrictions** – Require certain e-cig flavors to be sold in age-restricted locations in c-stores
 2. **Online sale restrictions** – Required heightened age verification process for e-cigs sold online
 3. **Flavored cigar ban** – FDA intends to propose a product standard to ban flavors in all cigars
 4. **Remove e-cigs that explicitly appeal to kids** – e.g., candy flavors, cartoon labels
 5. **Menthol ban in cigs/cigars** – Accelerate the proposed rulemaking process to ban menthol in all combustible tobacco products

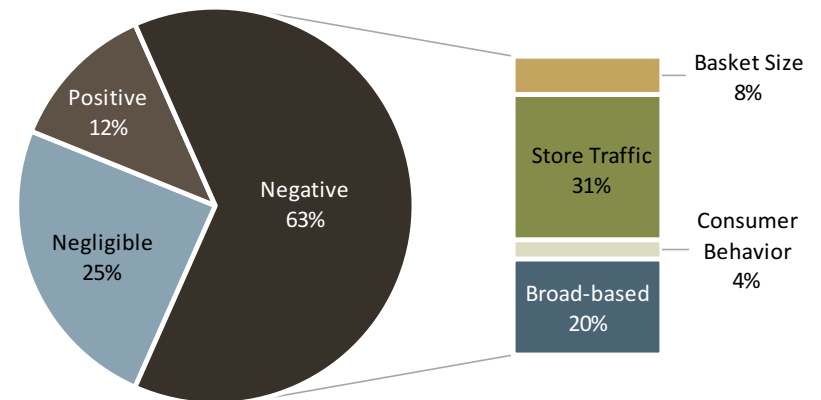
- **Bottom Line** – The FDA Must Carefully Navigate How to Reduce Youth Uptake While Accelerating Adult Smoker Conversion to Non-Combustible Alternative Products Like E-Cigs/Vapor/Heat-Not-Burn (HNB)

Retailers Broadly Disagree W/FDA's E-Cig Action

FDA's Action to Restrict Certain E-Cig Flavors Viewed As "Too Extreme"



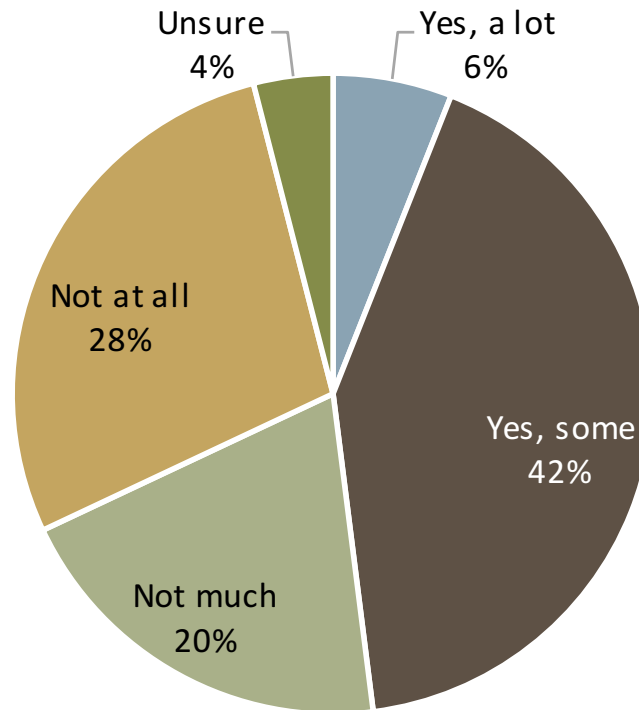
While E-Cigs Are Still A Tiny Contributor to Overall C-Store Sales, Retailers Anticipate Neg Impact As Consumers Go Elsewhere



"Tobacco Talk" Survey Takeaways:

- "The FDA is not going to reduce the consumption of underage smoking, teenagers will get the product one way or another"
- "Moving the legal age and focusing on removing 'youth targeted' marketing would have a similar, effective, impact"
- "Consumers will go elsewhere to purchase and will likely buy other products while they are there, reducing traffic and total sales"

Retailers Seeing Some Negative Impact on E-Cig Volumes



Source: 4Q18 "Tobacco Talk" Survey

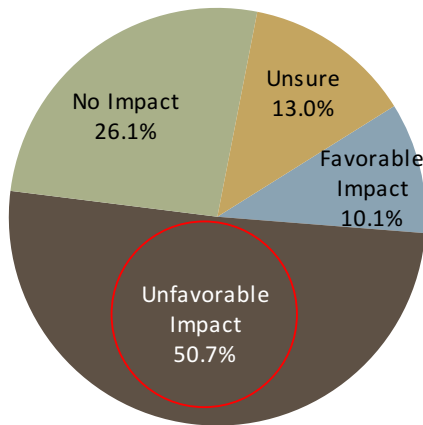
- "Initially sales fell way off but as people realized that whatever the FDA did would take months, if not years, than things normalized somewhat."
- "The real answer is not yet...legislation won't necessarily slow down the category - just cause a shift of balance to vape and age-restricted outlets and away from c-stores."

FDA Announces Comprehensive Nicotine Strategy

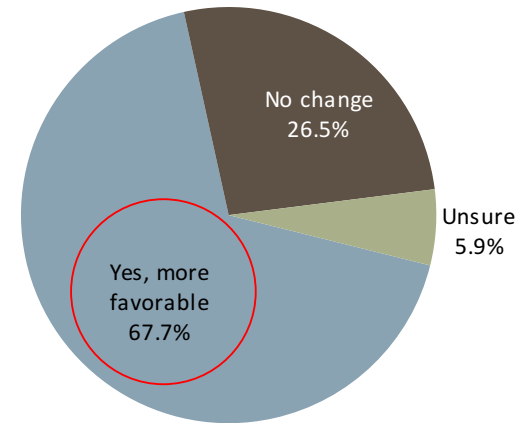
- **On 7/28, the FDA Announced a Comprehensive Regulatory Plan To Lower Cigarette Nicotine Levels & Reduce Addiction to Combustible Cigs**
 - Places Nicotine At the Center of the FDA's Regulatory Approach
 - Seeks to Lower Combustible Cig Nicotine Levels to "Render Cigs Minimally or Non-Addictive"
 - Embraces (Finally!) "Continuum of Risk" Approach (vs Abstinence)
 - Encourages Industry Innovation Especially In E-cigs/Vapor/RRPs
 - Extends the Premarket Tobacco Product Application (PMTA) Deadlines For Marketing Newly Regulated Non-Combustible Products to **August 8, 2022**
 - Allows Marketing to Continue After the New PMTA Submission Deadline As Long As The Application Remains Under Review (vs 1 year limit previously)
- **Bottom Line – We See This As A Positive Step Forward For the Industry & Public Health, & Expect It To Encourage A Faster Shift In Consumption to RRP**

Retailers View of FDA's Lower Nicotine Strategy

FDA Nicotine Strategy Broadly Expected to Be Negative For Combustible Cig Sales



FDA Nicotine Strategy Signals Favorable Shift in Agency's Stance Toward RRP



"Tobacco Talk" Survey Takeaways:

- >50% of Retailers Expect the FDA's New Strategy Could Adversely Impact Combustible Cig Consumption
 - "A De-Facto Ban On Cigarettes"
 - "It Will Create A Black Market"
- However, >67% of Retailers See A Favorable Shift In FDA's Stance In Favor of RRP
- Our View: New FDA Approach Is L.T. Industry Positive As With RRP:
 - (1) Consumers Presumably Live Longer; (2) Lower Risk Profile Encourages More RRP Usage; (3) RRP Could Merit More Favorable Tax Treatment; (4) Smoking Restrictions Potentially Relaxed for RRP

How Big Of A Risk Would A Potential Menthol Ban Be?

To Date, Menthol Banned or Restricted in At Least 5 Jurisdictions:

- San Francisco, Chicago, Berkeley, NYC, & Minneapolis

“Tobacco Talk” Survey Takeaways:

- A Ban in More Cities Would Be Negative for the Category
 - *“That will just be horrible... People will freak out. I mean...Newport!”*
 - *“It would impact the market and sites greatly, especially in urban markets.”*
- However, Retailers Also Recognize Consumers Would Also Seek Other Means
 - *“It will drive some shoppers to go to another city to buy products and hurt retailers in the city where the ban occurs. There will be some that will finally quit.”*
 - *“It would send consumers to other markets.”*
 - *“Initially it will be impactful but as time goes on I feel the consumer will adapt.”*

Our View:

- More Headline Risk Than Real Impact, In Our View
- Absent a Comprehensive Ban at the Federal Level, We Expect Some Smoker Attrition & Volume Pressure, But Ultimately a Manageable Risk

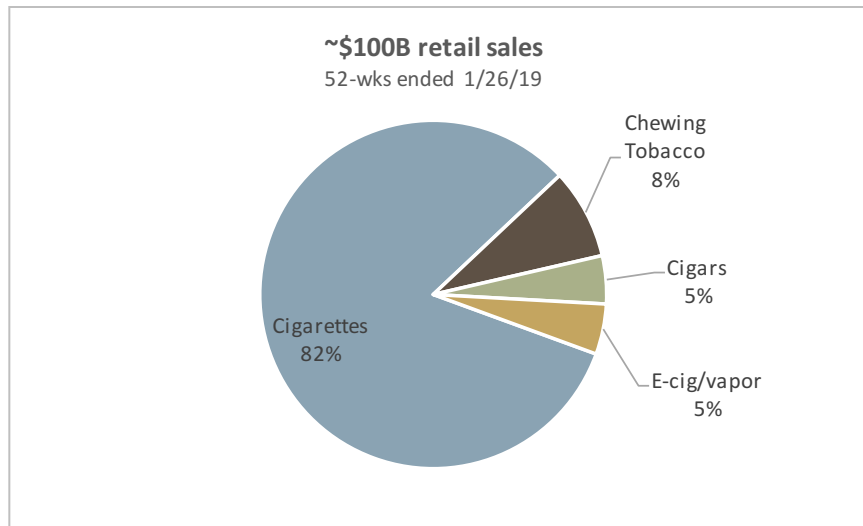
Note: Comments taken from our 2Q17 “Tobacco Talk” Retailer Survey.

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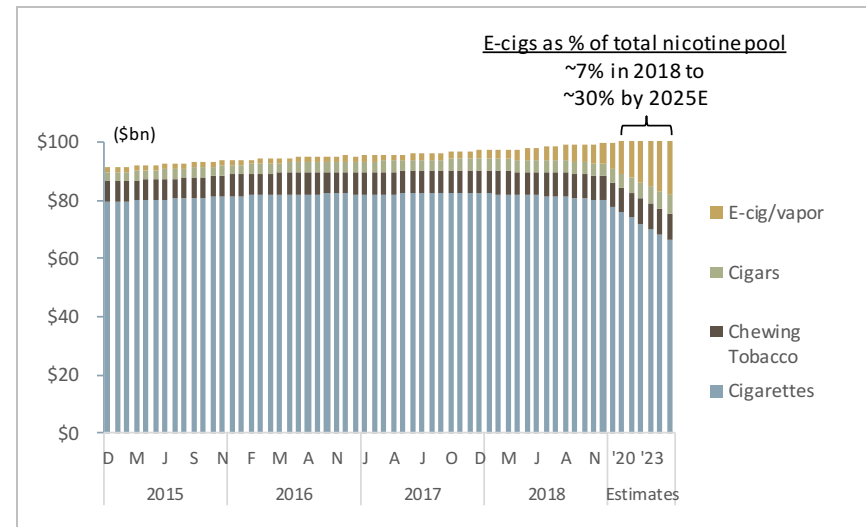
Sizing Vapor & The Total Nicotine Pool

Vapor In Context – Still “Early Days”

Cigarettes Continue to Dominate the U.S. Tobacco Landscape



By 2025, However, We See the Landscape Shifting Significantly Toward Vapor

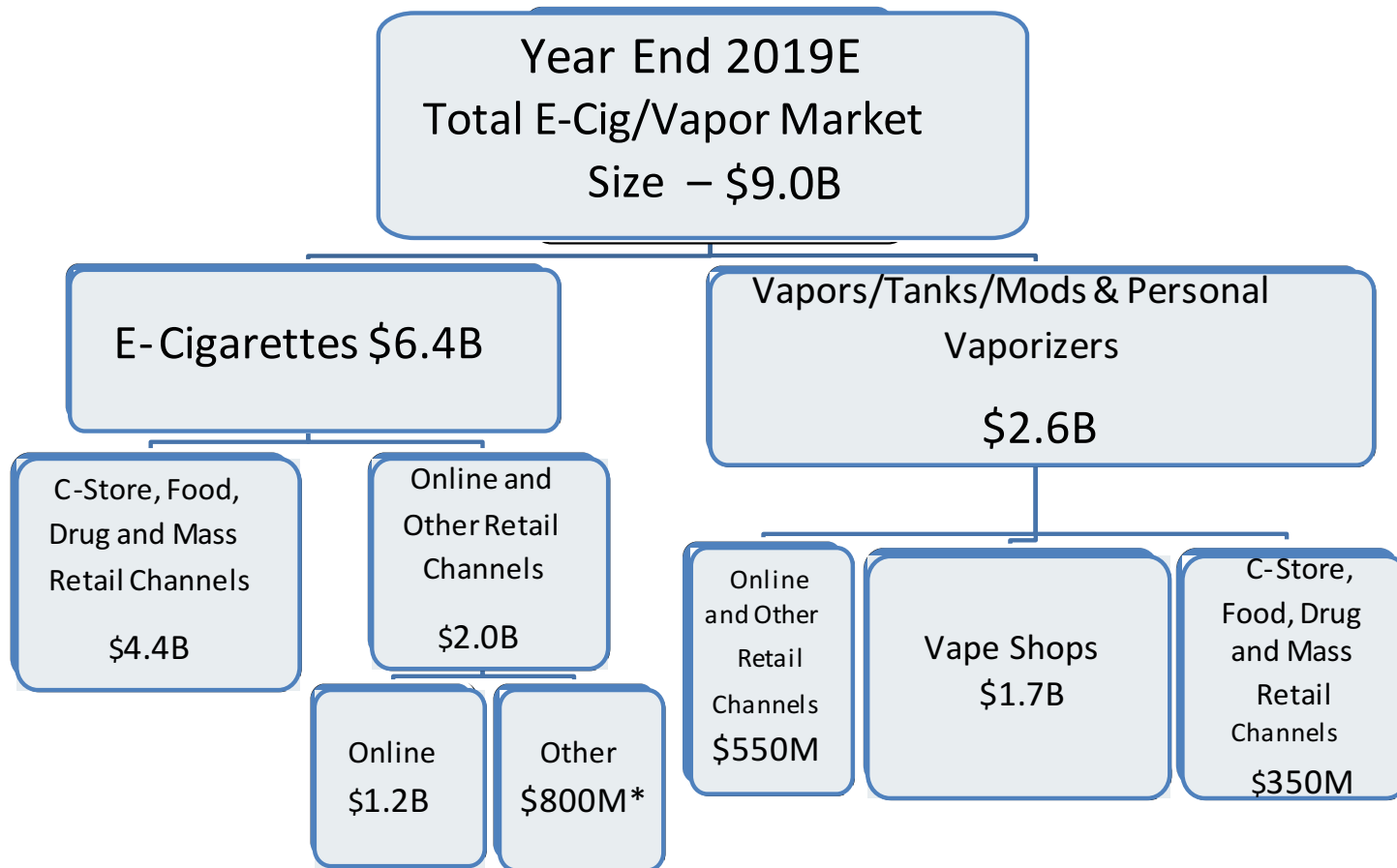


- U.S. Is Largest Market & Most Lucrative Opportunity
 - 50% of U.S. adult smokers have tried or expressed interest in Vapor
 - Continued innovation is critical in our view (taste, quality, convenience & harm reduction)
- We Estimate E-Cigs Are <10% of the Total U.S. Nicotine Pool Today, Going to ~30% By 2025
- We Estimate the Total U.S. Nicotine Pool is ~\$100B in Retail Sales Today, Going to ~\$115B by '25

Source for both graphs: Nielsen; Wells Fargo Securities, LLC estimates

2019E U.S. Vapor Market Size – \$9.0B in Retail Sales

Vapor & RRP retail sales in the U.S. will likely eclipse \$10B by 2020

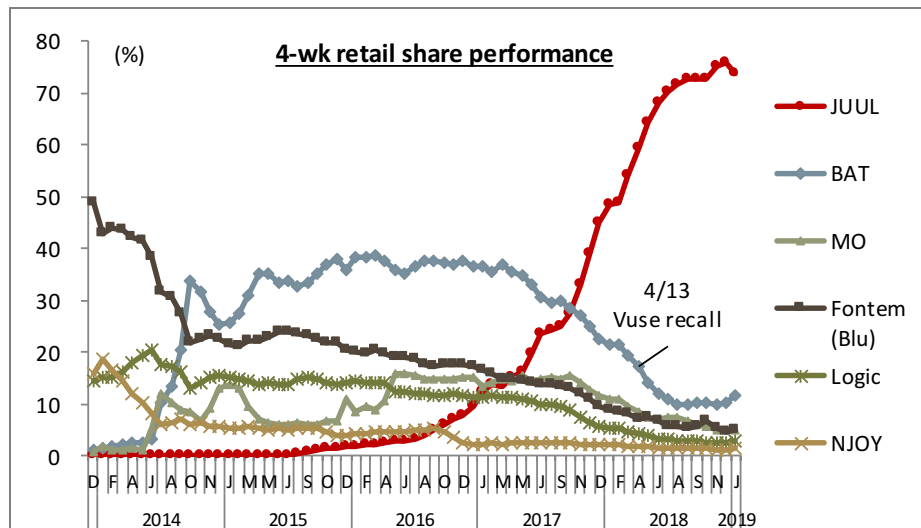


Source: Nielsen C-Store Database, Wells Fargo Securities, LLC estimates. *Other Retail channels include tobacco-only outlets and other e-cig retail locations.

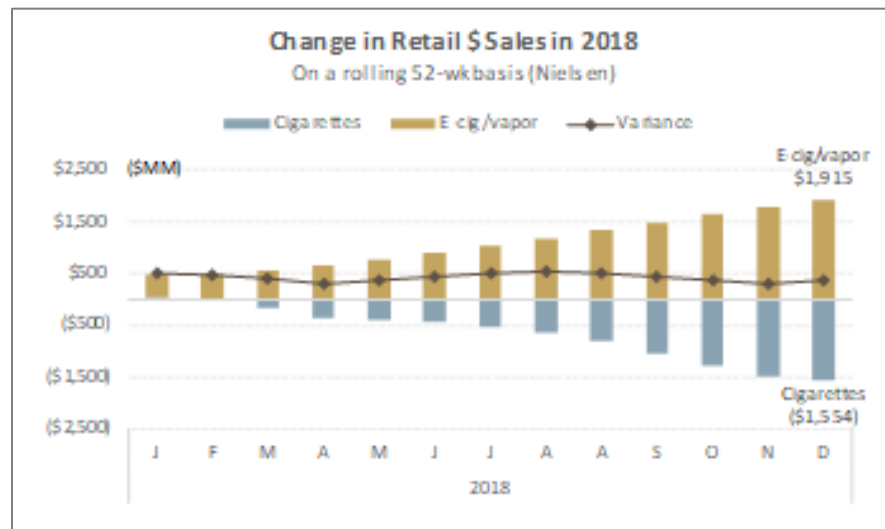
We See the Nicotine Volume/Profit Pool Growing

Nielsen All Channel Scanner Data Thru 1/26

E-Cig \$ Share Performance Thru Nielsen 4-wk period ended 1/26

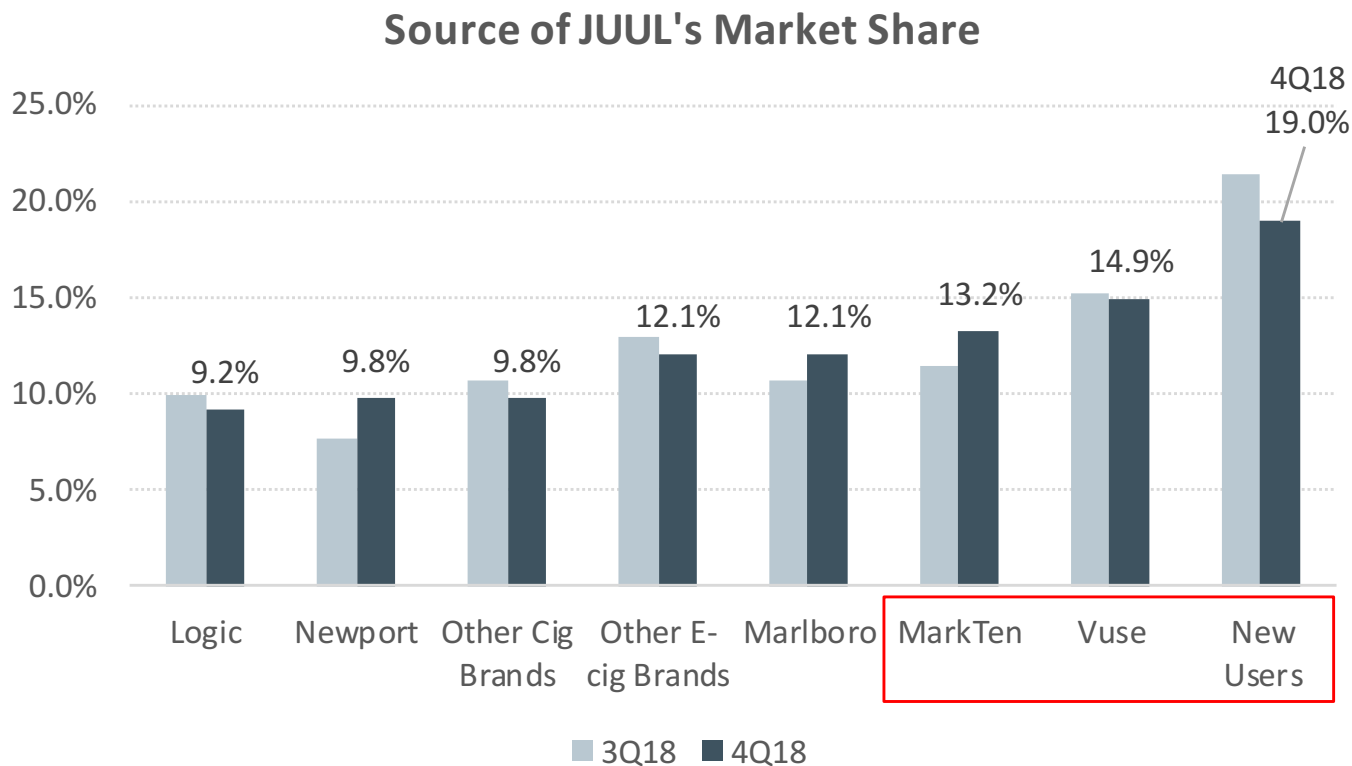


E-Cigs Contributing More Retail \$ Sales Than Cigs Are Losing



- As E-Cig/Vapor Product Quality Rises & Competition Improves, Category Volume Growth Should Accelerate
- FDA's New "Continuum of Risk" Strategy Should Support Further Growth
- JUUL Remains Market Leader By Wide Margin But There's Ample Room For Multiple Winners, In Our View
- **Bottom Line – The FDA's Harm Reduction Approach to Tobacco Should Drive Stronger RRP Innovation To Support Long-Term, Sustainable Growth**

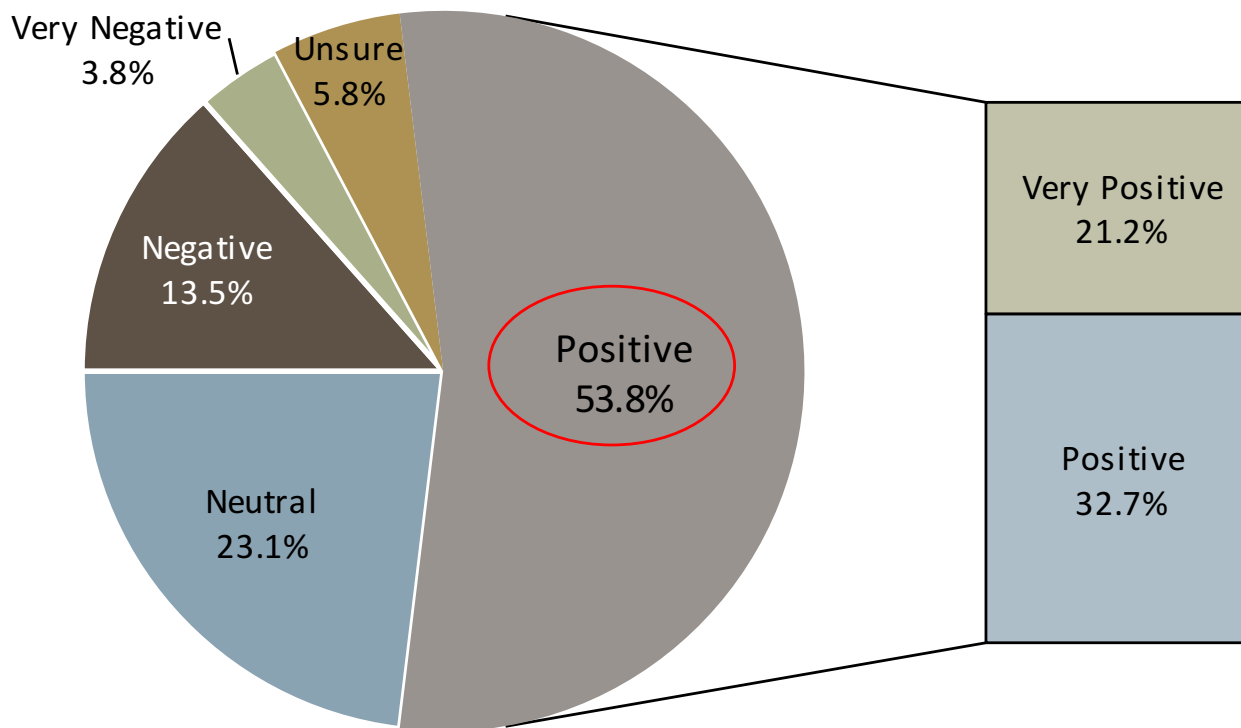
JUUL Bringing in New Users Driving Growth of Nic Pool



- "There are many new users, and I believe JUUL has pulled share from all the categories listed above."

Source: 4Q18 "Tobacco Talk" survey

Retailers View Altria's Decision to Acquire a Stake in JUUL Favorably



- "Altria has a better relationship with the FDA."
- "I think it is a positive move for Altria, if the FDA behaves but I think they paid too much for it."
- "I believe this was a smart move as Mark-Ten did not sell very well so now they have a 35% stake in the #1 vapor company."

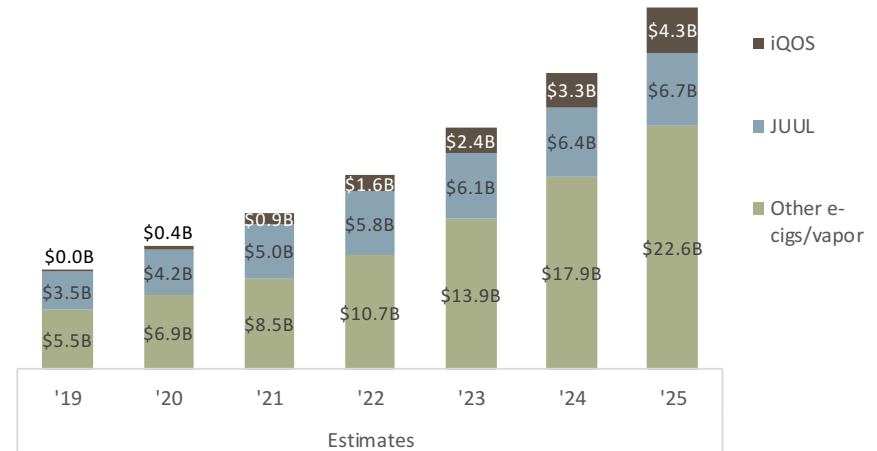
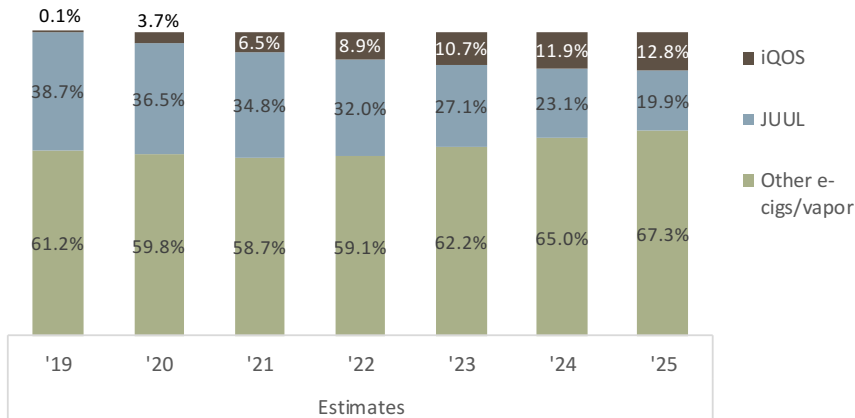
Source: 4Q18 "Tobacco Talk" survey

We See JUUL & iQOS* As the Strongest Likely Beneficiaries

We Believe JUUL & iQOS Could Represent $\geq 30\%$ of the U.S. E-Vapor Mkt by 2025

As the Mkt Expands/Matures, Their Mkt Shares May Moderate, But Topline Momentum Should Continue

Est \$ Share of U.S. E-Cig/Vapor Market
2019-2025E



- JUUL Has Single-Handily Reaccelerated the U.S. E-Vapor Category
- JUUL's Volume Increased +600% in 2018 to Over \$450M Refill Kit Pods, Contributing to Over \$1B in Net Revenues
- While Not Yet Approved For Sale in the U.S., the Success of iQOS in Several Int'l Markets Bodes Well for its Potential in the U.S.
- iQOS Could be Approved for Commercialization in the U.S. Any Day Now
- We Estimate that iQOS Could Accelerate MO's Revenue and Profit Growth and Drive Significant Incremental Value

Note(*): Assumes FDA approval of iQOS for commercialization. Source for both images: Nielsen; Wells Fargo Securities, LLC estimates

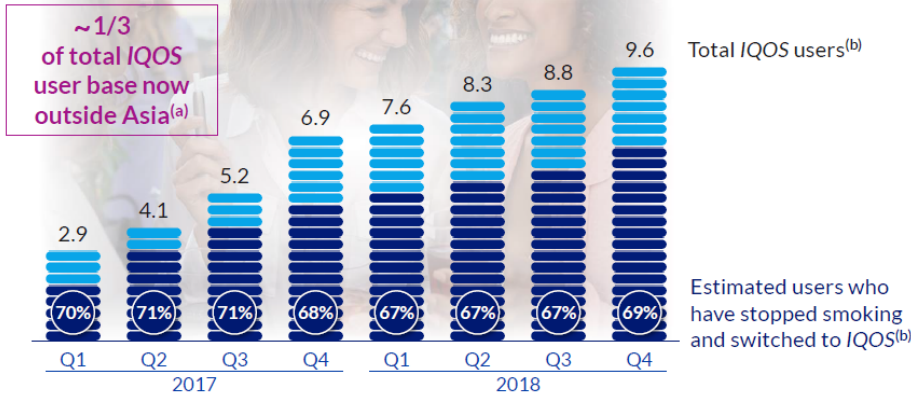
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iQOS' Strong Int'l Track Record Bodes Well For Its Future in the U.S.

iQOS' User Base Is Impressive & Growing

Most Adult Smokers Who Try iQOS Tend to Stick With it

iQOS: Continued User Growth
(in millions)



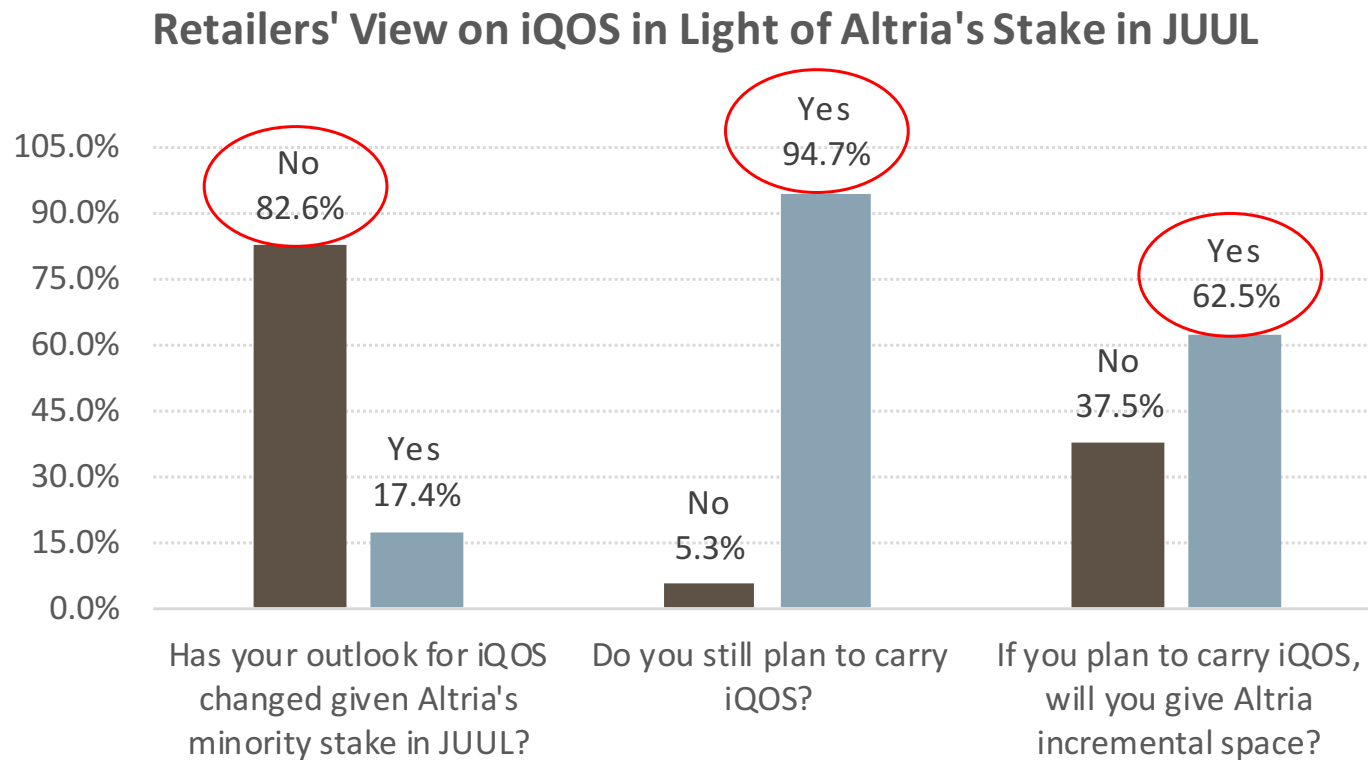
(a) As of Q4, 2018
(b) See Glossary for definition
Source: PMI Financials or estimates, and iQOS user panels and PMI Market Research



- iQOS's Share of the Cig/HNB Nicotine Pool is Growing in Every Int'l Market Where it Competes
- iQOS Conversion Rates Remain Incredibly High at ~70% - The Highest of Any HNB or E-Cig Product Out There
- PM & MO Remain Enthusiastic & Committed to Commercializing iQOS in the U.S. When Approved

"HNB" – stands for Heat Not Burn technology. Source for both images: PMI 2016 Investor Day presentation and Wells Fargo Securities, LLC

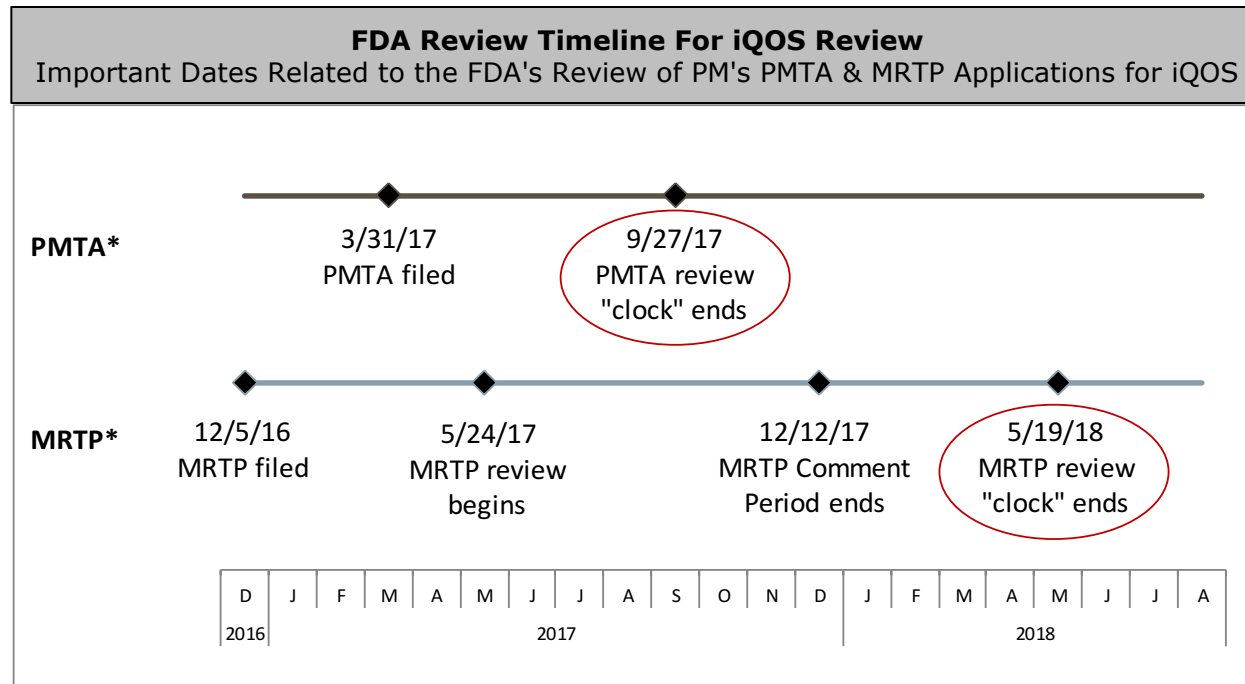
Retailers' View on IQOS Hasn't Changed Given Altria/JUUL



- “I think IQOS is a different proposition that needs to be conveyed through social media as the closest thing traditional smokes without the negative connotations. If they can create the same buzz JUUL did it will be hot.”

Source: 4Q18 “Tobacco Talk” survey

U.S. Opportunity – FDA Review & Decision Timeline Guides



➤ In a Nutshell:

- PMTA approval would allow iQOS to be commercialized in the U.S. without a health claim
- MRTP approval would allow iQOS to be marketed in the U.S. with a modified-risk health claim

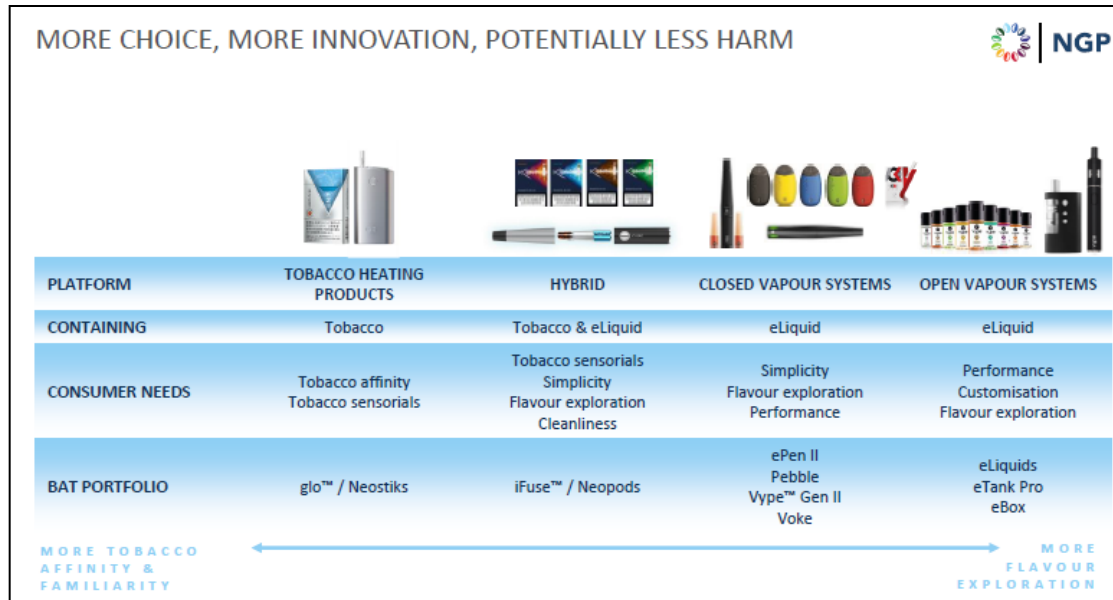
➤ Our Expectation:

- Commercialization in the U.S. **this year**
- Health claim approval in the U.S. **this year**, and possibly in conjunction with PMTA approval

Note: "PMTA" stands for **Premarket Tobacco Application**, which would grant the right to commercialize iQOS in the U.S.; "MRTP" stands for **Modified Risk Tobacco Product** application, which would grant the right to market iQOS with a reduced risk health claim. **Source for chart:** FDA; Wells Fargo Securities, LLC

RRP Competition – “The Future Is Smoke Free”

British American Tobacco’s Next-Gen Platform



Japan Tobacco’s Tobacco Vapor Product Launching Ploom TECH+ & Ploom S in 2019



Imperial Brands Is Prioritizing myblu IMB to Invest an Incremental GBP100M in 1H19



Source for images: British American Tobacco PLC, Japan Tobacco Inc, Reynolds American, Inc., Wells Fargo Securities, LLC

Bonnie Herzog - Wells Fargo Securities, LLC | Tobacco, Beverage & C-Store Sectors

What's Ahead: Global Industry Consolidation?

Key Themes in 2019

➤ **Heightened Degree of “Unknowns”**

- FDA E-Cig Flavor Crackdown
- Impact of JUUL on Cig Volume Cannibalization (esp for Altria)
- Timing of FDA PMTA/MRTP Approvals & Commercialization of IQOS

➤ **Need For Scale/Innovation**

- Need For Scale/Innovation May Spur Industry Consolidation and/or Equity/Strategic Partnerships
- RRP's Remain a Key Catalyst
- Profit Opportunity Maintains Attractiveness of the U.S. Market

➤ **Continued Deceleration of Combustible Cig Volumes**

➤ **Industry Pivots Towards Reduced-Risk Product Development**

PM/MO Combo – We View IQOS/JUUL As Catalyst For Reunification

- **We Believe FDA’s New Nicotine Strategy Supports Rationale for Deal**
- **iQOS Is Win-Win for Both Philip Morris & Altria Group, In Our View**
- **iQOS Worth More to PM By Owning MO**
 - PM Captures Full Margin of iQOS
 - Accelerates Growth in U.S. Given Full Control Over Sales/Distribution
 - Access to MO’s Strong FCF to Catapult Growth of iQOS Globally, In Our View
- **U.S. Market Is Attractive “Call Option,” In Our View**
 - Diversification Benefits
 - U.S. Is The 2nd Most Lucrative Cig Market in the World
- **JUUL Needs An International Partner with Infrastructure & Distribution Capabilities + Know How, In Our View**
- **At Minimum - Global Consolidation May Force PM’s Hand**

Additional Information Available Upon Request

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3=Underperform: The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

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