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February 4, 2009

Industry View
Attractive

Tobacco

We Know What Congress Did; What Will PM USA do?

Investment conclusion: We understand from industry sources that later today – or perhaps tomorrow – President Obama will sign the proposed SCHIP/FET increase into law, thus ending debate regarding the potential scale of the federal excise tax (FET) increase on tobacco products. Relative to the House bill, the final legislation differs in two small respects. First, the proposed excise tax hikes have been increased by a fraction of a percent across all products (e.g., the FET on cigarettes will now rise from \$0.39/pack to \$1.0066/pack, rather than \$1.00/pack, effective April 1). Second, the provisions that would have phased in the FET increases for cigarette equivalents such as Little Cigars have been eliminated. These alterations are in line with our expectations, our Attractive industry view, and our 2009 forecasts for US cigarette manufacturers.

What are the implications: (i) Although guaranteeing a challenging 12-18 months for the industry, significant FET pressure was expected, and passage of the legislation enhances operating certainty and eliminates the risk of an even higher tax hike; (ii) Moist Smokeless Tobacco will be a relative beneficiary, as its FET will increase from ~\$0.04 to only ~\$0.11/can; (iii) The Large Cigar FET, which increases from 21% to 53% of the manufacturer's wholesale price, creates a headwind – which we have forecasted – for MO's Middleton cigar business; and (iv) Excise taxes increase substantially on both Little Cigars and Roll Your Own tobacco (~\$0.04/pack to ~\$1.0066/pack equivalent), eliminating their historical federal excise tax advantage.

Where we differ: Although some in the market are disappointed that the Little Cigar and RYO excise tax increases are not phased in (because RAI has small exposure to these segments), that analysis completely misses the point (in our view). The most important going forward factor in the market is PM USA's cigarette pricing strategy, and they are likely to be more comfortable taking aggressive price increases if the risk of consumer migration towards lower-priced alternative products like Little Cigars has been reduced.

Recent Reports

Title	Date
Philip Morris International Inc: Quick Comment: Observations: JV & Imperial David J. Adelman / Matthew Grainger / Eileen Khoo, CFA	Feb 3, 2009
Tobacco: A Review of our FDA Risk Assessment; Attractive View David J. Adelman / Matthew Grainger / Eileen Khoo, CFA	Feb 2, 2009
Altria Group, Inc.: World Is Not Falling Apart; Attractive Industry View David J. Adelman / Matthew Grainger / Eileen Khoo, CFA	Jan 29, 2009

GICS Sector: Consumer Staples

Strategist's Recommended Weight	12.6%
S&P 500 Weight	12.6%

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Investment Case

Summary & Conclusions

I) Now the critical question is what will PM USA do?

The single most important variable in the US tobacco industry's 2009 operating and financial outlook – now that a substantial FET increase is about to be signed into law – is PM USA's pricing and promotional actions subsequent to enactment of the FET/SCHIP legislation. Simply put, PM USA is the market's pricing leader, so its action is likely to dictate the overall "state of play."

II) No question in our view that PM USA at least passes through all of the FET tax increase

With a 2008 underlying per-pack operating profit of \$0.59, and with relatively demanding – in light of the circumstances – EPS guidance, there is simply no question that PM USA will at least pass on all of the FET increase on or by its effective date (April 1, 2009). Simply put, even the absorption of 10% of the tax increase (e.g., ~\$0.06/pack) would have profoundly negative ramifications for the Company – and the industry's – business model, and it could encourage additional excise tax increases (e.g., why shouldn't governments aggressively increase tobacco taxes if the ultimate consumer is not burdened by the tax increase).

Furthermore, the likely and pragmatic action would be to take at least a moderate net price increase in conjunction with – and in addition to – passing through the FET increase. However, we remain firmly of the view – and this is consistent with our forecasts – that PM USA will not take sufficient incremental pricing to offset the full adverse volume and profit impact of passing through the substantial excise tax increase.

III) What will PM USA do with pricing/promotion through April 1?

Perhaps the most interesting and intriguing question is what will PM USA do with respect to pricing and promotional spending between today and April 1 (when the FET increase goes into effect)? There are essentially three potential scenarios:

- First, the Company could increase prices effective with all shipments on or after April 1, 2009. Because there is a "floor tax" element in the legislation, the trade has no incentive to "load up" in advance of a well-known tax increase. Although this is a theoretical option, we do not think it is PM USA's likely action, because the Company would lose the opportunity to both: a) Phase in the tax increase to consumers (and

presumably mute some of the adverse consumption impact), and b) Generate some "windfall" one-time profit, as it could reflect some/all of the excise tax increase before it actually has to pay higher taxes on shipments.

- Second, at the complete other extreme, PM USA could immediately increase prices by the full amount of the significant excise tax increase the moment the legislation is signed into law. While such tactics would both generate a substantial profit windfall and immediately highlight the real adverse consumer impact of Congressional action, it would raise the risk that some manufacturers – particularly smaller ones – would not immediately follow PM USA's move, potentially placing its brands at a temporary and substantial pricing disadvantage. Although wholesalers and retailers would, more likely than not, increase prices on all products following such action by the clear market leader, we are skeptical that PM USA would take such an aggressive action; and
- Finally, and what we expect, PM USA can phase in the substantial FET increase over the next two months, though a mix of significantly higher list wholesale prices coupled with higher promotional spending. Although not creating as large a profit "windfall" as option 2 above, such a course of action would allow PM USA to generate some level of above-normal profit, reduce the risk of being competitively disadvantaged (e.g., over-priced), and could potentially mute – due to the phase-in – the scale of the adverse impact on consumption and premium brand market share.

Exhibit 1

Prior / New Federal Excise Tax Rates Based on Senate SCHIP Legislation

	Prior Excise Tax Rate	Initial House Bill	New Excise Tax Rate	% Increase
Cigarettes (small)	\$0.39 per pack	\$1.00 per pack	\$1.0066 per pack	158%
Large Cigars	20.719% of manufacturer's price	52.4% of manufacturer's price	52.75% of manufacturer's price	155%
Large Cigars (maximum rate)	\$48.75 per thousand	\$400 per thousand	\$402.60 per thousand	726%
Snuff	\$0.585 per pound	\$1.50 per pound	\$1.51 per pound	158%
Snuff (per can)	\$0.04 per can	\$0.11 per can	\$0.11 per can	158%
Little Cigars	\$1.828 per thousand	\$50.00 per thousand (phased in 2009-15)	50.33 per thousand	2653%
Little Cigars (per pack of 20)	\$0.04 per pack	\$1.00 per pack	\$1.066 per pack	2653%
RYO Tobacco	\$1.0969 per pound	\$24.62 per pound	\$24.78 per pound	2159%
RYO Tobacco (per pack equivalent)	\$0.04 per pack	\$1.00 per pack	\$1.0066 per pack	2159%
Chewing Tobacco	\$0.195 per pound	\$0.50 per pound	\$0.5033 per pound	158%
Chewing Tobacco (per 3 oz. pouch)	\$0.04 per pouch	\$0.09 per pouch	\$0.09 per pouch	158%
Pipe Tobacco	\$1.0969 per pound	\$2.8126 per pound	\$2.8311 per pound	158%

Source: Company data, Morgan Stanley Research

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(as of January 31, 2009)

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Underweight/Sell	498	21%	101	17%	20%
Total	2,348		598		

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Industry Coverage:Tobacco

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