

## UBS Investment Research

## US Tobacco Intelligence Update

Americas

Tobacco

Sector Comment

## Thoughts on 3Q--From the Field

**■ Can Delivery Match Recent Outperformance this Q?**

Tobacco stocks have performed incredibly well YTD, again outperforming the broader market and consumer staples by 28% and 20%, respectively. While we believe industry fundamentals are holding up well, we are not expecting any blow-away results this Q. In this note, we provide thoughts picked up from our field work and provide a summary of our recently completed tobacco retailer survey. LO remains our top idea.

**■ The Key Themes We Expect to Resonate This Quarter**

1) Accelerated shipment declines in cigarettes due to inventory destocking (though underlying volume trends should be consistent with previous quarters), 2) solid pricing, though Lorillard should continue to lag the industry due to the drag from Newport Non Menthol, 3) continued outperformance of the Newport franchise, 4) strong underlying trends for the smokeless tobacco category and 5) slowing trends for Pall Mall.

**■ Updated Thoughts on the Marlboro Leadership Price (MLP) Program**

A few months back, we predicted that PM USA would cancel the MLP program due to significant pushback from retailers. Since then, it seems retailers have settled into the “new normal.” Looking ahead, we actually expect Altria to renew the program and make a few tweaks. Specifically, we expect PM USA to start segmenting MLP by performance. For instance, the best performing retailers will start to get paid more incentive monies than lower performing retailers. This is effectively what PM USA had done with its retail and wholesale leaders programs over the years.

17 October 2011

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## Update on Cigarette Trends

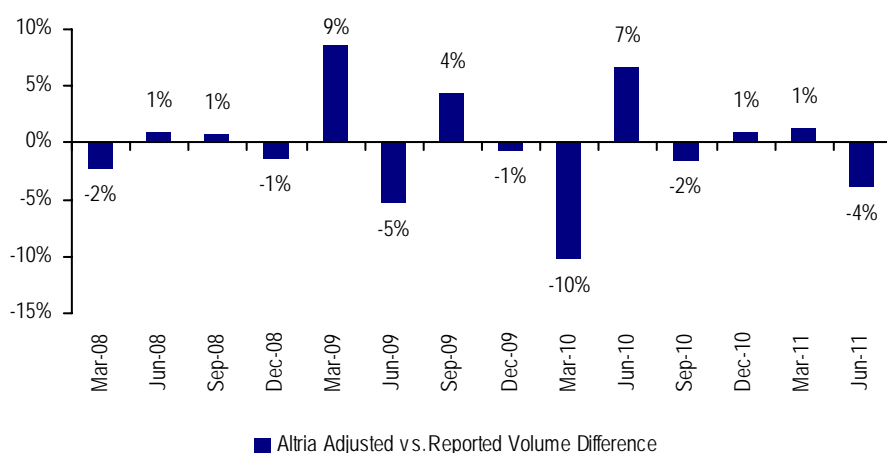
While volume headlines could create some anxiety this quarter, we encourage investors to focus on underlying “wholesale-to-retail” trends given the highly telegraphed inventory dynamics that will impact the September quarter (e.g. wholesalers loading up on inventory ahead of a price increase in the June Q). We expect underlying volumes for the cigarette category to decline 4% (in line with historical decline rates), though shipments could be down closer to 6% (again due to inventory dynamics). Lorillard should remain the best performer with *underlying* volumes up 7-8%, while Altria’s volumes are down closer to the industry. RAI will be down closer to -5% (mainly due to a sequential slowing of Pall Mall—which we discuss later in this report). On a shipment basis, Lorillard should be up 3%, Reynolds down -5% and Altria down closer to -10%.

**Table 1: There will be a disconnect between cigarette shipments and depletions**

	Manufacturing Shipments	Wholesale to Retail Shipments
Lorillard	3.2%	7% - 8%
Altria	-9.8%	-5%
Reynolds American	-5%	-4%

Source: Company filings, UBS

**Chart 1: Differences between cigarette shipments and depletions are not new for Altria (or the industry)**



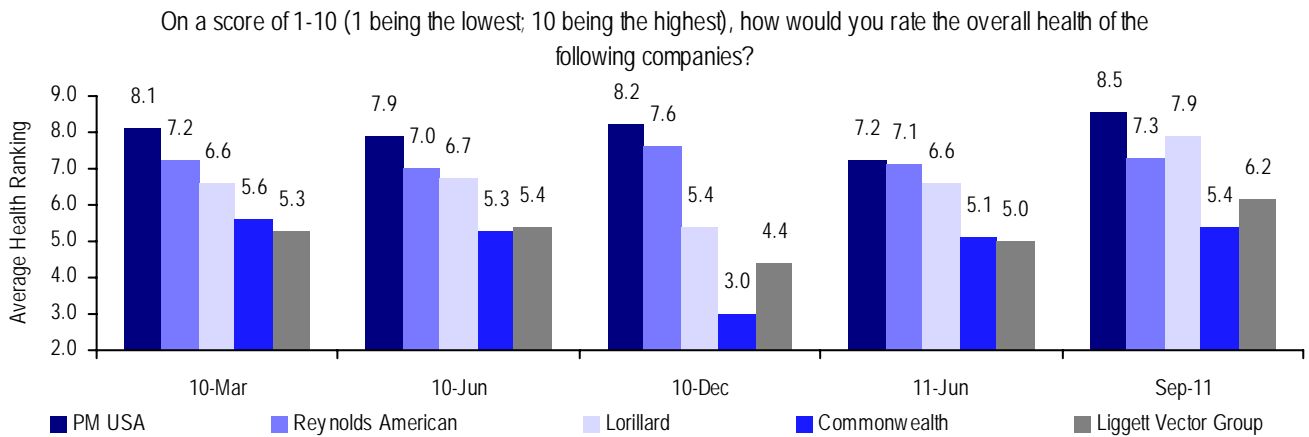
Source: UBS, Company disclosures

From a pricing perspective, we expect Altria to have the best net price realization (+6%) as the company ceded unprofitable share. Hopefully, this will dispel any concerns over PM USA potentially instigating a price war in cigarettes. RAI should have decent net pricing with LO lagging due to a drag from Newport Non Menthol. Our contacts suggest Newport Menthol pricing is tracking +5-6%.

## Lorillard Should Shine Again this Quarter

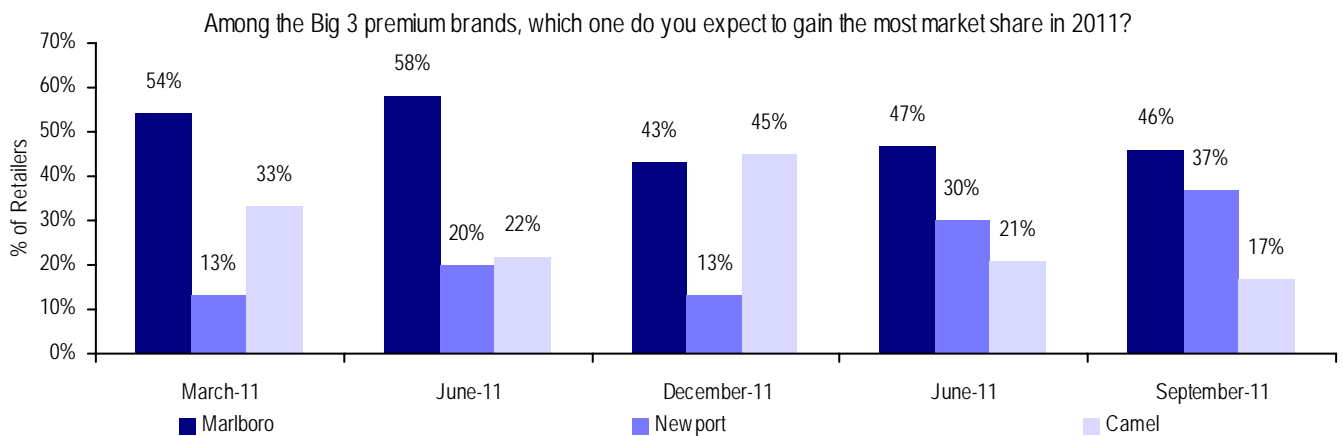
After picking up feedback from the trade and reviewing results from our September quarter retail survey, it is clear that Lorillard’s momentum seen over the past several quarters continued in the September quarter. In fact, for the first time since we started our tobacco retailer survey in 2010, Lorillard has overtaken Reynolds American as the 2<sup>nd</sup> healthiest tobacco company (behind Altria). Additionally, a larger proportion of retailers expect Lorillard to increase its share versus prior surveys.

**Chart 2: Lorillard surpassed Reynolds as the 2<sup>nd</sup> healthiest company this quarter with a 7.9 out of 10 ranking**



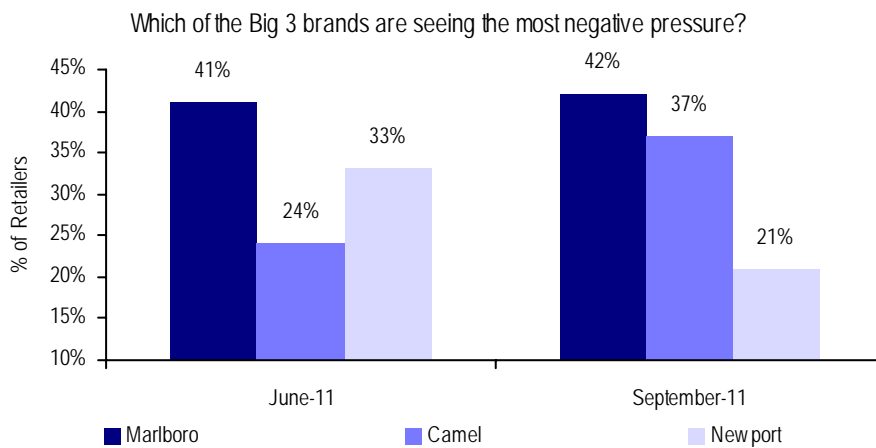
Source: UBS Tobacco Survey

**Chart 3: The amount of retailers that expect Lorillard to increase market share increased 7 pp while the amount that expected Reynolds to increase share declined 4 pp**



Source: UBS Tobacco Survey

**Chart 4: Only 21% of retailers see Newport facing the most negative pressure**

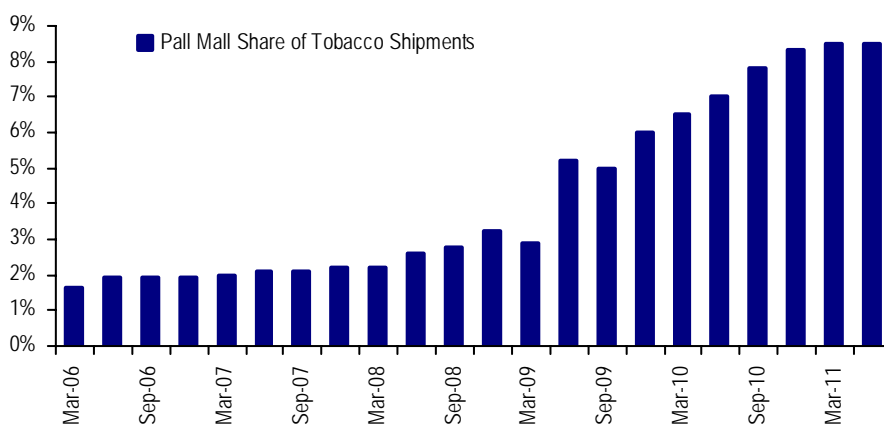


Source: UBS Tobacco Survey

### Pall Mall Slowing Down

Pall Mall has been a huge success story for RAI. As a reminder, RAI repositioned Pall Mall in 2006 as a discount brand. The value proposition was a long smoke with premium tobacco at a reasonable price (we akin this strategy to what Conwood originally did with Grizzly). Since its repositioning, Pall Mall has gone from 3.2% of the market in 2008 to 8.5% today and is now RAI’s biggest cigarette brand (30% of RAI’s total cigarette portfolio versus 10% back in 2008).

**Chart 5: Pall Mall has increased its share to 8.5% from 2% in 2006**



Source: Company filings

However, after some phenomenal growth over the past several quarters, our field research and survey work is pointing to a slowing in Pall Mall. While tough comparisons are certainly a partial factor in the slowdown, we also believe competition is heating up at the lower end of the market—especially with PM USA’s extra support of L&M over recent quarters. We estimate the brand will grow 7% in 3Q11 versus 14% in 2Q and 50% over the last 8 quarters. It is important to note that incremental spending behind L&M is likely coming from “Special Blends” and BASIC.

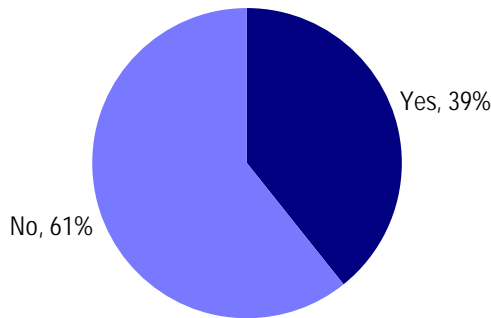
**Table 2: Pall Mall is slowing but still growing in a declining market**

	Mar 08	Jun 08	Sep 08	Dec 08	Mar 09	Jun 09	Sep 09	Dec 09	Mar 10	Jun 10	Sep 10	Dec 10	Mar 11	Jun 11
Pall Mall Y/Y Quarterly Growth	-2%	18%	33%	31%	17%	100%	58%	91%	138%	11%	45%	20%	16%	14%

Source: Company filings, UBS

**Chart 6: Close to 40% of retailers indicated PM USA's stepped up level of promotional support for L&M has had a negative impact on Pall Mall**

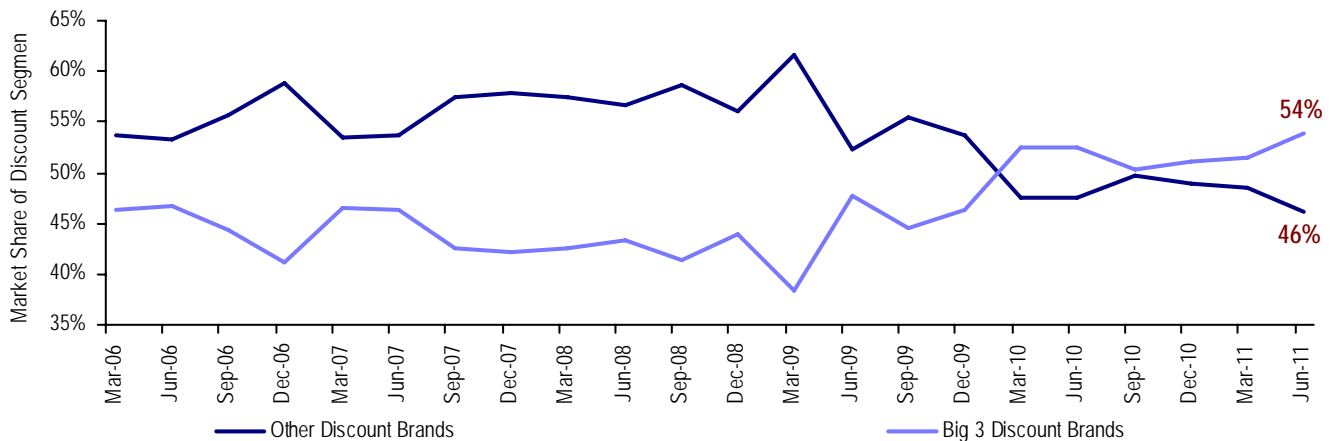
Has PM USA's stepped up level of promotional support for L&M had a negative impact on Pall Mall?



Source: UBS Tobacco Survey

While some may worry that Pall Mall, L&M and Maverick are growing, we believe it will help support the overall pricing picture of the industry longer term. Importantly, most of the share gains from these brands are coming at the expense of non Big 3 deep discount players.

**Chart 7: The Big 3 are taking a larger proportion of the discount segment in recent quarters. This should help longer term pricing power of the cigarette category.**



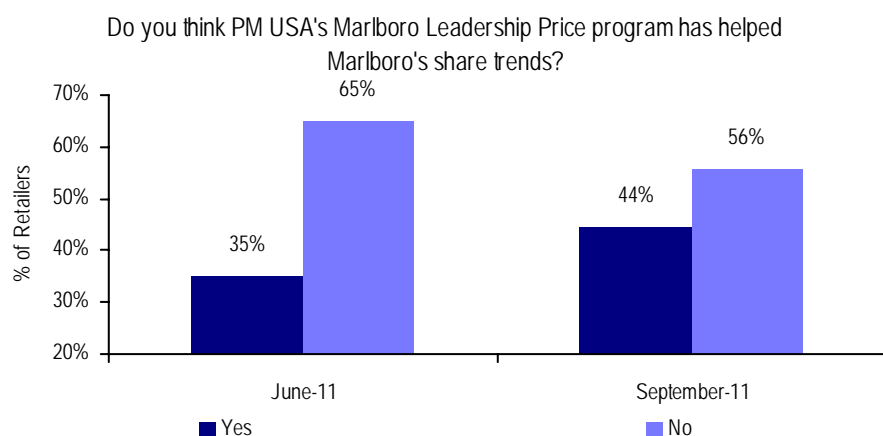
Source: Company filings

## An Update on the Marlboro Leadership Price (MLP) Program

We continue to get mixed feedback from retailers on the effectiveness of Altria's MLP program. Broadly speaking, retailers that have the program are

experiencing better trends than retailers that are not on the program. We estimate approximately 40%-50% of retailers that represent 70% of Marlboro's volumes are signed up on the program. As we expected, this number has increased since the original sign up date in April as retailers sought to remain competitive on pricing in the market. It is also important to remember that retailers have taken prices down on Marlboro also had to reduce price points on Camel and Newport due to "fair and equitable" clauses in their retail trade contracts. **We believe investors need to be careful on reading too much into scanner data since most of the price cuts are being entirely funded by the retailer and not the manufacturer.**

**Chart 8: 44% of retailers believe MLP has helped Marlboro share trends compared to 35% in June**



Source: UBS Tobacco Survey

A few months back, we predicted that PM USA would cancel the MLP program due to significant pushback from retailers. Since then, it seems retailers have settled into the "new normal." Looking ahead, we actually expect Altria to renew the program and make a few tweaks. Specifically, we expect PM USA to start segmenting MLP by performance. For instance, the best performing retailers will start to get paid more incentives monies than lower performing retailers. This is effectively what PM USA had done with its retail and wholesale leaders programs.

## Grizzly Volumes Accelerating Due to a New Retail Contract

We expect Grizzly volumes to accelerate sequentially as RAI begins to get the benefits of its new retail trade contract (we estimate 200-300 bps). In a nutshell, the American Snuff Company introduced a contract to retailers during the June quarter that provides incentive monies for providing Grizzly its "fair share" of shelf. We estimate this had led to anywhere between 4-8 new "facings" for Grizzly. In addition, retailers that sign onto the program need to have Grizzly as the lowest effective price in the MST category and need to provide more brand and price communication within the store.

While volumes should accelerate, we believe this will be offset by lower pricing as American Snuff doles out incremental monies as part of its new program. This will likely be the case until the initial implementation of the program is

lapped in the June Q of next year. In addition, American Snuff's numbers will look soft due to the divestment of lane limited.

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#### ■ **Statement of Risk**

The tobacco industry is highly regulated, and faces litigation, and legislation risk. Other risks associated with tobacco stocks are increases in excise taxes, smoking bands, and negative pricing prospects.

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UBS 12-Month Rating	Rating Category	Coverage <sup>1</sup>	IB Services <sup>2</sup>
Buy	Buy	59%	35%
Neutral	Hold/Neutral	35%	33%
Sell	Sell	6%	14%
UBS Short-Term Rating	Rating Category	Coverage <sup>3</sup>	IB Services <sup>4</sup>
Buy	Buy	less than 1%	0%
Sell	Sell	less than 1%	20%

1:Percentage of companies under coverage globally within the 12-month rating category.

2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

3:Percentage of companies under coverage globally within the Short-Term rating category.

4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Rating allocations are as of 30 September 2011.

### UBS Investment Research: Global Equity Rating Definitions

UBS 12-Month Rating	Definition
Buy	FSR is > 6% above the MRA.
Neutral	FSR is between -6% and 6% of the MRA.
Sell	FSR is > 6% below the MRA.
UBS Short-Term Rating	Definition
Buy	Buy: Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.
Sell	Sell: Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.

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**Forecast Stock Return (FSR)** is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

**Market Return Assumption (MRA)** is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium).

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**UBS Securities LLC:** Nik Modi; Benjamin Schmid.

**Company Disclosures**

Company Name	Reuters	12-mo rating	Short-term rating	Price	Price date
Altria Group <sup>16, 18, 22</sup>	MO.N	Buy	N/A	US\$27.42	17 Oct 2011
Lorillard <sup>16</sup>	LO.N	Buy	N/A	US\$116.60	17 Oct 2011
Reynolds American <sup>16</sup>	RAI.N	Buy	N/A	US\$39.04	17 Oct 2011

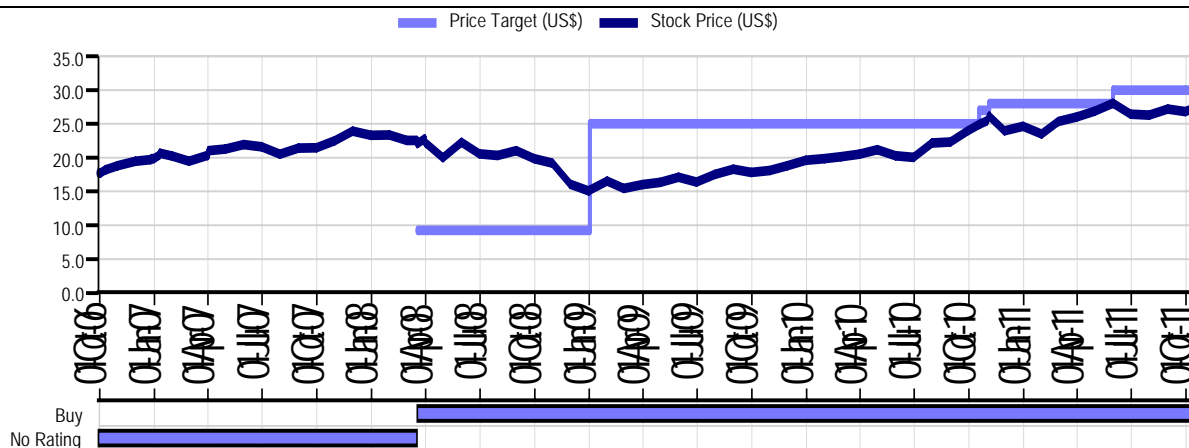
Source: UBS. All prices as of local market close.

Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

16. UBS Securities LLC makes a market in the securities and/or ADRs of this company.
18. The U.S. equity strategist, a member of his team, or one of their household members has a long common stock position in Altria Group.
22. UBS AG, its affiliates or subsidiaries held other significant financial interests in this company/entity as of last month's end (or the prior month's end if this report is dated less than 10 working days after the most recent month's end).

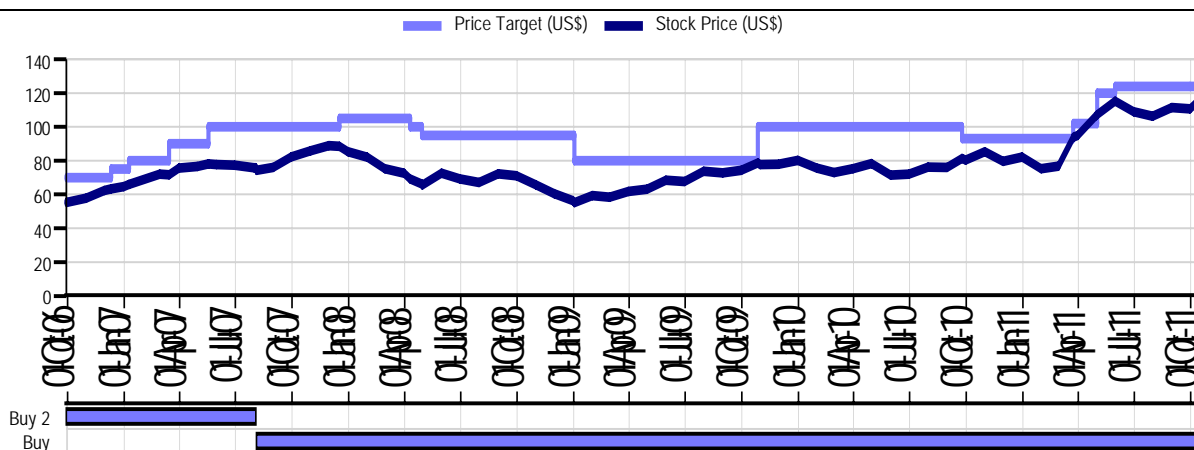
Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

**Altria Group (US\$)**



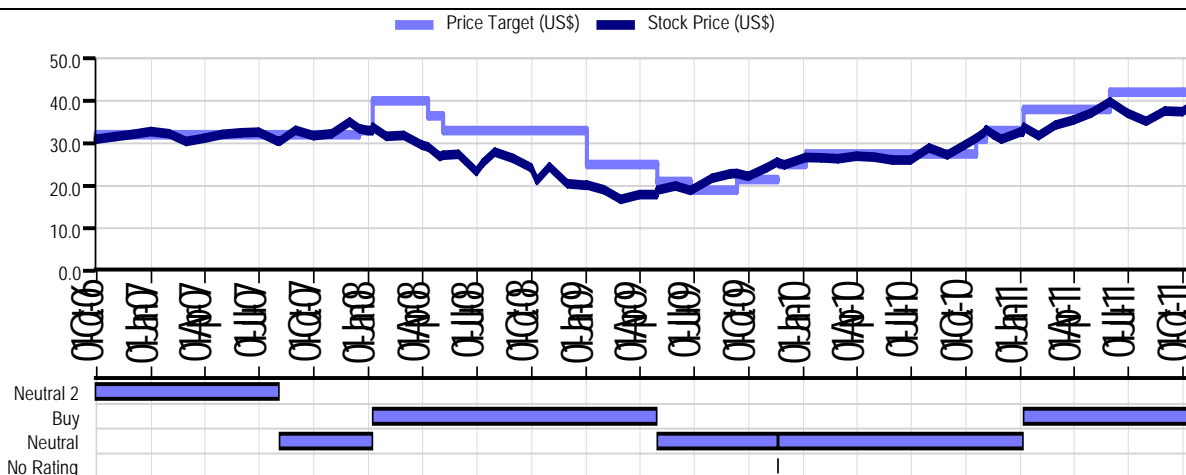
Source: UBS; as of 17 Oct 2011

**Lorillard (US\$)**



Source: UBS; as of 17 Oct 2011

**Reynolds American (US\$)**



Source: UBS; as of 17 Oct 2011

Note: On August 4, 2007 UBS revised its rating system. (See 'UBS Investment Research: Global Equity Rating Definitions' table for details). From September 9, 2006 through August 3, 2007 the UBS ratings and their definitions were: Buy 1 = FSR is > 6% above the MRA, higher degree of predictability; Buy 2 = FSR is > 6% above the MRA, lower degree of predictability; Neutral 1 = FSR is between -6% and 6% of the MRA, higher degree of predictability; Neutral 2 = FSR is between -6% and 6% of the MRA, lower degree of predictability; Reduce 1 = FSR is > 6% below the MRA, higher degree of predictability; Reduce 2 = FSR is > 6% below the MRA, lower degree of predictability. The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities. From October 13, 2003 through September 8, 2006 the percentage band criteria used in the rating system was 10%.

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