

Equities

4 April 2011 | 17 pages

Vivien's View of Global Tobacco

Italy: A Deep Dive

■ Industry Overview

- **Introducing Our Deep Dive Note Series** — In this introductory installment of our Deep Dive note series, we take a closer look at Italy's cigarette market, which we estimate represents roughly 21% of PM's volumes in the EU region (or 15% of EU volumes for the industry).
- **PM Market Share Trends** — On an annual basis, PM's market shares in Italy seem to be stabilizing somewhat, but the company's quarterly share trends tell a different story, as 1Q10's share gain was replaced with accelerating share losses for the remainder of the year. In large part this was driven by softening trends for the Marlboro franchise, which we believe is worth watching, as it could reflect the tough comps that PM is starting to see after the launch of several Marlboro line extensions over the last few years.
- **Resilient Volume Trends Helped by Trade-Down** — Italy's cigarette volume trends have historically outperformed those seen for the total EU market, which we attribute to the greater mix of premium-priced cigarettes sold in Italy (which has allowed for greater trade-down, thus helping consumers to stay in the category when prices rise).
- **Competitor Commentary** — To provide insight into the competitive landscape, we also include recent quotes from the various international tobacco companies that compete in Italy, to offer a consensus view of the category trends, and more color on the company-specific trends that each has been seeing over the last few quarters.
- **Maintain Hold on PM** — We reiterate our Hold (2L) rating on PM, as we believe that upside in the stock is limited today. With a small but growing proportion of PM's high-margin Marlboro franchise shifting to lower-margin Marlboro line extensions (which admittedly carry a terrific margin too!), we believe there is limited opportunity for positive earnings revision activity. As such we maintain our Hold rating and \$63.50 target price on PM.

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Opinion

Given the breadth of PM's business, herein we are introducing the first in our series of country-specific deep dive notes. While PM's geographically diverse portfolio helps to mitigate key market risk, 2010's results highlighted just how important a handful of key markets can be.

With that in mind, we begin our analysis in the EU (PM's highest-margin region), and specifically focus on Italy, the company's biggest volume contributor for the EU segment, and one of the company's highest-margin markets overall.

We summarize our key points below:

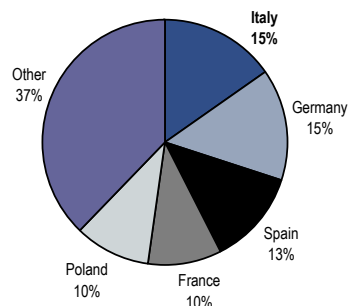
- 1. The Importance of Italy.** We estimate Italy accounted for over 20% of PM's EU volumes in 2010 and roughly 15% of cigarette industry volumes (or 5% of PM's global volumes, and 3% of global industry volumes, excluding the U.S., China and duty free). It is often the case that PM's out/underperformance in Italy mirrors the company's results in the EU.
- 2. Relevant Share Trends.** Italy has been touted as one of PM's stabilizing markets, but quarterly share trends tell a different story. Share gains have decelerated over the course of 2010, owing we believe to tough comps from PM's new Marlboro architecture implementation (which included new product introductions that are becoming increasingly hard to successfully anniversary).
- 3. Relevant Category Trends.** While Italy remains a more premium-priced market than others in the EU, trade-down has been notable. While PM has done a good job in capturing some of the trade-down through the introduction of new Marlboro line extensions, there remains a margin trade-off, as products like Marlboro Gold Touch are lower-margin than core Marlboro.
- 4. Possible Read-Through from Italy.** We estimate that PM generated roughly 7% of Marlboro volumes from Italy in 2010. As such, it should come as no surprise that Italy was one of the first markets in which PM launched several of their new Marlboro initiatives (e.g., Marlboro Gold Touch in 2Q08 and Marlboro Core Flavor in 2Q10). With that in mind, we believe that, like the trends seen in Italy, PM's market shares in other key markets could also be challenged as the company continues to anniversary key Marlboro line extensions.

Why We Care About Italy?

Italy is one of the largest cigarette markets in the EU, representing roughly 21% of PM's volumes in the EU region and 15% of EU industry volumes (or 5% of PM's global volumes, and 3% of global industry volumes, excluding the U.S., China and duty free).

Figure 1. Italy Is a Noteworthy EU Cigarette Market for PM...

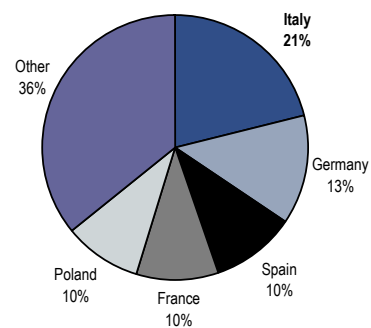
Industry: EU Volume Contribution by Country - 2010



Source: Company Reports and Citi Investment Research and Analysis

Figure 2. ...And For the Industry

PM: EU Volume Contribution by Country - 2010

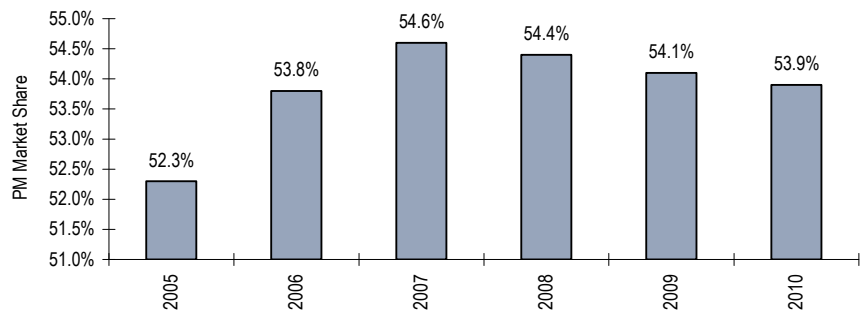


Source: Company Reports and Citi Investment Research and Analysis

PM Cigarette Trends in Italy

In Italy, PM is the dominant market share leader, with a 53.9% share in 2010, though the company has lost market share for three consecutive years. To be sure, on an annual basis, PM's market shares in Italy seem to be stabilizing (as has often been highlighted by management, as recently as last week).

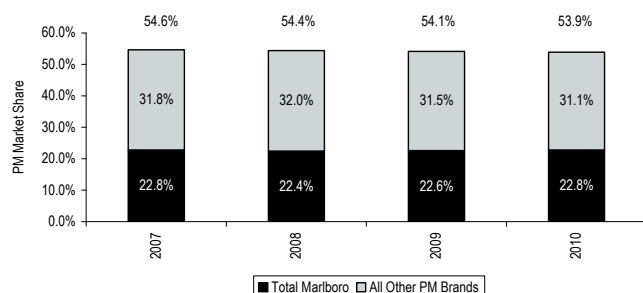
Figure 3. PM's Share Losses in Italy Continued into 2010



Source: Company Reports and Citi Investment Research and Analysis

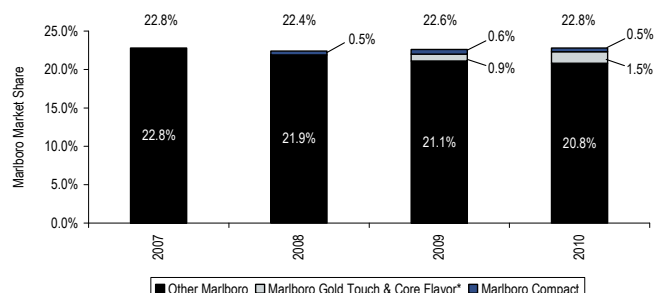
Helping to stem these market share losses has been Marlboro's market share recovery in Italy over the last few years, highlighting the success that PM has had with Marlboro's new brand architecture (and its related new product introductions). However, it's worth noting that these brand building efforts have failed to deliver a "halo effect" for the core Marlboro portfolio. Indeed, while Marlboro's 2010 market share in Italy finally returned to 2007's levels, we estimate that over the last three years, core Marlboro products have lost 200 bps of market share, excluding new Marlboro line extensions (i.e., Compact in 2007, Gold Touch in 2008 and Core Flavor in 2Q10). In fact, while PM reported that Marlboro Gold Touch had achieved a 1.4% market share in Italy in 1Q10, for the full year, the combined market shares for Marlboro Gold Touch and Core Flavor was only modestly higher at 1.5%.

Figure 4. Marlboro's Market Shares Are Back to 2007 Levels...



Source: Company Reports and Citi Investment Research and Analysis

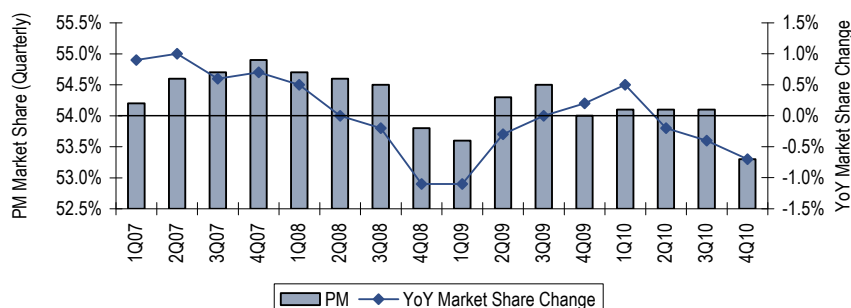
Figure 5. ...Largely Owing to New Product Launches



Source: Company Reports and Citi Investment Research and Analysis

What is more, PM's quarterly market share trends in 2010 may be more telling, given the deteriorating quarterly share trends seen over the course of the year.

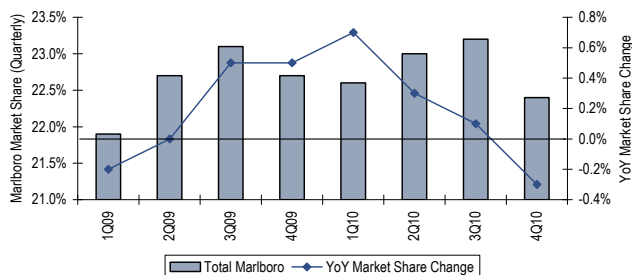
Figure 6. YoY Market Share Trends Weakened Throughout 2010



Source: Company Reports and Citi Investment Research and Analysis

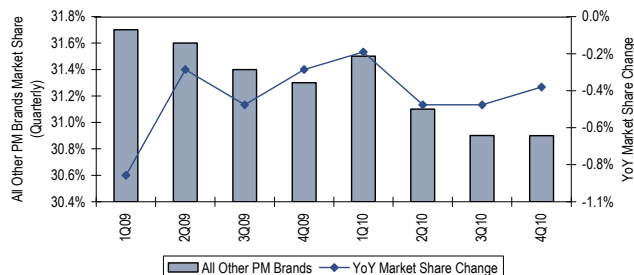
We worry that anniversarying these new Marlboro product launches could prove to be a challenge. While PM's other brands have been losing market share fairly consistently, Marlboro's share trends have reversed course thru 2010 (admittedly, 4Q10's share loss could have been exacerbated by industry price increases, but that still doesn't explain the decelerating market share gains seen in the prior two quarters).

Figure 7. Marlboro Weakness in Italy Is Problematic...



Source: Company Reports and Citi Investment Research and Analysis

Figure 8. ...As PM's Other Brands Were Already Losing Share

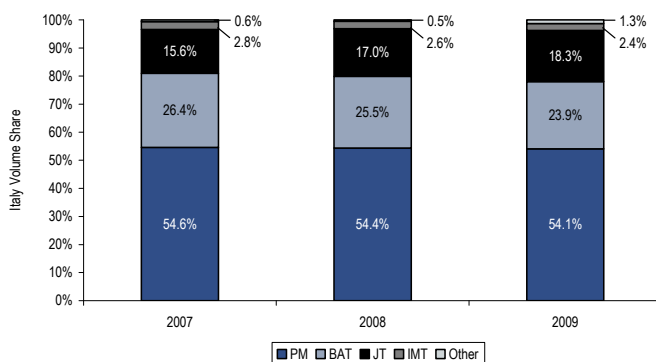


Source: Company Reports and Citi Investment Research and Analysis

Competitive Landscape in Italy

PM is the clear market share leader in the cigarette category in Italy. However, the company has a notable presence in the premium & above price segment, which we believe explains PM's market share losses, as does the relatively narrow price gap seen among the major cigarette brands sold in the market.

Figure 9. PM Has Been Losing Share to Lower-Cost Competitors



Source: Company Reports and Citi Investment Research and Analysis

Figure 10. PM Over-Indexes In Leading Premium-Priced Brands

	PM	BAT	JT	IMT
2009 Market Share	54.1%	23.9%	18.3%	2.4%
Premium & Above	Marlboro Philip Morris Merit Muratti	Dunhill Vogue		
Mid	Chesterfield Marlboro Gold Touch	Lucky Strike	Camel	
Low	Diana L&M	Pall Mall MS	Winston	

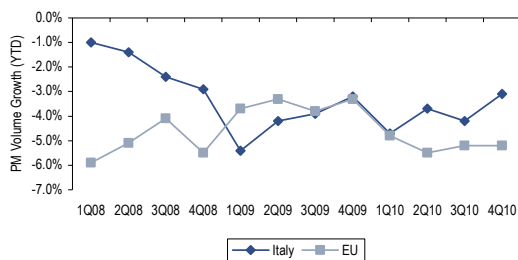
Source: Company Reports and Citi Investment Research and Analysis

It is worth noting that PM's portfolio architecture in Italy varies slightly from the corporate average, where: (i) Muratti is a mid-priced brand globally, vs. premium in Italy; (ii) Philip Morris is a mid-priced brand globally, vs. premium in Italy; and (iii) L&M is a mid-priced brand globally, vs. low-priced in Italy.

Cigarette Category Dynamics in Italy

Relative to the EU, cigarette volume trends in Italy are in fact pretty good, both for PM and the industry.

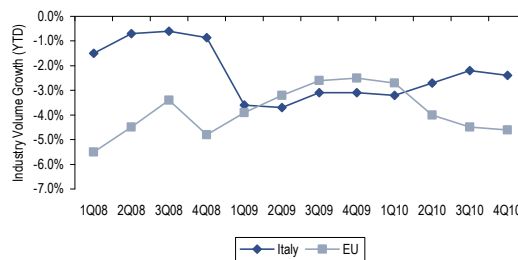
Figure 11. Better Volume Trends in Italy Than the EU for PM...



Note: Quarterly data reflects cumulative YTD volume growth.

Source: Company Reports and Citi Investment Research and Analysis

Figure 12. ...And the Cigarette Industry...



Note: Quarterly data reflects cumulative YTD volume growth.

Source: Company Reports and Citi Investment Research and Analysis

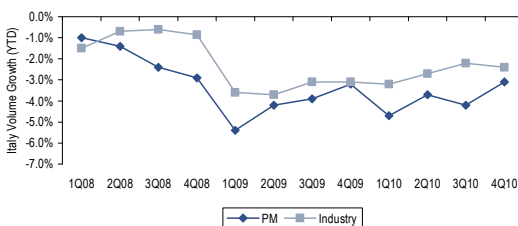
Figure 13. ...Such That Italy Is Often an Outperformer

	2007	2008	2009	2010	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10
PM - Italy Outperformance (+) / Underperformance (-) vs. EU	+	+	+	+	+	+	+	+	-	-	-	+	+	+	+	+
Industry - Italy Outperformance (+) / Underperformance (-) vs. EU	+	+	-	+	+	+	+	+	+	-	-	-	-	+	+	+

Source: Company Reports and Citi Investment Research and Analysis

However, given the size of the Italian cigarette market (despite its relatively healthy trends), **it is often the case that PM's relative volume performance in Italy mirrors that seen in the EU** (e.g., when PM's growth lags the industry's in Italy, the company also underperforms in the EU, and vice-versa).

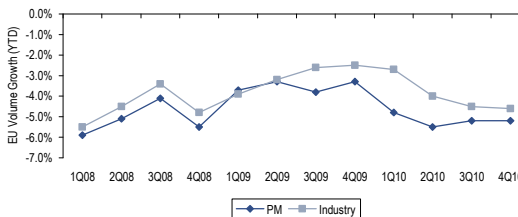
Figure 14. Given Italy's Importance, PM's Volume Trends There...



Note: Quarterly data reflects cumulative YTD volume growth.

Source: Company Reports and Citi Investment Research and Analysis

Figure 15. ...Often Impact PM's EU Volume Trends...



Note: Quarterly data reflects cumulative YTD volume growth.

Source: Company Reports and Citi Investment Research and Analysis

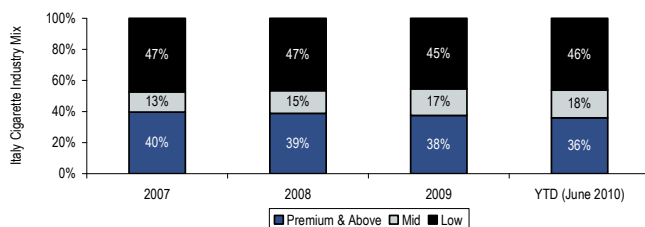
Figure 16. ...Such That PM's Outperformance/Underperformance in Italy and the EU Often Mirror One Another

	2007	2008	2009	2010	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10
Italy - PM Outperformance (+) / Underperformance (-) vs. Industry	+	-	-	-	+	-	-	-	-	-	-	-	-	-	-	-
EU - PM Outperformance (+) / Underperformance (-) vs. Industry	+	-	-	-	-	-	-	-	+	-	-	-	-	-	-	-

Source: Company Reports and Citi Investment Research and Analysis

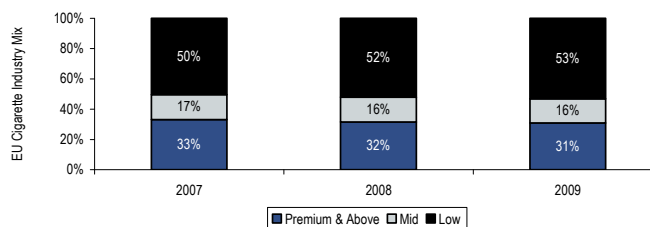
One of the drivers of Italy's general volume outperformance relative to the EU is the country's historically premium-heavy mix, as the premium & above price segments accounted for 40% of sales in Italy in 2007, vs. 33% for the EU. Further, the mid-priced segment in Italy has traditionally been smaller than that seen for the EU as a whole. As such, we believe Italy's category dynamics have kept more consumers in the category by offering room for trade-down (vs. trade-out of the category, which we believe happens after consumers trade-down so much that it becomes increasingly hard for consumers to justify staying in the category at all).

Figure 17. Cigarette Trade-Down In Italy...



Source: Company Reports and CIRA Estimates

Figure 18. ...Has Been More Pronounced Than in the EU



Source: Company Reports and Citi Investment Research and Analysis

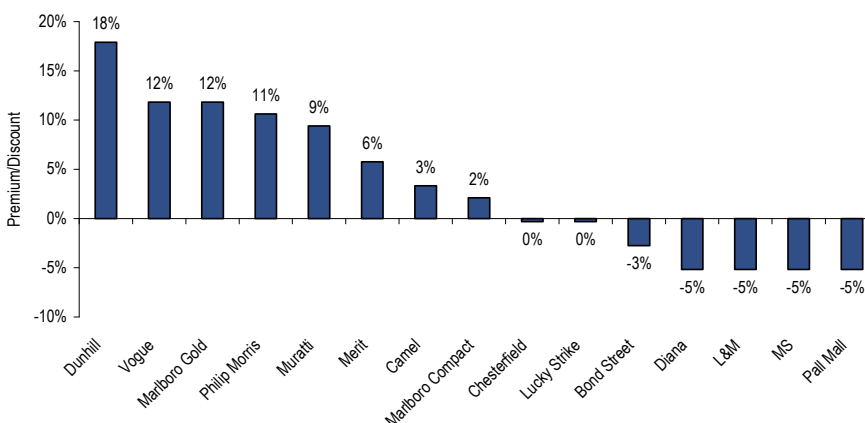
On a related note, it is also worth highlighting that the price gaps in Italy have in the past been narrower than those seen in other EU markets. We believe this has contributed to Italy's greater mix of premium & above priced cigarettes (as these smaller price gaps make higher-priced cigarettes a less expensive alternative).

Figure 19. In the EU, There Tends to be an Inverse Relationship Between Price Gaps and Category Mix

	2008				2009		
	PM Market Share	Marlboro Price Gap	Premium & Above Category Share		PM Market Share	Marlboro Price Gap	Premium & Above Category Share
France	40.8%	10%	48%	France	40.6%	10%	47%
Italy	54.4%	19%	39%	Italy	54.1%	18%	38%
Germany	36.9%	24%	36%	Germany	36.5%	30%	33%
Spain	31.9%	30%	19%	Spain	31.9%	21%	16%
Poland	37.6%	32%	12%	Poland	36.1%	25%	13%

Source: Company Reports and Citi Investment Research and Analysis

Figure 20. Cigarette Pricing Falls in a Fairly Narrow Range in Italy



Note: Reflects the average premium/discount when a brand offers multiple price points.

Source: AAMS and Citi Investment Research and Analysis

And, it is also likely that the generally higher levels of smoking incidence among adults in Italy, relative to other EU countries, is also contributing to Italy's cigarette industry volume outperformance, relative to the overall region.

Figure 21. Smoking Incidence in Selected European Union Member Countries

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Italy	24.4	24.1	24.0	24.2		22.3	23.0	22.4	22.4	23.3	21.7
U.K.	27.0	27.0	26.0	26.0	25.0	24.0	22.0	21.0	21.0	21.0	
Belgium	31.0	28.0	29.0	27.0	23.7	20.3	22.0	22.0	20.0	20.0	17.6
Denmark	30.5	29.5	28.0	28.0	25.2	25.6	24.7	23.9	23.2	16.0	20.0
Finland	23.4	23.8	23.4	22.2	23.0	21.8	21.4	20.6	20.4	19.0	
France	27.0	27.0	26.0		23.0		25.0		26.2		28.7
Iceland	22.9	23.6	21.6	22.4	20.2	19.5	19.3	19.4	17.8	15.8	
Luxembourg		26.0	26.0	28.0	27.0	23.0	21.0	21.0	20.0	19.0	
Netherlands	32.0	34.0	34.0	32.0	31.0	31.0	31.0	29.0	28.0	28.0	
Norway	32.0	30.0	29.0	26.0	26.0	25.0	24.0	22.0	21.0	21.0	

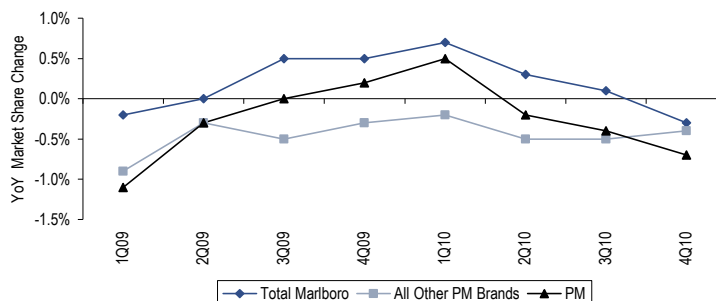
Note: Blanks indicate data is not available.

Source: OECD and Citi Investment Research and Analysis

Read-Through From PM's Cigarette Trends in Italy

As shown above, decelerating Marlboro share gains in Italy (and the recent 4Q10 share loss) drove the deterioration in PM's quarterly share growth trends in that market throughout 2010. As such, we believe PM's quarterly share trends in 2010 could foretell more wide-spread issues to come.

Figure 22. Recent Marlboro Share Weakness Is Driving Share Losses for PM in Italy



Source: Company Reports and Citi Investment Research and Analysis

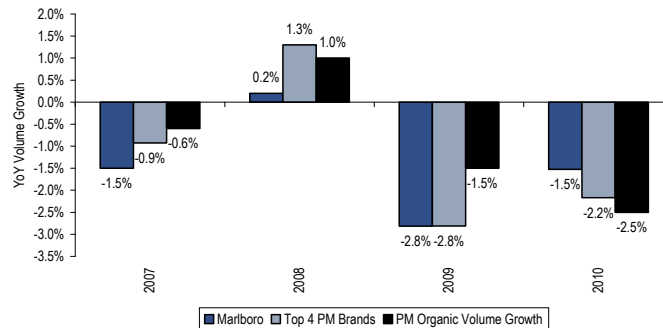
We estimate that PM generated roughly 7% of Marlboro volumes from Italy in 2010. As such, it should come as no surprise that Italy was one of the first markets in which PM launched several of their new Marlboro initiatives (e.g., Marlboro Gold Touch in 2Q08 and Marlboro Core Flavor in 2Q10). With that in mind, we believe that like the trends seen in Italy, PM's market shares in other key markets could also be challenged as the company continues to anniversary key Marlboro line extensions. To put this in context, we would note that:

1. On a total company basis, 2010 was the first year Marlboro volume growth outpaced PM's organic volume growth since the 2008 spin.

Given PM's experience in Italy, we advocate caution in reading too much into PM's better Marlboro trends. To be sure, the global Marlboro franchise outperformed PM's organic volume trends in 2010, similar to the

outperformance seen for the brand in Italy in 2010. However, the deterioration seen for Marlboro throughout the year in Italy could make the full year trends for the overall brand a bit misleading, as other markets too could be impacted by similar comparison issues.

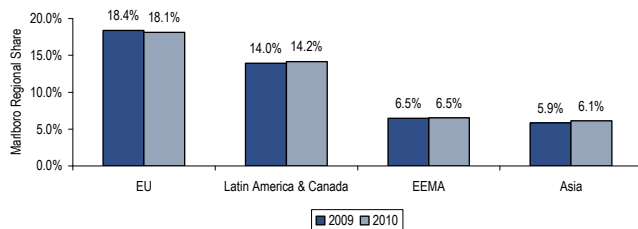
Figure 23. New Product Launches Might Have Driven Marlboro's Outperformance in 2010



Source: Company Reports and Citi Investment Research and Analysis

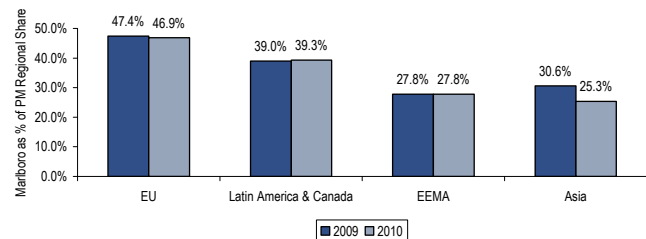
2. **Marlboro over-indexes in the EU.** We believe the read-through from Italy is particularly important given the importance of the Marlboro brand for PM's Italy and EU businesses (where the brand has the highest absolute share, and accounts for the biggest percentage of PM's regional market share, by our math).

Figure 24. Marlboro's Share is Highest in the EU...



Source: Company Reports and CIRA Estimates

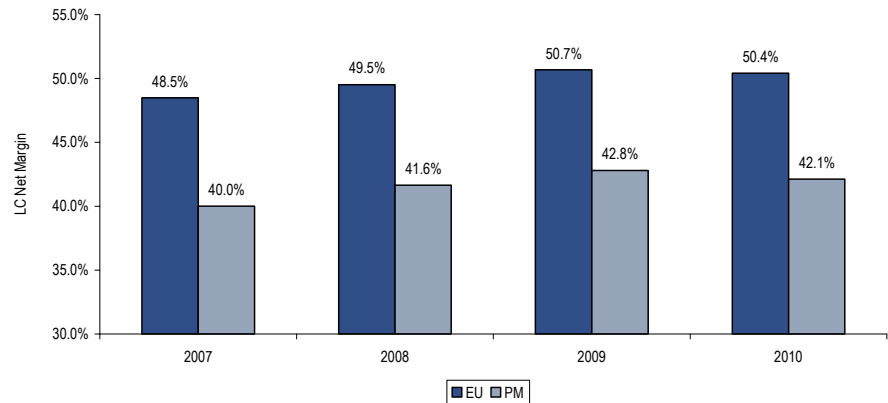
Figure 25. ...And, Accounts for Nearly 50% of PM's Share in the Region



Source: Company Reports and CIRA Estimates

3. **Margin Implications.** With the Marlboro franchise particularly important in the EU, the falling contribution seen from the brand in 2010 was, unsurprisingly, complemented by a 30 bps decline in the region's local currency profit margin. To the extent that lower-margin Marlboro line extensions continue to grab share, without also driving a recovery in the core Marlboro franchise, we could see a continuation of this trend.

Figure 26. PM's Leading Margins in the EU Are Reliant Upon Marlboro



Source: Company Reports and Citi Investment Research and Analysis

Competitor Quotables

BAT (3/28/11) – “In Italy, an improved mix, coupled with a price increase and lower costs, offset some of the volume decline, although profit was depressed by an adverse exchange rate. Market share was slightly down on last year, despite share growth of Global Drive Brands and overall share increasing over the last quarter.”

BAT (2/24/11) – “Pall Mall’s volume and top 40 share also saw growth globally [and Italy contributed].”

JT (2/8/11) – “We have also seen the signs of down trading in [Italy] where Winston also gained momentum because of that obvious reason.”

JT (2/8/11) – “[Total shipment and GFB shipment volume growth] was driven by strong performances in Italy and France. Market share increased in most key markets including France, Italy and Spain.”

JT (10/29/11) – “In South and West Europe total and GFB shipment volumes both returned to positive growth increasing 2.3% and 4.0% respectively. This was driven by the continued momentum of Winston in Italy.”

IMT (3/11/11) – “Strong pricing has been a key attribute in mature markets. Since September 2010 we have already taken or announced price increases in countries such as Spain, France, Italy, the Czech Republic, Greece, Austria, and the Netherlands.”

IMT (9/28/11) – “In a number of European markets we have introduced Origenes, starting in Spain, followed by Italy, and with others to come.”

PM (3/28/11) – “Italy, you see 54% market share for us, very stable. We are doing extremely well, so that’s an excellent market. We have seen over the last years, also, regular moderate price increases in that market.”

PM (2/23/11) – “In Italy, the market share of Marlboro increased [in 2010] from 22.6% to 22.8%, despite the economic pressure on consumers. This was achieved thanks to the continued growth of Marlboro Gold Touch and the introduction of Marlboro Core Flavor, a full flavor variant, which is also in a slimmer format.”

PM (2/10/11) – “We project a slightly weaker volume trend in...Italy, reflecting retail price increases ahead of inflation. Marlboro continues to do well in Italy. [We] have seen significant turnarounds in the demographic profile of the [Marlboro brand in Italy].”

PM (10/21/10) – “We expect to reap the benefit in the fourth quarter of recently implemented price increases [in Italy].”

PM (5/13/10) – “...you go to Italy...[we didn’t see this type of disruptive excise tax increase].”

Philip Morris International

(PM.N; US\$64.92; 2L)

Valuation

PM has traded at an average 3% premium to the S&P 500 over the last three years, ranging from a 17% discount to a 29% premium. On an absolute basis, over the last three years, PM has traded at an average 12.6x forward P/E (ranging from 9.8x to 14.9x). Meanwhile, the stock is currently trading at 12.9x our CY12 EPS estimate, essentially in-line with its historical average.

We believe PM deserves to trade at parity with the market multiple (or at a roughly 13x target P/E), which reflects our expectation for consistent double-digit EPS growth and continued strong cash flow generation. Given the S&P's roughly 13x P/E multiple (based on Citi's 2012 EPS estimate), and our CY12 EPS estimate of \$4.89, we have a \$63.50 target price on the stock.

Risks

We rate Philip Morris International a Low Risk stock. The company operates in an industry in which volumes are steadily declining in developed countries, which must be offset by price increases and/or cost cutting in order to maintain or increase operating income. Volume trends in most developing countries are positive; however, margins are significantly smaller in these markets. Additionally, excise tax increases can prove disruptive as consumers typically trade down to lower-margin, value-priced cigarette brands. Furthermore, government regulation of the industry remains a risk as changes such as requirements for generic packaging or health warning labels may undermine the industry's high margins. Finally, litigation is a concern, though not nearly as great of one as in the U.S.

Potential reasons the stock could materially underperform our target price include: (i) a slow reaction by consumers to PM's new product introductions, which have helped to drive volume and market share gains in several key markets, (ii) significant changes in exchange rates, and (iii) continued consumer trade-down driven by either continued macro weakness or higher excise taxes.

In citing reasons why the stock could materially outperform our target price, if management's EPS growth targets proved too conservative, PM's outperformance could help boost the stock price.

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Philip Morris International (PM)

Ratings and Target Price History Fundamental Research

Analyst: Vivien Azer

Covered since March 1 2011

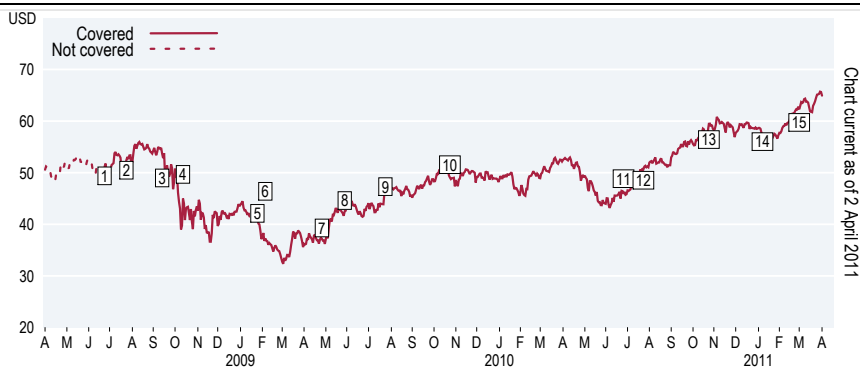


Chart current as of 2 April 2011

Date	Rating	Target Price	Closing Price
1 24-Jun-08	*1M	*62.00	51.17
2 24-Jul-08	1M	*64.00	52.46
3 12-Sep-08	1M	*62.00	53.68
4 13-Oct-08	1M	*57.00	44.99
5 26-Jan-09	1M	*47.00	41.13

* Indicates change

Date	Rating	Target Price	Closing Price
6 5-Feb-09	1M	*42.50	37.26
7 27-Apr-09	1M	*42.00	37.19
8 28-May-09	1M	*46.50	42.54
9 24-Jul-09	1M	*52.00	47.30
10 23-Oct-09	1M	*56.00	49.07

Date	Rating	Target Price	Closing Price
11 25-Jun-10	1M	*54.00	45.90
12 23-Jul-10	1M	*58.00	50.66
13 25-Oct-10	1M	*66.00	59.47
14 7-Jan-11	*2L	*60.50	56.42
15 1-Mar-11	2L	*63.50	62.27

Rating/target price changes above reflect Eastern Standard Time

Philip Morris International (PM)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Vivien Azer

Covered since March 1 2011

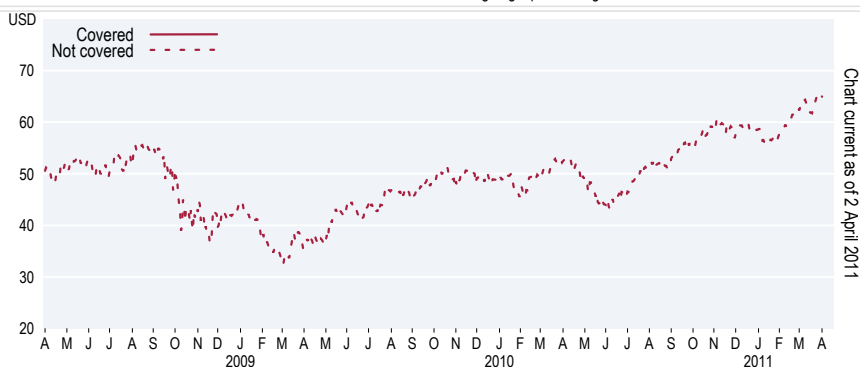


Chart current as of 2 April 2011

* Indicates change

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