

Japanese Tobacco in a Global Context

JT's global growth potential

- As regional and global asset management grows as an investment style, this area is not always well served by traditional sell-side research. In addition, since the Tohoku earthquake and with so much macro uncertainty, we thought it was worth re-examining Japan's place in the world, what it offers a portfolio, and how it plays to the major global themes and trends. With that in mind, we asked our analysts to give us their thoughts and will publish these views sector by sector. They may not be the definitive answer, but will hopefully help inform discussion and debate on how to view "Japan in a Global Context". This marks the seventh report in the series.

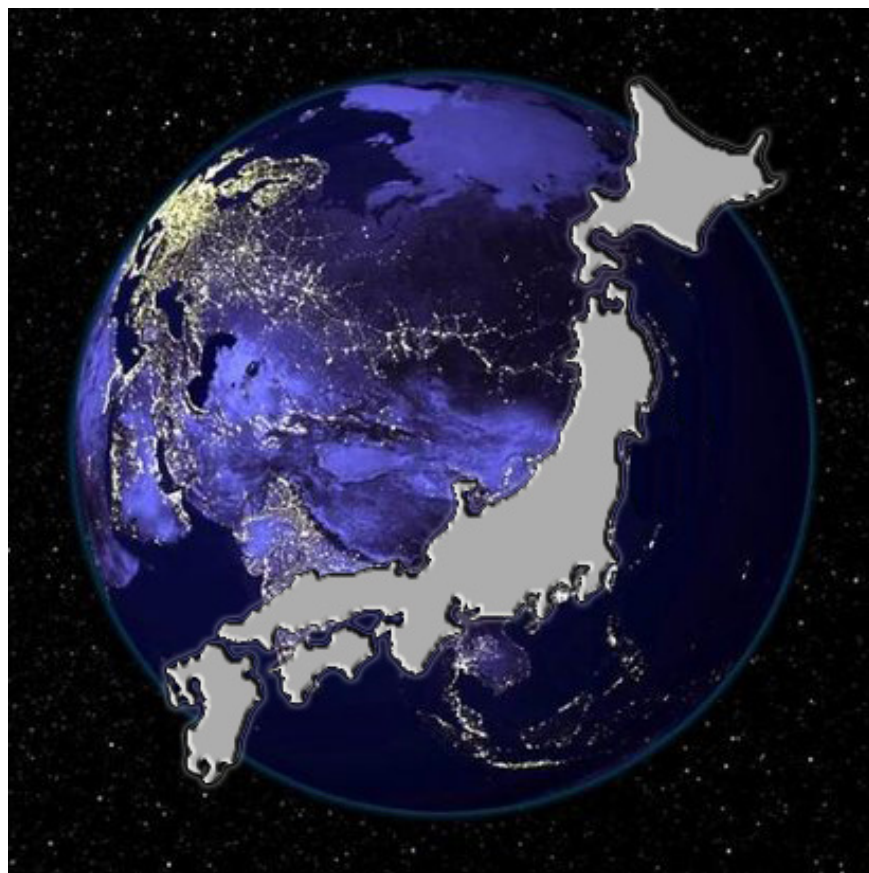
■ Industry Overview

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

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Contents

Overview	3
Chapter 1. Cigarettes: A growth industry	6
Chapter 2. JT's strategy	15
Chapter 3. Analysis of major national markets	23
Chapter 4: Growth potential and issues	31
Appendix A-1	36

Recent reports by the global Tobacco team

Analyst Name	Country	Date	Links
Vivien Azer	US	1/26/2012	Global Tobacco – Country Compendiums - Japan: A Deep Dive
Vivien Azer	US	5/18/2011	Annual Cigarette Synopsis - A Deep Dive into the Global Cigarette Industry
Adam Spielman	UK	7/18/2011	Imperial Tobacco Group PLC (IMT.L) - Pieces Fall Into Place For Upgrade
Nobuyoshi Miura	Japan	2/07/2012	Japan Tobacco (2914) - Rising share price consciousness
Nobuyoshi Miura	Japan	1/04/2012	Japan Tobacco (2914) - Consumption tax hike likely to be positive for JT
Nobuyoshi Miura	Japan	3/28/2011	Japan Tobacco (2914) - Drop in the share price a buying opportunity
Nobuyoshi Miura	Japan	2/16/2012	Japan Tobacco (2914) - We like the medium-term growth potential

Source: Citi Investment Research and Analysis.

Other 'Japan in a Global Context' reports

Analyst Name	Country	Date	Links
Hironari Nozaki	Japan	9/30/2011	Japanese Banks in a Global Context - Are Japanese banks attractive?
Graeme McDonald	Japan	10/27/2011	Japanese Industrials in a Global Context - Can the success story continue?
Arifumi Yoshida	Japan	11/24/2011	Japanese Auto Parts in a Global Context - Strong competitiveness and greater independence bring longer-term opportunities
Takao Kanai	Japan	1/12/2012	Japanese Chemicals in a Global Context: Japan's chemical firms accelerating tech-driven global push
Soichiro Fukuda	Japan	1/27/2012	Japanese Games in a Global Context - Social games and cloud gaming: the next growth chapter
Kumio Tomonaga	Japan	2/08/2012	Japanese Retail in a Global Context — At the other end of the deflation/growth cycle?

Source: Citi Investment Research and Analysis.

Overview

The global tobacco industry has grown steadily in the past few years, with retail sales reaching c\$408 billion in 2011, up 7% YoY. Many had feared that growing health consciousness and higher taxes would negatively impact demand and profits, but in reality higher prices are more than offsetting any volume weakness for the industry majors. Prices are increasing for two reasons: firstly to reflect higher taxes and secondly because the majors raise prices to offset falling volumes. In this report, we look at how price hikes drive growth and how the tobacco makers' margin has increased globally in the last five years. We see this trend of tax-induced price hikes continuing as cash-strapped governments globally look to raise revenues.

JT looks attractive in this global context. The acquisitions of RJR International in 1999 and Gallagher in 2007 is leading to increased market share for JT. We look at how it has been successful at building brand strength, with Winston now the #2 brand globally and #1 in the large Russian market, having grown global market share from 1% in 1999 to 4.3% last year. Regional mix is also attractive for JT as it has significant exposure to markets such as Russia and Japan where consumption remains high but prices are still low. We discuss the size of the global markets, JT's market and price segment positioning, and how these are working in its favor. Finally, we take a look at developed and emerging market differences: the former are seeing down-trading whereas in the latter more aspirational up-trading is happening—interestingly both cases are positive for JT.

In sum, we believe JT has the highest growth potential amongst the majors over the next few years. For valuations see our 16 February report [Japan Tobacco \(2914\) - We like the medium-term growth potential](#)

Prospects for the cigarette industry

Surprisingly, tobacco is a stable growth industry

Rising health consciousness around the world has actually encouraged growth in the cigarette industry, as the only solution to declining consumption has been to increase prices. The price of cigarettes has consistently trended up, so this has been a classic example of a stable growth industry.

Consumption down but earnings up

Markets are steadily expanding around the world. We exclude from consideration China, where there are barriers to entry, and the US, where there is significant litigation risk. Over the past four years, tax-exclusive sales at cigarette makers have increased at an annualized rate of 4.5%. Consumption volumes are down, but price increases are driving earnings.

A bright future

The future of the cigarette industry looks bright as well, as prices in Eastern Europe and Asia are likely to rise. Down the road, we expect earnings to be propelled not by business in Western Europe as in the past, but by business in countries where retail prices are still low, including Russia, Indonesia, and Japan. We also think African countries are promising over the long term. Some tobacco companies have been building platforms in these markets via M&A, etc.

Winston ideally positioned in the middle
of the market

JT has confirmed growth drivers

A cigarette company's future prospects depend on whether it has powerful global brands and a presence in regions with scope for potential sales growth. JT markets the world's second most popular brand, Winston. The company positions Winston cigarettes in the sub-premium price band in a number of markets. Winston is therefore in a good position to benefit from trends toward lower prices in developed markets, where smokers are shifting from premium to sub-premium brands, as well as trends toward more expensive cigarettes in emerging nations, where the shift is from budget brands to sub-premium brands.

Japan and Russia exposure a boon

Furthermore, JT has significant exposure to the markets of Russia and Japan, where consumption is high and retail prices are low. We think this regional mix is another factor likely to accelerate growth.

JT offers greatest growth potential over medium term

We calculate that JT has more growth
potential than the other three big players

There is a high correlation between retail prices and per-capita GDP. We have calculated scenarios for growth in tax-exclusive sales in different countries between 2011 and 2016 based on certain assumptions. As all of these calculations assume benefits from price hikes, they suggest profit growth potential. We see the largest scope for growth in Russia, followed by Indonesia, Japan, South Korea, Taiwan, Kazakhstan, and Switzerland. JT's growth potential of \$5.2bn tops that at Philip Morris, British American Tobacco (BAT), and Imperial Tobacco.

In Russia, tax increases are set to accelerate, and retail prices will probably rise sharply as well. Even in Japan, phased consumption tax increases are being considered. Our calculations reflect signs of such hikes being implemented.

Attractive valuations

Growth potential being underrated by the
market

Despite its significant profit growth potential, JT shares look undervalued compared to global peers. We think it is possible that with rising health consciousness and the push for a cigarette price hike due to pressure on national finances there could be room for correction in the JT share price.

More focus on shareholder returns

The Japanese government also plans to sell some of its JT shares. Currently it owns a 50% stake. With the revision to the JT Law last December, the government is now committed only to retaining a stake of a third or more and plans to sell 16.7% of shares outstanding. JT has commented that it will buy back

some of the shares the government sells. Between FY3/13 and FY3/15, JT plans to raise its IFRS-based dividend payout ratio to 40% from the current 30% and buy back shares from the market in an arrangement separate from the buyback from the government. We find this rapid improvement in shareholder return policies attractive.

Chapter 1. Cigarettes: A growth industry

Steady growth in tax-exclusive sales

China and the US outside our frame of
reference

When we speak of the global cigarette industry in this report, we do not include China or the US. There are two reasons.

1. Sales of foreign-made cigarettes in China, the world's largest consumer of cigarette, are restricted
2. In the US, where there is substantial litigation risk, JT is effectively a non-player
3. PM does not do business in the US. BAT only operates in the US through an affiliate

Market up 7% on a retail price basis in
2011

The global cigarette market is steadily growing. On a retail price basis, the market was up 7% YoY in 2011, to \$407.8bn, and we estimate that tax-exclusive maker sales rose 6% to ¥85.1bn. While shipments fell 1% YoY, to 3,146bn cigarettes, sales growth was supported by a 7% rise in selling prices. In particular, sales were boosted by a substantial price hike in Japan in October 2010 and by rising prices in Russia.

The gross margin on tax-exclusive sales for cigarettes is over 60%. Because sales increase as a result of tax hikes, profit margins have consistently improved. Most of the resulting additional sales therefore contribute to profits.

Average annual growth of 3.6% on a
retail price basis in recent years

Between 2007 and 2011, we estimate that average annual growth in the global market on a retail price basis was 3.6% and that growth in tax-exclusive maker sales was 4.5%. Breaking down retail sales, tobacco and consumption taxes accounted for about 68% in both 2007 and 2011. We understand the distributor's margin slipped to 11% from 12%, while the maker's share improved to 21% from 20%.

Consumption falling, but slowly

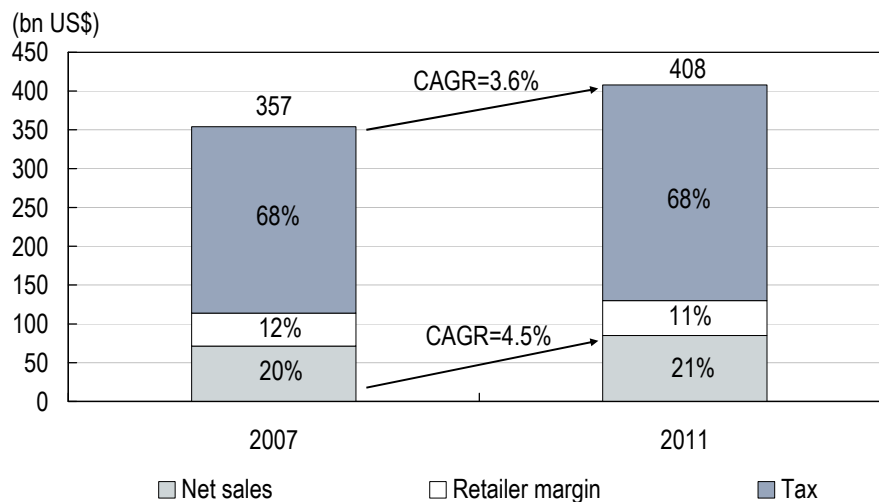
On the other hand, consumption declined by an average of 1% annually. Tougher anti-smoking efforts and tax hikes in various countries prompted cigarette companies to raise prices, and this is what caused sales to expand. Anti-smoking efforts in a number of countries were also undertaken in conjunction with the activities of the World Health Organization.

WHO convention, other efforts lowering
consumption

The WHO Framework Convention on Tobacco Control went into effect in February 2005. By May 2011, the number of countries that were parties to the convention had grown to 172. The purpose of the convention is to make sustainable and effective reduction in the spread of tobacco use and smoking. Specific provisions address price and tax measures to reduce demand for cigarettes, protection from exposure to passive smoking, regulation of cigarette advertising, regulations

regarding the sale of cigarettes to minors, and other aspect. As a result of such efforts, global consumption has been trending down since peaking at 3,843bn cigarettes in 2001.

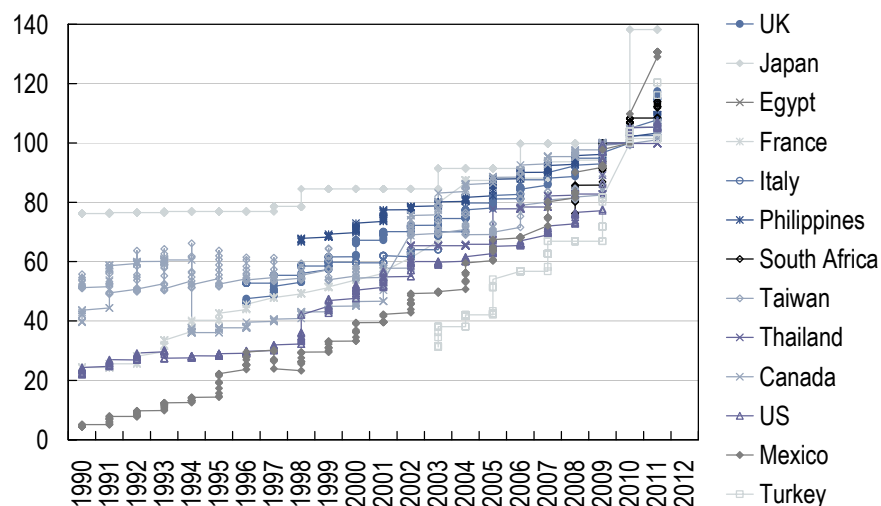
Figure 1. Global retail cigarette sales



Note: Excluding China and the US.

Source: Company data, TMA, Citi Investment Research and Analysis.

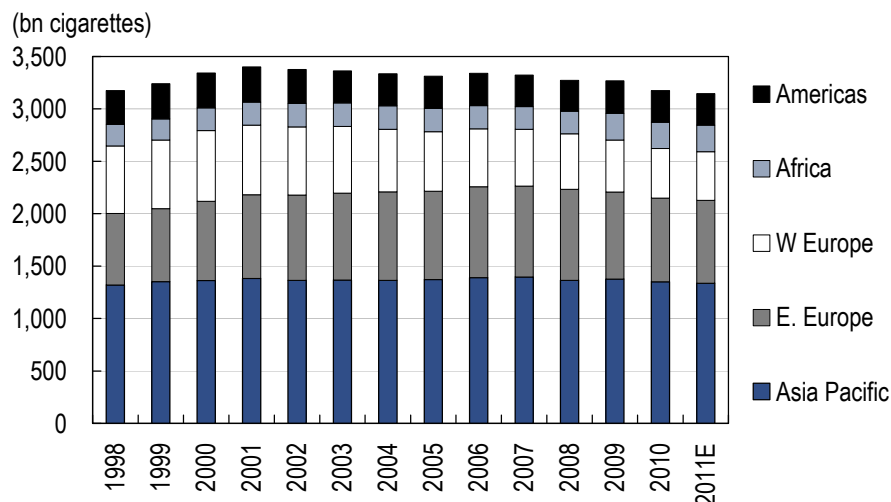
Figure 2. Cigarette CPI in different countries



Note: Jan. 2010 = 100.

Source: Datastream, Citi Investment Research and Analysis.

Figure 3. Global cigarette market



Note: Not including China and the US or duty-free sales.

Source: Company data, TMA, Citi Investment Research and Analysis.

Market size in different nations

Russia the biggest market by volume

We estimate cigarette consumption volume in 2011 at 371bn units in Russia, 220bn units in Indonesia, 195.4bn units in Japan, 100bn units in India, and 97bn units in Brazil (Figure 4).

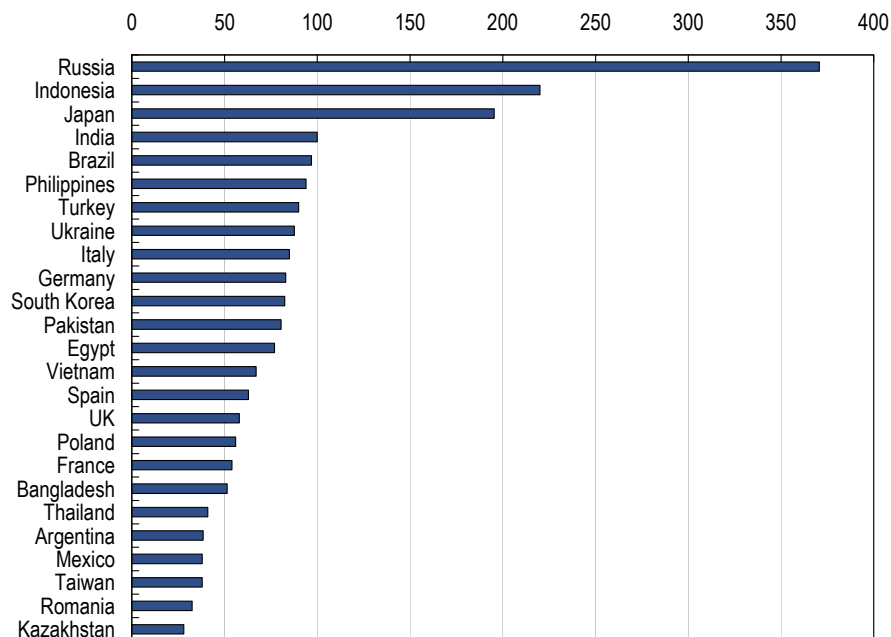
Japan the biggest market by sales

In terms of tax-exclusive sales, Japan leads at \$17.9bn, with Russia next at \$11.3bn, Germany at \$7.8bn, the UK at \$6.8bn, and Brazil at \$6.5bn (Figure 5). Consumption is falling in most nations, but tax-exclusive sales are growing.

Closed Chinese market accounts for 41% of global volume

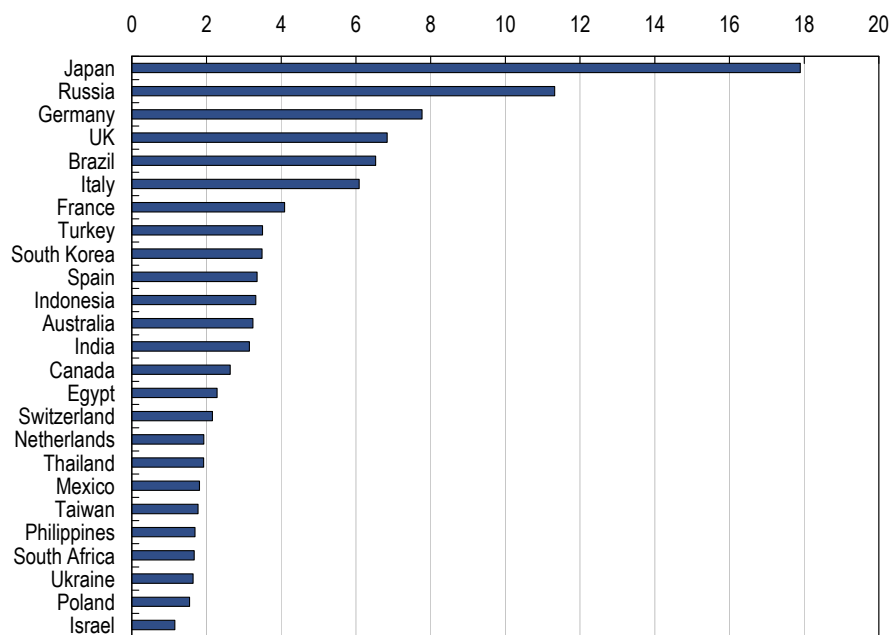
We note that in 2011 consumption in China is estimated at 2.408trn while consumption in the US is estimated at 291.6bn. Adding these two markets brings global consumption to 5.864trn units. China accounts for 41% of the total while the US accounts for 5%.

Figure 4. Top 25 nations in terms of cigarette consumption (2011, bn units)



Source: Company data, TMA, Citi Investment Research and Analysis.

Figure 5. Top 25 nations globally in tax-exclusive sales (2011, \$bn)



Source: Company data, TMA, Citi Investment Research and Analysis.

Starkly different trends from market to market

Generally speaking, the richer the country, the higher the retail price

There is a clear correlation (0.7902; see Figure 6) between retail prices and per-capita GDP based on 2011 data for 51 nations. As per-capita GDP rises, taxes tend to be hiked out of health concerns, and cigarette companies then hike prices by more than the tax increases. There are two factors behind price hikes: 1) tax increases and 2) firms' desire to improve their own earnings. This structure is entrenched.

High prices in some developed nations leading to down-trading

Of the 51 nations in our sample, 24 are above the trend line. Retail prices in developed nations like Australia, the UK, France, and Germany are relatively high. Indeed, in the UK, Germany, and France, we are seeing trends toward down-trading. That is, consumers are avoiding high-priced brands and shifting to somewhat lower-priced brands.

Prices surprisingly low in East Asia, some former Soviet states

In parts of Eastern Europe (Romania, Bulgaria, and Hungary) and parts of Africa (South Africa, Morocco, etc.), retail prices are high relative to per-capita GDP. In Eastern Europe, joining the EU resulted in a rise in retail prices.

On the other hand, retail prices are relatively low in East Asia (Japan, South Korea, Taiwan, Indonesia) and former Soviet states (Russia, Kazakhstan, Belarus, etc.). We think there are three reasons for these lower prices.

- 1) Retail prices have not kept up with economic development;
- 2) Tax hikes have yet to be implemented;
- 3) These areas have been historically tolerant of smoking.

Prices in East Asia could rise

There is no guarantee prices will remain this low moving forward. In fact, prices are low enough that we are seeing up-trading in these areas, the opposite of what is going on in Western Europe. In Japan and South Korea, retail prices had been locked at one level for many years, but this has been changing since 2010.

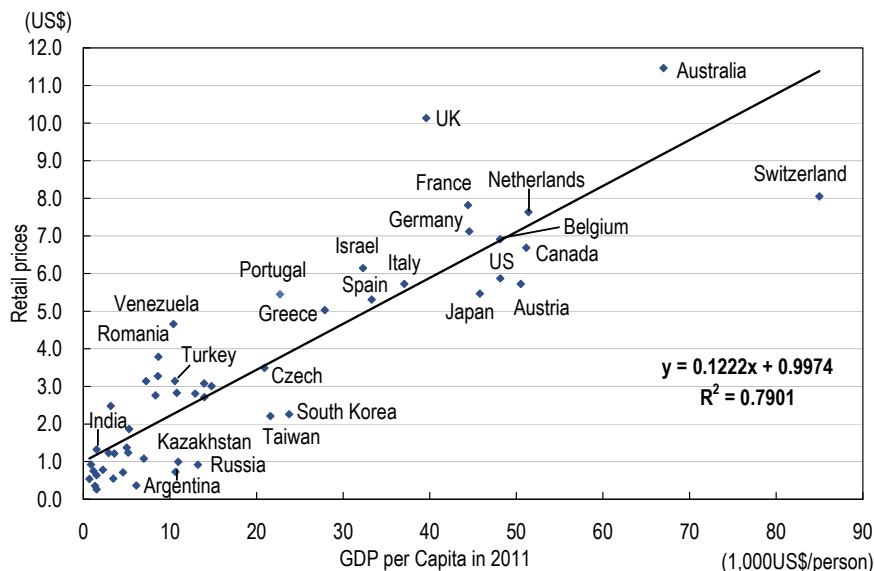
Up-trading and brand shifts in Russia, Japan

In Russia, the market weighting for the lowest-price cigarettes has fallen rapidly due to economic recovery and tax hikes by the Russian government. On the other hand, the weightings for mid-priced and sub-premium brands have risen. The same thing is happening in Japan. When taxes were hiked in October 2010, JT raised the price of its no. 3 domestic brand Seven Stars to ¥440 per pack from ¥300. Seven Stars is now the same price as Marlboro, shifting it from a standard brand to

a premium brand. Still, its market share remained steady after the price hike.

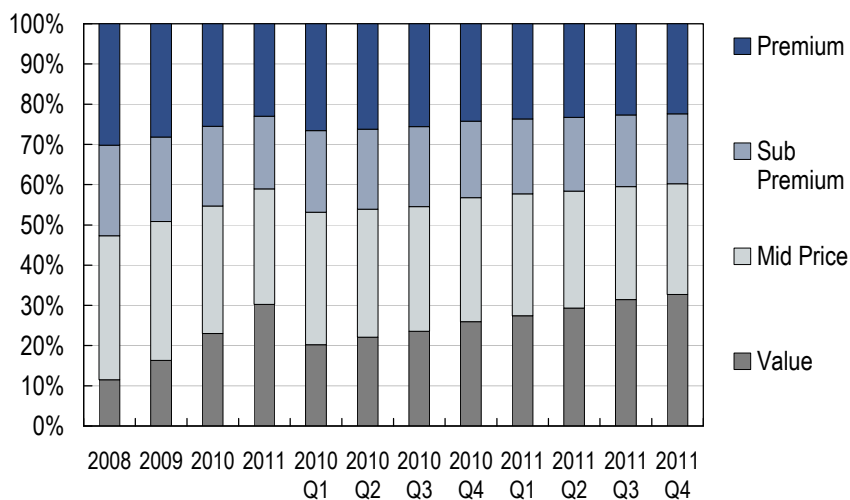
Moving forward, we expect to see price hikes by governments in different nations. In nations where prices are relatively low, we could see prices rise.

Figure 6. Per-capita GDP and retail prices (2011)



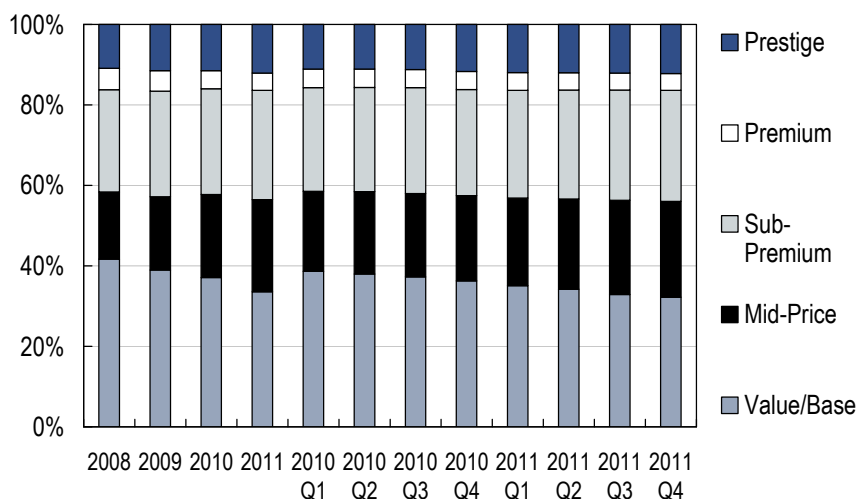
Note: 2016 per-capita GDP based on IMF forecasts.
Source: Company data, IMF, TMA, Citi Investment Research and Analysis.

Figure 7. UK sales volume by price band: Down-trading



Source: Company data.

Figure 8. Russian sales volume by price band: Up-trading



Source: Company data.

Significant scope for price hikes at cigarette companies

Room for price hikes as countries get richer

Price hikes are the wellspring of profit growth at cigarette companies. A comparison of expected 2016 per-capita GDP (based on IMF per-capita GDP forecasts) and 2011 retail prices suggests there is ample room for retail price hikes as economies grow (Figure 9).

More nations where prices look relatively low in 2016

Of the 51 nations in our sample, 15 (including the UK, France, and Germany) are above the trend line. We expect to see down-trading on the part of consumers continue in these nations. On the other hand, the number of nations where prices are relatively low increases to 36 from 27. Retail prices were on the high side in Spain and Italy in 2011, but they look like they will be on the low side in 2016.

We estimate growth in tax-exclusive sales in each nation between 2011 and 2016 based on the following assumptions:

1. 2016 per-capita GDP and retail prices will converge with the trend line;
2. Changes in consumption will follow past trends;
3. Consumption price sensitivity is set between 0.2 and 0.4 (the average for the US and Europe is 0.4);

4. The tax rate on cigarettes in Russia (cigarette tax, consumption tax) will rise from 36% in 2011 to 50% in 2016, with no changes in other nations.

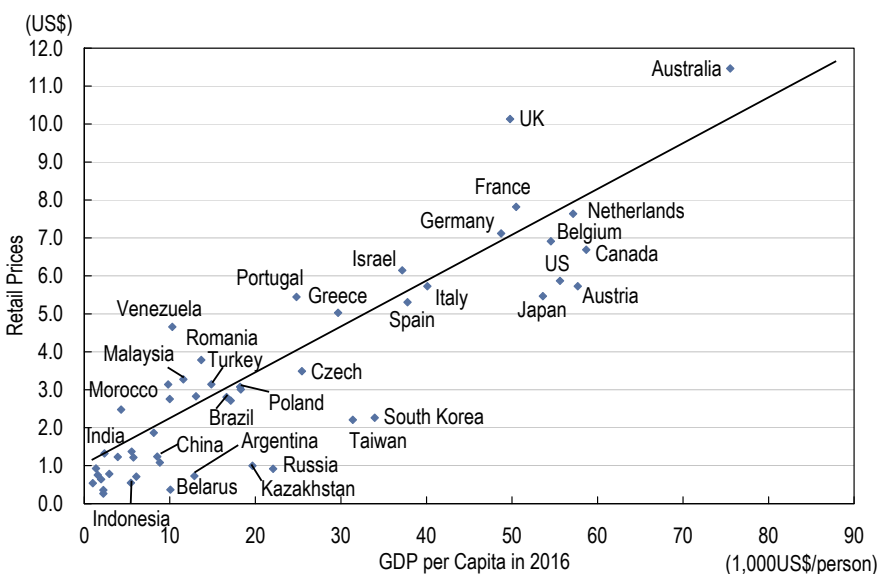
We estimate that Russia, Indonesia, and Japan have the most growth potential

Our calculations suggest that global tax-exclusive cigarette sales will rise by \$16bn. We anticipate the largest rise will come in Russia, at \$7.8bn, followed by Indonesia at \$2.4bn, Japan at \$2.1bn, South Korea at \$1.5bn, Taiwan at \$1bn, and Kazakhstan at ¥0.6bn.

Profits can rise even in the face of 20% consumption decline

We assume that global cigarette consumption will decline by about 20%. However, we think cigarette company profits will rise as price hikes offset the decline in consumption. Our calculations suggest that there is profit growth potential.

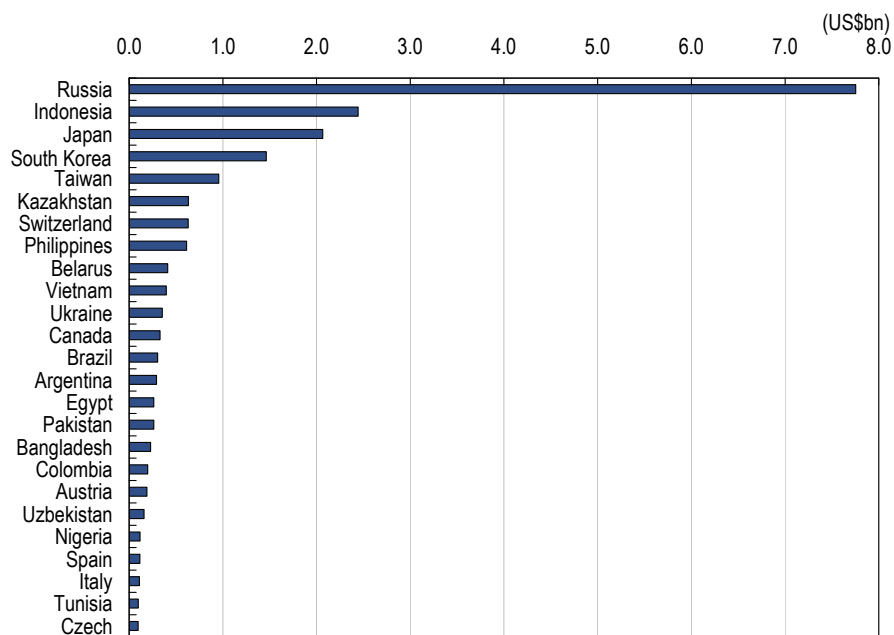
Figure 9. Per-capita GDP and retail prices (2011)



Note: 2016 per-capita GDP based on IMF forecasts.

Source: Company data, IMF, Citi Investment Research and Analysis.

Figure 10. Estimated rise on tax-exclusive sales in each nation (2011-2016)



Source: Company data, IMF, Citi Investment Research and Analysis.

Chapter 2. JT's strategy

Two acquisitions move JT into the winners circle

How to grow

The only way for cigarette companies to capture market expansion is to grow market share. Building in-house brands and sales channels are the key point here. M&A is an important strategy to strengthen presence in markets with high growth potential.

Big Four all growing

The cigarette majors had the following global market shares in 2010: Philip Morris 28.3%, BAT 22.3%, JT 17.3%, Imperial Tobacco 9.7%. All companies increased their share compared with 2006. JT acquired Gallaher in 2007, Imperial Tobacco acquired Altadis in 2008, and Philip Morris acquired Fortune Tobacco, the largest cigarette company in the Philippines, in 2010. The market share apart from these four companies declined from 36.4% in 2006 to 22.3% in 2010.

Long history of M&A

Takeovers are not a recent phenomenon. BAT acquired Rothmans International in 1998 and JT acquired RJR International in 1999. Tabacalera (Spain) and Seita (France) merged in the same year. Gallaher acquired Tabak (Austria) in 2001 and Imperial acquired Reemtsma in 2002.

New brands not the answer...

M&A and realignment are a consistent feature of the cigarette industry. Strict marketing regulations make it very difficult for cigarette companies to cultivate new brands. This means that expanding market share can basically only be achieved by increasing sales of existing brands or acquiring the brands of other companies.

...but strong existing brands the key to survival

The difference between the stalkers and the prey is the presence/absence of strong brands. Companies that do not have them gradually lose market share. Having strong global brands can be the difference between winning and losing in the global survival game.

RJR International a transformative acquisition for JT

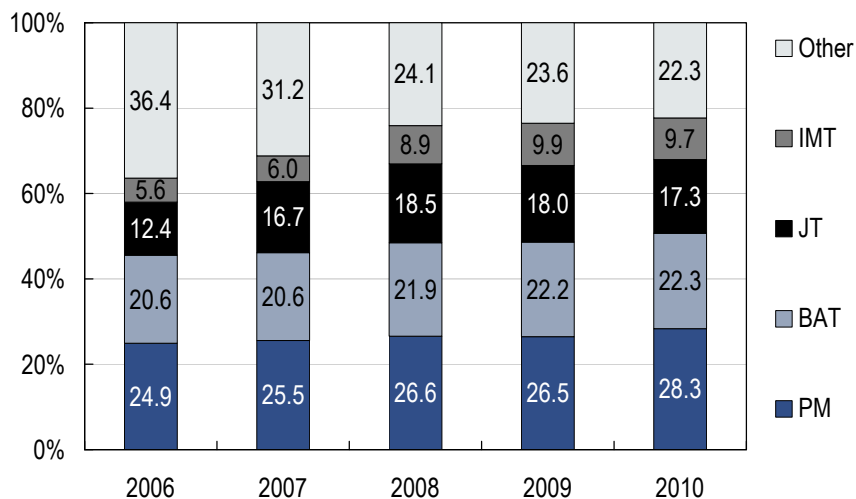
Before it acquired RJR International, JT was not in a strong position. Sales of Mild Seven, its main brand, were heavily weighted toward Japan and China, and lacked momentum in other countries. The acquisition of RJR International and Gallagher gave JT global brands and a good regional portfolio. We believe JT is now in the winners' camp.

Blip in JT market share growth

JT's market share has declined since 2009. This is due to a temporary drop in cigarette consumption in Russia caused by the global financial crisis, economic turmoil in Iran, declining sales volume in Ukraine, and a decline in cigarette

consumption in Japan following a large price hike in October 2010.

Figure 11. Global cigarette market share trends



Source: Company data, Citi Investment Research and Analysis.

Brand and regional portfolios

Six brands account for the bulk of JT sales...

JT's main brands are Winston, Mild Seven, Camel, LD, Seven Stars, and Glamour. These six brands account for 59% of sales. Different brands are strong in different regions. Winston mainly sells in Eastern and Western Europe, Camel in Western Europe, LD in Eastern Europe, and Mild Seven and Seven Stars in Japan.

...while the CIS and Japan are the key geographies

By region, the Commonwealth of Independent States (CIS) and Japan account for a high percentage of sales. Compared with rivals, JT has been slow to develop in Western Europe, Asia, Latin America, and Africa.

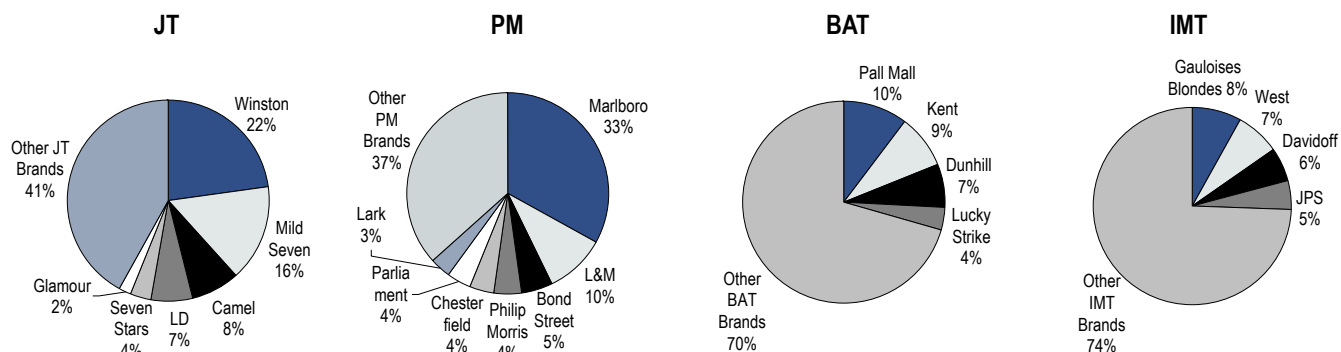
Good regional balance at Philip Morris...

The main Philip Morris brands include Marlboro, L&M, Bond Street, and Philip Morris. Marlboro is the world's largest band and is popular in many regions. Western Europe, EEMA (Eastern Europe, Middle East & Africa) and Asia Pacific accounts for a high percentage of sales but there is a good regional balance.

...and at BAT, too

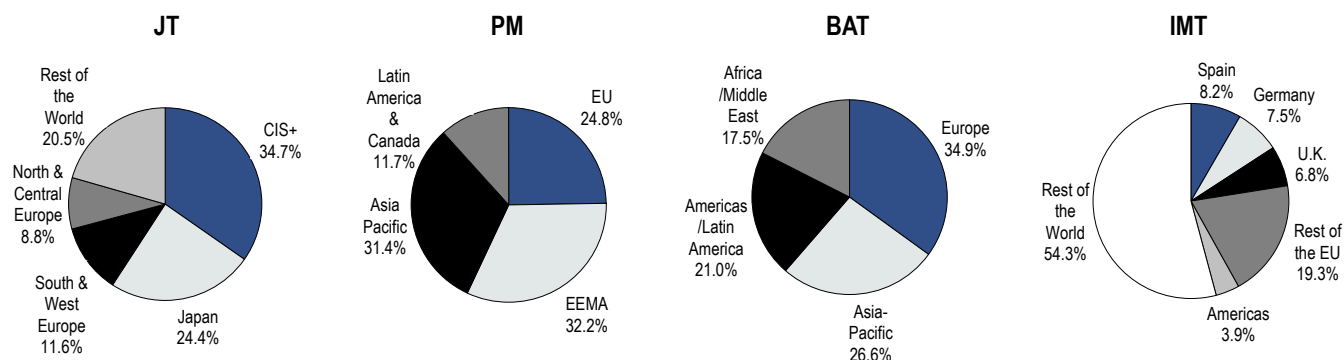
BAT's main brands are Pall Mall, Kent, Dunhill, and Lucky Strike. Strong brands do not account for a high portion of sales but the regional balance is the best of the major cigarette companies. Western Europe has the highest sales weighting for Imperial Tobacco, which is also working to bolster its presence in African countries.

Figure 12. Brand portfolios at global majors



Source: Company data, Citi Investment Research and Analysis.

Figure 13. Regional portfolios at global majors



Source: Company data, Citi Investment Research and Analysis.

JT's continuous business investment delivering results

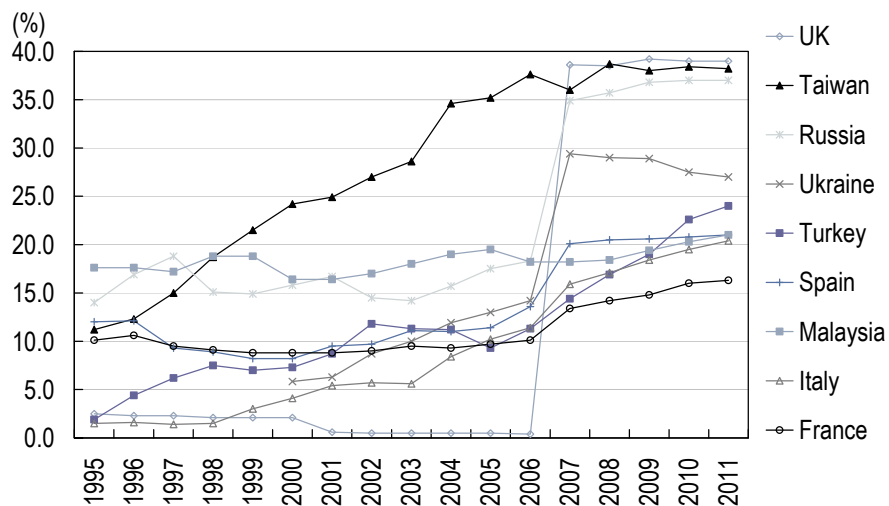
JT's fortunes turned around by RJR International

The main markets of RJR International, acquired by JT in 1999, are Russia, Spain, France, Italy, Canada, Turkey, and Malaysia. JT had been losing market share in most of these countries but the acquisition returned sales to a growth trajectory. In Italy, for example, market share was 1.5% before the acquisition; it is now more than 20%.

Marketing delivers results

In addition to measures to reduce excessive distribution channel inventory and improve quality, JT has used advertising to steadily establish brand image. A large increase in marketing costs since 2000 has delivered results. It is fair to describe JT as a company that continually invests in brands with a long-term perspective.

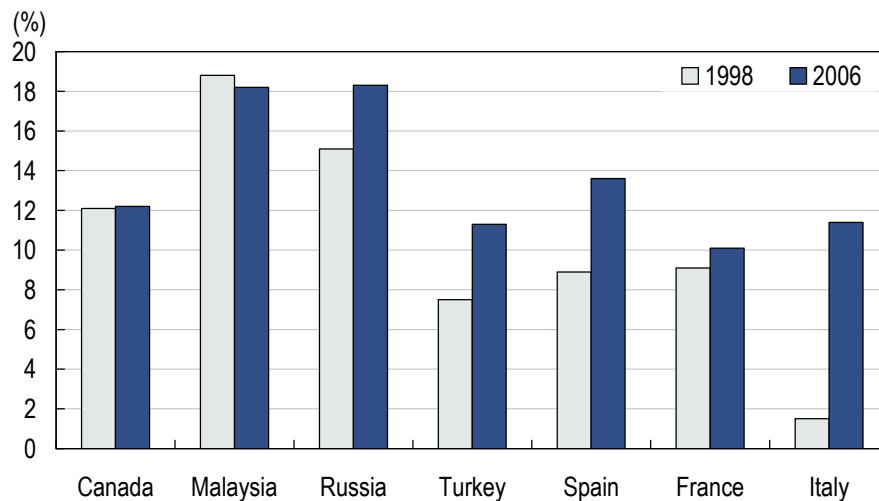
Figure 14. JT's sales share in major markets



Note: Share for RJR International prior to 1998.

Source: Company data, Citi Investment Research and Analysis.

Figure 15. Sales share in major markets before (1998) and after (2006) the acquisition of RJR



Note: Share for RJR International prior to 1998.

Source: Company data, Citi Investment Research and Analysis.

Winston a growth brand

One important point to keep in mind regarding JT is high growth for Winston, the number two brand in the world. From 2006 through 2010, Winston's annual average growth was 7.4%, in contrast to -1.4% growth at Marlboro (see Figure 17).

Winston can take advantage of both
down-trading and up-trading

JT positions Winston in the sub-premium price band in nations where it does business. Therefore, Winston can take advantage of both the down-trading (from premium to sub-premium brands) common in developed economies and the up-trading (from lower- and mid-priced brands to sub-premium brands) common in developing economies.

Winston did well in 2011 as well. Sales volume rose 5% YoY. Winston is an efficient brand in that it alone enables JT to benefit from the changes in global cigarette consumption.

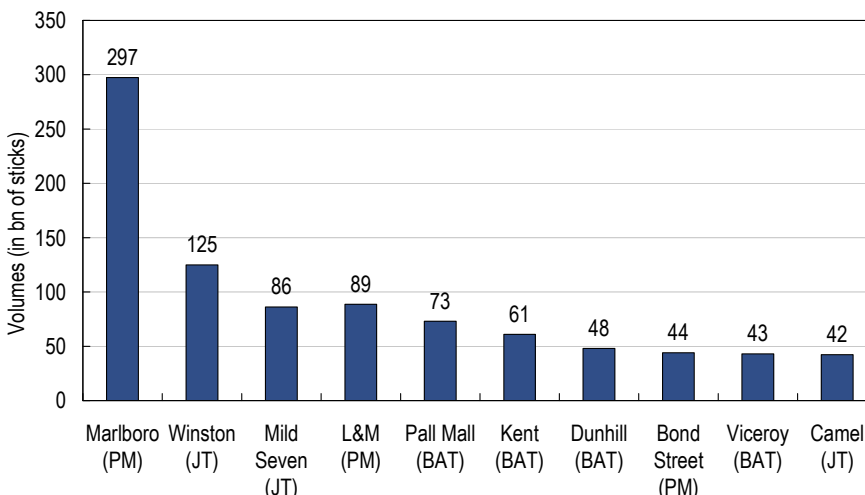
Another brand in the sub-premium space is the Philip Morris brand L&M. In fact, L&M was once the leader in this category. However, right now that place is occupied by Winston.

Winston in Russia a textbook case

Winston in Russia is a textbook example of success. Formerly, PM's sub-premium brand L&M had a runaway lock on the market. JT built a sales network covering the whole of Russia and installed displays of its products in cigarette shops, supermarkets, and convenience stores. Simultaneously, JT swiftly carried out a brand extension, launching Winston super-slims and king-size super-slims, as well as Wings by Winston. This brand investment gave a push to the growth of Winston.

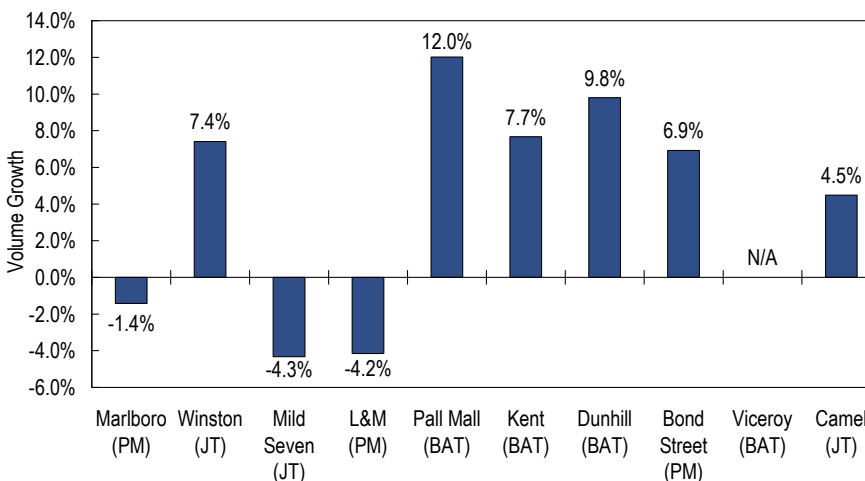
In contrast, Marlboro has been struggling, hurt by down-trading in Europe. As a result, the market shares of Winston, L&M, and Pall Mall have risen. In this environment, PM has launched numerous new products and worked to refresh its brands. The Marlboro market share has begun to bottom out thanks to this.

Figure 16. Top 10 brands in 2010



Source: Company data, Citi Investment Research and Analysis.

Figure 17. Growth rates for the top ten brands (CAGR for 2006-2010)



Source: Company data, Citi Investment Research and Analysis.

The global market share for Winston turned higher from 2000 on. Its share was just 1.0% at the time of the 1999 acquisition, but it appears to have hit 4.3% in 2011 (Figure 18).

Winston well positioned geographically

We also note that Russia accounts for 32% of Winston sales, compared with Turkey at 10%, Spain at 7%, Ukraine at 5%, and Italy at 5% (Figure 19). We think growth in these nations, all large markets, is a major reason for overall Winston brand growth.

Still room for Winston to grow

In 2011, the global share for Winston was 4.3%, less than half the share of Marlboro (9.7%). However, we think there remains significant growth potential for Winston. This is because 1) the brand is able to benefit from changing consumption in both developed and developing markets, 2) it has the top share in Russia, where the market is large, but its share there is only 11%, and 3) there is strong brand loyalty when it comes to cigarettes, so sales momentum tends to remain in place for a long period of time.

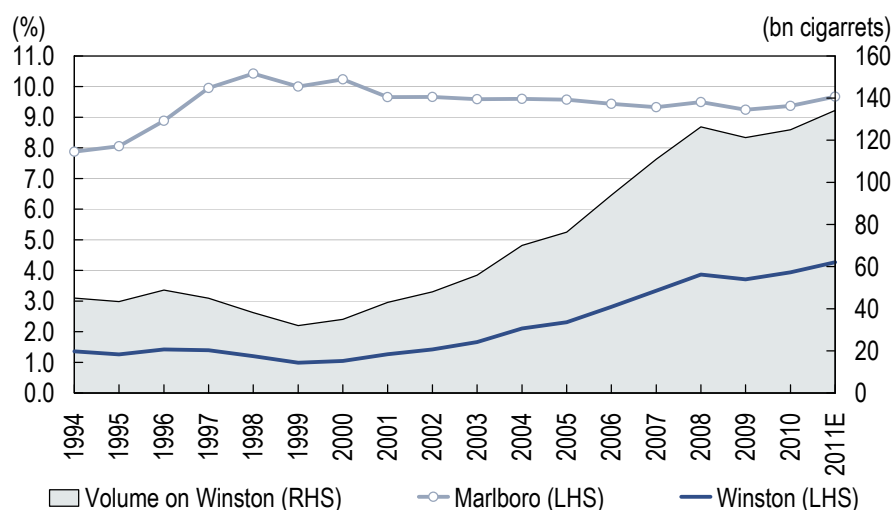
Many brands have long histories...

Incidentally, Winston went on sale in the US in 1954. It has a filter attached and at the time was a mold-breaking product. Marlboro was launched in 1924 but initially aimed at women. Other notable launches were as follows: Mild Seven in 1977, L&M in 1953, Pall Mall in 1899, Kent in 1952, and Camel in 1913.

...and long legs

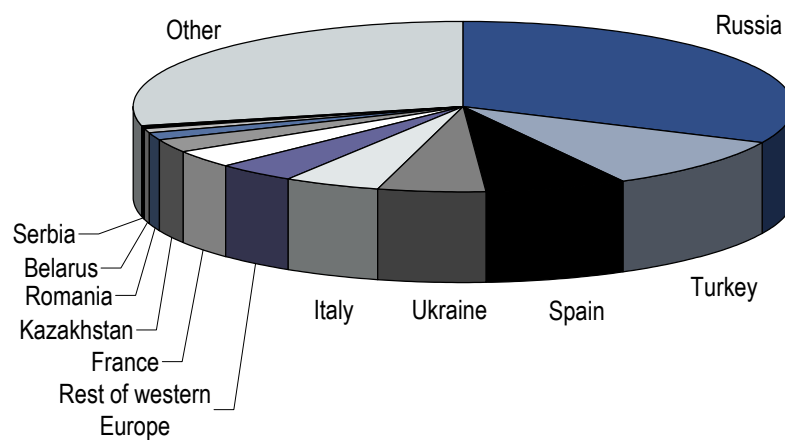
Many of the leading cigarette brands were thus launched before 1960. With JT's Mild Seven launching as late as 1977, it would probably still be classified as a new face in the tobacco industry. Looked at another way, once a product becomes a hit, its brand life is exceptionally long and its profit contribution to the company in question also goes on for a long time.

Figure 18. Global share for Winston and Marlboro



Source: Company data, TMA, Citi Investment Research and Analysis.

Figure 19. Winston's regional weighting (2010)



Source: JT data, Citi Investment Research and Analysis.

Chapter 3: Analysis of major national markets

Russia: Up-trading a tailwind for JT

Tax hikes coming in Russia

The focal point in the Russian market is the cigarette tax system. The Russian government has announced a schedule for tax hikes in 2012-2014, with an important feature being a proposal to raise the minimum cigarette tax (see Figure 20).

In Russia, cigarette taxes, which are the combination of the ad valorem tax and the weight tax, must exceed the minimum tobacco tax. Cigarette makers therefore need to increase the ad valorem tax in order to exceed the minimum tobacco tax. The ad valorem tax is paid on the retail price, so makers have to hike retail prices in order to increase the ad valorem tax.

We think the Russian government is looking to reduce consumption of low-priced products by raising the minimum tax. Low-priced products are sold for about RUB23 per pack, and they account for about 30% of the overall market.

Consumers trading up to mid-priced JT brands

Russian government measures are impacting JT's LD brand, the top brand in the mid-priced space, in both price and consumption terms. In January 2011, the LD retail price was raised 28%, while the shipment price was raised 23%. We note that sales volume rose 12% YoY for January-September 2011, as consumers switched from lower-priced brands. It appears consumption is shifting from lower-priced products to mid-priced products and from the mid-priced products to sub-premium brands.

We think LD shipments will rise 20% YoY in 2012 while Winston shipments rise 10%. In 2013 and 2014, we look for a significant rise in profitability for both brands due to a hike in the minimum cigarette tax.

Prices could surge over the coming five years

In 2011, we estimate the average per-pack retail price was RUB28. A look at Russia's per-capita GDP suggests that the acceptable retail price could be above RUB100 in 2016. It seems unlikely that cigarette consumption will fall sharply due to a rapid rise in retail prices from 2013.

Figure 20. Russian cigarette tax system (RUB/20 sticks)

	1/2009	1/2010	1/2011	1/2012E	7/2012E	1/2013E	1/2014E
Ad valorem	6.0%	6.5%	7.0%	7.5%	7.5%	8.0%	8.5%
Specific tax (RUB/1000)	150	205	280	360	390	550	800
Minimum tax (RUB/1000)	177	250	360	460	510	730	1040
VAT (%)	18	18	18	18	18	18	18
LD							
Retail price	15.0	18.0	23.0	28.0	32.0	45.0	57.0
Ad valorem	0.9	1.2	1.6	2.1	2.4	3.6	4.8
Specific tax (RUB/1000)	3.0	4.1	5.6	7.2	7.2	11.0	16.0
Retailer margin	3.0	3.6	4.6	5.6	6.4	9.0	11.4
VAT	1.2	1.4	1.7	2.0	2.4	3.3	3.8
Net price	6.9	7.7	9.5	11.1	13.6	18.1	21.0
Net price YoY%	17.2	12.7	22.6	17.1	22.1	63.4	15.7
Tobacco tax	3.9	5.3	7.2	9.3	9.6	14.6	20.8
Minimum tobacco tax	3.5	5.0	7.2	9.2	9.2	14.6	20.8
Winston							
Retail price	27	31	36	41	45	55	67
Ad valorem	1.6	2.0	2.5	3.1	3.4	4.4	5.7
Specific tax (RUB/1000)	3.0	4.1	5.6	7.2	7.2	11.0	16.0
Retailer margin	5.4	6.2	7.2	8.2	9.0	11.0	13.4
VAT	2.6	2.9	3.2	3.4	3.9	4.4	4.9
Net price	14.4	15.8	17.5	19.1	21.5	24.2	27.0
Net price YoY%	15.2	10.0	10.7	8.9	12.9	27.0	11.6
Tobacco tax	4.6	6.1	8.1	10.3	10.6	15.4	21.7
Minimum tobacco tax	3.5	5.0	7.2	9.2	9.2	14.6	20.8

Note: The ad valorem tax is applied to retail prices.

Source: JT, government data, Citi Investment Research and Analysis.

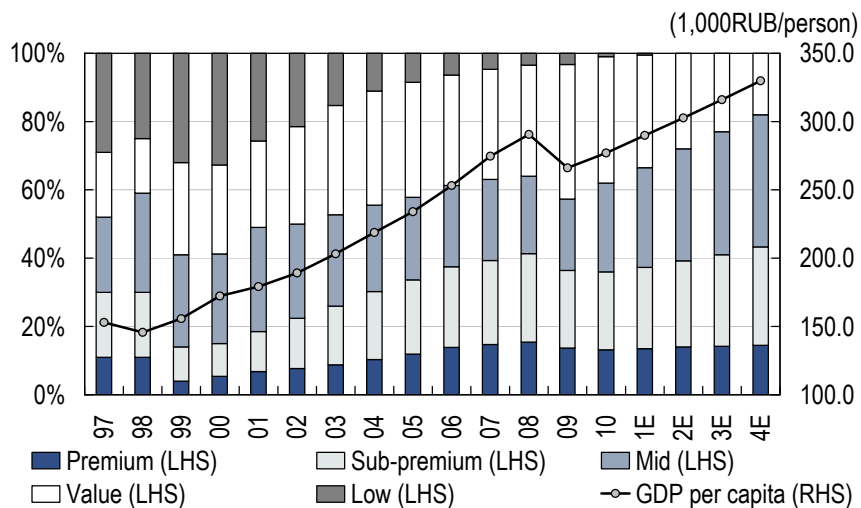
JT has more than a third of the Russian market...

JT's current share of sales is 37%. Premium brands account for 6% of sales, compared with 35% for sub-premium brands, 29% for mid-price brands, and 31% for low-priced brands. For premium brands and above, JT's share of sales in Russia is 12%, versus 48% for sub-premium brands, 46% for mid-price brands, and 34% for low-priced brands.

...and is well placed to capture consumers trading up

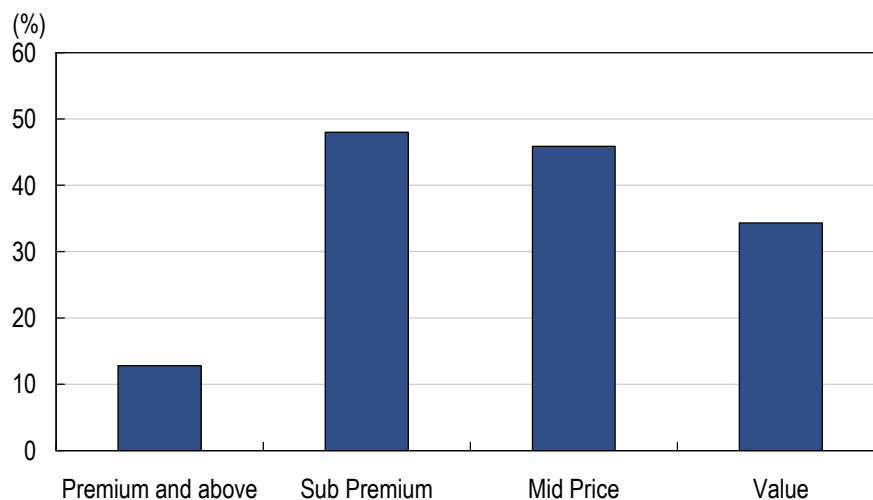
Going forward, we think consumption will shift from low-priced brands to mid-price brands and then from mid-price brands to sub-premium brands. JT has a high market share in mid-price and sub-premium brands, so it is likely to benefit most from the shift in consumption. In our view, JT will benefit from both a rise in ASP and a rise in sales volume.

Figure 21. Sales weightings in Russia by price band



Source: Company data, IMF, Citi Investment Research and Analysis.

Figure 22. JT's share of the Russian market by price band



Source: Company data, Citi Investment Research and Analysis.

Pricing mechanism has changed in Japan

Government more flexible than before on cigarette price hikes

Tax-exclusive sales at cigarette makers have moved more or less in line with consumption trends. However, sales turned up in FY3/11, rising 4%, and in FY3/12 we look for a 10% rise (Figure 23). This is due to the large price increase implemented by JT. We note that the government allowed JT to implement this large price increase. It appears the government has become more flexible with regards to requests by cigarette makers to raise prices.

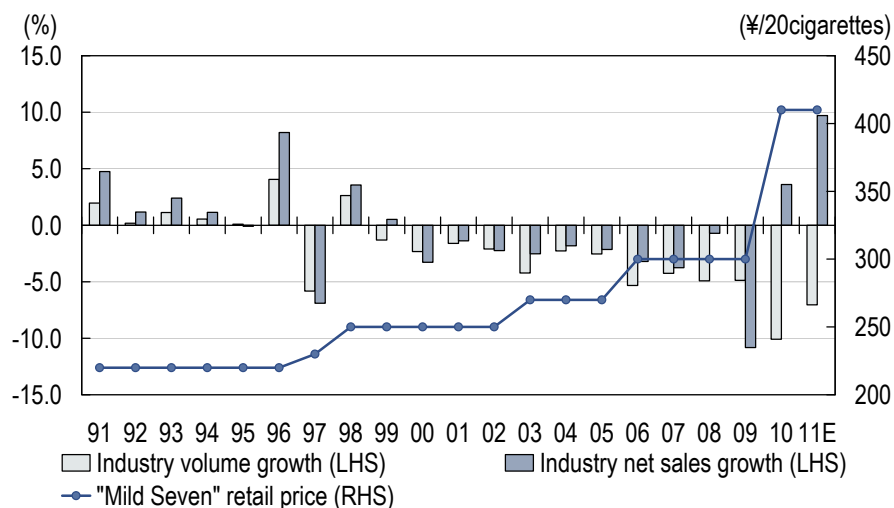
Next cigarette tax hike as soon as FY3/14?

Under the Tobacco Industry Law, the government must secure stable revenue from cigarette taxes. If consumption volume falls 3%-4% annually, the government could raise cigarette taxes as soon as FY3/14. In addition, the government is currently looking into hiking the consumption tax from its current level of 5% to 8% in April 2014 and 10% in October 2015. In all cases, we think JT will raise prices by more than the tax increase.

JT determined to keep domestic profits high

At minimum, JT says it is committed to maintaining the current level of profits from its domestic cigarette business in the medium term. This suggests to us that JT could hike prices even if taxes are not raised. Given the policies of the Japanese government and JT, we think the pace of retail price increase in Japan will gather speed moving forward.

Figure 23. Japan: Changes in consumption volume and tax-exclusive sales for cigarette makers



Source: TIOJ, MoF, company data, Citi Investment Research and Analysis.

Figure 24. Analysis of October 2010 price hike (¥/20 units)

Mild Seven				Seven Stars			
	Before price hike	After price hike	YoY%		Before price hike	After price hike	YoY%
Retail price	300	410	36.7	Retail price	300	440	46.7
Tobacco tax	174.9	244.9	40.0	Tobacco tax	174.9	244.9	40.0
Consumption tax	14.3	19.5	36.7	Consumption tax	14.3	21.0	46.7
Retailer margin	30.0	41.0	36.7	Retailer margin	30.0	44.0	46.7
Before-tax price	80.8	104.6	29.4	Before-tax price	80.8	130.2	61.0

Source: Citi Investment Research and Analysis.

JT's domestic market share has stabilized...

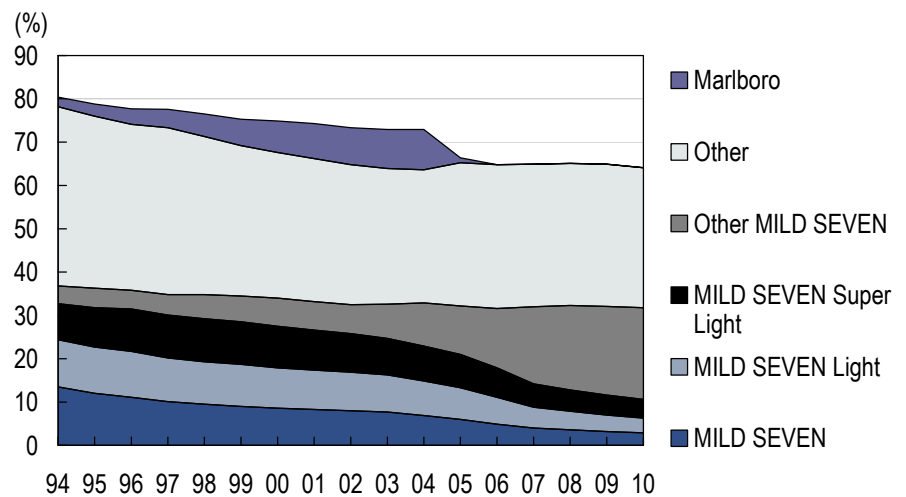
JT's license to manufacture and market Marlboro ended in April 2005. From 2006 onward, JT's share of the domestic market stabilized around 64%-65%. This reflects stabilization of the market share of the company's core Mild Seven brand through brand extension.

...and it is recovering from the earthquake

The March 11 disaster damaged JT's Koriyama and Kita-Kanto manufacturing plants and also sites involved in semi-finished products. This forced JT to temporarily suspend shipments and it was unable to provide adequate supplies even of its mainstay brands. However, the company's manufacturing and marketing framework has already been restored. Its market share recovered to 59.1% in December from a bottom of 20.7% in April 2011.

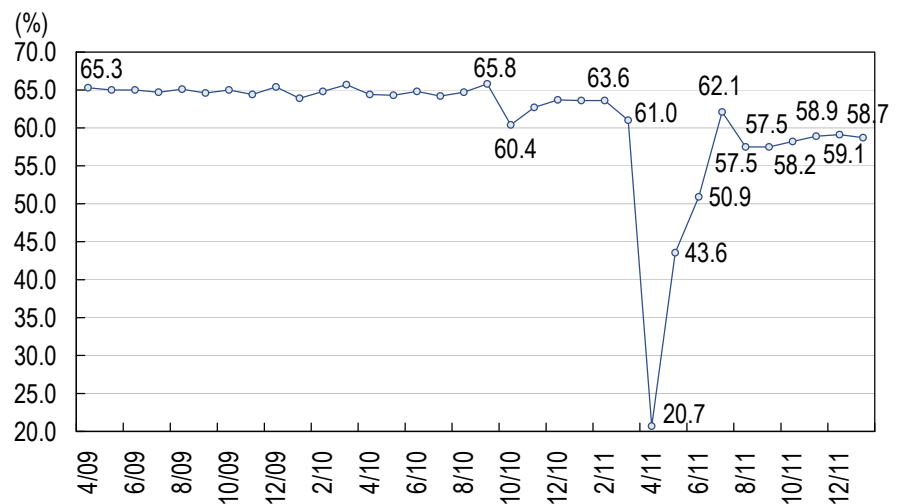
JT's market share has recovered to 93% of the pre-quake level. With JT continually introducing new products, we expect a gradual yet sustained market share recovery.

Figure 25. JT's sales share by market



Note: The Marlboro licensing contract ended at end-April 2005.
Source: Company data.

Figure 26. JT's monthly domestic sales share



Source: Company data.

Western Europe: Down-trading helps

Down-trading by Western European
consumers...

In 2011, 368bn cigarettes were consumed in the 13 countries of Western Europe, equivalent to 12% of the global market. The Western Europe cigarette market is contracting owing to economic difficulties in Spain and other countries and to rising retail prices due to repeated tax hikes. We estimate the market contracted some 3% over the past three years. Since 2008, smokers have been progressively shifting to low priced brands, with the result that the market weighting of the low-price band increased to 38% in 2011 from 30% in 2008.

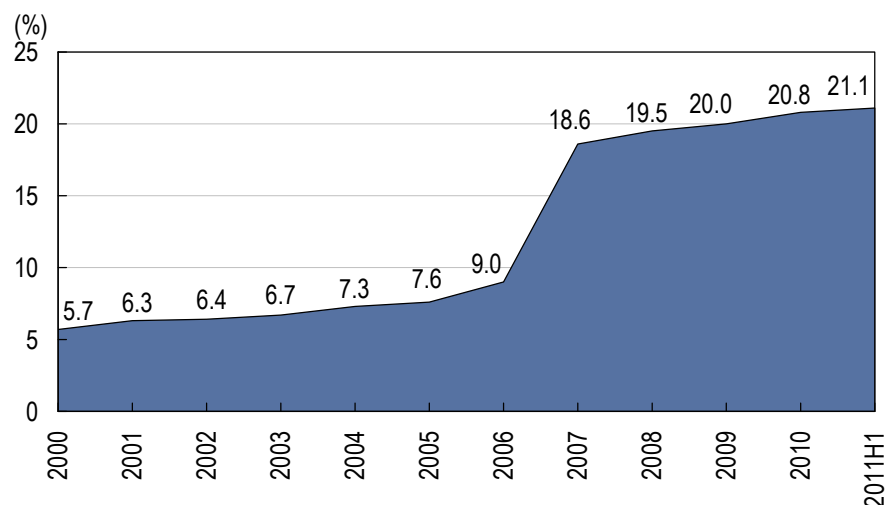
...plays to JT's strengths

This shift is beneficial for JT. We believe JT grew its share of the Western Europe market to over 21% in 2011 from 19.5% in 2008. We attribute this to a rise in the market share of Winston in line with the growing down-trading trend. Camel, now positioned as a sub-premium brand, is also expanding, albeit slightly, its share of the market.

JT has a fifth of the Spanish and Italian
markets

With its 1999 acquisition of RJR International, JT entered the Western Europe market. It has subsequently continued to almost consistently grow its share of the cigarette market in Italy, France and Spain. In 2011, JT commanded a 20.5% share of the cigarette market in Italy, a 16.3% share of the market in France and a 20.9% share in Spain, and we expect growth in market share to continue.

Figure 27. Japan Tobacco's share of the Western Europe cigarette market



Note: Western Europe refers to UK, Italy, Spain, Canary Islands, Portugal, Andorra, France, Ireland, Belgium, Holland, Gibraltar, Luxembourg, and Switzerland
Source: Company data.

Figure 28. Market share for the top 10 brands in the Western Europe cigarette market

Rank	Brand	Company	2008	2011 H1	Spread
1	Marlboro	PM	19.7%	19.1%	-0.6%
2	Winston	JT	5.5%	6.6%	1.1%
3	Camel	JT	6.2%	6.4%	0.2%
4	Pall Mall	BAT	3.4%	4.5%	1.1%
5	Chesterfield	PM	4.5%	3.7%	-0.8%
6	L&M	PM	2.6%	3.2%	0.6%
7	Fortuna	IMT	4.2%	3.3%	-0.9%
8	Philip Morris	PM	2.5%	3.1%	0.6%
9	B&H	JT	3.0%	2.9%	-0.1%
10	JPS	IMT	2.2%	2.9%	0.7%

Source: Company data.

Chapter 4: Growth potential and issues

JT has most medium-term growth potential

JT's domestic market share to stay steady over the coming five years

In Chapter 1, we broke down estimated growth in tax-exclusive sales for each country by company. We assumed that market shares in 2016 for all countries but Japan would be the same as in 2011. Based on current conditions, we assume JT will command 59% of the Japan market in 2016, Philip Morris 28% and BAT 13%.

JT has the greatest medium-term growth potential

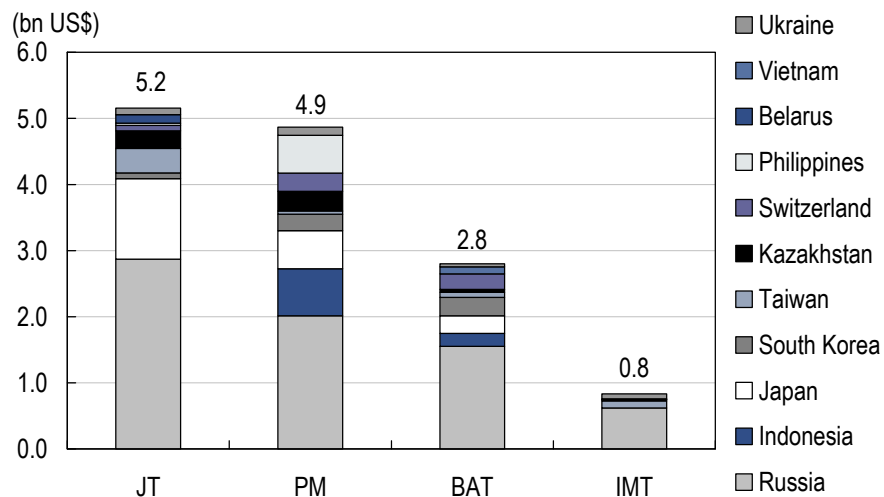
We deduce that JT has the greatest medium-term growth potential, followed by Philip Morris, BAT, and Imperial Tobacco. We anticipate significant contributions for JT from Russia, the market with the greatest growth potential, and Japan, the market with the third-greatest growth potential. Philip Morris operates in the greatest number of countries and so is not overly exposed to any particular market. From a longer term perspective, we think benefits from Indonesia will increase at Philip Morris and BAT.

Africa appealing

Looking at other regions, we feel Nigeria and other African countries are extremely attractive over the long run. We expect their considerable potential to have a positive impact at Philip Morris and BAT.

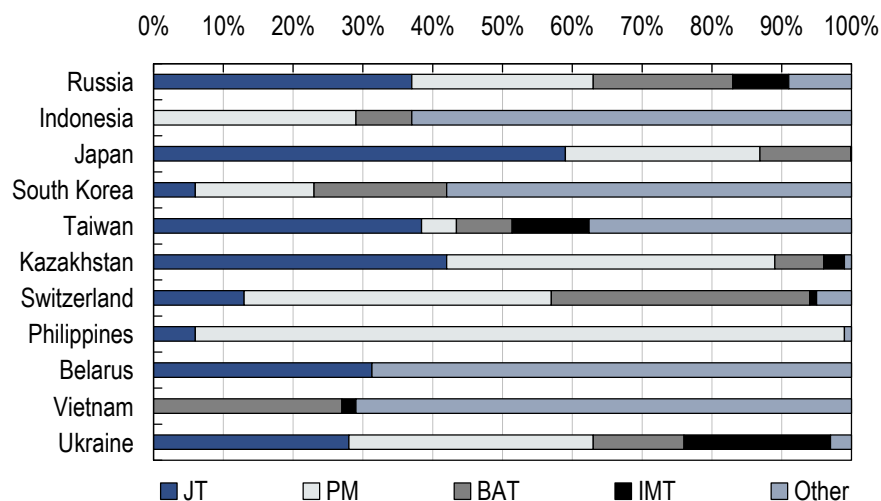
Over the medium term, we see considerable growth potential at JT and Philip Morris and fair growth potential at BAT and Imperial Tobacco. Taking a long-term perspective, however, we also find considerable latent growth potential at BAT and Imperial Tobacco.

Figure 29. Estimated share of growth in tax-exclusive cigarette sales by company (2011-2016)



Note: Before exclusion of retail margin.
Source: Citi Investment Research and Analysis.

Figure 30. Market share by company in countries with substantial profit growth potential



Source: Company data, Citi Investment Research and Analysis.

Issues for JT

We think JT faces the following four issues:

- Pace of business development in Indonesia and Africa, areas we believe have long-term growth potential ;
- Premium brand cultivation;
- Strengthening tobacco leaf procurement abilities; and
- Recovering the share of the Japanese market that it lost following the March 2011 earthquake

Indonesia full of promise

The cigarette market in Indonesia has already exceeded the scale of the market in Japan and continues to grow. Retail prices are low and so we think growth potential there is considerable. Philip Morris has a 29% share of the market in Indonesia, Gudang Garam has 21%, Djarum 20% and BAT has an 8% share. Philip Morris bought Sampoerna in 2005 and BAT purchased Bentoel in 2009, so both of these have established footholds in Indonesia. We think JT could follow their lead going forward.

JT has very limited exposure to Africa, operating just in Tanzania, South Africa, Sudan, and South Sudan. If state-owned companies were to be privatized, we think JT should seek to make acquisitions.

Premium brands will be key further down the road

From a longer-term perspective, fostering premium brands is important. Premium brands are the endpoint for up-trading by consumers in emerging markets. In the interim, we expect consumption to shift from low priced cigarettes to the mid-price or sub-premium space, JT's specialty. We think JT would certainly benefit from any such shift, but looking 10 years down the line, we think there is a need for JT to foster premium brands.

JT currently has premium brands like Sobranie, Camel, Mild Seven, and Seven Stars. Some issues exist with these brands, however. For instance, they tend to be concentrated in certain regions. Second, the pricing position of these brands differs from region to region.

JT needs more dedicated leaf tobacco suppliers

JT's ability to procure leaf tobacco is another problem spot. In some cases, the cultivation of leaf tobacco has to compete against grain cultivation. When grain prices rise, more land is dedicated to cultivating grain, which could result in leaf tobacco procurement problems. We estimate that globally JT used around 400,000 MT of leaf tobacco in 2010. We believe

JT procured around 10% of its leaf tobacco from contract farmers in Japan and 90% from independent brokers and dedicated suppliers. We feel that the procurement ratio for dedicated suppliers is too low.

BAT, meanwhile, has signed agreements with some 200,000 tobacco farmers around the world. In 2010, we believe it procured close to 400,000 MT of leaf tobacco from farmers and suppliers in emerging economies.

Glimmers of light in Japan of late

The final issue lies with recovering market share in Japan. We see no quick-fix solution to recovering market share and believe it will take some time for the company to regain its position. However, there have been signs of a recovery recently, and this gives us hope for the future.

Figure 31. Valuation

Code	Company	Rating	Price	Mkt Cap	FY1E=	EPS		PER (x)		PBR (x)	OPM		EV/EBITDA (x)		RoE	
						FY1E	FY2E	FY1E	FY2E		FY1E	FY2E	FY1E	FY2E	FY1E	FY2E
2914.T	JT	1	JPY 418,500.00	50.9	3/12	20,206.9	27,023.3	20.7	15.5	2.5	15.0%	17.3%	7.3	6.6	12.3%	15.2%
PM.N	Philip Morris	2	USD 81.55	140.7	12/12	5.3	5.9	15.3	13.8	nm	43.7%	44.3%	10.4	9.7	nm	nm
BATS.L	Brit Am Tobacco	2	GBP 31.45	97.2	12/11	1.9	2.1	16.2	15.0	nm	35.7%	36.3%	11.1	10.6	42.6%	51.2%
MO.N	Altria Group	2	USD 29.25	60.2	12/12	2.2	2.4	13.3	12.4	nm	42.1%	43.4%	8.5	8.2	88.0%	86.2%
IMT.L	Imperial Tobacco	1	GBP 24.49	38.5	9/12	2.0	2.2	12.2	11.2	3.2	35.5%	36.0%	10.1	9.5	21.6%	25.3%
ITC.BO	ITC	1	INR 202.80	32.0	3/12	7.9	9.3	25.7	21.8	nm	31.6%	32.8%	nm	nm	37.3%	41.8%
RAI.N	Reynolds American	1	USD 40.37	23.5	12/12	3.0	3.3	13.4	12.3	3.8	33.1%	33.9%	9.2	8.9	27.2%	31.5%
LO.N	Lorillard	1	USD 123.83	16.3	12/12	8.7	9.7	14.2	12.8	nm	41.1%	41.0%	8.9	8.4	nm	nm
033780.KS	KT&G	1	KRW 72,600.00	8.9	12/11	6,168.6	6,550.6	11.8	11.1	1.6	30.3%	30.0%	6.2	5.5	16.1%	14.6%
0336.HK	Huabao Intl	2H	HKD 5.85	2.4	3/12	0.5	0.6	10.9	9.7	3.2	59.3%	56.4%	8.1	6.9	31.4%	29.2%

Note: Share prices as of 15 February close

Source: Citi Investment Research and Analysis.

Appendix A-1

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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.

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Risk ratings, which took into account both price volatility and fundamental criteria, were: Low (L), Medium (M), High

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