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Project Star 2011: Presentation of results

Advisory - Strategic and Commercial Intelligence

19 June 2012

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19 June 2012

Dear Sirs,

KPMG Review of Tobacco consumption in the EU (Anti-Contraband and Anti-Counterfeit Cooperation Agreement)

We attach a copy of a confidential report on tobacco consumption in the EU ("Report") which has been prepared by KPMG LLP in accordance with the specific terms of reference ("the terms of reference") agreed between Philip Morris International Management S.A. ("PMI") and KPMG LLP.

KPMG LLP has agreed that the Report may be disclosed to you on the basis set out in this letter. KPMG LLP wishes you to be aware that KPMG LLP's work for PMI was performed to meet specific terms of reference agreed between PMI and KPMG LLP and that there were particular features determined for the purposes of the engagement. The Report should not therefore be regarded as suitable to be used or relied on by any other person or for any other purpose. Should you choose to rely on the Report you do so at your own risk. KPMG LLP will accordingly accept no responsibility or liability in respect of the Report to you or to any persons other than the addressees of the Report.

The report is issued to you on the basis that it is for your information only and, save as may be required by law, is not to be disclosed, quoted or referred to, in whole or in part to any other party other than the Relevant Administrations, as defined in the Anti-Contraband and Anti-Counterfeit Cooperation Agreement dated 9 July 2004, and we ask you as well as the Relevant Administrations to maintain the confidentiality of the report. Should you choose to disclose the report to any Relevant Administrations you will ensure that they understand the basis on which disclosure has been made and shall provide them with a copy of this letter.

Yours faithfully

KPMG LLP

Disclaimer

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This report on tobacco consumption in the EU (“Project Star 2011 Results") has been prepared by KPMG LLP in accordance with specific terms of reference (“terms of reference") agreed between Philip Morris International Management S.A. ("PMI") and KPMG LLP.

KPMG LLP wishes you to be aware that KPMG LLP's work for PMI was performed to meet specific terms of reference agreed between PMI and KPMG LLP and that there were particular features determined for the purposes of the engagement. The Project Star 2011 Results should not therefore be regarded as suitable to be used or relied on by any other person or for any other purpose. Should you choose to rely on this report you do so at your own risk. KPMG LLP will accordingly accept no responsibility or liability in respect of the Project Star 2011 Results to you or to any persons other than PMI.

Objectives for today

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- Provide an overview of developments in the EU illicit cigarette trade in 2011 identified as a result of Project Star. The presentation will cover;
  - Methodology
  - Market background and legal sales
  - Consumption and illicit market analysis
  - Source markets and brands
  - Review of PMI counterfeit and contraband
  - Conclusions

- A document containing detailed results for each Member State will be available following the presentation

- KPMG is happy to provide clarifications or respond to questions both at the end of the session and on an ongoing basis

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Project Star uses legal domestic sales, Empty Pack Survey results and consumer research to determine counterfeit and contraband volumes

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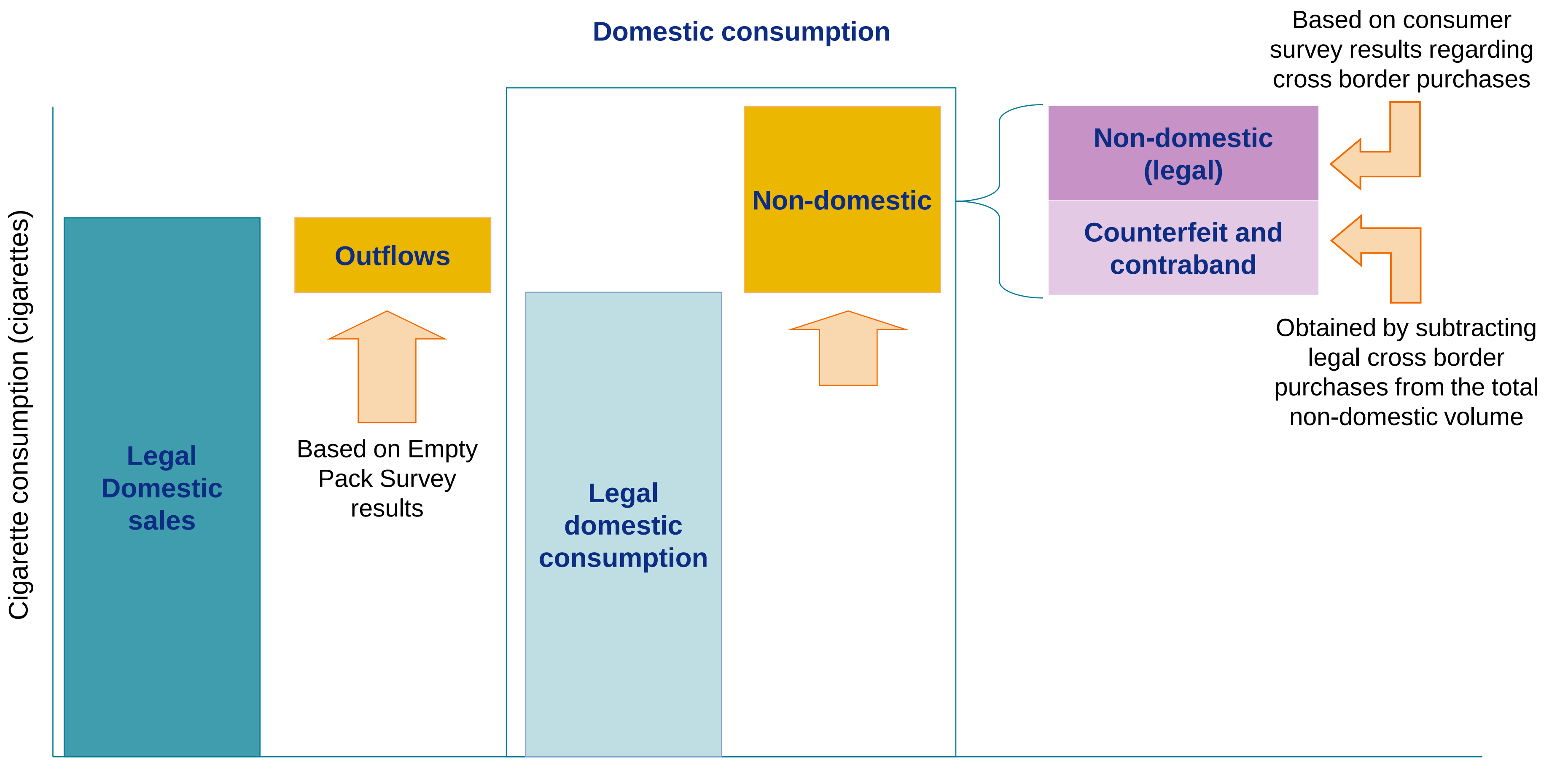

The Project Star methodology was developed by KPMG and approved by OLAF. It has been deployed on a consistent basis since 2006, enabling comparisons to be made between counterfeit and contraband volumes from year to year.

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Real GDP growth was positive in all Member States except Greece and Portugal, however, unemployment in the EU27 remained high at 9.7%

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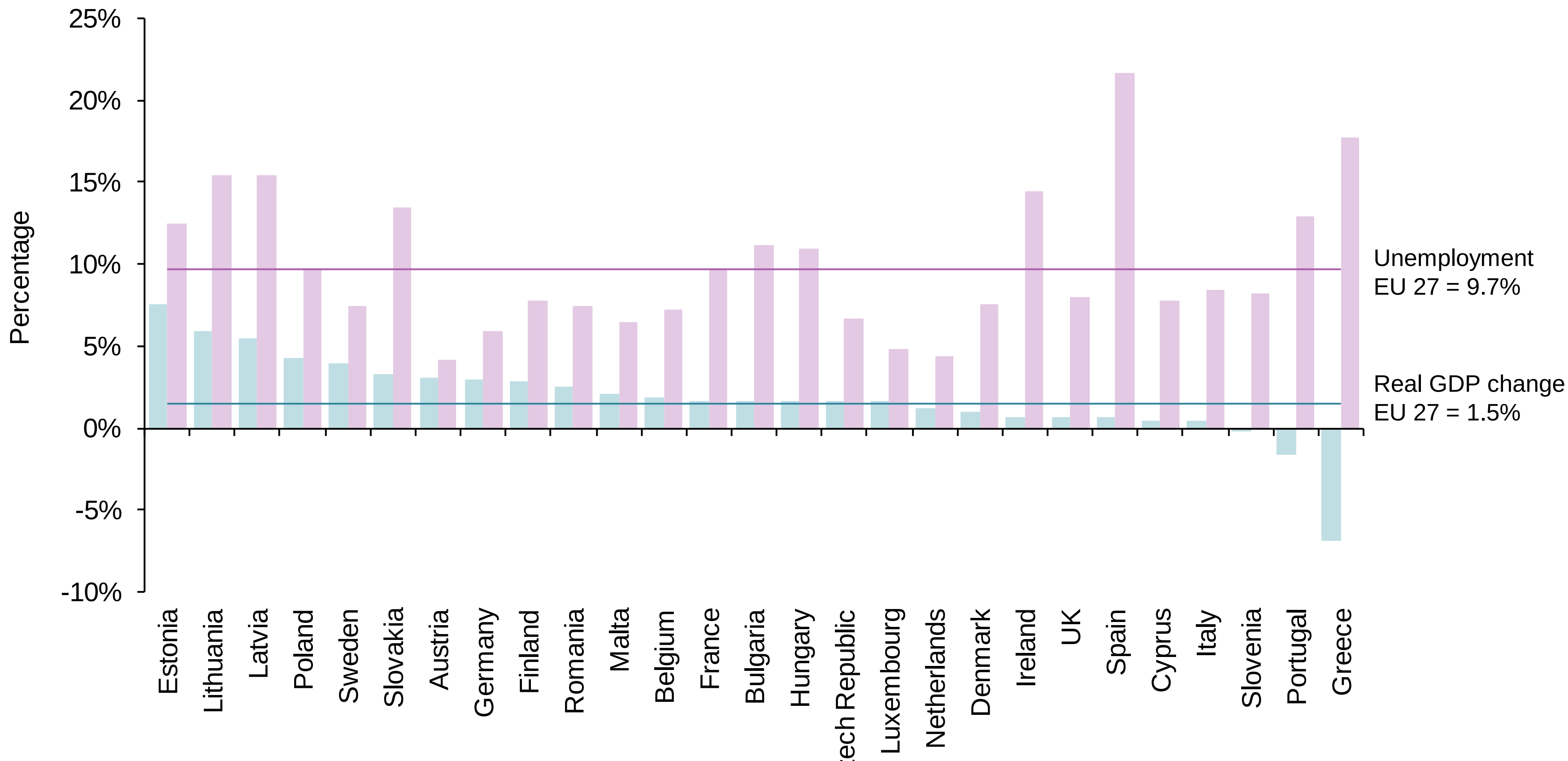
Real GDP change and unemployment rate, 2011[1](a)



Key:
- Annual change in real GDP 2011
- Annual change in real GDP 2011 EU-27
- Unemployment rate 2011
- Unemployment rate 2011 EU-27

Note: (a) Real GDP is an inflation-adjusted measure that reflects the value of all goods and services produced in a given year, expressed in base-year prices.

Source: (1) Eurostat, real GDP growth rate and unemployment rate, accessed April 2012

Price increases of over 5% were observed in 15 Member States in 2011

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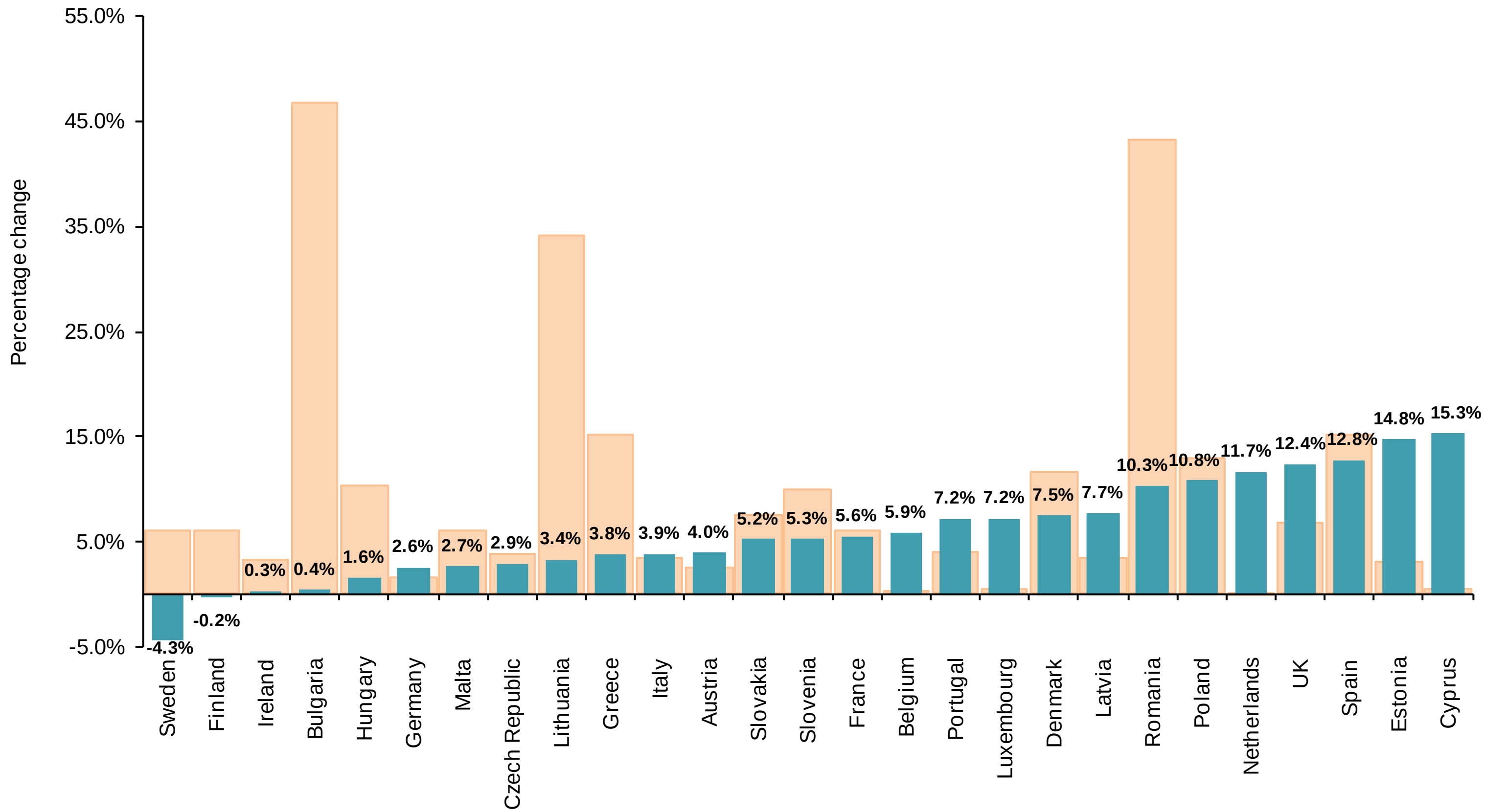
Percentage change in weighted average price, 2010-2011[(1)(a)(b)]



Key: Change in weighted average price 2010-2011
Change in weighted average price 2009-2010

Note: (a) Data labels for 2011 price change only
(b) Weighted average pack price change calculated in local currency
Source: (1) PMI Management and EU Tax Tables

Price differentials between Member States and neighbouring countries remained significant

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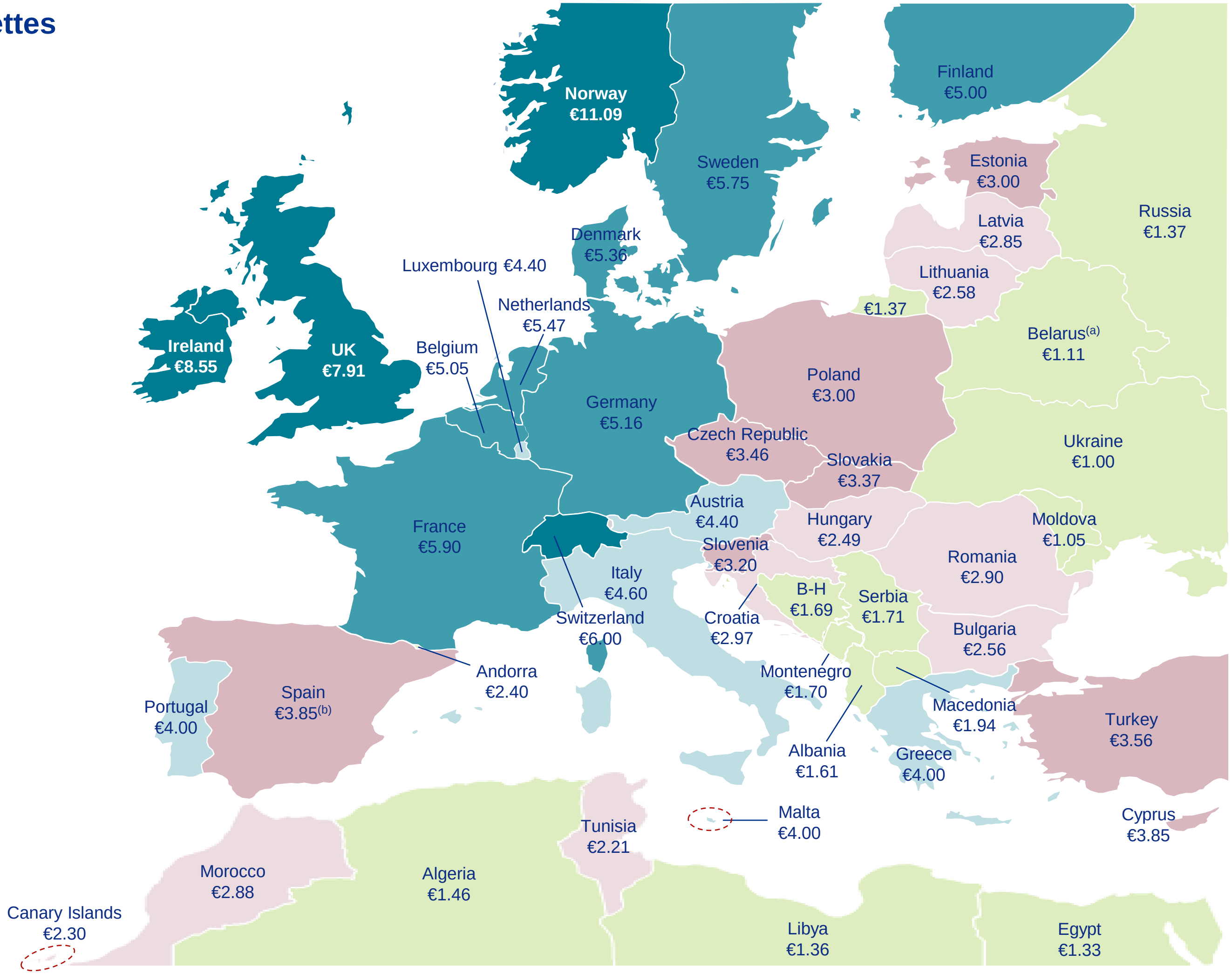
Map denotes Marlboro price per 20 cigarettes at 1 July 2011[(1)]



Key:
- €6.00 or more
- €5.00 to €5.99
- €4.00 to €4.99
- €3.00 to €3.99
- €2.00 to €2.99
- Less than €2.00

Notes:
(a) Based upon the price of a pack of 20 Kent cigarettes, a comparable premium brand, as Marlboro is not sold in Belarus
(b) A number of price changes took place in Spain between April and October in 2011, the average Marlboro price for the year per IMS data is €4.15

Source: (1) PMI Management and EU Tax Tables

In 2011, the steepest falls in legal domestic sales were observed in the Mediterranean region

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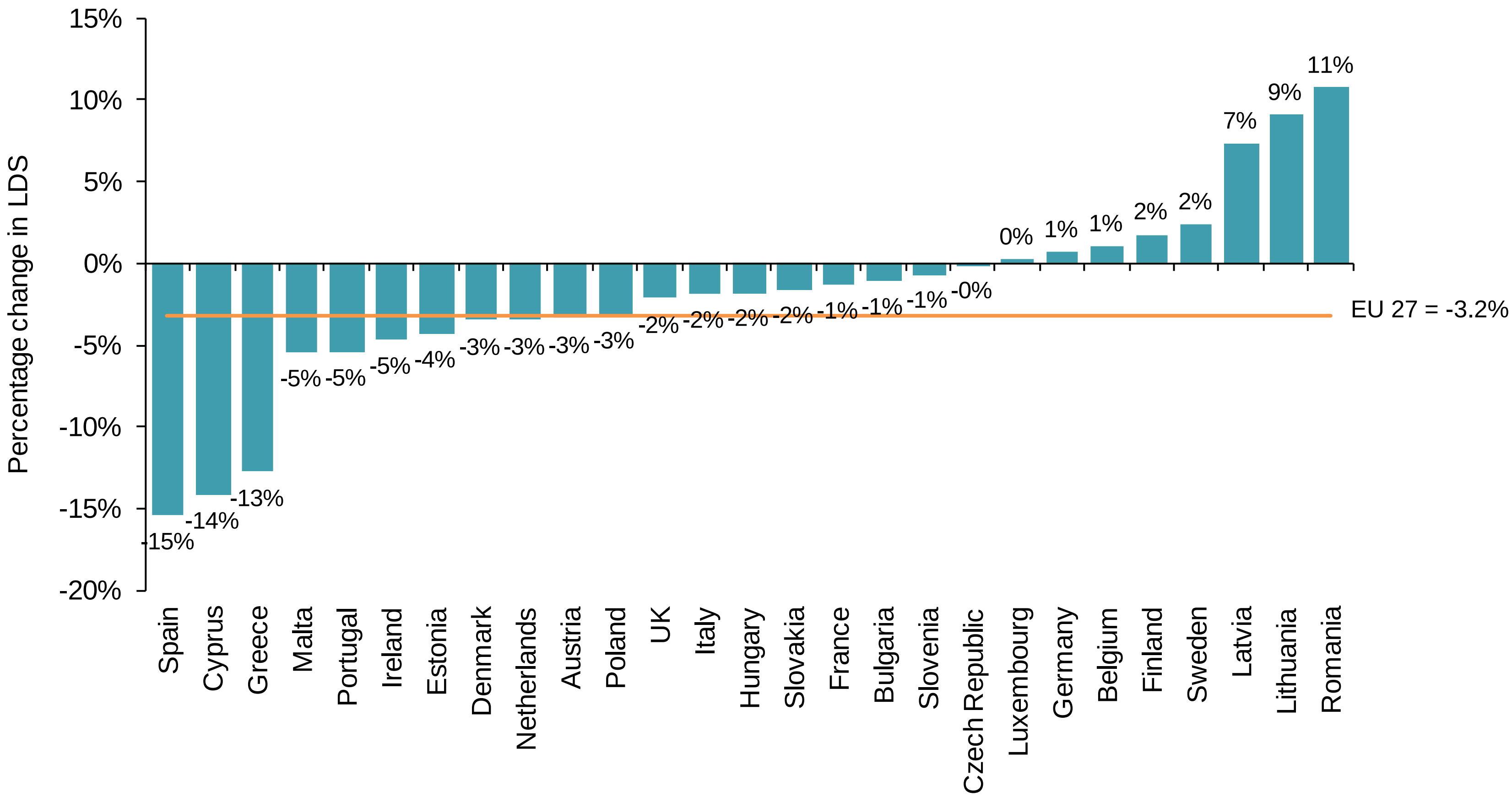
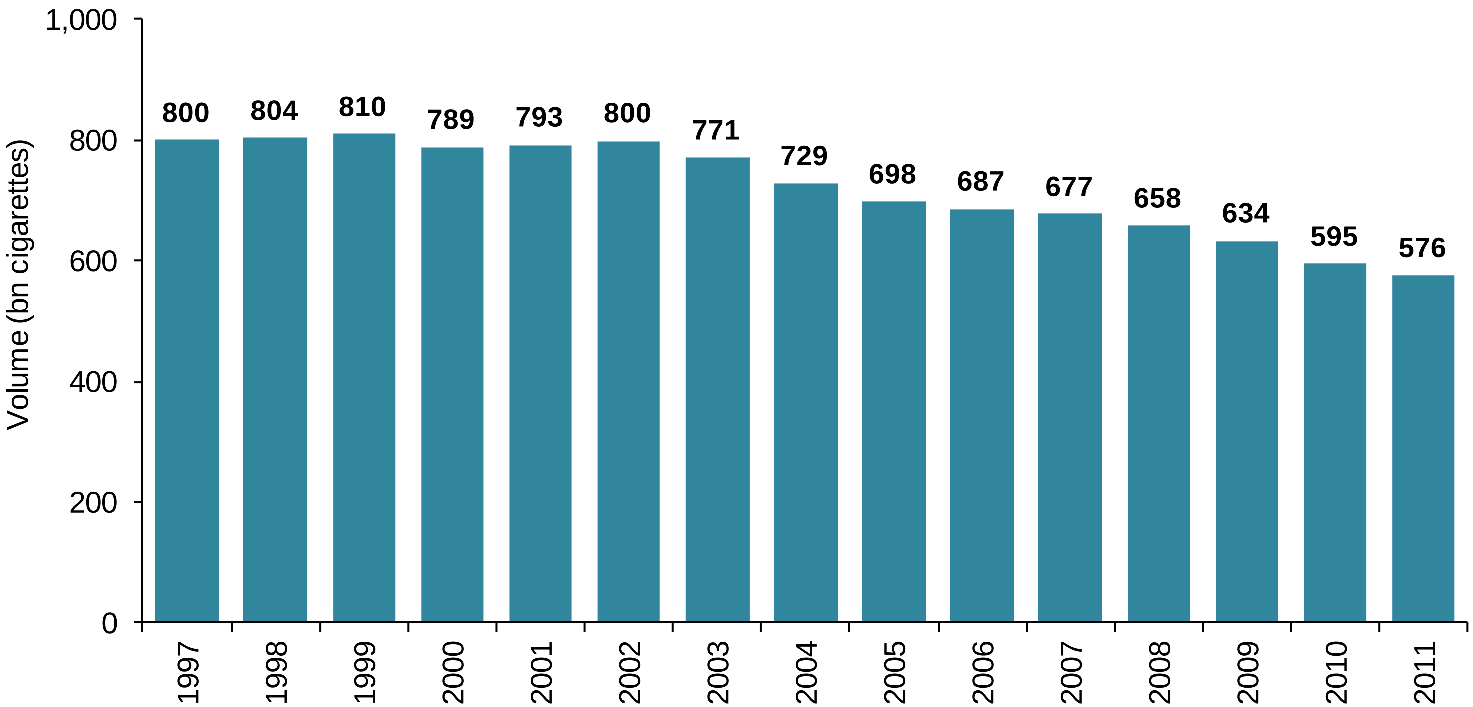
Percentage change in legal domestic sales for EU-27, 2010-2011[(1)]



Source: (1) In Market Sales provided by PMI

Total EU legal domestic sales declined by 3.2% in 2011, compared with a 6.1% fall the previous year

Historic Legal Domestic Sales for EU-27, 1997-2011[1]



Key: EU 27 Countries[a]

Note: (a) Romania and Bulgaria have been included at 2007 levels for each of the years 1997-2007

Source: (1) In Market Sales provided by PMI

Summary of market background and legal sales

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Despite growing economic concerns, real GDP increased in 24 of the 27 Member States in 2011

- The strongest real GDP growth was observed in the Baltic States, although unemployment remains high in that region
- The unemployment rate also exceeded 10% in Spain, Greece, Portugal, Ireland, Slovakia, Bulgaria and Hungary

Total EU legal domestic sales declined by 3.2% in 2011, compared with a 6.1% fall the previous year

- The steepest declines in legal domestic sales during 2011 were observed in the Mediterranean region

Price increases of over 5% were observed in 15 Member States in 2011

- Price differentials between Member States and neighbouring countries remained significant
  - The price of a pack of 20 Marlboro King Size ranges from €2.49 in Hungary, to €8.55 in Ireland
  - Prices range between €1.00 and €11.09 for 20 Marlboro King Size in countries bordering the European Union

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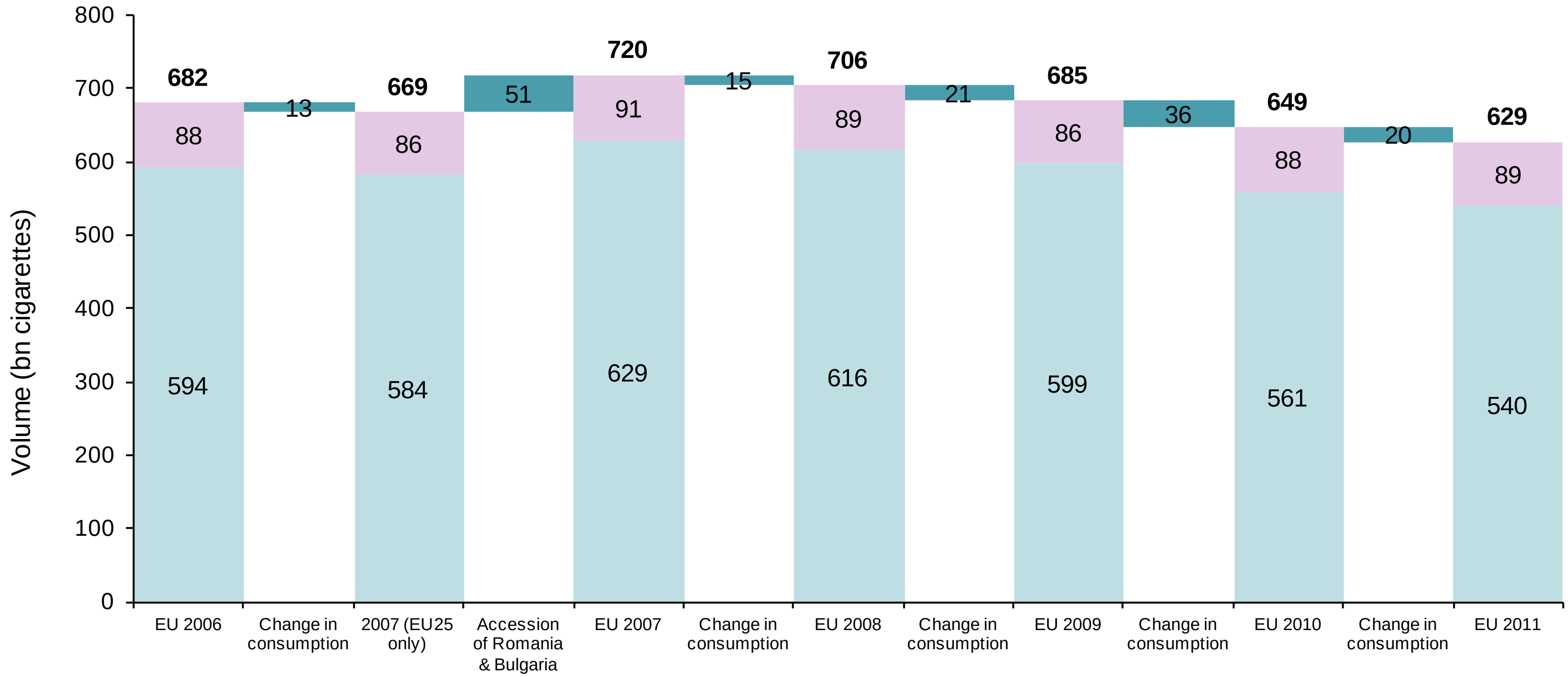
In 2011, total consumption declined while consumption of non-domestic products increased slightly

EU consumption by type, 2006-2011[(1)]



Key: Non-domestic
Legal domestic consumption

Source: (1) KPMG analysis based on Empty Pack Surveys, legal domestic sales and non-domestic (legal) research

The share of counterfeit and contraband consumption increased to 10.4%, or 65.3 billion cigarettes, in 2011

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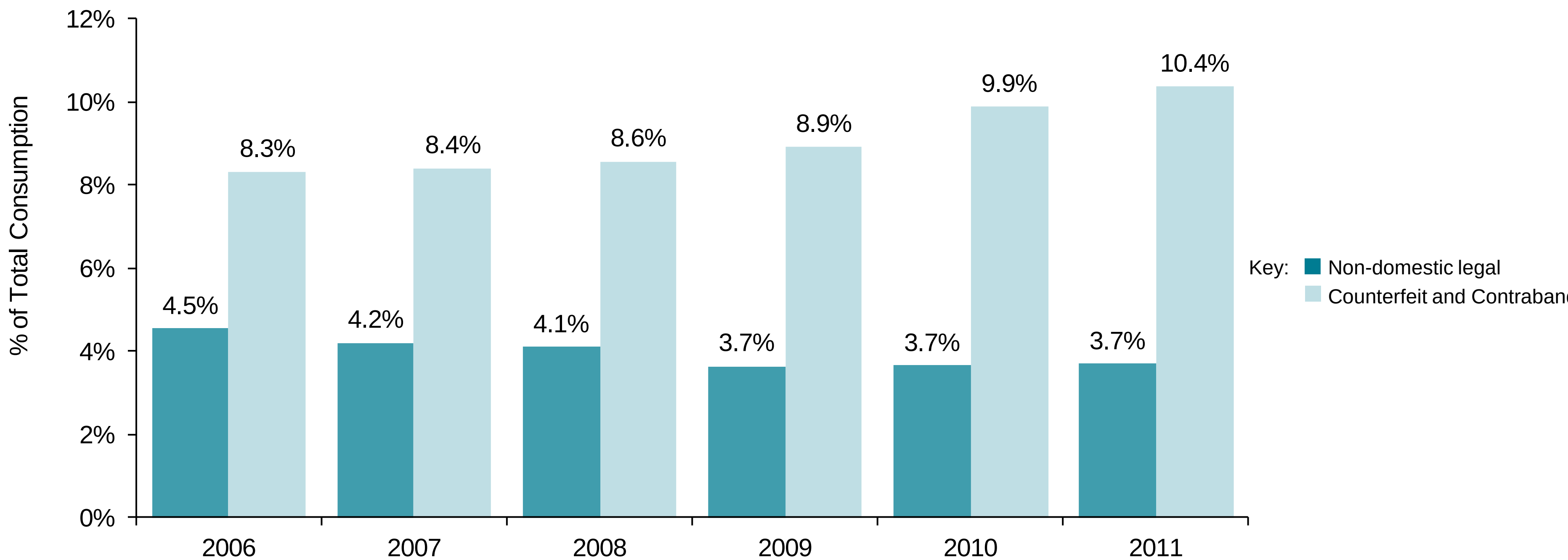
ND(L) and C&C share of total consumption 2006 – 2011(1)



	2006	2007	2008	2009	2010	2011
ND(L) volume (bn cigarettes)	31.0	30.3	29.0	25.0	23.7	23.3
C&C volume (bn cigarettes)	56.8	60.6	60.5	61.1	64.2	65.3

Source: (1) EU Flows Model 2006 - 2011

Latvia, Lithuania and Bulgaria remain the markets with the highest illicit product incidence, but all three experienced declines in illicit consumption levels in 2011

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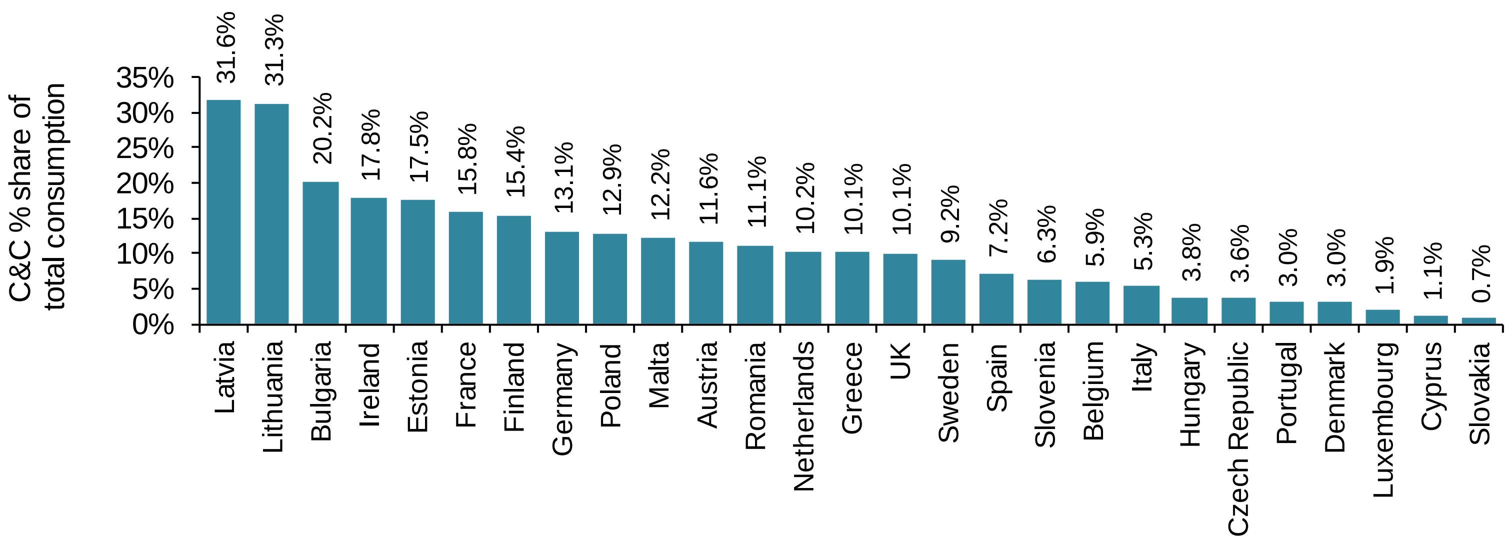
C&C share of consumption by country 2010 – 2011[(1)]



2011 C&C volumes (bn)	0.8	1.1	2.7	1.0	0.3	10.7	0.9	14.0	6.7	0.1	1.9	3.1	1.6	2.7	5.0	0.6	4.6	0.2	0.7	4.8	0.5	0.6	0.3	0.2	0.0	0.0	0.1

Source: (1) EU Flows Model 2010 - 2011

The share of C&C consumption accounted for by the Mediterranean region increased to 19.3% in 2011, whilst the share of the Eastern border countries declined significantly

Classification of markets

Share of total C&C inflows by destination regions, 2006-2011[1]

Key:
- Mediterranean EU countries – Cyprus, Greece, Italy, Malta, Portugal and Spain
- Eastern border EU countries – Bulgaria, Estonia, Finland, Hungary, Latvia, Lithuania, Poland, Romania and Slovakia
- Western and Central EU countries – Austria, Belgium, Czech Republic, Denmark, France, Germany, Ireland, Luxembourg, Netherlands, Slovenia, Sweden and UK

Source: (1) KPMG analysis based on Empty Pack Surveys, legal domestic sales and non-domestic (legal) research

Counterfeit and contraband increased significantly in the Mediterranean countries in 2011 to account for 12.6 billion cigarettes and 6.5% of consumption

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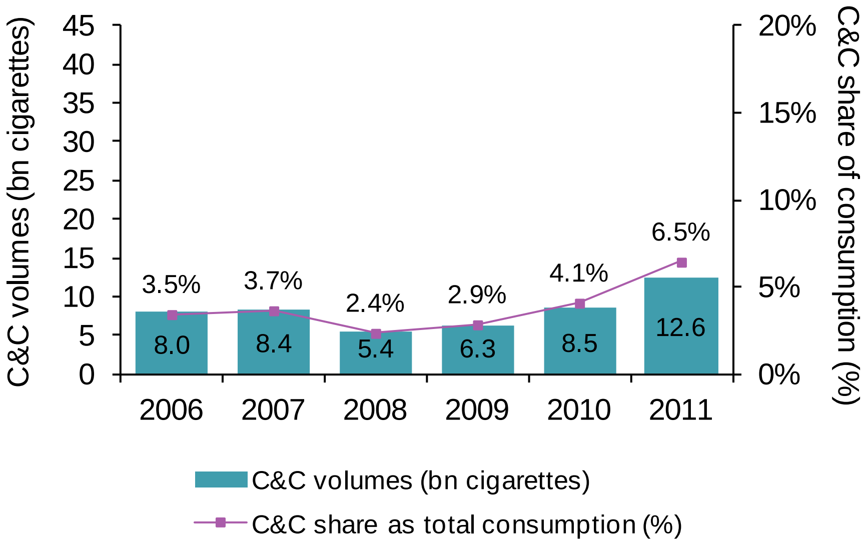
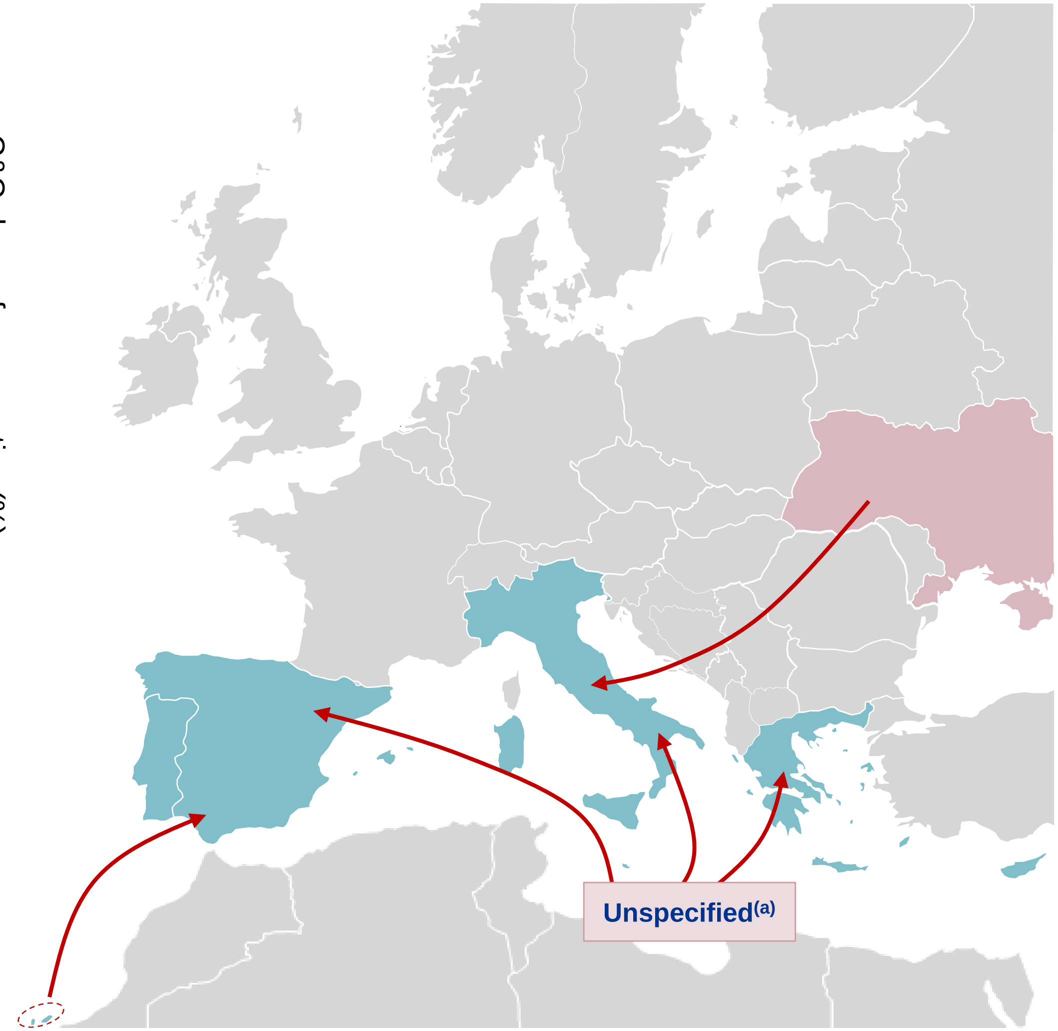
C&C inflows to Mediterranean EU countries, 2011[1]





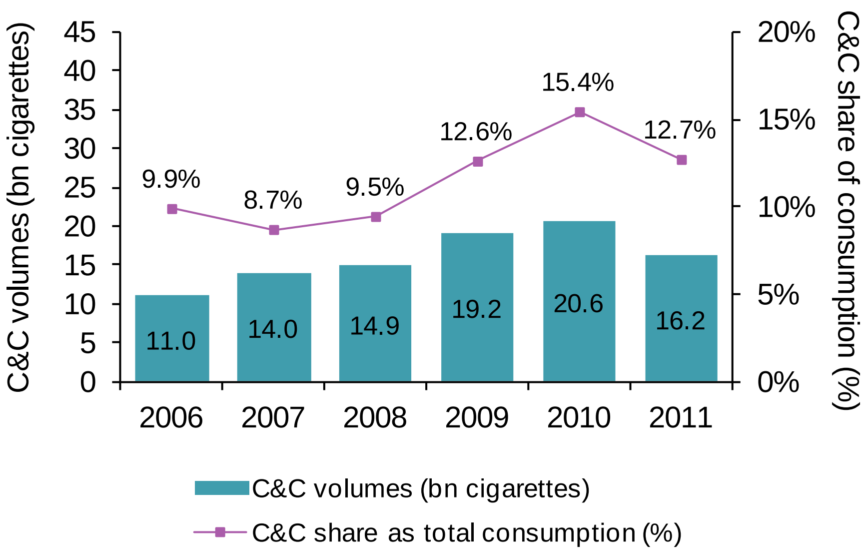
Key: EU – Mediterranean countries
Source countries with inflows of over 1 billion cigarettes in 2011
C&C flows of over 0.4 billion cigarettes in 2011

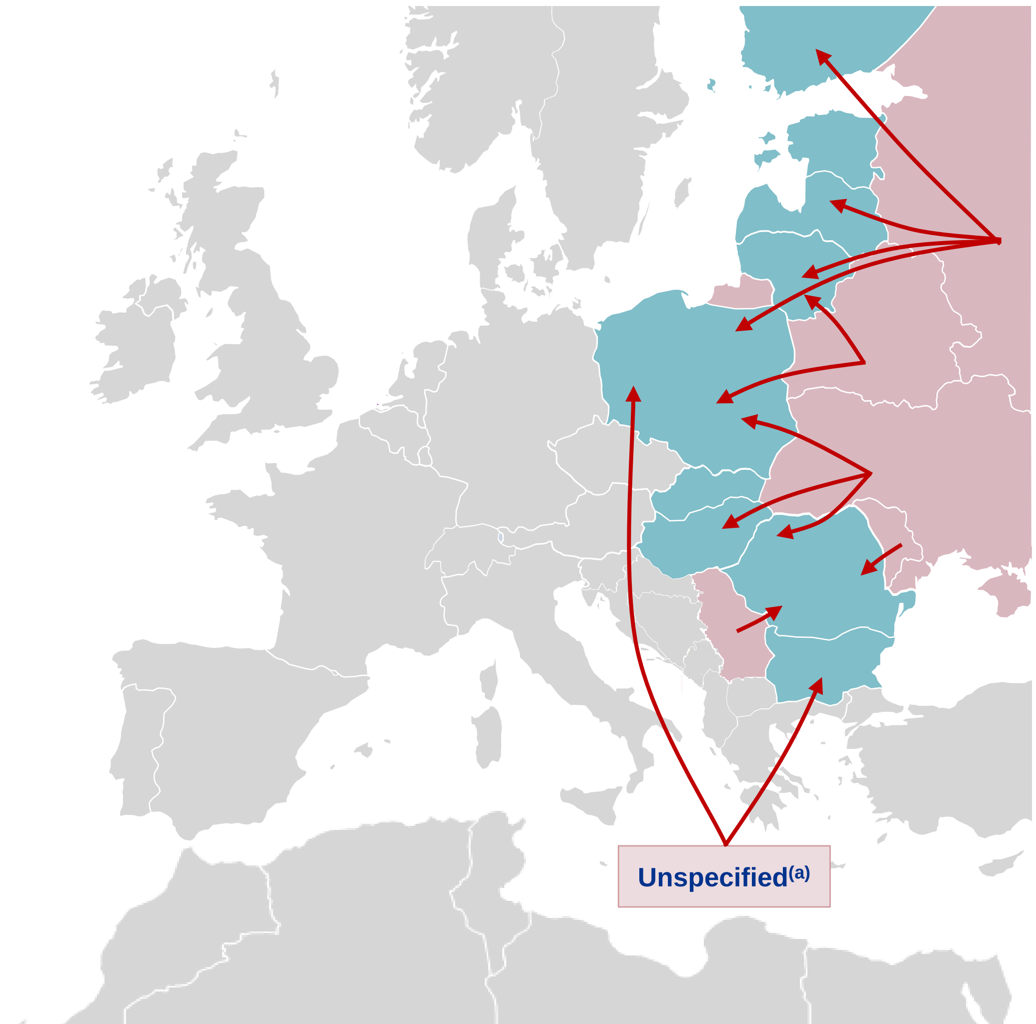
Note: (a) 'Unspecified' refers to packs which do no bear any specific market or Duty Free labelling

Source: (1) KPMG analysis based on Empty Pack Surveys, legal domestic sales and non-domestic (legal) research

In 2011 counterfeit and contraband as a share of consumption in Eastern border countries declined to close to the 2009 level

C&C inflows to Eastern border EU countries, 2011[(1)]





Key: EU - Eastern border countries

Source countries with inflows of over 1 billion cigarettes in 2011

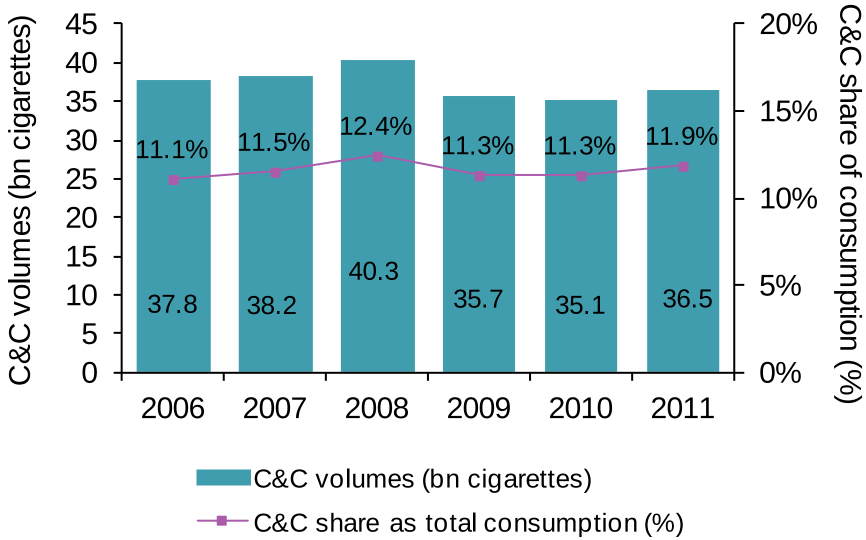
C&C flows of over 0.4 billion cigarettes in 2011

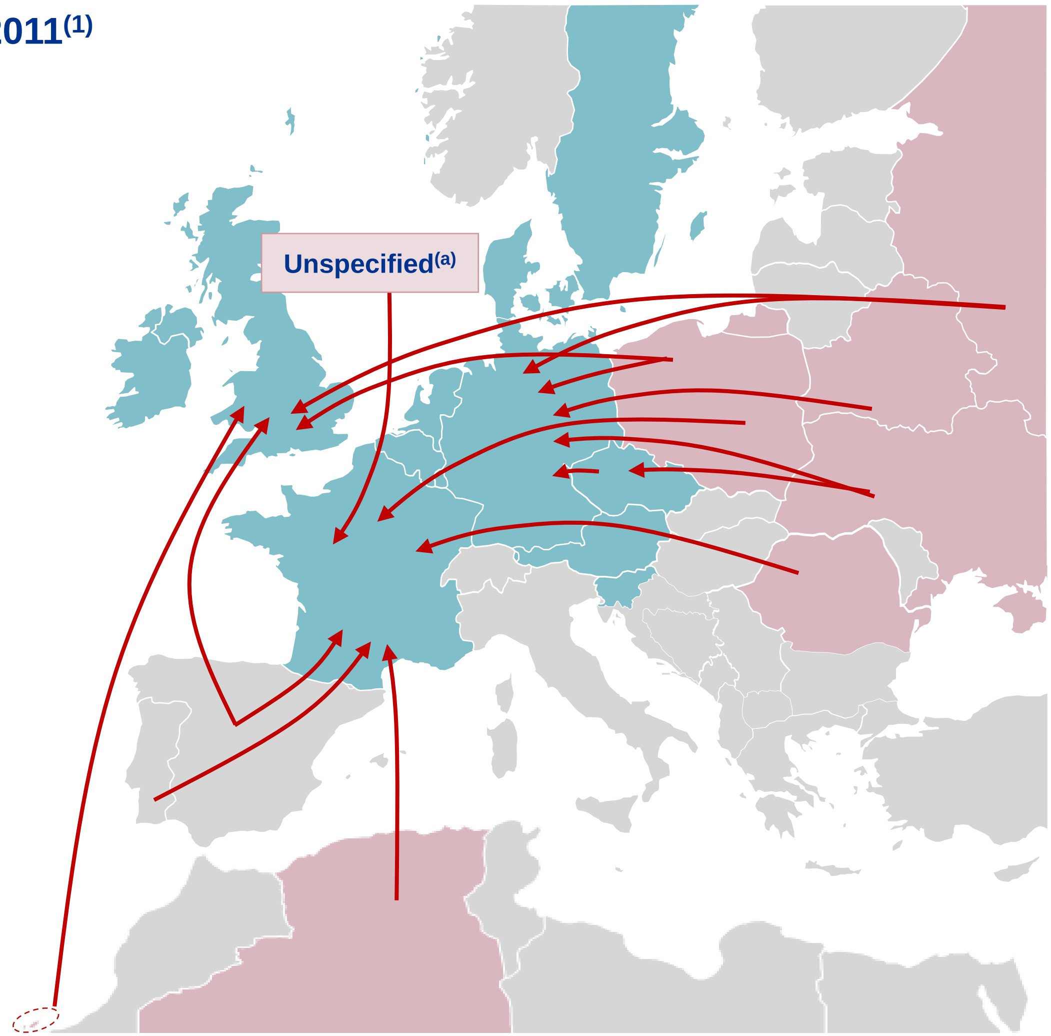
Note: (a) 'Unspecified' refers to packs which do no bear any specific market or Duty Free labelling

Source: (1) KPMG analysis based on Empty Pack Surveys, legal domestic sales and non-domestic (legal) research

Counterfeit and contraband share of consumption and volumes in the Western and Central EU markets increased slightly in 2011

C&C inflows to Western and Central EU countries, 2011[1]





Key:
- Western and Central EU countries
- Source countries with inflows of over 1 billion cigarettes in 2011
- C&C flows of over 0.4 billion cigarettes in 2011

Note: (a) ‘Unspecified’ refers to packs which do no bear any specific market or Duty Free labelling

Source: (1) KPMG analysis based on Empty Pack Surveys, legal domestic sales and non-domestic (legal) research

Summary of consumption and illicit market analysis

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Total consumption declined at a rate of 3.1% to 629 billion cigarettes in 2011

- Despite this decline, consumption of non-domestic increased slightly to 89 billion cigarettes

Counterfeit and contraband increased to 65.3 billion cigarettes, representing 10.4% of total consumption, up from 9.9% in 2010

- Latvia, Lithuania and Bulgaria remain the markets with the highest share of illicit products, but all three experienced declines in counterfeit and consumption levels in 2011

The share of illicit cigarette consumption in Mediterranean countries increased significantly in 2011

- C&C share of consumption in this region increased to 6.5% in 2011, up from 4.1% the previous year and equivalent to 12.6 billion cigarettes
  - Spain and Greece have seen significant increases in the volume of counterfeit and consumption consumed in 2011 compared to 2010

In 2011, counterfeit and contraband volumes in Eastern border countries declined for the first time since 2006

- Significant declines in counterfeit and contraband consumption were observed in Romania and Bulgaria during 2011; these countries had previously experienced rapid growth in the illicit trade since 2007

Counterfeit and contraband volumes increased slightly in the Western and Central EU countries in 2011

- This increase was primarily driven by France and Germany, whilst volumes in Czech Republic and the UK declined
- Despite this growth, C&C in these regions remains below the 2008 high, both as a share of total consumption and in volume terms.

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The share of counterfeit and contraband originating from outside the EU remained broadly stable in 2011 at 60%

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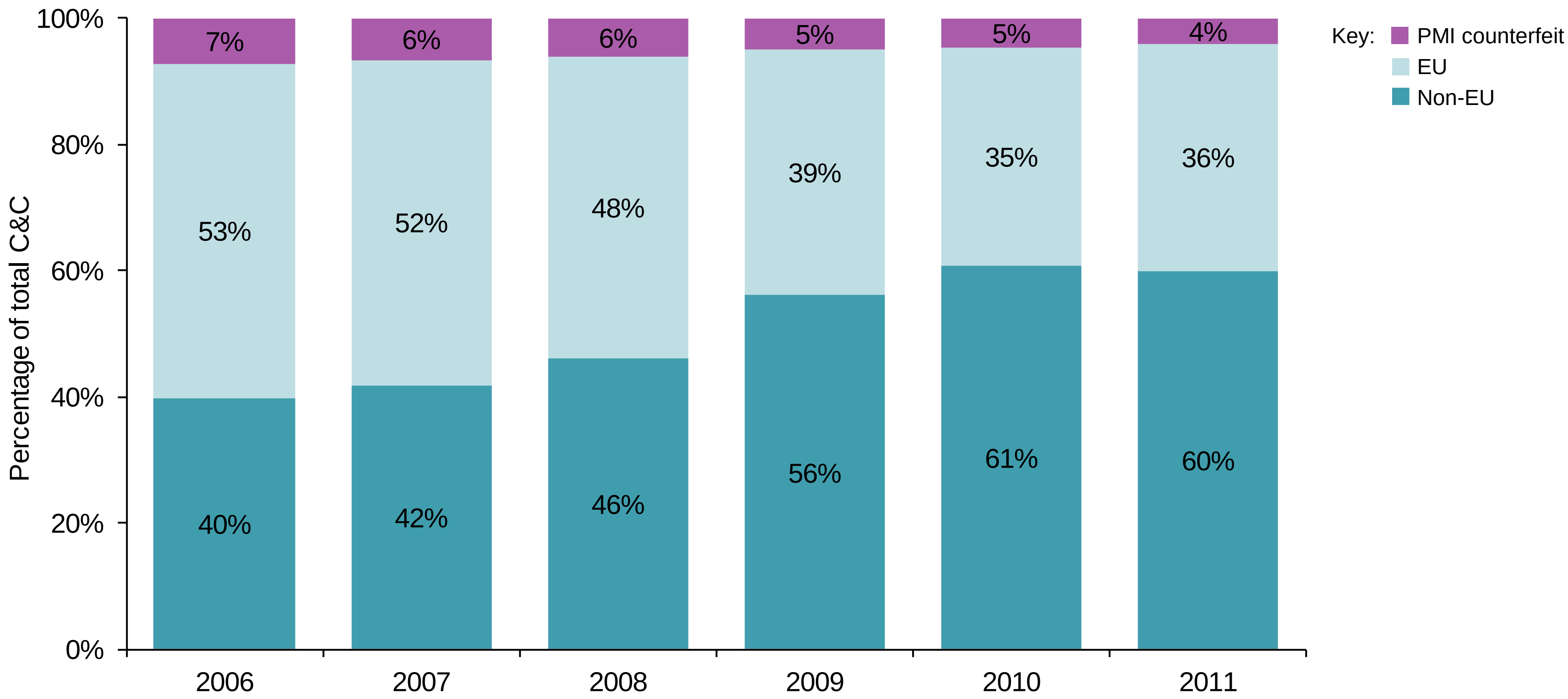
C&C inflows by origin, 2006-2011(1)

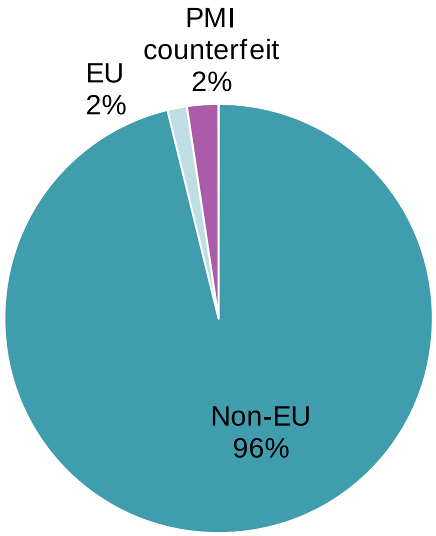


Source: (1) KPMG analysis based on Empty Pack Surveys, legal domestic sales and non-domestic (legal) research

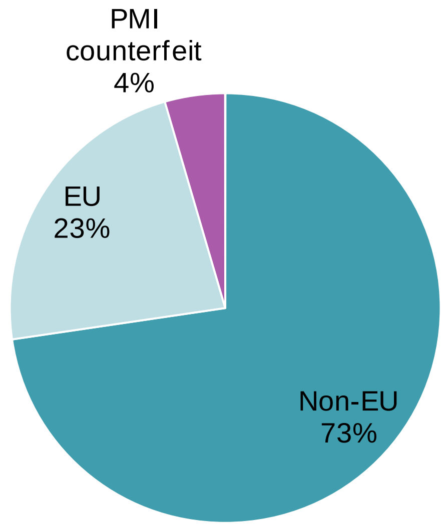
The illicit consumption by source market highlights the different nature of the challenges faced across the EU

Contraband inflows by origin, 2011(1)

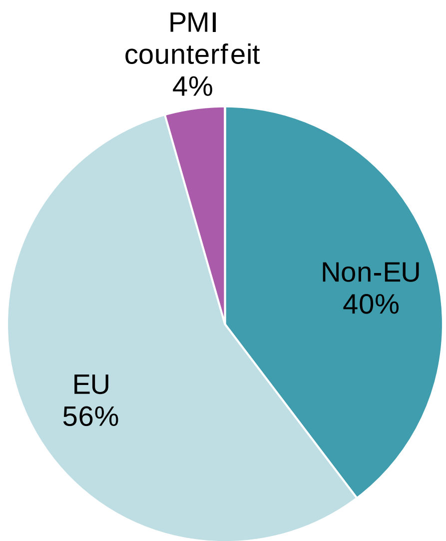
Eastern border EU countries



Mediterranean EU countries



Western and Central EU countries



Source: (1) KPMG analysis based on Empty Pack Surveys, legal domestic sales and non-domestic (legal) research

Unspecified products have become the largest source of illicit products from outside the EU, as Russian and Ukrainian inflows have declined

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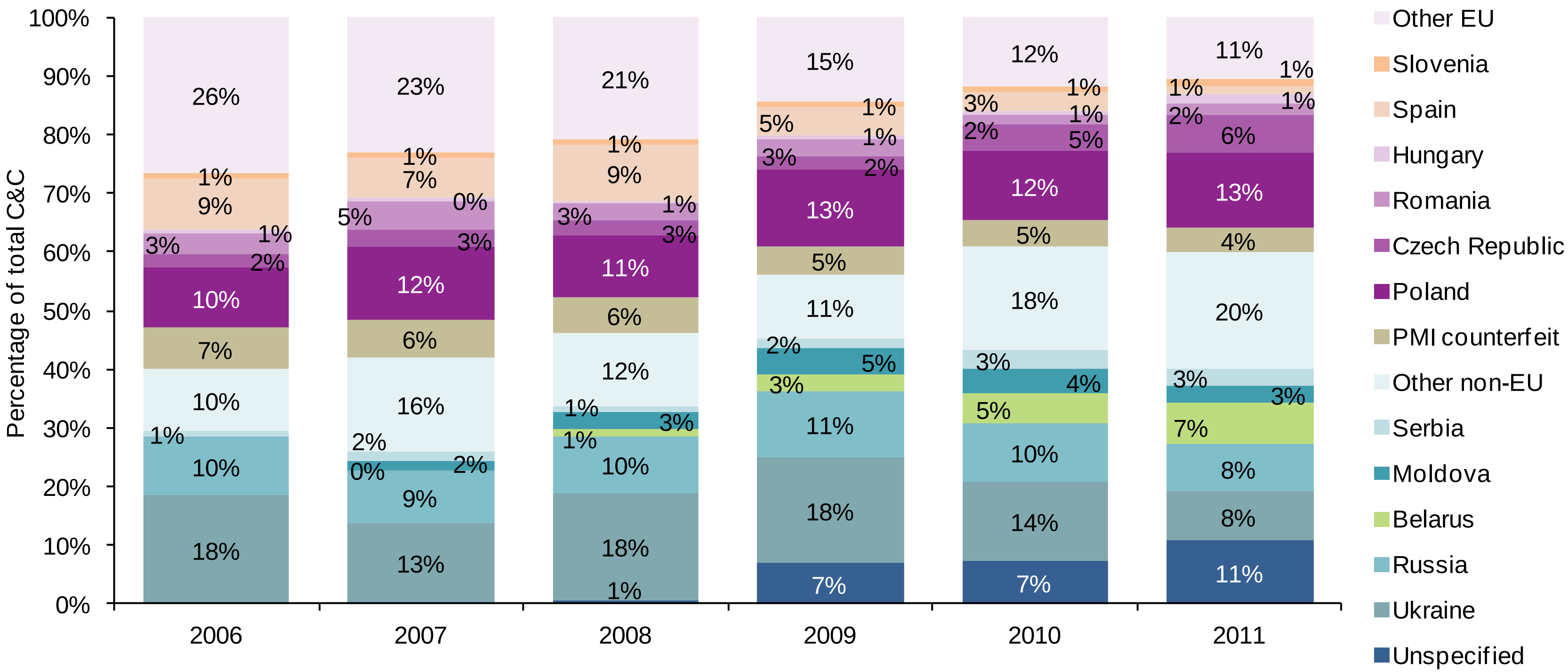
C&C inflows by origin, 2006-2011[(1)]



Unspecified packs are packs which do not bear any specific market or Duty Free labelling

Source: (1) KPMG analysis based on Empty Pack Surveys, legal domestic sales and non-domestic (legal) research

Unspecified products increased rapidly to 7.0 billion in 2011. All Unspecified brands are classed as illicit whites

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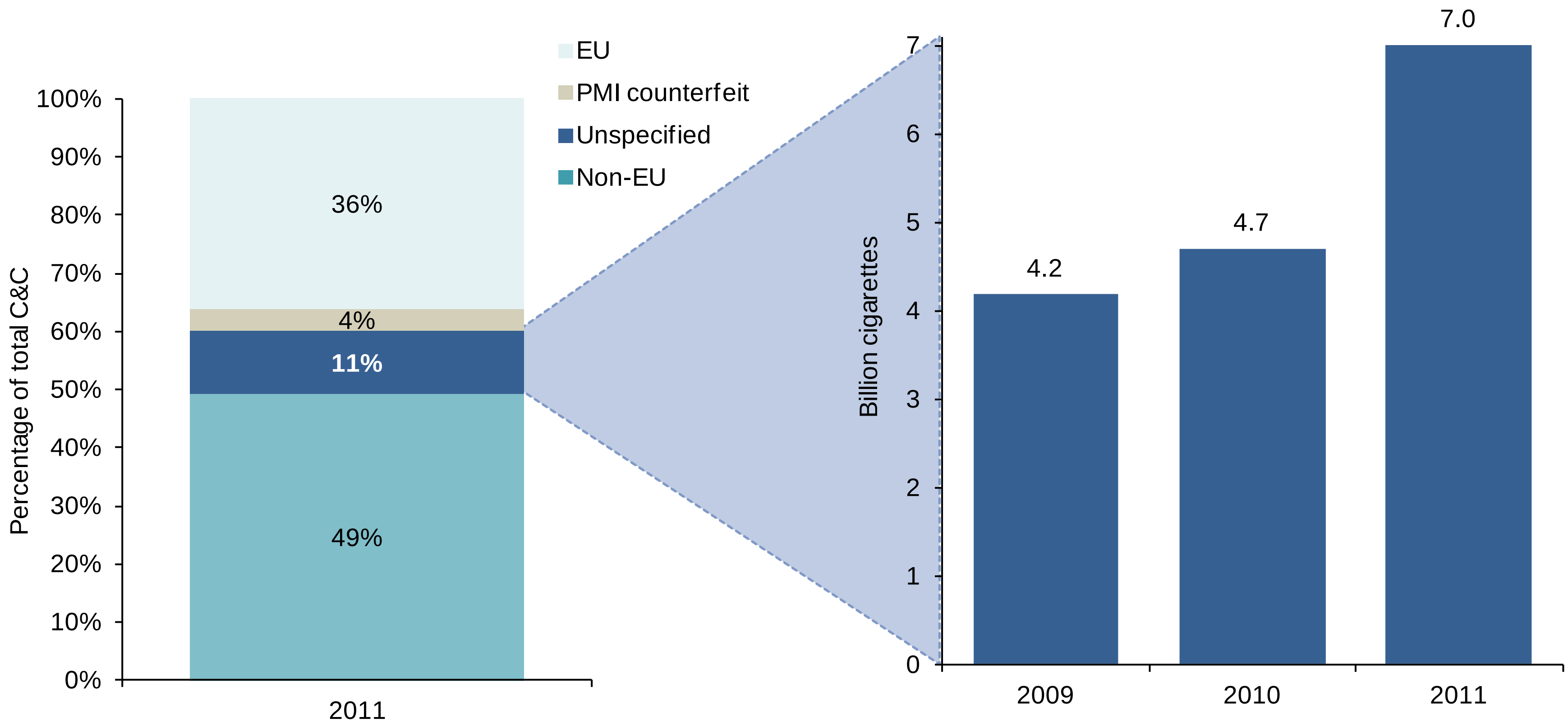
C&C inflows by origin 2011[(1)]

Unspecified contraband inflows from non-EU countries, 2009-2011[(1)]

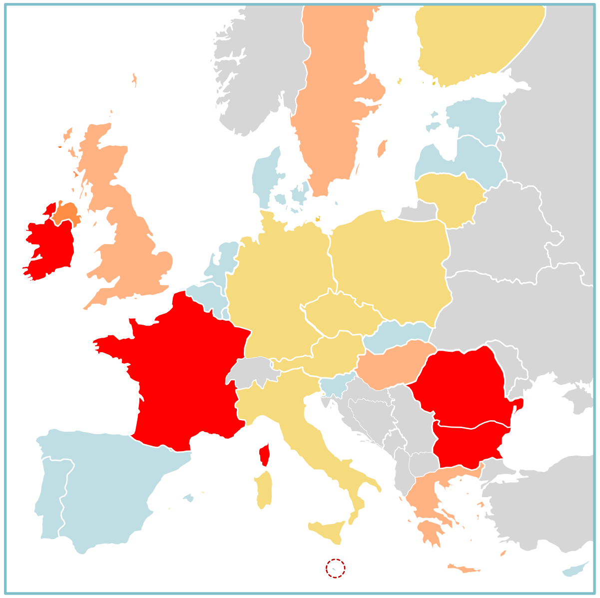


Source: (1) KPMG analysis based on Empty Pack Surveys, legal domestic sales and non-domestic (legal) research

The growth in Unspecified products has been driven by increased consumption in the Mediterranean countries

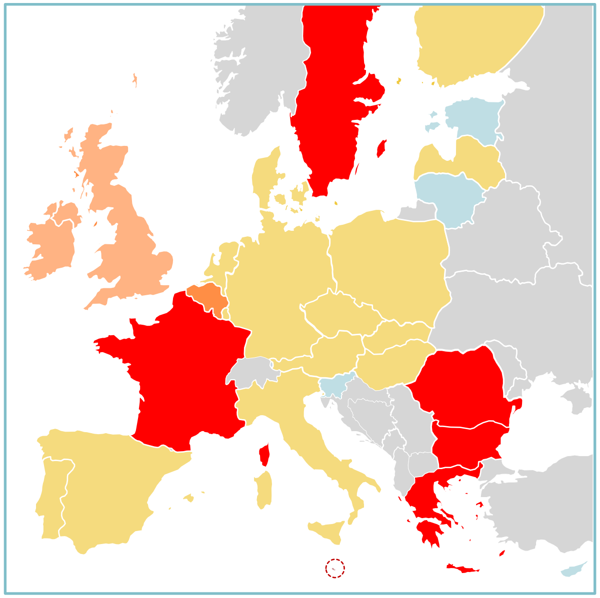
Unspecified share of total consumption 2009-2011[(1)(a)]

2009



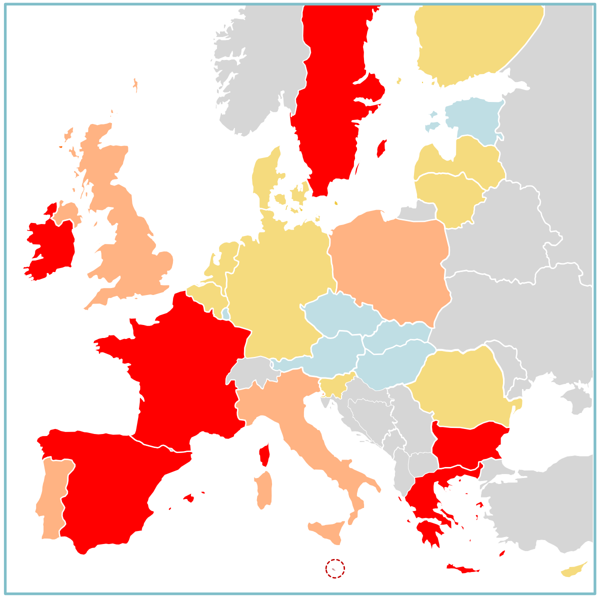
4.2bn

2010



4.7bn

2011



7.0bn

Key:
- No Unspecified observed
- Accounts for 0% - 0.49% consumption
- Accounts for 0.5% - 0.9% consumption
- Accounts for more than1.0% consumption

Note: (a) Unspecified refers to packs which do no bear any specific market or Duty Free labelling

Source: (1) KPMG analysis based on Empty Pack Surveys, legal domestic sales and non-domestic (legal) research

Karelia, Kaanee American International Tobacco and H. Van Landewyck accounted for 44% of Unspecified volumes consumed in the EU in 2011

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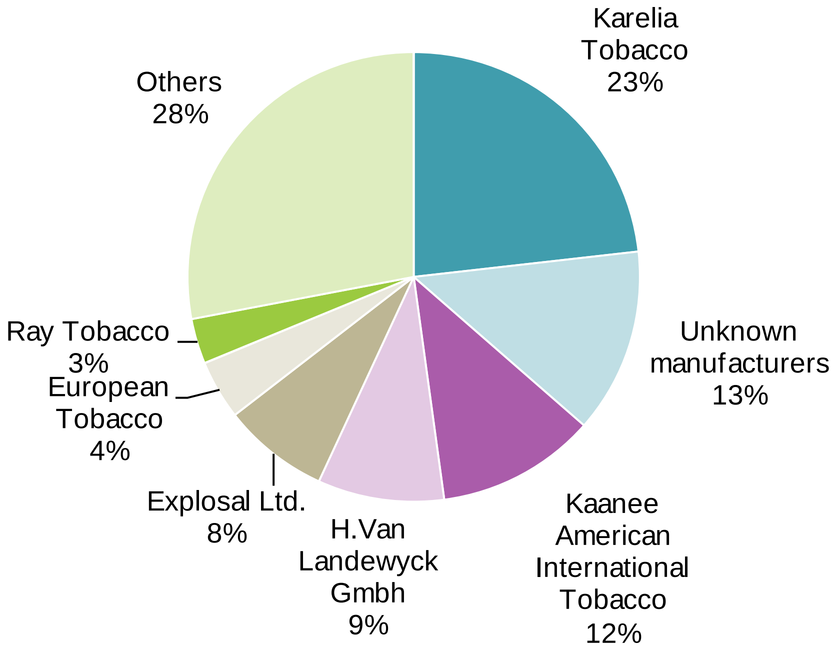
C&C inflows from Unspecified market by manufacturer, 2011(1)



100% = 7.0 billion cigarettes

Selected brands for major manufacturers of Unspecified	
Manufacturer	**Brand**
Karelia Tobacco	American Legend Karelia
Unknown manufacturers	Goal Amigos Lampsi
Kaanee American International Tobacco	Gold Mount
H.Van Landewyck Gmbh	Ducal Austin
Explosal Ltd.	Raquel Gold Classic
European Tobacco	President HD
Ray Tobacco	Walton

All Unspecified brands are classed as illicit whites

Source: (1) KPMG analysis based on Empty Pack Surveys, legal domestic sales and non-domestic (legal) research

Illicit white volumes increased to 24% of counterfeit and contraband volumes despite the decline of Jin Ling and Classic

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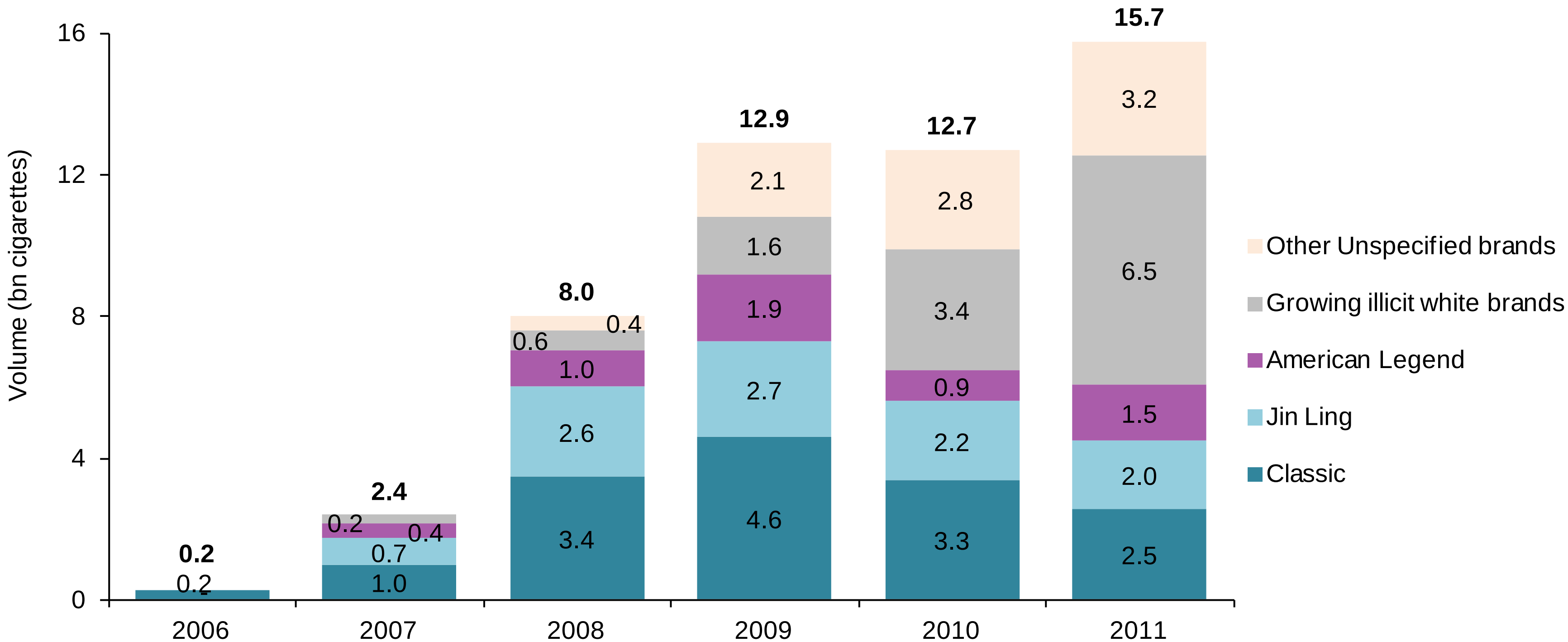
Consumption of key and growing illicit white brands, 2006-2011[(1)(a)]



% of total EU C&C	0%	4%	13%	21%	20%	24%

In 2011, 18 Illicit White brands had volumes of over 200 million cigarettes

Note: (a) This analysis covers illicit white brands with an inflow greater than 200 million sticks in 2011 as well as Unspecified brands.
Source: (1) KPMG analysis based on Empty Pack Surveys, legal domestic sales and non-domestic (legal) research

The share of counterfeit and contraband flows accounted for by fast growing illicit white brands doubled in 2011, reaching 6.5 billion cigarettes

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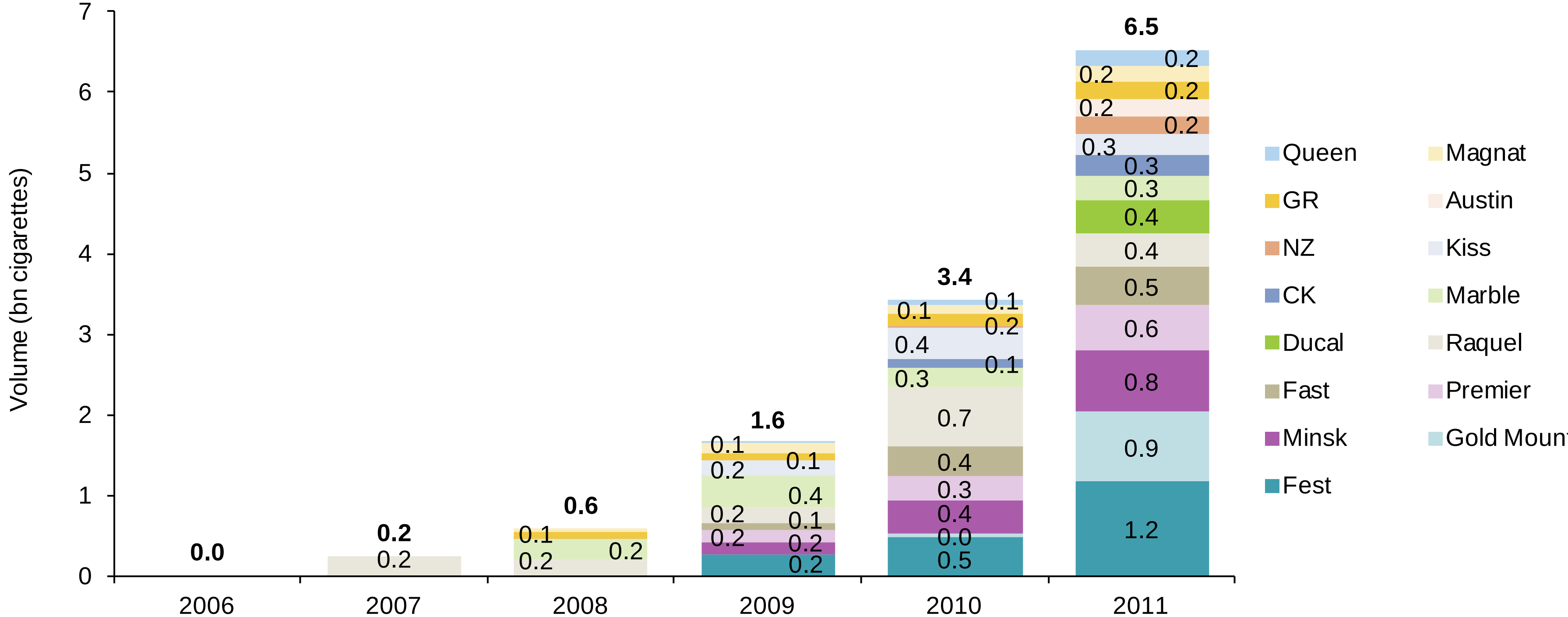
Consumption of growing illicit white brands, 2006-2011[(1)(a)]



% of total EU C&C	2006	2007	2008	2009	2010	2011
	0%	0%	1%	3%	5%	10%

Note: (a) Fast growing illicit brands are defined as those with an inflow greater than 200 million sticks in 2011

Source: (1) KPMG analysis based on Empty Pack Surveys, legal domestic sales and non-domestic (legal) research

The share of counterfeit and contraband accounted for by Marlboro, Viceroy and Classic declined whilst the share of Pall Mall, Route 66, American Legend and a number of growing illicit white brands increased in 2011

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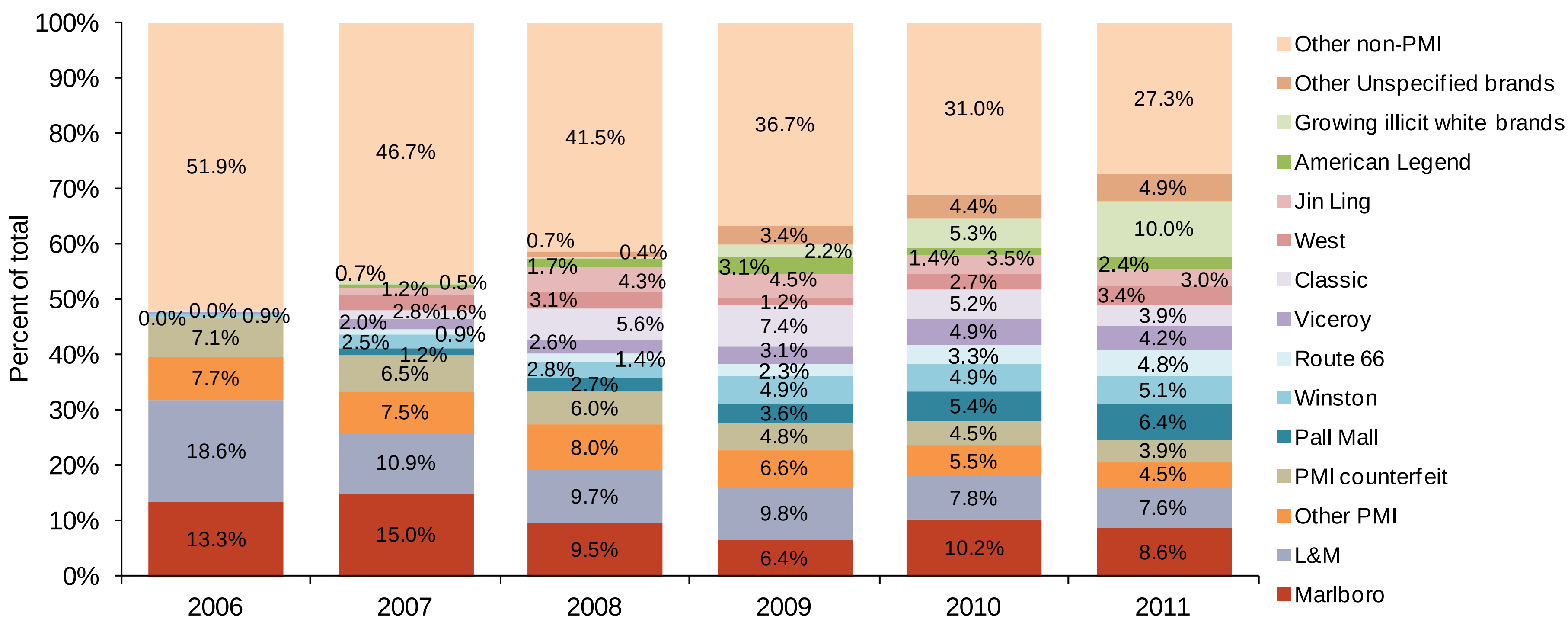
C&C inflows by brand, 2006-2011[(1)(a)]



Note: (a) Growing illicit brands include; Austin, CK, Ducal, Fast, Fest, Gold Mount, GR, Kiss, Magnat, Marble, Minsk, NZ, Premier, Queen and Raquel

Source: (1) KPMG analysis based on Empty Pack Surveys, legal domestic sales and non-domestic (legal) research

Summary of source markets and brand analysis

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The share of counterfeit and contraband originating from outside the EU remained broadly stable in 2011 at 60%

- Unspecified packs are now the largest source of illicit products from outside the EU, accounting for 11%
- Flows from Russia and Ukraine have decreased, while Belarus has become a major source
- Poland and the Czech Republic remain the main source markets of contraband originating from EU Member States

Consumption of Unspecified products increased rapidly to 7.0 billion cigarettes in 2011

- Karelia, Kaanee American International Tobacco and H.Van Landewyck were the largest suppliers of Unspecified product, representing a combined share of 44% of the EU total in 2011
- The growth in Unspecified products has been driven by increased consumption in the Mediterranean countries

Illicit white volumes increased to 24% of total EU counterfeit and contraband, exceeding 15 billion cigarettes in 2011

- Whilst consumption of Classic and Jin Ling further declined in 2011, volumes of American Legend increased to 1.5 billion cigarettes due to increased penetration in France
- A number of growing illicit white brands continued to increase in 2011, reaching a combined volume of 6.5 billion cigarettes
- There were 18 illicit white brands with inflows greater than 200 million cigarettes in 2011

The share of counterfeit and contraband accounted for by Marlboro, Viceroy and Classic declined in 2011

- Increased C&C levels were observed for Pall Mall, Route 66 and American Legend
- The biggest movement in share of C&C was the continued growth of a wide range of relatively small volume illicit brands

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Genuine PMI product share of EU counterfeit and contraband consumption declined to 20.7% in 2011

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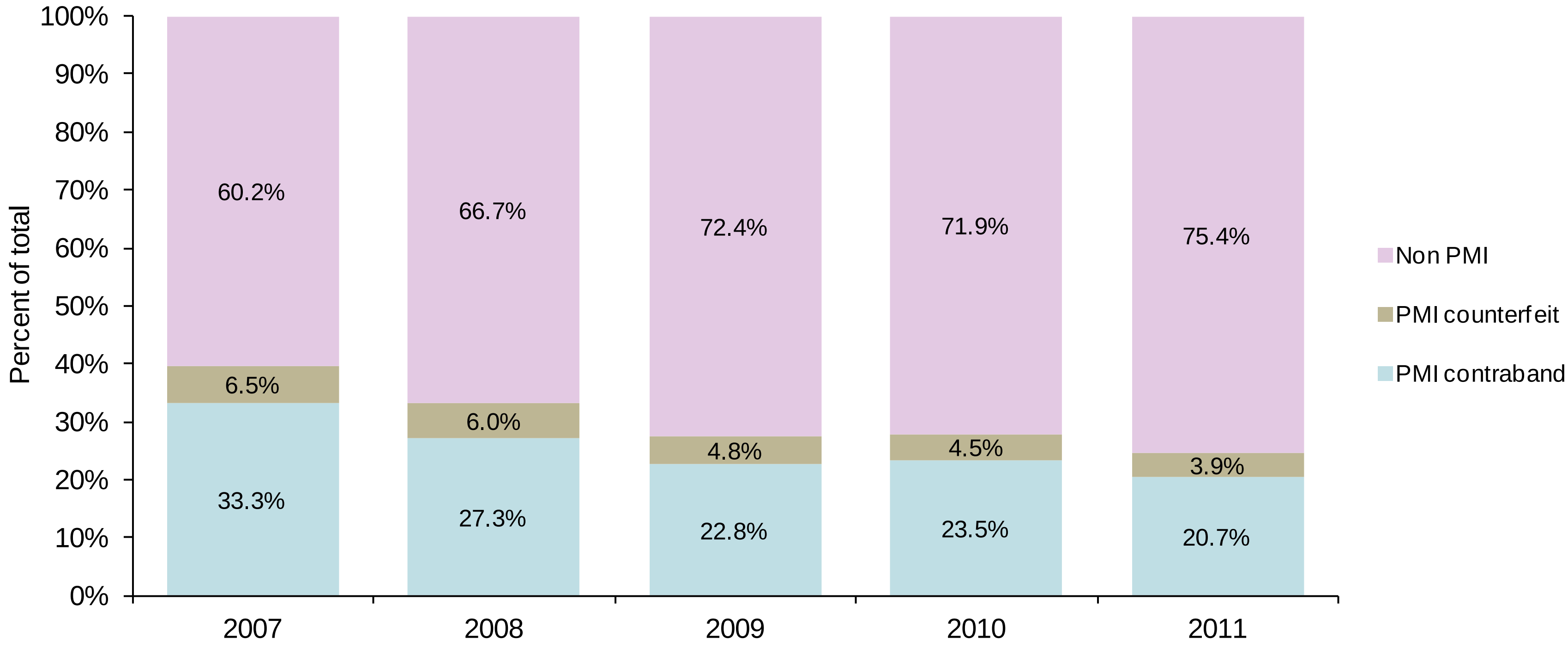
PMI share of C&C consumption, 2006-2011[(1)]



Source: (1) KPMG analysis based on Empty Pack Surveys, legal domestic sales and non-domestic (legal) research

Consumption of counterfeit of PMI products declined to 2.6 billion cigarettes in 2011

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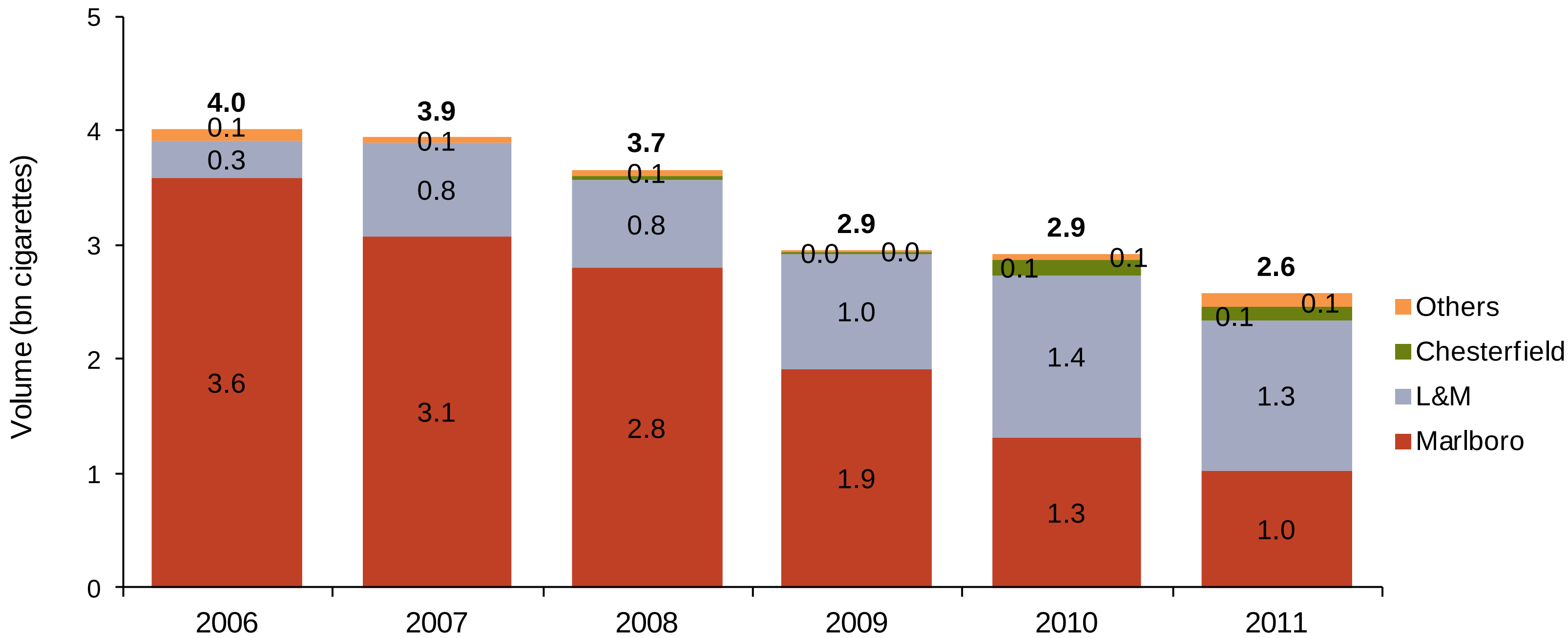
Consumption of counterfeit of PMI products, 2006-2011[1]



Source: (1) KPMG analysis based on Empty Pack Surveys, legal domestic sales and non-domestic (legal) research

Germany, France and Italy were the largest destination markets for counterfeit PMI products

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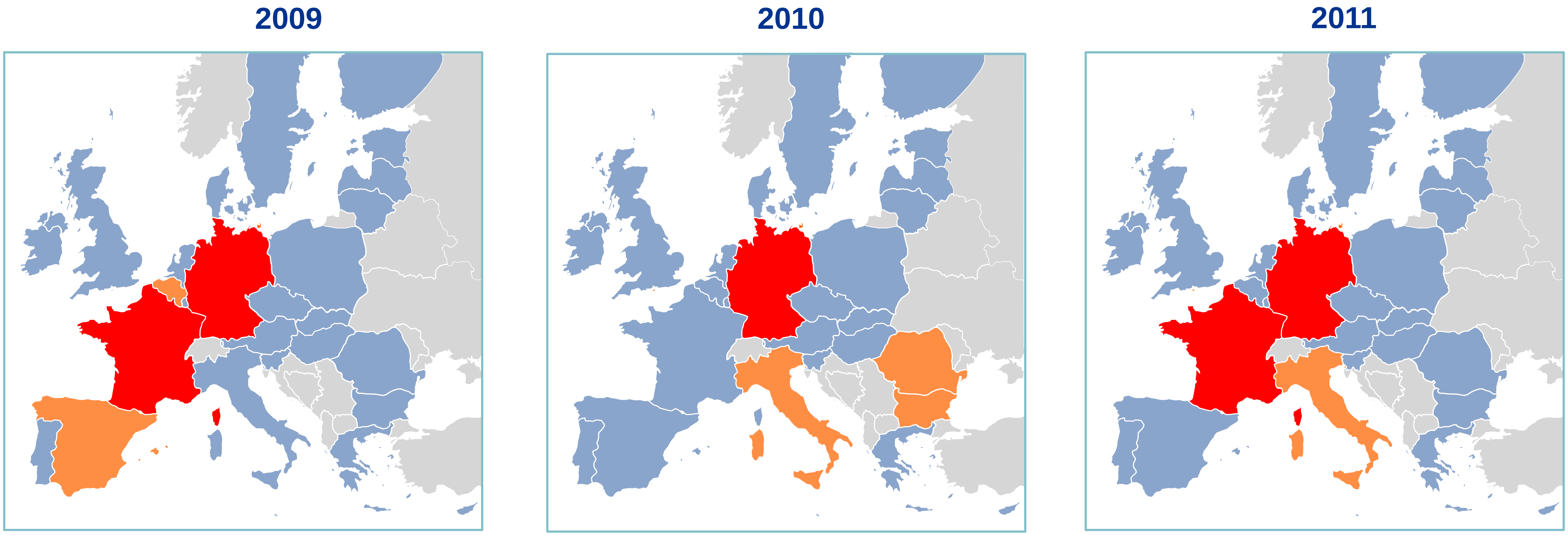
Consumption of counterfeit versions of PMI brands, 2009-2011[(1)]



Key:
- Less than 200 million cigarettes
- 200 to 400 million cigarettes
- More than 400 million cigarettes

Source: (1) KPMG analysis based on Empty Pack Surveys, legal domestic sales and non-domestic (legal) research

Summary of PMI counterfeit & contraband levels

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Genuine PMI product share of counterfeit and contraband continued to decline, reaching 20.7% in 2011

- The share of C&C consumption accounted for by counterfeit of PMI brands also declined, down to 3.9% in 2011.

Consumption of counterfeit PMI products declined to 2.6 billion cigarettes in 2011

- The volume of counterfeit Marlboro declined from 1.3 billion cigarettes in 2010 to 1.0 billion in 2011.
- Counterfeit L&M declined by 0.1 billion cigarettes to 1.3 billion in 2011.

Germany, France and Italy were the largest destination markets for counterfeit PMI products

- Germany remained the biggest destination market for counterfeit PMI products in 2011.

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- EU cigarette consumption fell by 3.1% in 2011
- Despite this, the volume of counterfeit and contraband increased to 65.3 billion cigarettes; equivalent to 10.4% of total consumption
- Rapid growth in counterfeit and contraband consumption has been most apparent in Mediterranean countries, in particular in Spain and Greece
- In 2011, counterfeit and contraband share of consumption in Eastern border countries declined to close to 2009 levels, whilst Latvia, Lithuania and Bulgaria remained the countries with the highest illicit levels in the EU
- Counterfeit and contraband volumes increased slightly in the Western and Central EU countries in 2011, driven by France and Germany
- Illicit white brands increased to 24% of counterfeit and contraband volumes driven by a large number of growing brands and Unspecified variants
- Consumption of Unspecified variants increased rapidly to 7.0 billion cigarettes
- PMI share of counterfeit and contraband in the EU declined to 20.7%

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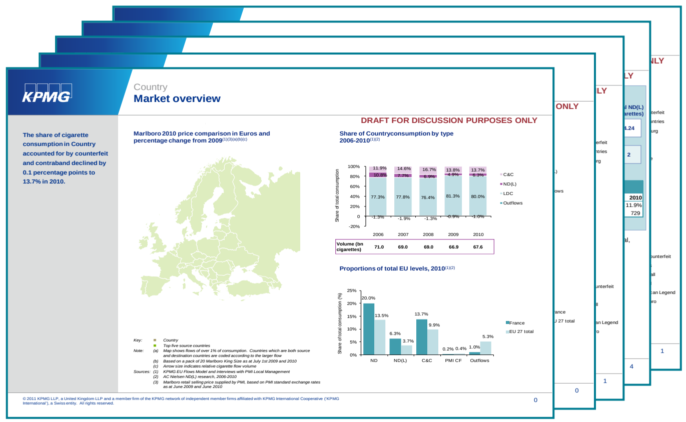
Copies of both this presentation and individual country results for 2011 are available for your collection after this meeting



Country results follow a similar structure to previous years and will provide an overview of the total consumption and legal sales trends and detail of both the counterfeit and contraband and non-domestic (legal) results

cutting through complexity™