E-Cigarettes, Vapor & E-Cigars EPPS
Vapor, Smoke and Mirrors
Key Trends Facing the Industry

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All estimates/forecasts are as of 2/6/15 unless otherwise stated.

Please see page 39 for rating definitions, important disclosures and required analyst certifications and to view price charts.

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Discussion Topics

- Total Tobacco Industry Consumption and Distribution Trends
- Reynolds’ Acquisition of Lorillard – Value Creating Transaction
- Should Be a Favorable Cig Pricing Environment in 2015
- Vapor Consumption Could Surpass Combustible Cigs in 10 Years...
- ...But Near Term, Vapor & E-Cig Growth is Decelerating
- Vapors/Tanks/Mods – Key Trend to Watch in Our View
- Vape Shops Popping Up All Over
- Retailers Divided on Best Way to Merchandise Vapor Category – “Tobacco Talk” Survey Takeaways
- Who Will Win the Vapor War?
- FDA Regulation Continues to be a Hot Topic
- What Is On The Top of Retailers’ Minds?
**Tobacco Industry Volume Outlook**

- **Total cigarette volume declining around 3-4% per year** – but still $80 billion in U.S. retail sales.

- **Premium Brands’ share is declining** – now ~70% of total industry volume, down from 91% in 1984.

- **“Other” tobacco product (OTP) category and e-cigs** – provide growth opportunity in our view, though smokeless tobacco growth is slowing.

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**Total Tobacco Volume: Premium and Discount**

- CAGR '96-'14E = -4.1%
- CAGR '08-'14E = -5.9%

**Total Smokeless Volume**

- CAGR '96-'14E = 4.4%
- CAGR '08-'14E = 5.5%

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Source for both graphs: Company data and Wells Fargo Securities, LLC estimates
Vapor Revolutionizing Tobacco Industry

Vapor Consumption (e-cigs and vapors/tanks/mods or VTMs) could surpass combustible cigs in 10 years

The combined profit pool could grow at a CAGR of 6.6% over the next decade

Source for graphs: Company data and Wells Fargo Securities, LLC estimates
Distribution Channels – Convenience Still Winning

- Convenience continues to take tobacco share from other channels
- Dollar stores have entered category (Family Dollar and Dollar General)
- Leading drug store CVS has stopped selling tobacco products – c-stores experiencing halo effect on tobacco sales
- Vape Shops – a trend to monitor

Retailer Comment – “Some pressure from Vape shops on our e-cig business. However, helping to grow the product and awareness.”

Retailer Comment – “Dollar Stores will show continued growth and will be stealing share from entrenched retailers.”

Source for data and charts: Wells Fargo Securities, LLC Tobacco Talk Retailer Surveys

Wells Fargo Securities, LLC
RAI/LO Combination: Value Creating Transaction for LT Shareholders

- Reynolds is divesting its Kool, Winston, and Salem brands to Imperial – as well as the blu e-cig brand - Marty Orlowsky (former Lorillard CEO) is to oversee Imperial’s U.S. Operations.

- Reynolds formalized its strategic partnership with BAT

- Probability of BAT acquiring Reynolds now higher in our view (Reynolds has not weighed in on this)

- Vast majority (98%) of retailers believe deal will get approved, albeit with additional brand divestitures, though market is pricing in only ~65% probability as shown below:

- RAI-LO transaction may spark further industry consolidation with e-cigs/vapor as the catalyst

Source: Wells Fargo Securities, LLC estimates
RAI/LO Combination: What Does It Mean for Retailers?

- Retailers see both pros & cons to RAI-LO combination
  - Stronger competitor to Altria welcomed
  - Lower cig margins remain a concern
- Vapor expected to flourish - Lower vapor margins from Big 3 remain a concern
- Majority of retailers believe no impact to pricing
- Impact on retailer gross margin – majority believe retailer gross margins on cigarettes would go down
- Retailers generally positive on RAI-LO Combination’s impact on overall vapor category - Many believe this would create higher barriers to entry for smaller brands

BOTTOM LINE:

RAI-LO combination both positive & negative in our opinion – competition should be lower, but Altria could be better kept “in check” and retailers would have one less rep and complexity to deal with
Expect Robust Cigarette Net Price Realization in 2015

- Large stockpiles of cash getting larger
- Pricing not as critical to drive top line
- Manufacturers Realize 2.5x More Earnings Leverage on a Point of Pricing vs. a Point of Volume

We expect strong cigarette net pricing over the next few years – close to the long-term average of ~6%.

Source for graphs: Company data and Wells Fargo Securities, LLC estimates

Bonnie Herzog - Wells Fargo Securities, LLC | Beverage & Tobacco Sectors
Price Increases Helping Manufacturers More Than Retailers

- “Tobacco Talk” survey respondents said price increases do not have much of a positive impact on retailer gross profit margins
- Cigarette gross profit margins continue to decline for retailers
- Environment expected to remain challenging

Retailer Comment – “Slight increase for the retailer but most of the money is going to the manufacturer.”

Source for data and charts: Wells Fargo Securities, LLC Tobacco Talk Retailer Surveys
C-Store Vapor Growth Remains Robust (>20%) But Slightly Moderating

- Vapor taking total tobacco share, currently ~4%,
- Total e-cig/vapor retail size likely around $3.5b by end of 2015
- Vapor is to tobacco what energy drinks are to beverages –
  - Profitable and quickly growing in volume and shelf space at retail
  - Increasingly gaining consumer acceptance

Source for data and charts: Wells Fargo Securities, LLC Tobacco Talk Retailer Surveys
2015 Vapor Market Size – $3.5B in the U.S.

Vapor consumption could surpass combustible cigs in 10 years

Expected 2015 Vapor Market Size – $3.5B

- E-Cigarettes $1.5B
  - C-Store, Food, Drug and Mass Retail Channels $700M
  - Online and Other Retail Channels $800M
  - Online $400M
  - Other $400M*

- Vapors/Tanks/Mods & Personal Vaporizers $2.0B
  - Online and Other Retail Channels $400M
  - Vape Shops $1,200M
  - C-Store, Food, Drug and Mass Retail Channels $400M

Source: Nielsen C-Store Database, Wells Fargo Securities, LLC estimates
*Other Non-Tracking channels include tobacco-only outlets and other e-cig retail locations.
2015 Global Vapor Market Size – Exceeds $7B

- According to our Independent Vapor Manufacturer Survey, the global market for vapor products expected by the end of 2015 is ~$7.3B
- There are more than 19,000 vape shops globally – about half of which are in the U.S.

![Vape shops in the U.S. and Globally](chart.png)

Source: Wells Fargo Securities, LLC estimates and Tobacco Talk Surveys
Vape Shops Impacting E-Cig Sales: Increasing Awareness and Consumer Education

- Vape shops opening up around the country
- 62% of retailers say they are impacting e-cig sales
- 15% expect a negative impact in the future.

Source for data and chart: Wells Fargo Securities, LLC Tobacco Talk Retailer Surveys

Bonnie Herzog - Wells Fargo Securities, LLC | Beverage & Tobacco Sectors
Public Perception of the Vapor Category is Deteriorating

- The % of people who believe vapor/e-cigs are just as harmful as combustible cigs doubled in 2014 vs. 2013 to 15%
- However, category momentum continues and we expect ~40% growth in 2015

![Public Perception of Safety of Vapor/E-Cigs Relative to Combustible Cigs](chart)

Source: Action on Smoking and Health, Wells Fargo Securities, LLC

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Wake Up Call! Action Needed to Keep Vapor Momentum Alive

We’re Increasingly Concerned That Action is Needed For Vapor Momentum to Continue

“Tobacco Talk” Survey – Highlights Key Issues:

1) FDA must take leadership and act soon to improve consumers’ increasingly negative perception of the relative risks of vapor and uncertainty surrounding the category;

2) The industry must align, particularly to push for modified risk claims so that public perception doesn’t deteriorate further; and

3) Vape shops need to be regulated more closely as they are “playing by their own set of rules” potentially harming the industry’s reputation.

We Remain Bullish Long-Term

- We still believe consumption of vapor and other non-combustibles (such as heat-not-burn) could surpass consumption of combustible cigs in the next decade (by 2023).
- Technological innovation is crucial
- Big Tobacco will be pivotal in shaping the non-combustible nicotine industry
Vapors/Tanks/Mods (VTM): Not Your Father’s E-Cig

- Typical VTM user - former smoker, tried e-cigs, but quickly moved to tank-style systems and eventually mods

- Vaping substantially more affordable than combustible cigs and rechargeable e-cigs

- “Open system” VTM's not emulating the razor/blade model since any juice can be used with any VTM –
  - LOGIC Pro and blu+ are “closed” system – hitting shelves over next few months

- VTM's could be a threat OR potential opportunity for Big Tobacco

VTMs Taking E-Cig Share - Growing 3x Faster Than Vapor Category

- VTMs overwhelmingly taking e-cig share according to our “Tobacco Talk” surveys
- VTM growth expected to continue in 2015
- Average VTM consumer's weekly spend about 30% less than e-cig consumer’s weekly spend
- VTMs provide: (1) greater consumer satisfaction; (2) an attractive “vaping lifestyle” factor; and (3) better affordability

Source for data and charts: Wells Fargo Securities, LLC estimates and Tobacco Talk Retailer Surveys

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Mix Shift to VTM\textsuperscript{s} Taking Place in the U.S. and Globally

- Mix shift of E-Cigs to VTM\textsuperscript{s} Is 45\%/55\% Currently in the U.S. – From 65\%/35\% A Year Ago
- Global Mix of E-Cigs to VTM\textsuperscript{s} is 50\%/50\%

Source for data and charts: Wells Fargo Securities, LLC estimates and Tobacco Talk Retailer Surveys

Bonnie Herzog - Wells Fargo Securities, LLC | Beverage & Tobacco Sectors
VTM Traction at Retail Continues

- **Vast majority of retailers carry or plan to carry E-cigs & VTM:s**
- **Increasing prevalence of VTM:s could be somewhat marginalizing the “cig-alike” e-cigs but, incrementally growing the overall “Vapor” category**

Source for data and charts: Wells Fargo Securities, LLC Tobacco Talk Retailer Surveys

*Bonnie Herzog - Wells Fargo Securities, LLC | Beverage & Tobacco Sectors*
Vapor Repeat Purchases Surpass Trial Purchases

- Nearly 60% of total vapor sales are repeat purchases
- Significant dual use of cigs and e-cigs

Source: Wells Fargo Securities, LLC Tobacco Talk Surveys
Vapor Displacing >4% of Combustible Cig Volume

- Dual Use (~19% of Vapor Consumers) Is More Prevalent Than Full Conversion (~8% of Vapor Consumers)
- Conversion is HIGHER for VTM Consumers (8% vs. 7.4% for E-Cig Consumers) – Bodes well for Better Performing Products
- Retailers Believe 4.3% of Combustible Cigarette Volume is Being Displaced by the Vapor Category – Speaks to Vapor’s Potential – Still Early Innings

Source for both charts: Wells Fargo Securities, LLC estimates Tobacco Talk Surveys
Combustible Cig Volumes Not Declining As Much As Expected

- One key reason is dual use remains high
- According to Lorillard, 47% of adult smokers have tried e-cigs with 24% having used in the past 3 months and 15% in past 7 days

Source: Wells Fargo Securities, LLC estimates, company reports

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Revenue mix of E-cigs to VTM expected to be ~55/45% in 6 months compared to ~65/35% today

Source for data and charts: Wells Fargo Securities, LLC Tobacco Talk Retailer Surveys

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Vapor Gaining Share and Shelf Space From Combustible Cigarettes

- E-cigs and VTM s continue to take shelf space
- E-cig growth driven by
  - Increased advertising spend
  - Greater visibility at retail

Source for data and charts: Wells Fargo Securities, LLC Tobacco Talk Retailer Surveys
Vapor Trends at Retail Shifting to VTM from E-Cigs

- Mixed feedback on VTM introductions from NJOY and FIN
- However if retailers can look beyond the companies' recent e-cig trends, their new VTM offerings show promise

Source for chart: Wells Fargo Securities, LLC Tobacco Talk Retailer Surveys

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E-Cigs 3x More Profitable to Retailers Than Combustible Cigs

- E-cig margin trends vs. Combustible cigs improving for retailers
- We expect retailers to continue to embrace vapor – cigarette gross profit margins for retailers remain on downward trend
- Independents offer higher margins than Big Tobacco

Source for data and charts: Wells Fargo Securities, LLC Tobacco Talk Retailer Surveys

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E-Cig Growth Continues to Decelerate

- C-stores Reign Supreme in E-Cig Distribution – Retailers Drawn to E-Cigs for Fat Margins and "Low Maintenance" Selling (No Controlling Contracts)

- Technology Must Improve for E-Cigarette Growth to Re-Accelerate In Our View

- E-Cig Volume Increasing Driven by Vuse and MarkTen - But $ Sales Not Growing as Fast Given Heavy Discounting

E-Cigarette Growth [Q/Q]

<table>
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<tr>
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<th>Accelerated</th>
<th>Stayed the Same</th>
<th>Decelerated</th>
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<td>Q4 2013</td>
<td>54.1%</td>
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<td>Q2 2014</td>
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<td>Q3 2014</td>
<td>27.0%</td>
<td>25.8%</td>
<td>23.9%</td>
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<tr>
<td>Q4 2014</td>
<td>26.1%</td>
<td>27.0%</td>
<td>25.8%</td>
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</table>

Annual Growth of E-Cigarettes

- E-Cig growth is decelerating

Source for data and charts: Wells Fargo Securities, LLC Tobacco Talk Retailer Surveys
E-Cig Growth Continues to Decelerate Per Nielsen Data

- Annual Growth Estimated To Be ~10%
- Category Growth in Measured Channels Decelerating
- However, Category Growth Improved with National Rollouts from Reynolds & Philip Morris USA

Why?

1. The Need for the Next Step Function in Innovation
2. Emerging Vapors/Tanks/Mods Vapor Products Could be Marginalizing the “Cig-alike” E-Cigs but Incrementally Growing the Overall Vapor Category

Source: The Nielsen Company and Wells Fargo Securities, LLC.
“Nationwide” e-cig launches by Altria and Reynolds have taken share from Lorillard

In the recent Nielsen period, Reynolds and Altria took 35% and 5% share in c-stores, respectively.

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Source: The Nielsen Company and Wells Fargo Securities, LLC, last 12 months retail value tracked by Nielsen $551M
Lorillard’s blu Ceding Share as Vuse and MarkTen Go Nationwide

- Lorillard’s blu has lost share – and expected to fall further as Vuse and MarkTen expand nationwide

- Reynolds and Altria are heavily utilizing coupons, other promos & consumer engagement strategies to drive trial and awareness of Vuse and MarkTen

- Excited about VTMs blu+ and LOGIC Pro, coming out in next few months

Source for data and charts: Wells Fargo Securities, LLC Tobacco Talk Retailer Surveys
Bonnie Herzog - Wells Fargo Securities, LLC | Beverage & Tobacco Sectors
Quotes on VTMss From our Recent “Tobacco Talk” Surveys

- “Tanks are growing faster than all other categories.”
- “Looks like a growth segment we can't ignore.”
- “Outpacing all traditional E-Cigs in sales....Higher margins and consumer satisfaction is amazing.”
- “Be careful here!! These are likely ‘target one’ of regulation.”
- “Looking forward to getting Vaporizers and e-liquids rolled out in test sites to see how they perform.”
- “E-Cigs are slowing dramatically now that vapors have hit the streets.”
- “As the consumer became more aware of the Vapor devices we are seeing sales move from E-Cigs to the Vapor side.”
- “Vapor is what help us to accelerate sales.”
- “The liquid vapors are coming on strong.”

Source: Wells Fargo Securities, LLC Tobacco Talk Surveys
Retailers Divided on Best Way to Merchandise E-cigs

- Retailers want a separate E-Cig section to merchandise effectively, preferably near conventional cigarettes.
- Lack of counter space remains a challenge.

Source: Wells Fargo Securities, LLC Tobacco Talk Surveys
Who Will Win The Vapor War?

- “Big Tobacco” presents a triple threat in our view – plentiful cash, strong distribution power, superior brand building capabilities

- Plenty of room for several other players including: Logic, NJOY, Mistic, Fin, 21st Century and Krave

- We expect growth of the combined profit pool for e-cigs & combustible cigs will increase 6.6% in the next decade in our view (above the 4-5% historical growth for cigs)

- Big Tobacco incentivized to switch consumers to e-cigs given MSA payments tied only to combustible cigs

- Big Tobacco may have no choice but to enter the vapor/tank category either organically or via acquisition. However, we see a few challenges:
  1) distribution of vapors/tanks is primarily online and in vape shops, channels over which big tobacco has limited control (this would also be a challenge for c-store retailers)
  2) limited branding and commoditization of vapors/tanks
  3) potential compression of revenue pool given lower spend per consumer on vapors/tanks
FDA Deeming E-Cigs Regulation

Highlights Include:

- Companies can keep existing products on the market and can bring new products to market – this is key in our view since continued innovation is critical to future growth;
- No free samples;
- No sale to anyone under age 18;
- No health claims in advertising;
- Must register ingredients with the FDA; and
- Must have a warning label stating nicotine is addictive but this isn’t required until 2 years after rule is finalized

Proposal Did NOT Include:

- Restrictions of flavors (although this could be re-evaluated later);
- A ban on internet sales to adults; and
- A ban on t.v. advertising

Bottom line, e-cig/vapor regulations should ultimately increase the barriers to entry. For now, regs don’t seem onerous for retailers which is positive in our view.
## E-Cigarette/Vapor Taxation: States Have Started to Pursue

<table>
<thead>
<tr>
<th>State</th>
<th>Rate</th>
<th>Status</th>
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<tbody>
<tr>
<td>North Carolina</td>
<td>$0.05 per mL of nicotine liquid</td>
<td>Passed</td>
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<tr>
<td>Minnesota</td>
<td>95% OTP</td>
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<tr>
<td>Hawaii</td>
<td>Actual wholesale cost</td>
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<td>Indiana</td>
<td>24% OTP</td>
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<td>Kentucky</td>
<td>15% and 20% OTP</td>
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<td>New Jersey</td>
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<td>75% OTP</td>
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</tr>
<tr>
<td>Ohio</td>
<td>$1.85 Cigarette Tax</td>
<td>Pending</td>
</tr>
</tbody>
</table>

*Source for table: Wells Fargo Securities, LLC, National Association of Tobacco Outlets (NATO)*
What is on the Top of Retailers’ Minds?

- Most Excited About:
  - Growth of vapor/tanks/mods
  - Altria and Reynolds’ national launches of MarkTen and Vuse
  - Moist tobacco rebounding
  - Increasing innovation across the board

- Most Concerned About:
  - Taxes on the category
  - Profit erosion for retailers
  - Continued consumption decline for the tobacco category and how the c-store channel should think about merchandising
  - Manufacturers’ low commodity-style price points for e-cigs
  - FDA regulations that could ultimately stifle innovation once finalized
In Conclusion…

So we wonder:

Is this the beginning of the end of combustible cigarettes?
Disclosures

LO Basis and Risks: Our valuation range of $69-71 implies a forward EV/EBITDA multiple of 10.4x and a forward P/E multiple of 16.4x, above historical averages, but in-line with RAI’s acq. terms. Risks include unfavorable regulation and increased competition in cigarettes.

RAI Basis and Risks: Our valuation range of $79-81 assumes an 11.8x forward EV/EBITDA multiple and an 18.4x forward P/E multiple, both above RAI’s historical averages. Risks to our valuation include increased competitive pressure within the category and a pullback in consumer spending.

MO Basis and Risks: Our valuation range of $59-61 is based on a 12.5x forward EV/EBITDA multiple and a 19.4x forward P/E multiple—both premiums to historical averages, which we believe are justified given MO’s total tobacco strategy. Risks include increased price competition and increased downtrading by consumers.
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LO: Risks include unfavorable regulation and increased competition in cigarettes.
MO: Risks include increased price competition and increased downtrading by consumers.
RAI: Risks to our valuation include increased competitive pressure within the category and a pullback in consumer spending.

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3=Underperform: The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

SECTOR RATING
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M=Market Weight: Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.
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