

U.S. Tobacco Industry 2Q 2017 Preview

Tobacco

MO Balancing Profitability & Market Share Pressures

USD	Rating		Price	FY EPS				FY P/E	
Ticker	Curr.	Prior	07/14/17	2017E	Prior	2018E	Prior	2017	2018
Tobacco, Overweight									
MO	1	NC	73.93	3.28	3.30	3.57	3.59	22.5x	20.7x
RAI	2	NC	65.56	2.54	2.55	2.76	2.77	25.8x	23.8x

Source: Company data and Wells Fargo Securities, LLC estimates

1 = Outperform, 2 = Market Perform, 3 = Underperform, V = Volatile, * = Company is on the Priority Stock List
 NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful

• **Thoughts on MO & RAI Heading Into Q2 & Our Outlook For FY17**

– We're lowering our Q2 EPS est. for MO by \$0.02 to \$0.86 (+6.2% y/y) and our Q2 EPS est. for RAI by \$0.01 to \$0.64 (+10.9% y/y) as we believe both faced greater pressure from the CA excise tax increase and lower-priced brands. Although we expect strong pricing, given the early price increase, we're now anticipating slightly softer topline growth. Q2 expectations include: **(1) topline growth** of +1.7%/+2.8% for MO/RAI; **(2) cig vol to decline** -3.9% for MO and -3.4% for RAI (incl +0.9% Newport); **(3) solid net price realization** of +5.7%/+4.9% for MO/RAI; **(4) smokeless volume** of -2.8%/+2.3% MO/RAI; and **(5) op margin expansion** of +290bps/+255bps for MO/RAI. Due to n.t. pressure on Marlboro vol/share largely related to CA's \$2/pk excise tax increase & lower priced brands as well as lingering neg impacts from its USSTC recall, we expect MO to maintain its 7.5%-9.5% adj. diluted FY17 EPS growth guidance (and not raise the midpoint by 50bps as it has in every Q2 over the last 5 years). We expect MO to take a cautious approach to full year expectations while it continues to execute its l.t. strategy to maximize core tobacco profitability & modest share gains. For the industry, we expect cig vol to decline 3.8% in FY17 reflecting the full impact of CA's cig tax increase with strong price realization (+5-6%) to largely offset vol pressure, aided by favorable macro tailwinds supporting a strong adult tobacco consumer. **Bottom line, we see a negative risk/reward on MO ahead of Q2 but encourage l.t. investors to build positions on any weakness in the stock.**

• **More Thoughts on MO** – We expect volume to be a major focus this quarter as MO battles pressure on two fronts: **(1) CA cig tax hike**, and **(2) lingering effects of USSTC's January recall of smokeless products**. On cig volume, we expect Marlboro/total vol to decline 4.5/3.9% as a result of MO's sizeable exposure to CA. Retailers participating in our recent "Tobacco Talk" survey were also slightly more cautious on Marlboro's share this year with 37% expecting losses vs 25% in Q1 (see charts below) as trends are softening and the brand is facing greater pressure from lower-priced brands. Nielsen data further substantiates these trends (see charts below). In smokeless, most of our retailer contacts indicated lingering negative effects of the recall, including out-of-stocks and "problems with a few select SKUs," although for the most part, retailers confirm that inventories are "close" to being fully replenished. **Bottom line** – Despite well-telegraphed volume pressure, we expect MO to drive solid Q2 profitability supported by its early list price increase in March (usually a May event). As such, we anticipate strong net price realization of +5-6% in FY17, which should support strong OCI margin expansion (+260bp) and +8.3% EPS growth, the midpoint of MO's 7.5-9.5% FY17 EPS growth guidance.

Please see page 12 for rating definitions, important disclosures and required analyst certifications. All estimates/forecasts are as of 07/16/17 unless otherwise stated. 07/16/17 21:39:39 ET

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Together we'll go far

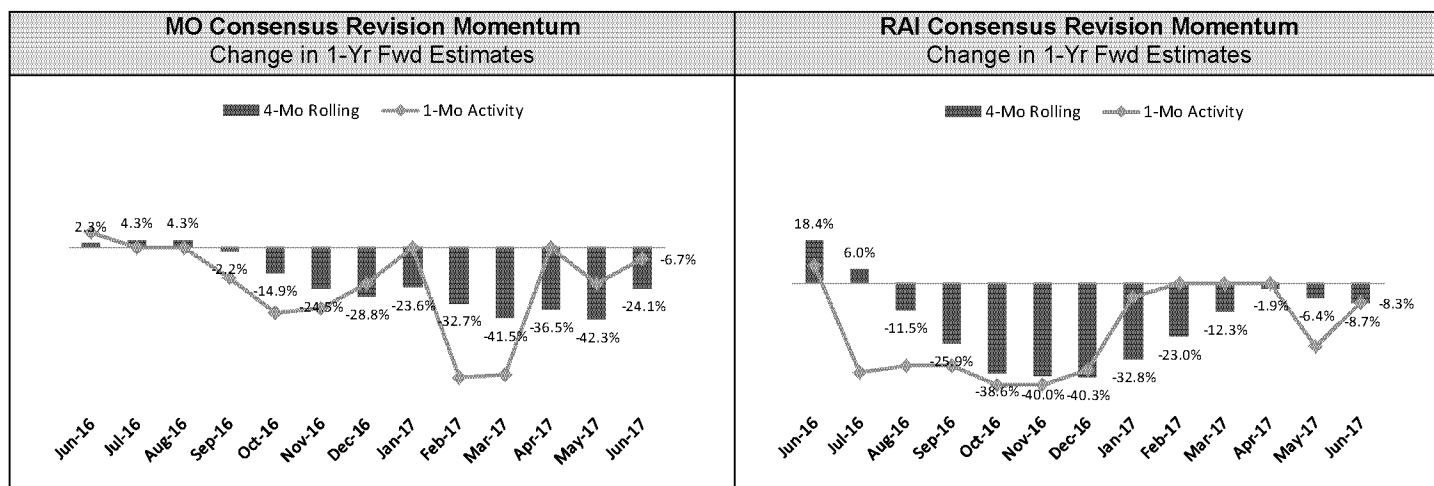


- **Our Thoughts on RAI** – Given the imminent closure of BAT-RAI on or around July 25, we don't expect RAI to release results or hold a call. However, we maintain our bullish view on RAI's l.t. prospects under BAT as we see a long runway of growth ahead for RAI's Newport and Natural American Spirit (NAS) with limited risk from city-level menthol bans as we expect consumers to simply find other means to acquire the product (online, cross border, or black market) or revert back to non-menthol cigs (see our recent report, "*Menthol Bans – The Domino Hasn't Fallen*"). Over the l.t., we expect Newport & NAS to buoy RAI cig vol performance, and also see an opportunity for BAT to take RAI's VUSE platform to int'l markets.

Observations / Trends We Are Seeing Around MO & RAI

MO Full Year Guidance Trends Adj. Diluted EPS Growth Guidance Midpoints	More Retailers in Our "Tobacco Talk" Survey Expect Marlboro To Cede Market Share in 2017 Than Last Qtr												
<p>Guidance for FY</p>	<p>Mkt Share Expectations for Marlboro Brand in 2017 Wells Fargo "Tobacco Talk" Survey</p> <table><thead><tr><th></th><th>1Q17</th><th>2Q17</th></tr></thead><tbody><tr><td>Gain share</td><td>50%</td><td>44%</td></tr><tr><td>Lose share</td><td>25%</td><td>36%</td></tr><tr><td>No change</td><td>25%</td><td>21%</td></tr></tbody></table>		1Q17	2Q17	Gain share	50%	44%	Lose share	25%	36%	No change	25%	21%
	1Q17	2Q17											
Gain share	50%	44%											
Lose share	25%	36%											
No change	25%	21%											
<p>"We are seeing Marlboro share pressure within the southeast (however, not related to California tax hike). Share pressure is from lower tier brands (L&M and American Spirit) and also in menthol segment (Newport)."</p> <p>"Marlboro is staying about the same in my areas, no significant change either way."</p> <p>"Yes, Marlboro is facing pressure. I believe the losses are due to growth of Newport, Kool and Winston."</p> <p>"Marlboro is failing due to a confused consumer message, reduced promotions, and a lack of support for their higher priced brands."</p> <p>"Marlboro Mainline has taken the biggest hit in our CA stores, all other states CO, OR and WA slightly up."</p> <p>"Yes, they are increasing discounting in states with low-end pressure and also increasing the length of time to run their business enhancement funds."</p>													
Retailers Remain Bullish on Newport Brand Expected to Gain >85bps of Incremental Share in 2017	Retailers Still Expect RJR to Win Most New Shelf Space in '17; Excitement Builds Around Newport Platinum Launch												
<p>Simple Hist Avg</p> <p>Outlook for 2015E</p> <p>Outlook for 2016E</p> <p>Outlook for 2017E</p>	<p>To Gain the Most</p> <p>To Lose the Most</p>												
Retailer Comments													
<p>"Yes, Newport Platinum is arriving in our stores this week. Very attractive packaging - especially for the 21-34 old smokers."</p> <p>"Newport Platinum looks pretty nice."</p> <p>"Newport is buying share in our market with 50c off on pack promotions. Newport Box King and Box 100s are our #1 and #3 share SKUs and these promotions are building on those strong share numbers. Newport platinum will be an interesting brand and I expect it to gain some share at the expense of several of the Marlboro SKUs."</p> <p>"Newport Platinum is the only new addition. Expectation is a .4 share on this packaging. Doubtful they will see growth from the new line extension."</p> <p>"Newport is growing here, and RJR is bringing out another line, Platinum. ITG is trying, but I don't believe they can keep promoting as they have."</p>													

Source: Company reports, Wells Fargo Securities, LLC estimates



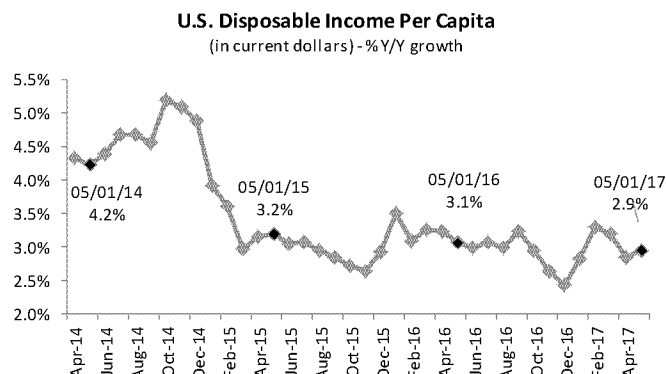
Source: Company reports, Wells Fargo Securities, LLC estimates

Big Picture – Macro & Fundamentals

- **Macro trend - Consumer:** U.S. Consumer In Good Shape Boosted By A Strengthening Economy, Improved Job Prospects, Wage Growth, & Confidence
- **Macro trend – Gas Prices:** Strong Negative Correlation Between Cig Industry Vol & Changes in Gas Prices Suggest Cig Vol Deceleration Could Start to Ease in 2018, All Else Being Equal
- **Fundamentals – MO/RAI:** We See Company Cig Sales Outpacing The Category On Healthy Pricing & Improved Premium Mix

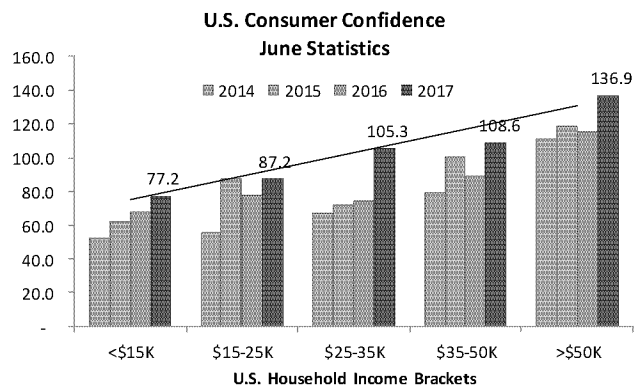
U.S. Consumer Remains on Solid Footing

Disposable Income Gains Supports Healthy Consumption



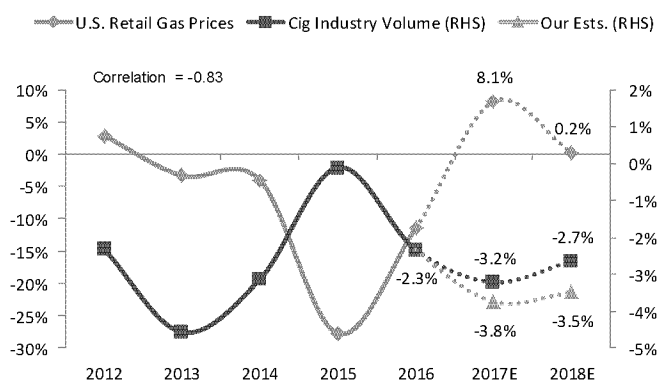
Consumer Confidence Up On Job Market & Income Growth

U.S. Consumer Confidence By Household Income Bracket



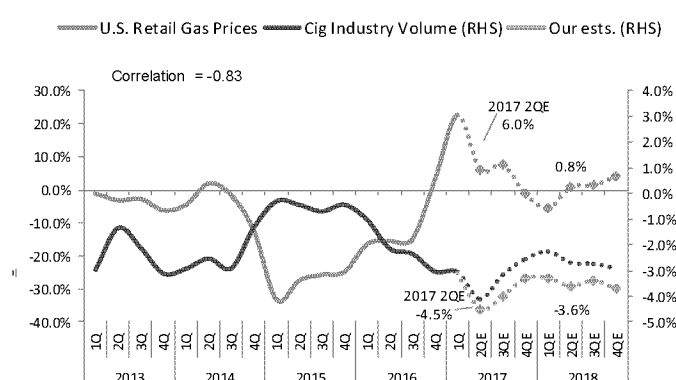
All Else Equal, Cig Vol Deceleration Should Start to Ease

Cig Industry Volume vs U.S. Gas Price Trends - ANNUAL



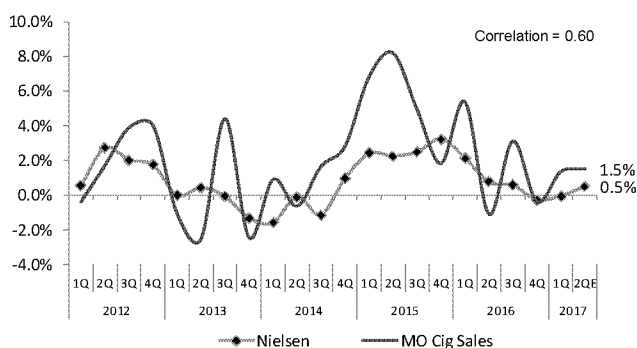
Cig Volumes Show Strong Correlation to Gas Price Trends

Cig Industry Volume vs U.S. Gas Price Trends - QUARTERLY



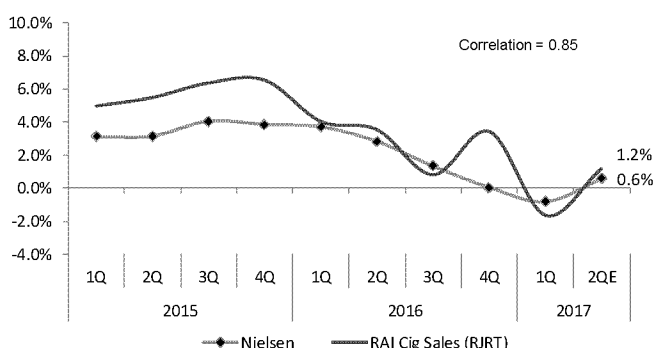
We See MO Net Sales Outpacing the Industry in Q2

Driven By Strong 5.7% Pricing & Better Mix



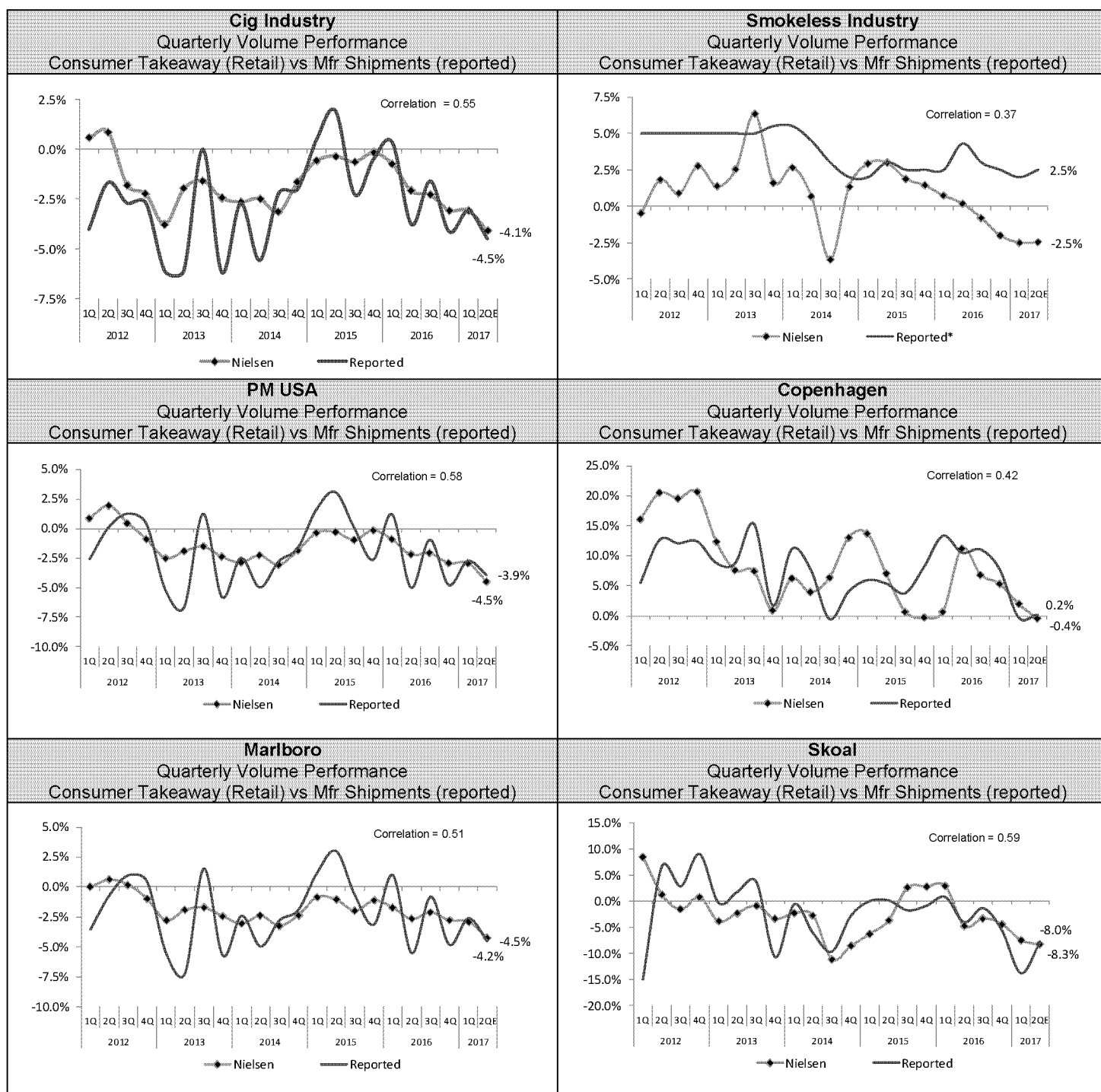
We Expect Newport to Drive Incremental Sales Gains

Driving RJR's Premium Mix Higher By 1.1ppt & Pricing



Source: FactSet, Nielsen AOC+C Database, U.S. Energy Information Administration (EIA), and Wells Fargo Securities, LLC estimates

Consumption vs Shipment – MO Vol Trends at Retail (Consumer) Based on Nielsen Scanner Data vs Wholesale (Mfr) Reported



Source: Nielsen AOC+C Database and Wells Fargo Securities, LLC estimates

The figure consists of six subplots, each representing a different cigarette brand. Each subplot is a line chart titled 'Quarterly Volume Performance' with the subtitle 'Consumer Takeaway (Retail) vs Mfr Shipments (reported)'. The x-axis represents time in quarters from 1Q 2012 to 2Q 2017. The y-axis represents volume performance in percentage. Two data series are plotted: Nielsen (retail, represented by a line with diamond markers) and Reported (mfr shipments, represented by a solid line). The correlation coefficient for each brand is displayed in the top right of each chart.

- Newport:** Correlation = 0.68 on 1-qtr lag (RAI led). Final values: 0.9% (Nielsen), -0.5% (Reported).
- Camel:** Correlation = 0.59. Final values: -5.5% (Nielsen), -6.4% (Reported).
- Pall Mall:** Correlation = 0.53. Final values: -8.8% (Nielsen), -6.0% (Reported).
- Natural American Spirit:** Correlation = 0.80. Note: FDA ban on "no additives" & "all natural" labeling goes into effect ~Aug 19. Final values: 4.0% (Nielsen), 2.0% (Reported).
- RAI Moist Snuff Total:** Correlation = 0.63. Final values: 2.3% (Nielsen), 0.8% (Reported).
- Grizzly:** Correlation = 0.80. Final values: 3.1% (Nielsen), 2.5% (Reported).

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MO Valuation

Our \$80 price target for Altria Group is based on the following methodologies: **(1)** forward EV-to-EBITDA and P/E analysis (absolute and relative); **(2)** a ten-year discounted cash flow (DCF) analysis; **(3)** ROIC and economic profit; and **(4)** dividend yield.

In terms of performance, MO's stock price has underperformed the S&P increasing 8.7% YTD and 8.7% in the last six months vs the S&P up 9.3% and 7.6% respectively.

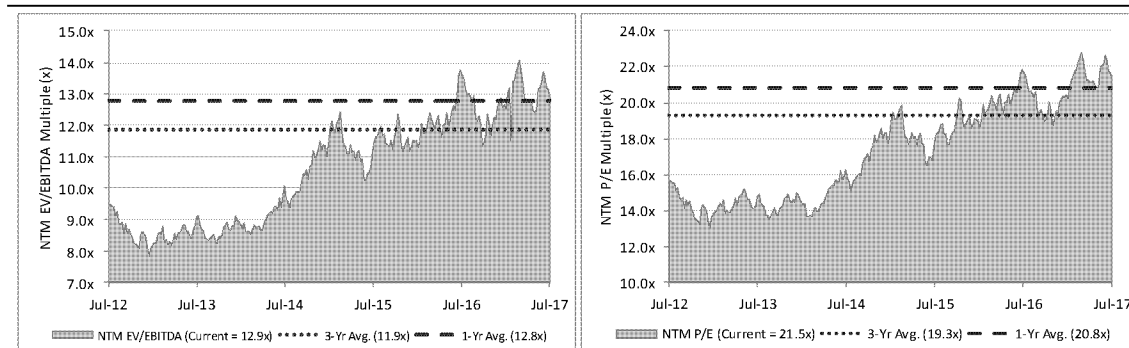
Forward EV-to-EBITDA (absolute and relative). Our \$80 price target implies a 2018 forward EV-to-EBITDA multiple of 14.3x, which is a 9.2% premium to the company's current multiple of 13.1x and a 0.6% premium to the company's one-year average EV-to-EBITDA of 14.2x which we believe is justified given MO's strong, leading position in the overall industry and upside potential from IQOS.

Forward P/E (absolute and relative). Our forward 2018 P/E multiple of 22.4x is a 7.74% premium to the company's current multiple of 20.8x and a 11.3% premium to the company's one-year average historical forward P/E multiple of 20.1x. On a relative forward P/E basis, MO is currently trading at an 8.2% premium to the broader Staples sector versus its historical 3-year average discount of ~2% and its 5-year discount of ~6%. Further, MO's forward P/E multiple is almost 1 turn lower than PM's forward P/E multiple which we believe is unwarranted given the long-term growth prospects both companies have with IQOS and the potential that MO could be acquired by PM.

CY18 P/E Valuation Multiples	Price 7/14/2017	Current			Post-Election (avg)			2016 (avg)			3-Year Average	
		Mult.	vs. Avg Staples	vs. S&P500	Mult.	vs. Avg Staples	vs. S&P500	Mult.	vs. Avg Staples	vs. S&P500	Mult.	vs. Avg Staples
PM	\$118.76	21.7x	113.3%	125.7%	20.3x	104.9%	120.2%	19.8x	101.8%	124.3%	18.7x	98.5%
MO	\$73.80	20.7x	108.2%	120.0%	20.4x	105.5%	120.9%	19.3x	99.2%	121.1%	18.6x	98.2%
RAI	\$65.40	24.0x	125.2%	139.0%	22.9x	118.3%	135.6%	19.8x	101.6%	124.0%	19.5x	102.7%
BATS-GB	53	17.1x	89.3%	99.1%	16.8x	87.1%	99.8%	16.9x	86.6%	105.7%	16.5x	87.2%
IMB-GB	35	12.8x	67.1%	74.5%	13.3x	68.8%	78.9%	15.1x	77.8%	95.0%	14.5x	76.6%
2914-JP	3,837	15.5x	81.0%	89.9%	15.8x	81.5%	93.4%	17.2x	88.4%	107.9%	16.0x	84.5%
Avg. Tobacco		18.6x	97.4%	108.0%	18.2x	94.4%	108.2%	18.0x	92.6%	113.0%	17.3x	91.3%
XLP		19.1x		93.0%	19.3x		147.9%	19.5x		146.3%	19.0x	
SPX		17.2x			16.9x			15.9x			15.9x	

Source: FactSet, Wells Fargo Securities, LLC

MO Historical Valuation Trends



Source: FactSet, Wells Fargo Securities, LLC

RAI Valuation

Our \$65 12-month price target for Reynolds American is based on the following methodologies: **(1)** forward EV-to-EBITDA and P/E analysis (absolute and relative – based on our post-deal pro forma estimates); **(2)** a ten-year discounted cash flow (DCF) analysis; **(3)** ROIC and economic profit; and **(4)** dividend yield.

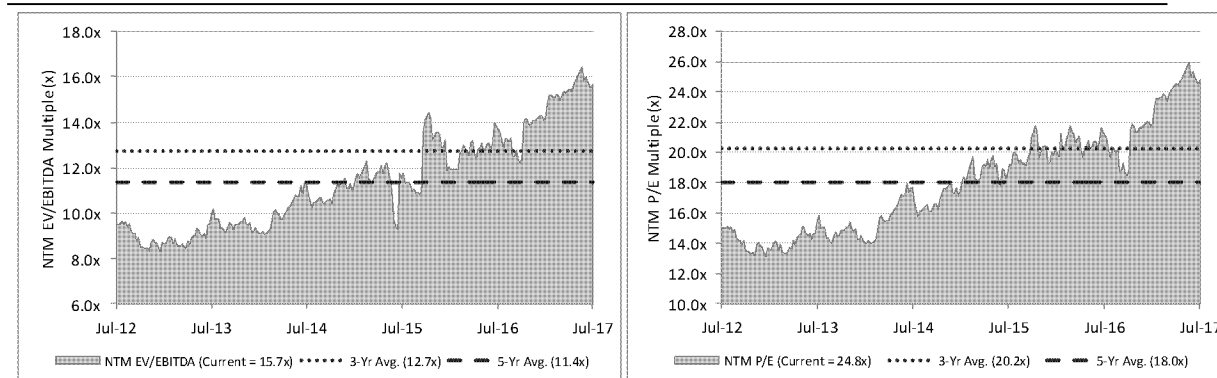
Forward EV-to-EBITDA (absolute and relative). Our \$65 price target implies a 2018 EV-to-EBITDA multiple of 14.8x, a slight discount to the company's current multiple of 14.9x and above the company's one-year average EV-to-EBITDA multiple of 13.9x which we believe is justified given the incremental growth and profitability due to RAI's strong #2 position in the U.S. & the pending BAT/RAI deal.

Forward P/E (absolute and relative). Our forward 2018 P/E multiple of 23.5x is a slight discount to the company's current multiple of 23.6x which reflects BAT/RAI deal parity, and a 9.9% premium to the company's one-year average historical forward P/E multiple of 21.4x. On a relative forward P/E basis, RAI is currently trading at a 25% premium to the broader Staples sector versus a 2.7% premium to its historical 3-year average and a 2.3% discount to its 5-year average.

CY18 P/E Valuation Multiples	Price 7/14/2017	Current			Post-Election (avg)			2016 (avg)			3-Year Average			5-Year Average		
		Mult.	vs. Avg Staples	vs. S&P500	Mult.	vs. Avg Staples	vs. S&P500	Mult.	vs. Avg Staples	vs. S&P500	Mult.	vs. Avg Staples	vs. S&P500	Mult.	vs. Avg Staples	vs. S&P500
PM	\$119.00	21.7x	113.5%	126.0%	20.3x	104.9%	120.3%	19.8x	101.8%	124.3%	18.7x	98.5%	117.6%	17.2x	96.5%	113.9%
MO	\$73.80	20.7x	108.1%	120.0%	20.4x	105.5%	120.9%	19.3x	99.2%	121.1%	18.6x	98.2%	117.3%	16.8x	94.2%	111.2%
RAI	\$65.39	24.0x	125.0%	138.9%	22.9x	118.3%	135.6%	19.8x	101.6%	124.0%	19.5x	102.7%	122.6%	17.4x	97.7%	115.4%
BATS-GB	53	17.1x	89.3%	99.1%	16.8x	87.1%	99.8%	16.9x	86.6%	105.7%	16.5x	87.2%	104.1%	15.6x	87.8%	103.6%
IMB-GB	35	12.8x	67.1%	74.5%	13.3x	68.8%	78.9%	15.1x	77.8%	95.0%	14.5x	76.6%	91.4%	13.2x	74.0%	87.3%
2914-JP	3,837	15.5x	81.0%	89.9%	15.8x	81.5%	93.4%	17.2x	88.4%	107.9%	16.0x	84.5%	101.0%	14.5x	81.3%	96.0%
Avg. Tobacco		18.6x	97.3%	108.1%	18.2x	94.4%	108.2%	18.0x	92.6%	113.0%	17.3x	91.3%	109.0%	15.8x	88.6%	104.6%
XLP		19.2x		#DIV/0!	19.3x		#DIV/0!	19.5x		#DIV/0!	19.0x		#DIV/0!	17.8x		#DIV/0!
SPX		17.3x			16.9x			15.9x			15.9x			15.1x		

Source: FactSet, Wells Fargo Securities, LLC

RAI Historical Valuation Trends



Source: FactSet, Wells Fargo Securities, LLC

Altria Group (MO) - Quarterly Earnings Model

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(\$MM, except per-share data)

Source for all tables: Wells Fargo Securities, LLC estimates and company reports

	2012	2013	2014	2015	1Q16	2Q16	3Q16	4Q16	2016	1Q17	2Q17E	3Q17E	4Q17E	2017E	2018E
Revenue	24,618	24,466	24,522	25,434	6,066	6,521	6,905	6,252	25,744	6,083	6,523	6,885	6,309	25,800	26,178
Excise Taxes on Products	7,118	6,803	6,577	6,580	1,536	1,640	1,712	1,519	6,407	1,494	1,558	1,612	1,446	6,110	5,947
Net Revenue (net of excise taxes)	17,500	17,663	17,945	18,854	4,530	4,881	5,193	4,733	19,337	4,589	4,965	5,273	4,863	19,690	20,231
% Growth	2.3%	0.9%	1.6%	5.1%	6.0%	0.1%	4.3%	0.1%	2.6%	1.3%	1.7%	1.5%	2.7%	1.8%	2.7%
Cost of Sales	7,937	7,870	7,828	7,837	1,862	1,924	2,043	1,905	7,734	1,810	1,794	1,970	1,958	7,531	7,691
% of Net Revenue	45.4%	44.6%	43.6%	41.6%	41.1%	39.4%	39.3%	40.2%	40.0%	39.4%	36.1%	37.4%	40.3%	38.2%	38.0%
Gross Profit	9,563	9,793	10,117	11,017	2,668	2,957	3,150	2,828	11,603	2,779	3,172	3,303	2,905	12,159	12,540
gross margin	54.6%	55.4%	56.4%	58.4%	58.9%	60.6%	60.7%	59.8%	60.0%	60.6%	63.9%	62.6%	59.7%	61.8%	62.0%
Marketing, Admin & Research Costs	2,046	2,071	2,229	2,316	475	494	655	646	2,270	461	521	606	559	2,148	2,067
% of Net Revenue	11.7%	11.7%	12.4%	12.3%	10.5%	10.1%	12.6%	13.6%	11.7%	10.0%	10.5%	11.5%	11.5%	10.9%	10.2%
Operating profit (OCI)	7,517	7,722	7,888	8,701	2,193	2,463	2,495	2,182	9,333	2,318	2,650	2,697	2,346	10,011	10,473
OCI margin	43.0%	43.7%	44.0%	46.1%	48.4%	50.5%	48.0%	46.1%	48.3%	50.5%	53.4%	51.1%	48.2%	50.8%	51.8%
Amortization	20	20	20	21	5	5	5	6	21	5	5	5	5	20	20
General corporate expenses	228	235	241	237	39	46	57	72	214	35	40	53	53	181	181
% of Net Revenue	1.3%	1.3%	1.3%	1.3%	0.9%	0.9%	1.3%	1.5%	1.1%	0.9%	0.8%	1.0%	1.1%	0.9%	0.9%
EBIT (ex. SABMiller stake)	7,269	7,467	7,627	8,443	2,149	2,412	2,433	2,104	9,098	2,278	2,606	2,639	2,287	9,810	10,272
EBIT Margin	41.5%	42.3%	42.5%	44.8%	47.4%	49.4%	46.9%	44.5%	47.1%	49.6%	52.5%	50.0%	47.0%	49.8%	50.8%
Interest expense, net	1,126	1,049	808	791	194	192	179	176	741	179	174	163	163	679	610
AB InBev equity income	(960)	(988)	(1,057)	(883)	(232)	(220)	(259)	5	(706)	(95)	(165)	(218)	(221)	(699)	(978)
Pretax Income	7,103	7,406	7,876	8,535	2,187	2,440	2,513	1,923	9,063	2,194	2,598	2,694	2,345	9,830	10,640
Income taxes	2,628	2,651	2,757	3,029	773	856	903	604	3,136	783	930	962	837	3,512	3,790
Equity earnings and minority interest, net	(1)	0	0	(2)	(1)	(1)	(1)	(2)	(5)	(1)	0	0	0	(1)	0
Net Income	4,474	4,755	5,119	5,504	1,413	1,583	1,609	1,317	5,922	1,410	1,668	1,732	1,508	6,317	6,850
Diluted shares outstanding	2,025	1,999	1,979	1,961	1,956	1,954	1,952	1,946	1,952	1,939	1,930	1,923	1,916	1,927	1,921
Recurring Diluted EPS	\$2.21	\$2.38	\$2.60	\$2.80	\$0.72	\$0.81	\$0.82	\$0.68	\$3.03	\$0.73	\$0.86	\$0.90	\$0.79	\$3.28	\$3.57
Dividends per share	\$1.70	\$1.84	\$2.00	\$2.17	\$0.57	\$0.57	\$0.61	\$0.61	\$2.35	\$0.61	\$0.61	\$0.66	\$0.66	\$2.55	\$2.78
Dividend Growth	7.6%	8.2%	8.7%	8.5%	0.0%	0.0%	8.0%	0.0%	8.3%	0.0%	0.0%	9.0%	0.0%	8.5%	9.0%
EBITDA	7,494	7,679	7,835	8,668	2,198	2,461	2,484	2,159	9,302	2,330	2,660	2,697	2,341	10,028	10,500
EBITDA margin	42.8%	43.5%	43.7%	46.0%	48.5%	50.4%	47.8%	45.8%	48.1%	50.8%	53.6%	51.1%	48.1%	50.9%	51.9%
Effective tax rate	37.0%	36.1%	35.0%	35.5%	35.3%	35.1%	35.9%	31.4%	34.6%	35.7%	35.8%	35.7%	35.7%	35.7%	35.6%

YOY Growth	2012	2013	2014	2015	1Q16	2Q16	3Q16	4Q16	2016	1Q17	2Q17E	3Q17E	4Q17E	2017E	2018E
Smokeable Volume	-0.2%	-4.1%	-3.0%	0.6%	1.2%	-4.9%	-0.9%	-4.7%	-2.4%	-2.7%	-3.8%	-4.7%	-4.2%	-3.9%	-3.4%
Smokeless Volume	3.9%	3.2%	0.7%	2.5%	7.8%	4.3%	5.6%	2.2%	4.9%	-5.0%	-2.8%	1.0%	3.5%	-0.8%	3.7%
Net Sales	2.3%	0.9%	1.6%	5.1%	6.0%	0.1%	4.3%	0.1%	2.6%	1.3%	1.7%	1.5%	2.7%	1.8%	2.7%
Gross Profit	1.0%	2.4%	3.3%	8.9%	7.8%	3.0%	7.9%	2.8%	5.3%	4.2%	7.3%	4.9%	2.7%	4.8%	3.1%
EBITDA	5.5%	2.5%	2.0%	10.6%	12.3%	7.6%	6.7%	3.0%	7.3%	6.0%	8.1%	8.6%	8.4%	7.8%	4.7%
Operating Income	5.1%	2.7%	2.1%	10.3%	11.5%	7.0%	6.8%	4.0%	7.3%	5.7%	7.6%	8.1%	7.5%	7.3%	4.6%
Net Income	5.9%	6.3%	7.7%	7.5%	13.4%	8.5%	9.4%	-0.5%	7.6%	-0.2%	5.3%	7.6%	14.5%	6.7%	8.4%
EPS	8.0%	7.6%	9.2%	8.2%	14.3%	9.5%	9.3%	1.5%	8.2%	1.4%	6.2%	9.8%	16.2%	8.3%	8.8%

Smokeable Unit Analysis (per thousands)	2012	2013	2014	2015	1Q16	2Q16	3Q16	4Q16	2016	1Q17	2Q17E	3Q17E	4Q17E	2017E	2018E
Smokeable Volume (in billions)	134.9	129.3	125.4	126.0	29.5	31.5	32.9	29.1	122.9	28.7	30.2	31.3	27.8	118.0	113.9
Net Sales	111.91	116.60	122.58	128.54	131.35	132.90	134.72	135.14	133.54	137.42	140.69	142.43	142.92	140.88	147.65
Operating income	46.07	49.20	54.10	59.67	63.22	66.64	64.26	62.18	64.13	70.12	75.19	72.20	68.74	71.65	76.54
Excise taxes	51.31	50.96	50.67	50.44	50.19	50.24	50.29	50.25	50.24	50.18	49.64	49.69	49.81	49.83	49.83
Total costs	28.28	28.96	29.91	30.66	27.19	27.18	31.06	34.64	29.98	27.84	26.81	31.24	35.48	30.28	30.98

Smokeless Unit Analysis (per can)	2012	2013	2014	2015	1Q16	2Q16	3Q16	4Q16	2016	1Q17	2Q17E	3Q17E	4Q17E	2017E	2018E
Smokeless Volume (in millions)	763.3	787.5	793.3	813.5	206.1	217.9	216.4	213.1	853.5	195.8	211.9	218.6	220.5	846.7	877.7
Net Sales	2.07	2.09	2.11	2.15	2.17	2.24	2.28	2.29	2.24	2.23	2.29	2.33	2.34	2.30	2.34
Operating income	1.26	1.30	1.34	1.37	1.42	1.55	1.45	1.36	1.45	1.38	1.45	1.50	1.50	1.46	1.52
Excise taxes	0.15	0.17	0.17	0.16	0.16	0.16	0.16	0.15	0.16	0.15	0.15	0.15	0.15	0.15	0.15

Reynolds American (RAI) - Quarterly Earnings Model

Wells Fargo Securities, LLC

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(\$MM, except per-share data)

Source for all tables: Company reports, Wells Fargo Securities, LLC estimates

	2012	2013	2014	2015	1Q16	2Q16	3Q16	4Q16	2016	1Q17	2Q17E	3Q17E	4Q17E	2017E	2018E
Gross Sales	12,227	11,966	12,096	14,884	3,947	4,315	4,330	4,254	16,846	3,931	4,376	4,484	4,388	17,179	17,664
Excise Taxes	3,923	3,730	3,625	4,209	1,030	1,120	1,125	1,068	4,343	982	1,091	1,118	1,057	4,248	4,196
% of Gross Sales	32.1%	31.2%	30.0%	28.3%	26.1%	26.0%	26.0%	25.1%	25.8%	25.0%	24.9%	24.9%	24.1%	24.7%	23.8%
Net Sales	8,304	8,236	8,471	10,675	2,917	3,195	3,205	3,186	12,503	2,949	3,285	3,366	3,331	12,930	13,469
MSA, Grower Buyout Exp & FDA Fees	2,710	2,155	2,249	2,685	680	768	757	716	2,921	774	828	844	794	3,240	3,253
Cost of Goods Sold, net	1,435	1,486	1,556	1,796	466	481	452	471	1,870	415	404	401	439	1,659	1,728
Total Cost of Goods Sold	4,145	3,860	3,805	4,443	1,146	1,249	1,209	1,187	4,791	1,189	1,232	1,245	1,232	4,898	4,981
Gross Profit	4,159	4,376	4,666	6,232	1,771	1,946	1,996	1,999	7,712	1,760	2,053	2,120	2,098	8,032	8,487
<i>Gross Margin</i>	50.1%	53.1%	55.1%	58.4%	60.7%	60.9%	62.3%	62.7%	61.7%	59.7%	62.5%	63.0%	63.0%	62.1%	63.0%
S, G&A Expense	1,275	1,354	1,550	1,776	446	474	436	459	1,815	408	456	426	465	1,755	1,687
% of Net Sales	15.4%	16.4%	18.3%	16.6%	15.3%	14.8%	13.6%	14.4%	14.5%	13.8%	13.9%	12.6%	14.0%	13.6%	12.5%
Amortization	21	23	23	18	6	6	6	5	23	6	6	6	4	22	22
Operating Income	2,863	3,021	3,105	4,438	1,319	1,466	1,554	1,535	5,874	1,346	1,591	1,689	1,629	6,255	6,778
<i>Operating margin</i>	34.5%	36.7%	36.7%	41.6%	45.2%	45.9%	48.5%	48.2%	47.0%	45.6%	48.4%	50.2%	48.9%	48.4%	50.3%
Interest Expense, net	227	254	283	564	171	150	148	149	618	147	140	138	132	557	519
Other Expense, net	14	7	(58)	-55	6	-1	10	-1	14	4	1	2	1	8	8
Pretax Income	2,622	2,760	2,880	3,929	1,142	1,317	1,396	1,387	5,242	1,195	1,450	1,549	1,496	5,690	6,251
Taxes	934	1,015	1,049	1,420	421	489	521	508	1,939	400	532	573	548	2,053	2,301
<i>Effective tax rate</i>	35.6%	36.8%	36.6%	36.6%	36.9%	37.1%	37.3%	36.6%	37.0%	33.5%	36.7%	37.0%	36.6%	36.1%	36.8%
Income from discontinued operations															
Net Income	1,686	1,745	1,831	2,509	721	828	875	879	3,303	795	918	976	949	3,637	3,951
Diluted Shares Outstanding	1,136	1,094	1,070	1,268	1,431	1,430	1,430	1,429	1,430	1,430	1,430	1,430	1,430	1,430	1,430
EPS	1.48	1.60	1.71	1.98	0.50	0.58	0.61	0.62	2.31	0.56	0.64	0.68	0.66	2.54	2.76
EBITDA	2,994	3,124	3,348	4,560	1,349	1,497	1,619	1,600	6,066	1,378	1,623	1,728	1,663	6,393	6,921
<i>EBITDA Margin</i>	36.1%	37.9%	39.5%	42.7%	46.2%	46.9%	50.5%	50.2%	48.5%	46.7%	49.4%	51.4%	49.9%	49.4%	51.4%
Dividend per Share	\$ 1.15	\$1.22	\$1.34	\$1.39	\$0.42	\$0.42	\$0.46	\$0.46	\$1.76	\$0.51	\$0.51	\$0.51	\$0.51	\$2.04	\$2.27
Dividend Growth	5.4%	6.8%	9.8%	3.7%	16.7%	0.0%	9.5%	0.0%	26.6%	-71.0%	0.0%	0.0%	0.0%	15.9%	11.0%

	2012	2013	2014	2015	1Q16	2Q16	3Q16	4Q16	2016	1Q17	2Q17E	3Q17E	4Q17E	2017E	2018E
YOY Growth															
Cigarette Volume	-5.6%	-6.7%	24.8%	0.3%	0.6%	25.7%	-2.5%	-2.3%	-1.5%	-4.8%	-3.4%	-1.3%	-1.9%	-2.8%	-2.3%
American Snuff Volume	8.0%	6.5%	2.8%	2.8%	3.3%	-0.5%	2.1%	-1.5%	0.8%	4.4%	2.3%	1.4%	1.5%	2.4%	2.2%
Net Sales	-2.8%	-0.8%	2.9%	26.0%	41.8%	33.0%	1.4%	4.3%	17.1%	1.1%	2.8%	5.0%	4.5%	3.4%	4.2%
Gross Profit	-1.5%	5.2%	6.6%	33.6%	47.5%	39.6%	9.8%	9.9%	23.7%	-0.6%	5.5%	6.2%	5.0%	4.2%	5.7%
EBITDA	1.3%	4.3%	7.2%	36.2%	70.1%	44.1%	12.5%	24.3%	33.0%	2.1%	8.4%	6.7%	3.9%	5.4%	8.3%
Operating Income	1.6%	5.5%	2.8%	42.9%	72.4%	45.0%	10.6%	22.1%	32.4%	2.0%	8.5%	8.7%	6.1%	6.5%	8.4%
Net Income	2.4%	3.5%	4.9%	37.0%	57.8%	43.0%	12.0%	27.0%	31.6%	10.3%	10.8%	11.5%	7.9%	10.1%	8.6%
EPS	5.5%	7.5%	7.3%	15.8%	16.3%	13.7%	12.7%	29.2%	16.7%	10.4%	10.9%	11.6%	7.9%	10.1%	8.6%
Cigarette Unit Analysis (per thousands)															
Cigarette Volume (in billions)	68.90	64.30	80.25	80.48	18.80	20.50	20.50	19.50	79.30	17.90	19.80	20.24	19.14	77.08	75.28
Net Sales	101.02	104.63	110.93	107.28	128.24	129.07	129.37	133.59	130.06	132.46	135.18	135.84	140.47	136.03	142.72
Total Costs	67.68	66.25	67.05	59.68	68.62	67.32	64.15	65.59	66.38	71.56	68.99	66.25	69.42	68.97	69.98
Operating Income	33.34	38.38	43.89	47.60	59.63	61.76	65.22	68.00	63.68	60.89	66.20	69.58	71.06	67.06	72.74
Excise taxes	50.32	50.25	52.97	44.61	50.43	50.29	50.44	50.46	50.40	50.34	50.33	50.33	50.33	50.33	50.33
Master Settlement Agreement and other s	34.40	31.66	31.98	32.66	33.51	35.07	34.59	34.31	34.39	40.61	39.28	39.25	38.94	39.50	40.61
Federal tobacco buyout expense	3.16	3.25	2.67	-	-	-	-	-	-	-	-	-	-	-	-
FDA fees	1.77	1.98	2.21	2.32	2.66	2.39	2.34	2.41	2.45	2.63	2.51	2.46	2.53	2.53	2.61
YOY Growth in per 000s															
Net Sales		3.6%	6.0%	-3.3%	49.0%	42.4%	3.7%	6.1%	21.2%	3.3%	4.7%	5.0%	5.2%	4.6%	4.9%
Operating income		15.1%	14.3%	8.5%	72.7%	53.6%	12.0%	20.9%	33.8%	2.1%	7.2%	6.7%	4.5%	5.3%	8.5%
Snuff Unit Analysis (per can)															
American Snuff Volume (in millions)	437.2	465.8	478.6	478.6	121.4	127.8	127.9	125.9	502.9	126.7	130.8	129.7	127.8	514.9	526.5
Net Sales	1.56	1.60	1.64	1.64	1.78	1.82	1.83	1.84	1.82	1.91	1.93	1.93	1.95	1.93	2.05
Operating income	0.87	0.91	0.92	0.92	1.10	1.08	1.05	1.10	1.08	1.24	1.22	1.16	1.21	1.21	1.31
Excise taxes	0.11	0.11	0.11	0.11	0.11	0.11	0.11	0.10	0.11	0.10	0.10	0.10	0.10	0.10	0.10

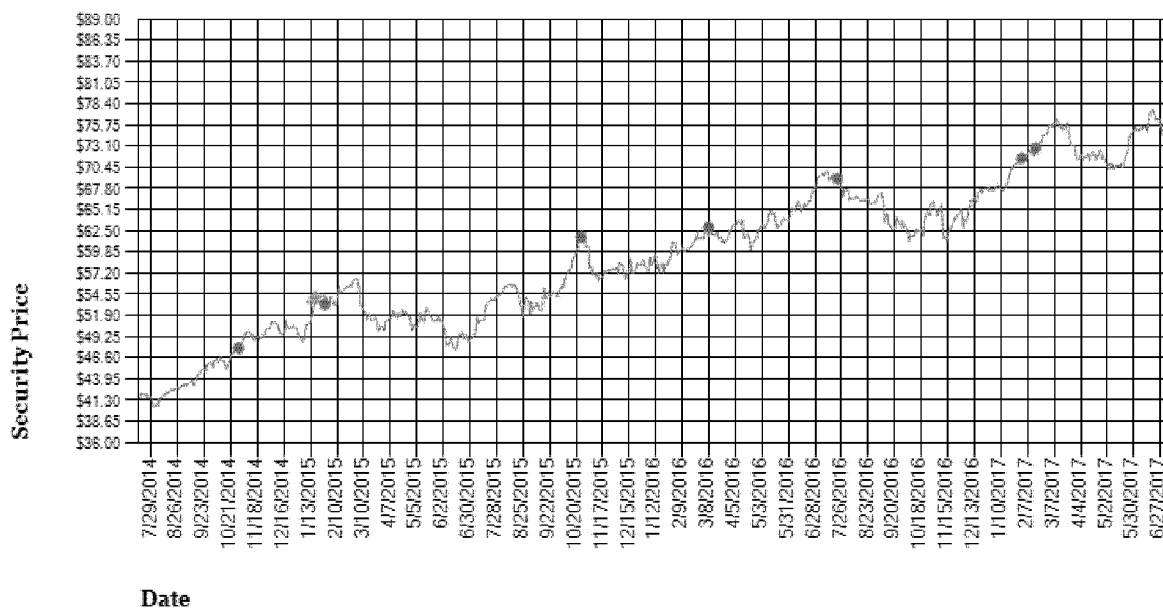
Rating Basis Information:

MO Thesis: We believe Altria is achieving a better balance between stabilizing Marlboro market share and growing profitably. We see further upside from strong pricing trends and potential of vapor/iQOS that isn't currently reflected in the stock.

RAI Thesis: We believe RAI remains one of the most innovative consumer product companies and has been successful over the years in: (1) repositioning brands, (2) creating excitement, (3) driving trial for new products and categories, and (4) incorporating technology into its products as a way to increase the value proposition for consumers. Moreover, RAI has transformed itself into an innovative, comprehensive "total tobacco" company, with leading brands and a solid strategy for long-term growth. However, given its pending acquisition by BAT, we rate the stock a Market Perform given limited further upside potential.

Required Disclosures

Altria Group, Inc. (MO) 3-yr. Price Performance



Date	Published Price (\$)	Rating Code	Price Target	Val. Rng. Low	Val. Rng. High	Close Price (\$)
7/15/2014		Herzog				
7/15/2014	NA	2	NE	41.00	43.00	41.76
* 10/30/2014	47.55	2	NE	46.00	48.00	47.50
▲* 1/20/2015	53.05	1	NE	56.00	58.00	53.83
* 1/30/2015	53.10	1	NE	59.00	61.00	53.10
* 10/26/2015	61.05	1	NE	64.00	66.00	61.40
* 3/9/2016	62.30	1	NE	69.00	71.00	62.81
* 7/22/2016	68.86	1	NE	73.00	75.00	68.86
* 2/1/2017	71.39	1	NE	76.00	78.00	71.39
* 2/16/2017	72.71	1	NE	79.00	81.00	72.71

Source: Wells Fargo Securities, LLC estimates and Reuters data

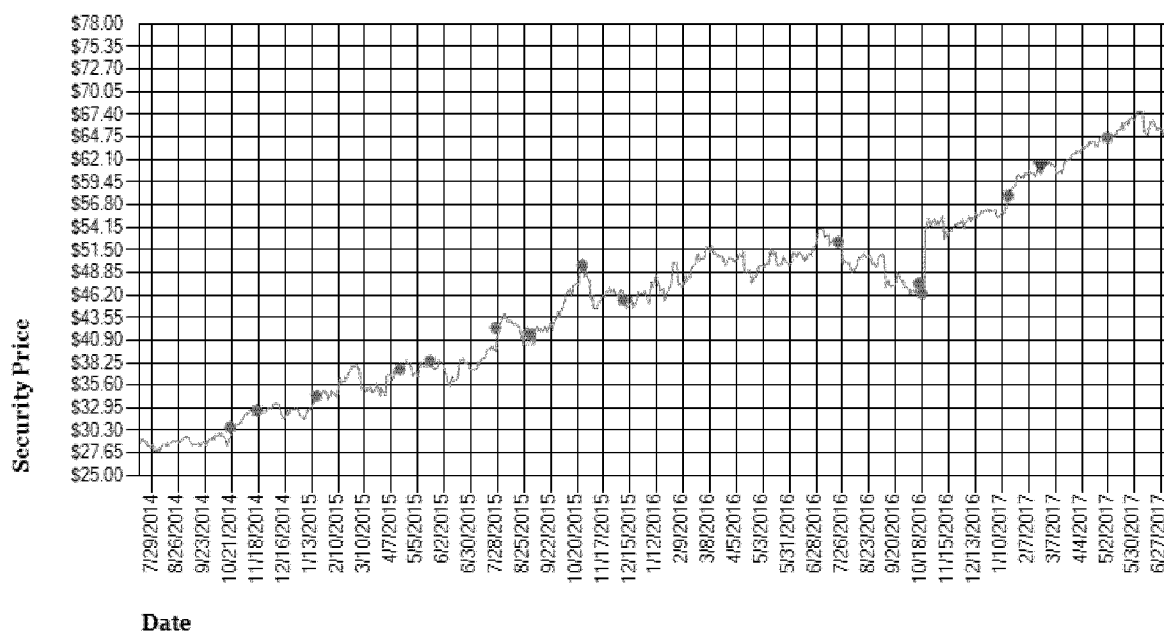
Symbol Key

- ▼ Rating Downgrade
- ▲ Rating Upgrade
- * Price Target/Val Range Change
- Initiation, Resumption, Drop or Suspend
- Analyst Change
- Split Adjustment

Rating Code Key

- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

Reynolds American Inc. (RAI) 3-yr. Price Performance



Date	Published Price (\$)	Rating Code	Price Target	Val. Rng. Low	Val. Rng. High	Close Price (\$)
7/15/2014		Herzog				
7/15/2014	NA	1	NE	32.00	33.00	29.42
* 10/21/2014	30.52	1	NE	33.50	34.50	30.52
* 11/17/2014	32.35	1	NE	34.50	35.50	32.35
* 1/20/2015	33.79	1	NE	39.50	40.50	34.26
* 4/17/2015	37.35	1	NE	40.50	41.50	37.35
* 5/18/2015	38.18	1	NE	44.50	45.50	38.18
* 7/28/2015	84.20	1	NE	47.00	48.00	42.10
□ 9/1/2015		2-for-1 stock split				
* 9/2/2015	40.94	1	NE	47.00	49.00	41.25
* 10/26/2015	48.89	1	NE	52.00	54.00	49.49
* 12/9/2015	45.42	1	NE	53.00	55.00	45.42
* 7/22/2016	52.29	1	NE	56.00	58.00	52.29
* 10/15/2016	47.27	1	NE	55.00	57.00	47.27
* 10/19/2016	46.20	1	NE	54.00	56.00	46.29
* 1/17/2017	57.92	1	NE	58.00	60.00	57.68
▼ 2/22/2017	60.95	2	NE	58.00	60.00	60.95
* 5/3/2017	64.47	2	NE	64.00	66.00	64.47

Source: Wells Fargo Securities, LLC estimates and Reuters data

Symbol Key

- ▼ Rating Downgrade
- ▲ Rating Upgrade
- Price Target/Val Range Change
- Initiation, Resumption, Drop or Suspend
- Analyst Change
- Split Adjustment

Rating Code Key

- 1 Outperform/Buy
- 2 Market Perform/Hold
- 3 Underperform/Sell
- SR Suspended
- NR Not Rated
- NE No Estimate

Additional Information Available Upon Request

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RAI: Risks to our target include increased competitive pressure within the category and a pullback in consumer spending.

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2=Market Perform: The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD

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

O=Overweight: Industry expected to outperform the relevant broad market benchmark over the next 12 months.

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

U=Underweight: Industry expected to underperform the relevant broad market benchmark over the next 12 months.

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As of: July 16, 2017

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