

Management's Discussion and Analysis of Financial Condition and Results of Operations

Description of Our Company

We are a holding company whose subsidiaries and affiliates, and their licensees, are engaged in the manufacture and sale of cigarettes and other tobacco products in markets outside the United States of America. We manage our business in four segments:

- European Union;
- Eastern Europe, Middle East & Africa ("EEMA");
- Asia; and
- Latin America & Canada.

Our products are sold in more than 180 markets and, in many of these markets, they hold the number one or number two market share position. We have a wide range of premium, mid-price and low-price brands. Our portfolio comprises both international and local brands.

We use the term net revenues to refer to our operating revenues from the sale of our products, net of sales and promotion incentives. Our net revenues and operating income are affected by various factors, including the volume of products we sell, the price of our products, changes in currency exchange rates and the mix of products we sell. Mix is a term used to refer to the proportionate value of premium-price brands to mid-price or low-price brands in any given market (product mix). Mix can also refer to the proportion of shipment volume in more profitable markets versus shipment volume in less profitable markets (geographic mix). We often collect excise taxes from our customers and then remit them to governments, and, in those circumstances, we include the excise taxes in our net revenues and in excise taxes on products. Our cost of sales consists principally of tobacco leaf, non-tobacco raw materials, labor and manufacturing costs.

Our marketing, administration and research costs include the costs of marketing and selling our products, other costs generally not related to the manufacture of our products (including general corporate expenses), and costs incurred to develop new products. The most significant components of our marketing, administration and research costs are marketing and sales expenses and general and administrative expenses.

We are a legal entity separate and distinct from our direct and indirect subsidiaries. Accordingly, our right, and thus the right of our creditors and stockholders, to participate in any distribution of the assets or earnings of any subsidiary is subject to the prior rights of creditors of such subsidiary, except to the extent that claims of our company itself as a creditor may be recognized. As a holding company, our principal sources of funds, including funds to make payment on our debt securities, are from the receipt of dividends and repayment of debt from our subsidiaries. Our principal wholly owned and majority-owned subsidiaries currently are not

limited by long-term debt or other agreements in their ability to pay cash dividends or to make other distributions with respect to their common stock.

Prior to March 28, 2008, we were a wholly owned subsidiary of Altria Group, Inc. ("Altria").

Executive Summary

The following executive summary provides significant highlights from the Discussion and Analysis that follows.

• **Consolidated Operating Results**—The changes in our reported diluted earnings per share ("diluted EPS") for the year ended December 31, 2012, from the comparable 2011 amounts, were as follows:

	Diluted EPS	% Growth
For the year ended December 31, 2011	\$ 4.85	
2011 Asset impairment and exit costs	0.05	
2011 Tax items	(0.02)	
Subtotal of 2011 items	0.03	
2012 Asset impairment and exit costs	(0.03)	
2012 Tax items	(0.02)	
Subtotal of 2012 items	(0.05)	
Currency	(0.23)	
Interest	(0.03)	
Change in tax rate	0.02	
Impact of lower shares outstanding and share-based payments	0.20	
Operations	0.38	
For the year ended December 31, 2012	\$ 5.17	6.6%

See the discussion of events affecting the comparability of statement of earnings amounts in the Consolidated Operating Results section of the following Discussion and Analysis.

• **Asset Impairment and Exit Costs**—During 2012, we recorded pre-tax asset impairment and exit costs of \$83 million (\$52 million after tax and noncontrolling interests or \$0.03 per share) primarily related to factory restructurings and the consolidation of R&D activities, as well as contract termination charges in Asia. During 2011, we recorded pre-tax asset impairment and exit costs of \$109 million (\$82 million after tax or \$0.05 per share) primarily related to factory and R&D restructurings, as well as a contract termination charge in EEMA. For further details, see Note 5. *Asset Impairment and Exit Costs* to our consolidated financial statements.

• **Income Taxes**—The 2012 effective tax rate was unfavorably impacted by an additional income tax provision of \$79 million following the conclusion of the IRS examination of Altria's consolidated tax returns for the years 2004–2006, partially offset by a \$40 million benefit from a tax accounting method change in Germany. The 2011 effective tax rate was favorably impacted by an enacted decrease in corporate income tax rates in Greece (\$11 million) and the reversal of

a valuation allowance in Brazil (\$15 million). The special tax items discussed in this paragraph decreased our diluted EPS by \$0.02 per share in 2012 and increased our diluted EPS by \$0.02 per share in 2011. Excluding the impact of the special items in each year, the change in tax rate that increased our diluted EPS by \$0.02 per share in 2012 was primarily due to earnings mix and repatriation cost differences.

● **Currency**—The unfavorable currency impact during 2012 was due primarily to the Argentine peso, Brazilian real, the Euro, Indonesian rupiah, Polish zloty, Russian ruble and Turkish lira, partially offset by the Japanese yen and the Swiss franc.

● **Interest**—The unfavorable impact of interest was due primarily to higher average debt levels, partially offset by lower average interest rates on debt.

● **Lower Shares Outstanding and Share-Based Payments**—The favorable diluted EPS impact was due to the repurchase of our common stock pursuant to our share repurchase programs.

● **Operations**—The increase in diluted EPS of \$0.38 from our operations was due primarily to the following segments:

- **EEMA:** Higher pricing and favorable volume/mix, partially offset by higher marketing, administration and research costs;
- **Asia:** Higher pricing and lower manufacturing costs (reflecting favorable shipping costs related to substantial air freight expenses to ship product to Japan in 2011), partially offset by higher marketing, administration and research costs and unfavorable volume/mix attributable to Japan; and
- **Latin America & Canada:** Higher pricing, partially offset by unfavorable volume/mix and higher manufacturing costs.

For further details, see the “Consolidated Operating Results” and “Operating Results by Business Segment” sections of the following “Discussion and Analysis.”

● **2013 Forecasted Results**—On February 7, 2013, we announced our forecast for 2013 full-year reported diluted EPS to be in a range of \$5.68 to \$5.78, at prevailing exchange rates at that time, versus \$5.17 in 2012. Excluding a forecasted total unfavorable currency impact of approximately \$0.06 per share for the full-year 2013, the reported diluted earnings per share range represents a projected increase of 10% to 12% versus adjusted diluted earnings per share of \$5.22 in 2012. We calculated 2012 adjusted diluted EPS as reported diluted EPS of \$5.17, plus the \$0.02 per share charge related to discrete tax items, and the \$0.03 per share charge related to asset impairment and exit costs.

This 2013 guidance excludes the impact of potential future acquisitions, unanticipated asset impairment and exit cost charges and any unusual events. The factors described in the *Cautionary Factors That May Affect Future Results* section of the following *Discussion and Analysis* represent continuing risks to this forecast.

Adjusted diluted EPS is not a U.S. GAAP measure. We define adjusted diluted EPS as reported diluted EPS adjusted for asset impairment and exit costs, discrete tax items and unusual items. We believe it is appropriate to disclose this measure as it represents core earnings, improves comparability and helps investors analyze business performance and trends. Adjusted diluted EPS should be considered neither in isolation nor as a substitute for reported diluted EPS prepared in accordance with U.S. GAAP.

Discussion and Analysis

Critical Accounting Policies and Estimates

Note 2. *Summary of Significant Accounting Policies* to our consolidated financial statements includes a summary of the significant accounting policies and methods used in the preparation of our consolidated financial statements. In most instances, we must use a particular accounting policy or method because it is the only one that is permitted under accounting principles generally accepted in the United States of America (“U.S. GAAP”).

The preparation of financial statements requires that we use estimates and assumptions that affect the reported amounts of our assets, liabilities, net revenues and expenses, as well as our disclosure of contingencies. If actual amounts differ from previous estimates, we include the revisions in our consolidated results of operations in the period during which we know the actual amounts. Historically, aggregate differences, if any, between our estimates and actual amounts in any year have not had a significant impact on our consolidated financial statements.

The selection and disclosure of our critical accounting policies and estimates have been discussed with our Audit Committee. The following is a discussion of the more significant assumptions, estimates, accounting policies and methods used in the preparation of our consolidated financial statements:

● **Revenue Recognition**—As required by U.S. GAAP, we recognize revenues, net of sales and promotion incentives. Our net revenues include excise taxes and shipping and handling charges billed to our customers. Our net revenues are recognized upon shipment or delivery of goods when title and risk of loss pass to our customers. We record shipping and handling costs paid to third parties as part of cost of sales.

● **Goodwill and Non-Amortizable Intangible Assets Valuation**—We test goodwill and non-amortizable intangible assets annually for impairment or more frequently if events occur that would warrant such review. We perform our annual impairment analysis in the first quarter of each year. The impairment analysis involves comparing the fair value of each reporting unit or non-amortizable intangible asset to the carrying value. If the carrying value exceeds the fair value, goodwill or a non-amortizable intangible asset is considered impaired. To determine the fair value of goodwill, we primarily use a discounted cash flow model, supported by the market approach using earnings multiples of comparable companies. To determine the fair value of non-amortizable intangible

assets, we primarily use a discounted cash flow model applying the relief-from-royalty method. These discounted cash flow models include management assumptions relevant for forecasting operating cash flows, which are subject to changes in business conditions, such as volumes and prices, costs to produce, discount rates and estimated capital needs. Management considers historical experience and all available information at the time the fair values are estimated, and we believe these assumptions are consistent with the assumptions a hypothetical marketplace participant would use. We concluded that the fair value of our reporting units and non-amortizable intangible assets exceeded the carrying value and any reasonable movement in the assumptions would not result in an impairment. Since the March 28, 2008, spin-off from Altria, we have not recorded a charge to earnings for an impairment of goodwill or non-amortizable intangible assets.

● **Marketing and Advertising Costs**—As required by U.S. GAAP, we record marketing costs as an expense in the year to which costs relate. We do not defer amounts on our balance sheet. We expense advertising costs during the year in which the costs are incurred. We record trade promotion costs as a reduction of revenues during the year in which these programs are offered, relying on estimates of utilization and redemption rates that have been developed from historical information. Such programs include, but are not limited to, discounts, rebates, in-store display incentives and volume-based incentives. For interim reporting purposes, advertising and certain consumer incentives are charged to earnings based on estimated sales and related expenses for the full year.

● **Employee Benefit Plans**—As discussed in Note 13. *Benefit Plans* to our consolidated financial statements, we provide a range of benefits to our employees and retired employees, including pensions, postretirement health care and postemployment benefits (primarily severance). We record annual amounts relating to these plans based on calculations specified by U.S. GAAP. These calculations include various actuarial assumptions, such as discount rates, assumed rates of return on plan assets, compensation increases and turnover rates. We review actuarial assumptions on an annual basis and make modifications to the assumptions based on current rates and trends when it is deemed appropriate to do so. As permitted by U.S. GAAP, any effect of the modifications is generally amortized over future periods. We believe that the assumptions utilized in calculating our obligations under these plans are reasonable based upon advice from our actuaries.

At December 31, 2012, our discount rate was 4.05% for our U.S. pension and postretirement plans. This rate was 45 basis points lower than our 2011 discount rate of 4.50%. Our weighted-average discount rate assumption for our non-U.S. pension plans decreased to 2.38%, from 3.40% at December 31, 2011. Our weighted-average discount rate assumption for our non-U.S. postretirement plans was 4.59% at December 31, 2012, and 5.45% at December 31, 2011. We anticipate that assumption changes, coupled with the amortization of deferred losses, will increase 2013 pre-tax U.S. and non-U.S. pension and postretirement expense to approximately

\$327 million as compared with \$222 million in 2012, excluding amounts related to early retirement programs. A fifty-basis-point decrease in our discount rate would increase our 2013 pension and postretirement expense by approximately \$60 million, and a fifty-basis-point increase in our discount rate would decrease our 2013 pension and postretirement expense by approximately \$50 million. Similarly, a fifty-basis-point decrease (increase) in the expected return on plan assets would increase (decrease) our 2013 pension expense by approximately \$30 million.

See Note 13. *Benefit Plans* to our consolidated financial statements for a sensitivity discussion of the assumed health care cost trend rates.

● **Income Taxes**—Income tax provisions for jurisdictions outside the United States, as well as state and local income tax provisions, are determined on a separate company basis, and the related assets and liabilities are recorded in our consolidated balance sheets.

The extent of our operations involves dealing with uncertainties and judgments in the application of complex tax regulations in a multitude of jurisdictions. The final taxes paid are dependent upon many factors, including negotiations with taxing authorities in various jurisdictions and resolution of disputes arising from federal, state, and international tax audits. In accordance with the authoritative guidance for income taxes, we evaluate potential tax exposures and record tax liabilities for anticipated tax audit issues based on our estimate of whether, and the extent to which, additional taxes will be due. We adjust these reserves in light of changing facts and circumstances; however, due to the complexity of some of these uncertainties, the ultimate resolution may result in a payment that is materially different from our current estimate of the tax liabilities. If our estimate of tax liabilities proves to be less than the ultimate assessment, an additional charge to expense would result. If payment of these amounts ultimately proves to be less than the recorded amounts, the reversal of the liabilities would result in tax benefits being recognized in the period when we determine the liabilities are no longer necessary.

The effective tax rates used for interim reporting are based on our full-year geographic earnings mix projections and cash repatriation plans. Changes in currency exchange rates, earnings mix or in cash repatriation plans could have an impact on the effective tax rates, which we monitor each quarter. Significant judgment is required in determining income tax provisions and in evaluating tax positions.

At December 31, 2012, applicable United States federal income taxes and foreign withholding taxes have not been provided on approximately \$18 billion of accumulated earnings of foreign subsidiaries that are expected to be permanently reinvested. These earnings have been or will be invested to support the growth of our international business. Further, we do not foresee a need to repatriate these earnings to the U.S. since our U.S. cash requirements are supported by distributions from foreign entities of earnings that have not been designated as permanently reinvested and existing credit facilities. Repatriation of earnings from foreign subsidiaries for which we have asserted that the earnings are

permanently reinvested would result in additional U.S. income and foreign withholding taxes. The determination of the amount of additional taxes related to the repatriation of these earnings is not practicable.

Prior to the spin-off of PMI by Altria, we were a wholly owned subsidiary of Altria. We participated in a tax-sharing agreement with Altria for U.S. tax liabilities, and our accounts were included with those of Altria for purposes of its U.S. federal income tax return. Under the terms of the agreement, taxes were computed on a separate company basis. To the extent that we generated foreign tax credits, capital losses and other credits that could not be utilized on a separate company basis, but were utilized in Altria's consolidated U.S. federal income tax return, we would recognize the resulting benefit in the calculation of our provision for income taxes. We made payments to, or were reimbursed by, Altria for the tax effects resulting from our inclusion in Altria's consolidated United States federal income tax return. On the date of the spin-off of PMI by Altria, we entered into a Tax Sharing Agreement with Altria. The Tax Sharing Agreement generally governs Altria's and our respective rights, responsibilities and obligations for pre-distribution periods and for potential taxes on the spin-off of PMI by Altria. With respect to any potential tax resulting from the spin-off of PMI by Altria, responsibility for the tax will be allocated to the party that acted (or failed to act) in a manner which resulted in the tax. Beginning March 31, 2008, we were no longer a member of the Altria consolidated tax return group, and we filed our own U.S. federal consolidated income tax return.

● **Fair Value Assessment of PMFTC Inc.**—As discussed in Note 6. *Acquisitions and Other Business Arrangements*, on February 25, 2010, our affiliate, Philip Morris Philippines Manufacturing Inc. ("PMPMI"), and Fortune Tobacco Corporation ("FTC") combined their respective business activities by transferring selected assets and liabilities of PMPMI and FTC to a new company called PMFTC Inc. ("PMFTC"). PMPMI and FTC hold equal economic interests in PMFTC, while we manage the day-to-day operations of PMFTC and have a majority of its Board of Directors. Consequently, we accounted for the contributed assets and liabilities of FTC as a business combination.

The fair value of the assets and liabilities contributed by FTC in this non-cash transaction was determined to be \$1.17 billion. FTC holds the right to sell its interest in PMFTC to us, except in certain circumstances, during the period from February 25, 2015, through February 24, 2018, at an agreed-upon value of \$1.17 billion, which was recorded on our consolidated balance sheet as a redeemable noncontrolling interest at the date of the business combination.

In future periods, if the fair value of 50% of PMFTC were to drop below the redemption value of \$1.17 billion, the difference would be treated as a special dividend to FTC and would reduce our earnings per share. Reductions in earnings per share may be partially or fully reversed in subsequent periods if the fair value of the redeemable noncontrolling interest increases relative to the redemption value. Such increases in earnings per share would be limited to cumulative prior reductions. At December 31, 2012, we determined that 50% of the fair value of PMFTC exceeded the redemption value of \$1.17 billion and that any reasonable movement in the assumptions would not result in the fair value being less than the redemption value.

● **Hedging**—As discussed below in "Market Risk," we use derivative financial instruments principally to reduce exposures to market risks resulting from fluctuations in foreign currency exchange rates by creating offsetting exposures. For derivatives to which we have elected to apply hedge accounting, we meet the requirements of U.S. GAAP. As a result, gains and losses on these derivatives are initially deferred in accumulated other comprehensive losses on the consolidated balance sheet and recognized in the consolidated statement of earnings in the periods when the related hedged transactions are also recognized in operating results. If we had elected not to use the hedge accounting provisions permitted under U.S. GAAP, gains (losses) deferred in stockholders' (deficit) equity would have been recorded in our net earnings.

● **Contingencies**—As discussed in Note 21. *Contingencies* to our consolidated financial statements, legal proceedings covering a wide range of matters are pending or threatened against us, and/or our subsidiaries, and/or our indemnitees in various jurisdictions. We and our subsidiaries record provisions in the consolidated financial statements for pending litigation when we determine that an unfavorable outcome is probable and the amount of the loss can be reasonably estimated. The variability in pleadings in multiple jurisdictions, together with the actual experience of management in litigating claims, demonstrate that the monetary relief that may be specified in a lawsuit bears little relevance to the ultimate outcome. Much of the tobacco-related litigation is in its early stages, and litigation is subject to uncertainty. At the present time, while it is reasonably possible that an unfavorable outcome in a case may occur, after assessing the information available to it (i) management has not concluded that it is probable that a loss has been incurred in any of the pending tobacco-related cases; (ii) management is unable to estimate the possible loss or range of loss for any of the pending tobacco-related cases; and (iii) accordingly, no estimated loss has been accrued in the consolidated financial statements for unfavorable outcomes in these cases, if any. Legal defense costs are expensed as incurred.

Consolidated Operating Results

See pages 47 to 50 for a discussion of our “Cautionary Factors That May Affect Future Results.” Our cigarette volume, net revenues, excise taxes on products and operating companies income by segment were as follows:

(in millions)	2012	2011	2010
Cigarette Volume			
European Union	197,966	211,493	222,964
Eastern Europe, Middle East & Africa	303,828	290,250	289,312
Asia	326,582	313,282	282,290
Latin America & Canada	98,660	100,241	105,290
Total cigarette volume	927,036	915,266	899,856

(in millions)	2012	2011	2010
Net Revenues			
European Union	\$27,338	\$29,768	\$28,050
Eastern Europe, Middle East & Africa	19,272	17,452	15,928
Asia	21,071	19,590	15,235
Latin America & Canada	9,712	9,536	8,500
Net revenues	\$77,393	\$76,346	\$67,713

(in millions)	2012	2011	2010
Excise Taxes on Products			
European Union	\$18,812	\$20,556	\$19,239
Eastern Europe, Middle East & Africa	10,940	9,571	8,519
Asia	9,873	8,885	7,300
Latin America & Canada	6,391	6,237	5,447
Excise taxes on products	\$46,016	\$45,249	\$40,505

(in millions)	2012	2011	2010
Operating Income			
Operating companies income:			
European Union	\$ 4,187	\$ 4,560	\$ 4,311
Eastern Europe, Middle East & Africa	3,726	3,229	3,152
Asia	5,197	4,836	3,049
Latin America & Canada	1,043	988	953
Amortization of intangibles	(97)	(98)	(88)
General corporate expenses	(210)	(183)	(177)
Operating income	\$13,846	\$13,332	\$11,200

As discussed in Note 12. *Segment Reporting* to our consolidated financial statements, we evaluate segment performance and allocate resources based on operating companies income, which we define as operating income before general corporate expenses and amortization of intangibles. We believe it is appropriate to disclose this measure to help investors analyze the business performance and trends of our various business segments.

References to total international cigarette market, total cigarette market, total market and market shares throughout this “Discussion and Analysis” reflect our best estimates based on a number of internal and external sources.

The following events that occurred during 2012, 2011 and 2010 affected the comparability of our statement of earnings amounts:

● **Asset Impairment and Exit Costs**—For the years ended December 31, 2012, 2011 and 2010, pre-tax asset impairment and exit costs by segment were as follows:

(in millions)	2012	2011	2010
Separation programs:			
European Union	\$ —	\$ 35	\$27
Eastern Europe, Middle East & Africa	—	6	—
Asia	13	7	—
Latin America & Canada	29	15	—
Total separation programs	42	63	27
Contract termination charges:			
Eastern Europe, Middle East & Africa	—	12	—
Asia	13	—	20
Total contract termination charges	13	12	20
Asset impairment charges:			
European Union	5	10	—
Eastern Europe, Middle East & Africa	5	7	—
Asia	13	8	—
Latin America & Canada	5	9	—
Total asset impairment charges	28	34	—
Asset impairment and exit costs	\$83	\$109	\$47

For further details, see Note 5. *Asset Impairment and Exit Costs* to our consolidated financial statements.

● **Acquisitions and Other Business Arrangements**—In 2012, we did not have any acquisitions and other business arrangements. For details on 2011 and 2010, see Note 6. *Acquisitions and Other Business Arrangements* to our consolidated financial statements.

2012 compared with 2011

The following discussion compares our consolidated operating results for the year ended December 31, 2012, with the year ended December 31, 2011.

Our cigarette shipment volume of 927.0 billion units increased by 11.8 billion (1.3%), due primarily to gains in:

- EEMA, driven mainly by Egypt, Russia and Turkey; and
- Asia, driven mainly by Indonesia, the Philippines, Thailand and Vietnam, partially offset by Japan and Korea.

These gains were partially offset by declines in:

- the European Union, predominantly due to France and southern Europe; and
- Latin America & Canada, mainly due to Argentina, Canada, Colombia and Mexico.

Excluding acquisitions, our cigarette shipment volume was up by 1.3%. Excluding acquisitions and the Japan hurdle of 6.3 billion units related to additional volume shipped in the second quarter of 2011 as a result of the disruption of our principal competitor’s supply chain following the natural disaster in March 2011, our cigarette shipment volume was up by 2.0%.

Our market share in our top 30 OCI markets was 37.4%, up by 0.6 share points. Our market share grew in a number of markets, notably Algeria, Argentina, Australia, Belgium, Brazil, Colombia, Egypt, Greece, Indonesia, Mexico, Poland, Russia, Thailand, Turkey and Ukraine.

Total cigarette shipment volume of *Marlboro* of 301.6 billion units was up by 0.5%, or by 1.1%, excluding the Japan hurdle. This increase is due primarily to growth in: EEMA of 3.6%, notably in the Middle East, North Africa and Turkey, partly offset by Romania, Russia and Ukraine; Asia of 3.6%, principally driven by Indonesia, the Philippines and Vietnam, partly offset by Japan and Korea; and Latin America & Canada of 0.7%, notably in Brazil and Colombia, partly offset by Argentina. Cigarette shipments of *Marlboro* declined in the European Union by 4.6%, notably in France, Italy and Spain.

Total cigarette shipment volume of *L&M* of 93.7 billion units was up by 4.0%, reflecting growth in: EEMA of 8.6%, notably in Egypt, Russia and Turkey; Asia of 14.8%, mainly in Thailand; and Latin America & Canada of 6.9%, mainly in Brazil and Colombia. Cigarette shipment volume of *L&M* declined in the European Union by 4.1%, notably in Greece, Poland and Spain, partly offset by growth in France.

Total cigarette shipment volume of *Bond Street* of 46.8 billion units increased by 4.1%, led mainly by growth in Kazakhstan and Ukraine, partly offset by a decline in Hungary.

Total cigarette shipment volume of *Parliament* of 43.4 billion units was up by 10.1%, or by 11.1%, excluding the Japan hurdle, fueled by strong growth in EEMA of 16.5%, driven by Kazakhstan, Russia, Turkey and Ukraine. Cigarette shipment volume of *Parliament* declined in Asia by 4.3%, notably in Japan and Korea.

Total cigarette shipment volume of *Philip Morris* of 38.0 billion units decreased by 3.2%, or by 1.4%, excluding the Japan hurdle, mainly reflecting a decline in Japan and the Philippines, partly offset by growth in Argentina and Portugal.

Total cigarette shipment volume of *Chesterfield* of 35.5 billion units was down by 3.2%, due mainly to Ukraine, partly offset by growth in the European Union, notably in Poland, Portugal and the United Kingdom.

Total cigarette shipment volume of *Lark* of 32.1 billion units decreased by 4.6%. Excluding the Japan hurdle, cigarette shipment volume of *Lark* increased 3.5%.

Our other tobacco products ("OTP") consist mainly of tobacco for roll-your-own and make-your-own cigarettes, pipe tobacco, cigars and cigarillos. Total shipment volume of OTP, in cigarette equivalent units, excluding acquisitions, grew by 9.8% to 31.2 billion units, notably in Belgium, France, Germany, Greece, Italy and Spain, partly offset by Poland.

Total shipment volume for cigarettes and OTP combined was up by 1.5%, excluding acquisitions. Total shipment volume for cigarettes and OTP combined was up by 2.2%, excluding acquisitions and the Japan hurdle.

Our net revenues and excise taxes on products were as follows:

(in millions)	2012	2011	Variance	%
Net revenues	\$77,393	\$76,346	\$1,047	1.4%
Excise taxes on products	46,016	45,249	767	1.7%
Net revenues, excluding excise taxes on products	\$31,377	\$31,097	\$ 280	0.9%

Currency movements decreased net revenues by \$5.0 billion and net revenues, excluding excise taxes on products, by \$1.5 billion. The \$1.5 billion decrease was due primarily to the Argentine peso, Brazilian real, Euro, Indonesian rupiah, Mexican peso, Polish zloty, Russian ruble and Turkish lira, partially offset by the Japanese yen and Philippine peso.

Net revenues shown in the table above include \$1,709 million in 2012 and \$1,589 million in 2011 related to sales of OTP. These net revenue amounts include excise taxes billed to customers. Excluding excise taxes, net revenues for OTP were \$676 million in 2012 and \$616 million in 2011.

Net revenues, which include excise taxes billed to customers, increased \$1.0 billion (1.4%). Excluding excise taxes, net revenues increased \$280 million (0.9%) to \$31.4 billion. This increase was due to:

- price increases (\$1.8 billion) and
- the impact of acquisitions (\$28 million), partly offset by
- unfavorable currency (\$1.5 billion) and
- unfavorable volume/mix (\$12 million).

Excise taxes on products increased \$767 million (1.7%), due to:

- higher excise taxes resulting from changes in retail prices and tax rates (\$3.9 billion) and
- volume/mix (\$415 million), partly offset by
- favorable currency (\$3.5 billion).

Governments have consistently increased excise taxes in most of the markets in which we operate. As discussed under the caption "Business Environment," we expect excise taxes to continue to increase.

Our cost of sales; marketing, administration and research costs; and operating income were as follows:

(in millions)	2012	2011	Variance	%
Cost of sales	\$10,373	\$10,678	\$(305)	(2.9)%
Marketing, administration and research costs	6,978	6,880	98	1.4%
Operating income	13,846	13,332	514	3.9%

Cost of sales decreased \$305 million (2.9%), due primarily to:

- favorable currency (\$557 million), partly offset by
- volume/mix (\$221 million),
- higher manufacturing costs (\$16 million) and
- the impact of acquisitions (\$15 million).

With regard to tobacco leaf prices, we continue to expect modest increases going forward, broadly in line with inflation, as the market has now been stabilized, due in part to our increased direct involvement with local farmers. We also anticipate some cost pressure in 2013, driven in large measure by the historical leaf tobacco price increases that will continue to affect our product costs in the current year, higher prices for cloves and higher prices for a number of other direct materials we use in the production of our brands.

Marketing, administration and research costs increased \$98 million (1.4%), due to:

- higher expenses (\$424 million, principally related to increased marketing expenditures, notably in Germany, Indonesia and Russia, increased headcount and business infrastructure in Russia and expenditures incurred to combat illicit trade in cigarettes) and
- the impact of acquisitions (\$9 million), partly offset by
- favorable currency (\$335 million).

Operating income increased by \$514 million (3.9%). This increase was due primarily to:

- price increases (\$1.8 billion), partly offset by
- unfavorable currency (\$600 million),
- higher marketing, administration and research costs (\$424 million) and
- unfavorable volume/mix (\$233 million).

Interest expense, net, of \$859 million increased \$59 million, due primarily to higher average debt levels, partially offset by lower average interest rates on debt.

Our effective tax rate increased 0.4 percentage points to 29.5%. The 2012 effective tax rate was unfavorably impacted by an additional income tax provision of \$79 million following the conclusion of the IRS examination of Altria's consolidated tax returns for the years 2004–2006, partially offset by a \$40 million benefit from a tax accounting method change in Germany. The 2011 effective tax rate was favorably impacted by an enacted decrease in corporate income tax rates in Greece (\$11 million) and the reversal of a valuation allowance in Brazil (\$15 million). The effective tax rate is based on our full-year geographic earnings mix and cash repatriation plans. Changes in our cash repatriation plans could have an impact on the effective tax rate, which we monitor each quarter. Significant judgment is required in determining income tax provisions and in evaluating tax positions. Based upon tax regulations in existence at December 31, 2012, the American Taxpayer Relief Act of 2012 and our cash repatriation plans, we estimate that our 2013 effective tax rate will be approximately 29% to 30%.

We are regularly examined by tax authorities around the world, and we are currently under examination in a number of jurisdictions. It is reasonably possible that within the next twelve months certain tax examinations will close, which could result in a change in unrecognized tax benefits along with related interest and penalties. An estimate of any possible charge cannot be made at this time.

Net earnings attributable to PMI of \$8.8 billion increased \$209 million (2.4%). This increase was due primarily to higher operating income, partially offset by a higher effective tax rate and higher interest expense, net. Diluted and basic EPS of \$5.17 increased by 6.6%. Excluding an unfavorable currency impact of \$0.23, diluted EPS increased by 11.3%. Excluding the unfavorable currency impact and the 2011 earnings per share hurdle of \$0.10 related to Japan, diluted EPS increased by 13.7%.

2011 compared with 2010

The following discussion compares our consolidated operating results for the year ended December 31, 2011, with the year ended December 31, 2010.

Our cigarette shipment volume of 915.3 billion units increased 15.4 billion (1.7%), due primarily to gains in:

- Asia, primarily driven by a higher total market and share in Indonesia, higher share in Japan (including the benefit from the shortages of competitors' products) and Korea, as well as the favorable impact of the business combination in the Philippines; and
- EEMA, primarily due to higher total markets in Algeria and Saudi Arabia, and higher share in Algeria and Turkey.

These gains were partially offset by declines in:

- the European Union, primarily due to lower total markets and share, mainly in Italy, Portugal and Spain, and a lower total market in Greece; and
- Latin America & Canada, due mainly to Mexico, reflecting a lower total market, partly offset by a higher total market and share in Argentina, and higher share in Canada.

Excluding acquisitions (primarily the business combination with Fortune Tobacco Corporation in the Philippines in 2010), our cigarette shipment volume was up 0.5%, driven by growth from each of our top ten brands by volume, which, collectively, represented more than 75% of our total cigarette shipment volume.

Our market share performance was stable or registered growth in a number of markets, including Algeria, Argentina, Australia, Austria, Belgium, Canada, France, Germany, Greece, Hong Kong, Indonesia, Japan, Korea, Malaysia, Mexico, the Netherlands, the Philippines, Russia, Singapore, Thailand and Turkey.

Total cigarette shipments of *Marlboro* of 300.1 billion units were up by 0.9%, due primarily to an increase in Asia of 8.8%, mainly Indonesia, Japan, Korea and Vietnam; and growth in EEMA of 5.3%, primarily due to the Middle East and North Africa. These increases were partially offset by declines in the European Union of 5.1%, mainly reflecting lower total markets and share, primarily in Italy, Portugal and Spain, a lower market in Greece, and lower share in Germany, partly offset by share growth in Belgium and Hungary; and in Latin America & Canada of 5.8%, mainly due to a lower total market in Mexico, partly offset by share growth in Argentina, Colombia and Brazil.

Total cigarette shipments of *L&M* of 90.1 billion units were up by 1.7%, reflecting growth in the European Union, EEMA and Latin America & Canada segments.

Total cigarette shipments of *Bond Street* of 45.0 billion units increased by 2.0%, led mainly by growth in Kazakhstan, Russia and Ukraine, partially offset by declines in Hungary and Turkey.

Total cigarette shipments of *Parliament* of 39.4 billion units were up by 12.1%.

Total cigarette shipments of *Philip Morris* of 39.3 billion units increased by 1.4%, mainly reflecting growth in Japan and Argentina, partly offset by a decline in the Philippines.

Total cigarette shipments of *Chesterfield* of 36.7 billion units were up by 0.6%, driven by growth in the European Union, primarily in Germany and Portugal.

Total cigarette shipments of *Lark* of 33.7 billion units increased by 17.5%, driven by growth in Japan, partially offset by a decline in Turkey.

Total shipment volume of OTP, in cigarette equivalent units, excluding acquisitions, grew by 8.3%, notably in Benelux, France, Italy and Germany.

Total shipment volume for cigarettes and OTP combined was up by 0.8% excluding acquisitions.

Our net revenues and excise taxes on products were as follows:

(in millions)	2011	2010	Variance	%
Net revenues	\$76,346	\$67,713	\$8,633	12.7%
Excise taxes on products	45,249	40,505	4,744	11.7%
Net revenues, excluding excise taxes on products	\$31,097	\$27,208	\$3,889	14.3%

Currency movements increased net revenues by \$2.6 billion and net revenues, excluding excise taxes on products, by \$1.2 billion. The \$1.2 billion increase was due primarily to the Australian dollar, the Euro, Indonesian rupiah, Japanese yen, Russian ruble and the Swiss franc, partially offset by the Turkish lira.

Net revenues shown in the table above include \$1,589 million in 2011 and \$1,321 million in 2010 related to sales of OTP. These net revenue amounts include excise taxes billed to customers. Excluding excise taxes, net revenues for OTP were \$616 million in 2011 and \$514 million in 2010.

Net revenues, which include excise taxes billed to customers, increased \$8.6 billion (12.7%). Excluding excise taxes, net revenues increased \$3.9 billion (14.3%) to \$31.1 billion. This increase was due to:

- price increases (\$1.9 billion),
- favorable currency (\$1.2 billion),
- favorable volume/mix (\$609 million) and
- the impact of acquisitions (\$137 million).

Excise taxes on products increased \$4.7 billion (11.7%), due to:

- higher excise taxes resulting from changes in retail prices and tax rates (\$3.2 billion),
- currency movements (\$1.3 billion),

- volume/mix (\$198 million) and
- the impact of acquisitions (\$52 million).

Our cost of sales; marketing, administration and research costs; and operating income were as follows:

(in millions)	2011	2010	Variance	%
Cost of sales	\$10,678	\$ 9,713	\$ 965	9.9%
Marketing, administration and research costs	6,880	6,160	720	11.7%
Operating income	13,332	11,200	2,132	19.0%

Cost of sales increased \$965 million (9.9%), due to:

- higher manufacturing costs (\$428 million, including air freight costs related to additional shipments to Japan),
- currency movements (\$254 million),
- volume/mix (\$187 million) and
- the impact of acquisitions (\$96 million).

Marketing, administration and research costs increased \$720 million (11.7%), due to:

- currency (\$427 million),
- higher expenses (\$278 million, principally related to increased marketing investment in Japan and Russia, and business infrastructure investment in Russia) and
- the impact of acquisitions (\$15 million).

Operating income increased \$2.1 billion (19.0%).

This increase was due primarily to:

- price increases (\$1.9 billion),
- favorable currency (\$565 million) and
- favorable volume/mix (\$422 million), partially offset by
- higher manufacturing expenses (\$428 million),
- higher marketing, administration and research costs (\$278 million) and
- higher asset impairment and exit costs (\$62 million).

Interest expense, net, of \$800 million decreased \$76 million, due primarily to lower average interest rates on debt and higher interest income, partially offset by higher average debt levels.

Our effective tax rate increased 1.7 percentage points to 29.1%, due primarily to higher discrete tax items in 2010 that benefited our 2010 effective tax rate. The 2011 effective tax rate was favorably impacted by an enacted decrease in corporate income tax rates in Greece (\$11 million) and the reversal of a valuation allowance in Brazil (\$15 million). The 2010 effective tax rate was favorably impacted by the reversal of tax reserves (\$148 million) following the conclusion of the IRS examination of Altria Group, Inc.'s consolidated tax returns for the years 2000 through 2003, partially offset by the negative impact of an enacted increase in corporate income tax rates in Greece (\$21 million) and the net result of an audit in Italy (\$6 million).

Net earnings attributable to PMI of \$8.6 billion increased \$1.3 billion (18.3%). This increase was due primarily to higher operating income, partially offset by a higher effective tax rate. Diluted and basic EPS of \$4.85 increased by 23.7% and 23.4%, respectively. Excluding a favorable currency impact of \$0.19, diluted EPS increased by 18.9%.

Operating Results by Business Segment

Business Environment

Taxes, Legislation, Regulation and Other Matters Regarding the Manufacture, Marketing, Sale and Use of Tobacco Products

The tobacco industry faces a number of challenges that may adversely affect our business, volume, results of operations, cash flows and financial position. These challenges, which are discussed below and in “*Cautionary Factors That May Affect Future Results*,” include:

- actual and proposed tobacco legislation and regulation;
- actual and proposed excise tax increases, as well as changes in excise tax structures and retail selling price regulations;
- price gaps and changes in price gaps between premium and mid-price and low-price brands and between cigarettes and other tobacco products;
- increased efforts by tobacco control advocates and governments to “denormalize” smoking and impose extreme regulatory requirements impacting our ability to communicate with adult consumers and differentiate our products from competitors’ products, including legislation to mandate plain (generic) packaging resulting in the expropriation of our brands and trademarks;
- actual and proposed extreme regulatory requirements related to the ingredients in tobacco products, including restrictions and complete bans;
- other actual and proposed restrictions affecting tobacco manufacturing, testing and performance standards and requirements, packaging, marketing, advertising, product display and sales;
- governmental and private bans and restrictions on smoking;
- illicit trade in cigarettes and other tobacco products, including counterfeit, contraband and so called “illicit whites;”
- actual and proposed restrictions on imports in certain jurisdictions;
- pending and threatened litigation as discussed in Note 21. *Contingencies*; and
- governmental investigations.

In the ordinary course of business, many factors can affect the timing of sales to customers, including the timing of holidays and other annual or special events, the timing

of promotions, customer incentive programs and customer inventory programs, as well as the actual or speculated timing of pricing actions and tax-driven price increases.

● **Framework Convention on Tobacco Control:** The World Health Organization’s (“WHO”) Framework Convention on Tobacco Control (“FCTC”) entered into force in February 2005. As of February 2013, 175 countries, as well as the European Community, have become Parties to the FCTC. The FCTC is the first international public health treaty, and its objective is to establish a global agenda for tobacco regulation with the purpose of reducing initiation of tobacco use and encouraging cessation. The treaty recommends (and, in certain instances, requires) Parties to have in place or enact legislation that would:

- establish specific actions to prevent youth smoking;
- restrict and/or eliminate all tobacco product advertising, marketing, promotions and sponsorships;
- initiate public education campaigns to inform the public about the health consequences of smoking and the benefits of quitting;
- implement regulations imposing tobacco product testing, disclosure and performance standards;
- impose health warning requirements on tobacco product packaging;
- adopt measures aimed at eliminating illicit trade in tobacco products;
- restrict smoking in public places;
- implement public health-based fiscal policies (tax and price measures);
- adopt and implement measures that ensure that packaging and labeling, including descriptive terms, do not create the false impression that one brand of tobacco products is safer than another;
- phase out or restrict duty free tobacco sales; and
- encourage litigation against tobacco product manufacturers.

In many respects, the areas of regulation we support mirror provisions of the FCTC. For example, we have long advocated for laws that strictly prohibit the sale of tobacco products to minors, limit public smoking, mandate the placement of health warnings on tobacco product packaging, and regulate product content to ensure that changes to the product do not increase the adverse health effects of smoking and to establish a regulatory framework for future reduced risk products. We also strongly support the use of tax and price policies to achieve public health objectives, provided that they do not result in increased illicit trade. We do not, however, agree with the current views of the WHO and others who are pursuing policies that have gone far beyond the original text of the FCTC treaty.

For example, following the entry into force of the FCTC, the Conference of the Parties (“CoP”), the governing body of the FCTC, has adopted several guidelines proposed

by tobacco control advocates and supported by WHO that provide non-binding recommendations which purport to supplement specific articles of the treaty. The recommendations include measures that we strongly oppose, such as point-of-sale display bans, plain packaging, a ban on all forms of communications to adult smokers, measures to prohibit or restrict ingredients that may increase the palatability or attractiveness of tobacco products, bans on charitable contributions, measures to prevent the use of journalistic expression or political commentary “for the promotion of tobacco use,” bans on retailer incentive programs and limits on tobacco industry involvement in the development of tobacco policy and regulations.

These recommendations and the actions of the WHO and others reflect an extreme application of the treaty, are not based on sound evidence of a public health benefit, and in many cases are likely to lead to adverse consequences. The evidence does not show that these measures will help achieve the public health goals of the original treaty provisions. In fact, as we discuss below, some of these extreme measures are likely to undermine the original goals of the FCTC and public health by leading to a further increase in illicit trade, the proliferation of low-price cigarettes and, in the case of measures such as plain packaging, will result in the expropriation of our trademarks, harm competition and violate international treaties.

Although to date only a few governments have adopted these extreme measures, it is not possible to predict whether or to what extent the various CoP guidelines and WHO recommendations will be adopted. If governments choose to implement regulation based on these extreme recommendations, such regulation may adversely affect our business, volume, results of operations, cash flows and financial position. In some instances, including those described below, where such regulation has been adopted, we have commenced legal proceedings challenging the regulation. It is not possible to predict the outcome of these legal proceedings.

● **Excise Taxes:** Tobacco products are subject to substantial excise taxes and to other product taxation worldwide. Significant increases in tobacco-related taxes or fees have been proposed or enacted and are likely to continue to be proposed or enacted. For example, the Philippines recently enacted a new excise tax law that increased the excise tax on the premium-price segment by more than 100% and on the low-price segment by nearly 340% in 2013 and provides for further significant increases primarily affecting the lower tier until both tiers are merged in 2017. In addition, in certain jurisdictions, our products are subject to tax structures that discriminate against premium price products and manufactured cigarettes.

Excessive and disruptive tax increases and discriminatory tax structures, which we oppose, are expected to continue to have an adverse impact on our sales of cigarettes, due to lower consumption levels and to a shift in consumer purchases from premium to non-premium, discount, other low-price or low-taxed tobacco products, such as fine-cut tobacco, and/or illicit products. Such tax increases undermine public health and ultimately undercut government revenue objectives.

At the fifth session of the CoP held in November 2012, the Parties did not adopt guidelines on price and tax measures to reduce the demand for tobacco but instead adopted a brief “set of guiding principles and recommendations for implementation of Article 6,” which does not include extreme proposals. An inter-session working group will prepare and present new draft guidelines at the sixth session of the CoP in 2014.

● **EU Tobacco Products Directive:** In December 2012, the European Commission adopted its proposal for a significantly revised EU Tobacco Products Directive (2001/37/EC). Among other things, the European Commission’s proposal includes a ban on menthol cigarettes, a ban on slim cigarettes, oversized health warnings covering 75% of the front and back panels, as well as 50% of the side panels of cigarette packs, mandatory sizes and shapes for tobacco packaging, and further restrictions on product descriptions and brand differentiation. Under the proposal, Member States would have the option to further standardize tobacco packaging, including by introducing plain packaging, if justified in the “public interest.” The proposal would also require non-traditional nicotine-containing products, such as certain e-cigarettes, as well as certain reduced risk products under development, to obtain approval under the Medicinal Products Directive. In addition, by seeking to prohibit accurate, substantiated product descriptions related to reduced risk, the European Commission’s proposal would introduce significant hurdles to the commercialization of reduced risk products in the EU.

The proposal may be amended and must be approved by the European Parliament and the Council of Ministers, a process that, according to the European Commission, is expected to continue until 2014, with full implementation in 2015 and 2016. It is not possible to predict the ultimate outcome of this legislative process.

● **Plain Packaging:** We strongly oppose plain packaging, which not only constitutes an expropriation of our valuable trademarks, but is a pure and simple confiscation of the core of our business. We believe that transforming the industry into a low-price commodity business will not reduce consumption, smoking incidence or initiation. Indeed, there is no sound evidence that plain packaging will have any measurable impact on smoking behavior. Even many public health advocates agree today that plain packaging will have no impact on current smokers and claim that the measure is intended to reduce initiation among youth. However, the data do not support that claim either. On the contrary, over time plain packaging is likely to be counterproductive from a public health perspective because it will increase the availability of cheaper tobacco products and spur an increase in illicit trade. Cheaper tobacco products are known to increase consumption, especially among youth. Further, increased illicit trade will hurt the legitimate industry, its entire supply chain and government revenues. Moreover, plain packaging imposes on free competition and trade as well as the use of intellectual property; it violates the terms of: (1) the Agreement on Trade-Related Aspects of Intellectual Property Rights (“TRIPS”), which prohibits unjustified encumbrances on trademarks and protects geographical indications; (2) the

Paris Convention, which prevents acts that constitute unfair competition; and (3) the Agreement on Technical Barriers to Trade, which prohibits regulations that constitute barriers to trade. We will take all steps necessary to ensure that all constituencies understand the adverse consequences of plain packaging and to obtain all protection and relief to which we are entitled under the law.

Plain packaging went into effect in Australia in December 2012. The Australian law bans the use of company branding, logos and colors on packaging of all tobacco products for sale to consumers other than the brand name and variant, which may be printed only in specified locations and in a uniform font. It also imposes restrictions on the branding of cigarette sticks.

The Australian plain packaging legislation triggered three legal challenges. Our Australian subsidiary, Philip Morris Limited (“PML”), and other major tobacco companies filed lawsuits against the government in the High Court of Australia arguing that by implementing plain packaging, the government violated the Australian Constitution because it acquired property without compensation. The High Court initially heard the cases brought by certain British American Tobacco companies (“BAT”) and by JT International. In August 2012, the High Court issued its ruling in favor of the government. In the court’s written reasons, published in October 2012, a majority of the Justices recognized that plain packaging deprived the plaintiffs of property. However, because no “benefit” inured to the government or a third party, the court held that plain packaging did not violate the Australian Constitution. We expect that the court’s ruling will also apply to PML’s case. Given the particular nature of the Australian Constitution, we do not expect the decision to be a significant adverse precedent in other jurisdictions. In fact, we expect that the court’s finding that plain packaging deprives tobacco manufacturers of their intellectual property would raise serious questions about the legality of plain packaging legislation in other jurisdictions.

Our subsidiary, Philip Morris Asia Limited, has initiated international arbitration proceedings against the Australian government pursuant to the Hong Kong-Australia Bilateral Investment Treaty (the “Investment Treaty”). Formal proceedings under the Investment Treaty commenced in November 2011. In the arbitration, Philip Morris Asia Limited is seeking substantial compensation from the Australian government. The arbitration may take several years to complete.

Three World Trade Organization (“WTO”) members, Ukraine, Honduras and the Dominican Republic, have initiated WTO dispute settlement cases against Australia. They claim, among other things, that plain packaging creates unnecessary barriers to trade in violation of the WTO Agreement on Technical Barriers to Trade; unjustifiably encumbers the use of trademarks and reduces the protection of geographical indications in violation of TRIPS; and will create confusion among consumers in violation of the Paris Convention. In September 2012, Ukraine requested a panel to hear the dispute, which the Dispute Settlement Body of the WTO is now establishing. Thirty-four countries and the European Union have intervened as third parties in the Ukrainian case, including Indonesia, China, Japan, Korea

and the United States. Honduras and the Dominican Republic have both announced they will request that panels be formed to hear their disputes against Australia. WTO dispute settlement cases can take several years to complete. It is not possible to predict the outcome of these cases.

Although plain packaging was already recommended in 2008 under the FCTC guidelines adopted by the third CoP, to date no country other than Australia has adopted this measure. Two countries, the UK and New Zealand conducted consultations to consider plain packaging. In the UK, between April and August 2012, the Department of Health held a public consultation “to seek the views of interested people, businesses and organisations on a policy initiative that would require the packaging of tobacco products to be standardized [plain], the aim being to improve public health by reducing the use of tobacco.” It is not possible to predict whether the consultation will result in any legislative action. In New Zealand, the government announced in February 2013 that it would agree in principle to follow Australia but that it would “wait and see what happens with Australia’s legal cases” before adopting legislation and implementing regulation. Thus, plain packaging is not expected to proceed in New Zealand, if at all, until the WTO and other challenges to Australia’s legislation are resolved.

In addition, in some instances, such as under the recently adopted proposal of the European Commission, excessively large health warnings, combined with other standardization measures and packaging restrictions, may impact our ability to use our distinctive brands and trademarks in a manner that approximates, or is substantially equivalent to, plain packaging.

● **Restrictions and Bans on the Use of Ingredients and Disclosure Laws:** Until recently, efforts to regulate the use of ingredients have focused on whether ingredients increase the toxicity and/or addictiveness of cigarette smoke. Increasingly, however, tobacco control advocates and some regulators, including the WHO, the European Commission and individual governments, are considering regulating or have regulated cigarette ingredients with the stated objective of reducing the “palatability” or “attractiveness” of cigarette smoke, smoking and/or tobacco products. We oppose regulations that would ban ingredients for the purpose of reducing the palatability or attractiveness of tobacco products because, in light of the millions of smokers in countries like Canada, the UK and China who prefer cigarettes without ingredients, there is no reasonable basis to conclude that an ingredient ban would reduce smoking prevalence or youth smoking initiation. Indeed, we do not believe it is appropriate to use “attractiveness,” which is an inherently subjective and variable term, as a basis for regulation of ingredients, let alone bans of entire product categories. It also lacks scientific, empirically verified criteria.

In November 2010, the fourth session of the CoP adopted “partial” and “provisional” guidelines on Articles 9 and 10 of the FCTC (regulation of contents and disclosure of tobacco products). Among other things, these guidelines recommend that Parties implement measures to prohibit or restrict ingredients and colorings that may increase the palatability or attractiveness of tobacco products. The CoP

determined that these guidelines will have to be periodically re-assessed “in light of the scientific evidence and country experience.” The Working Group on Articles 9 and 10 is expected to present a set of recommendations focused on toxicity and addictiveness at future sessions of the CoP.

In March 2012, Brazil’s National Sanitation Agency (“ANVISA”) published a resolution that prohibits the use of all synthetic and natural substances with flavoring or aromatic properties, with a limited exception to allow for the use of sugars to replace those lost during the tobacco leaf-drying process. Manufacturers have until September 2013 to comply with the resolution. The ban, if implemented, would make it impossible to continue producing the traditional American Blend tobacco products currently preferred by Brazilian smokers and will require manufacturers to modify most, if not all, products in the market. In September 2012, Sinditabaco (a tobacco industry union of which Philip Morris Brasil Ltda. is a member) filed a lawsuit in Brazilian federal court against ANVISA challenging the ingredients ban. The lawsuit claims that ANVISA lacks authority to institute the ban, failed to produce evidence justifying or supporting the ban, failed to comply with due process and proportionality requirements and ignored the unintended consequences of the measure, such as encouraging illicit trade. In December 2012, the court granted Sinditabaco a preliminary injunction, suspending ANVISA’s ingredients ban until a full hearing of the dispute. In February 2013, ANVISA appealed the injunction order.

We oppose bans or sweeping restrictions on ingredients such as those recently adopted in Brazil or the ban on menthol proposed by the European Commission, which are arbitrary and without any scientific evidence demonstrating a public health benefit. We support regulations that would restrict the use of ingredients that are determined, based on sound scientific testing methods and data, to significantly increase the adverse health effects of tobacco smoke or youth smoking initiation.

Many countries have enacted or proposed legislation or regulations that require cigarette manufacturers to disclose to governments and to the public the ingredients used in the manufacture of tobacco products and, in certain cases, to provide toxicological information about those ingredients. We have made and will continue to make full disclosures where adequate assurances of trade secret protection are provided. In jurisdictions where it is not possible to obtain appropriate assurances of trade secret protection, we will seek to resolve the matter with governments through alternative means.

● **Bans on Display of Tobacco Products at Retail:** In a few of our markets, governments have banned the display of tobacco products at the point of sale (“display bans”), while in other countries proposals for display bans have been specifically rejected. In some countries, proposals are currently under consideration. We oppose display bans on the grounds that they unnecessarily restrict competition and encourage illicit trade—consequences that undermine public health objectives. Further, the data show that where implemented, display bans have not reduced smoking prevalence and initiation, or had any material beneficial impact on public

health. In some markets, our subsidiaries and, in some cases, individual retailers, have commenced legal proceedings to overturn display bans.

● **Health Warning Requirements:** We support health warning requirements designed to inform consumers of the risks of smoking and defer to governments on the content of the warnings, whether graphic or textual, except for content that vilifies tobacco companies or is not justified by the actual repercussions of smoking. In countries where health warnings are not required, we place them on packaging voluntarily in the official language or languages of the country. For example, we are voluntarily placing health warnings on packaging in many African countries in official local languages occupying 30% of the front and back of the pack. In most of our markets, governments require large and often graphic health warnings on cigarette packs, consistent with, and often larger than, the FCTC minimum of 30% of the front and back of the pack. For instance, Egypt, Hong Kong, Panama, and Singapore are among the growing number of countries requiring health warnings occupying 50% of the front and back of the pack. We have not opposed such health warning requirements.

To date, only a few countries have implemented warnings covering more than 50% of the front and/or back of the pack. They include, for instance, Australia (75% front and 90% back), Mexico (30% front and 100% back), Uruguay (80% front and back) and Canada (75% front and back).

The data show that disproportionately increasing the size of health warnings does not effectively reduce tobacco consumption. For this reason, and because it infringes upon our intellectual property rights, leaving insufficient space for our distinctive trademarks and pack designs, we oppose extremely large health warnings. In a few markets we have commenced legal proceedings challenging extreme warning size requirements or content that is not justified by the actual repercussions of smoking.

We believe governments should continue to educate the public on the serious health effects of smoking. Our corporate Web site, www.pmi.com, includes, among other things, the views of public health authorities on smoking, disease causation in smokers, addiction and exposure to environmental tobacco smoke (“ETS”). The site reflects our agreement with the medical and scientific consensus that cigarette smoking is addictive and causes lung cancer, heart disease, emphysema and other serious diseases in smokers. The Web site advises the public to rely on the messages of public health authorities in making all smoking-related decisions. The information on our Web site is not, and shall not be deemed to be, a part of this document or incorporated into any filings we make with the SEC.

● **Other Packaging Restrictions:** Tobacco control advocates and some regulators are calling for further restrictions on packaging, including standardizing the shape, format and lay-out of packaging, as well as broad restrictions on how the space left for branding and product descriptions can be used. Such measures further restrict our ability to provide information to consumers and to differentiate our brands from those of our competitors.

Many countries, including all EU Member States, prohibit descriptors such as “lights,” “mild” and “low tar.” We do not oppose these types of descriptor bans.

Some public health advocates, governments, and the FCTC guidelines have sought the implementation of, and in some cases have passed, restrictions on packaging and labeling that prohibit (1) the use of colors that are alleged to suggest that a brand is less harmful than others, (2) specific descriptive phrases deemed to be misleading, including, for example, “premium,” “full flavor,” “international,” “gold,” “silver,” and “menthol” and (3) in one country, all but one pack variation per brand. The measures proposed by the European Commission would also prohibit any references on the pack to taste and flavor as well as pack design elements suggesting a “positive social effect.” We believe such regulations are unreasonably broad, unnecessarily limit brand and product differentiation, are anticompetitive, prevent us from providing consumers with factual information about our products, unduly restrict our intellectual property and violate international trade agreements. We oppose these broad packaging restrictions and in some instances have commenced litigation to challenge them.

● **Bans and Restrictions on Advertising, Marketing, Promotions and Sponsorships:** For many years, countries have imposed partial or total bans on tobacco advertising, marketing, promotions and sponsorships. The FCTC calls for a “comprehensive ban on advertising, promotion and sponsorship” and requires governments that have no constitutional constraints to ban all forms of advertising. Where constitutional constraints exist, the FCTC requires governments to restrict to the fullest extent possible advertising on radio and television, advertising in print and other media, including the Internet, and sponsorships of international events within five years of the effective date of a country’s ratification of the FCTC. The FCTC also requires disclosure of expenditures on advertising, promotion and sponsorship where such activities are not prohibited. The CoP-adopted guidelines recommend that governments adopt extreme and sweeping prohibitions, including all forms of communications to adult smokers. We oppose complete bans on advertising and communications. We believe that the available evidence does not support the contention that limitations on marketing are effective in reducing smoking prevalence, but we would generally not oppose such limitations as long as manufacturers retain the ability to communicate directly and effectively to adult smokers.

● **Restrictions on Product Design and Emissions:** Tobacco control advocates and some regulators are calling for regulations to further standardize tobacco products themselves by, for example, requiring that cigarettes have a certain minimum diameter, which amounts to a ban on slim cigarettes, or requiring the use of standardized filter and cigarette paper designs. We oppose such restrictions. We believe that there is no correlation between product design variations and overall smoking rates or youth smoking initiation, nor any scientific evidence showing a health benefit that would result from product design restrictions.

Many countries, including all EU Member States, have established, and continue to consider reducing, maximum yields of tar, nicotine and/or carbon monoxide, as measured by the ISO standard test method. Several countries, including Brazil and Canada, require manufacturers to test and report by-brand yields of up to 47 of the more than 100 smoke constituents that have been identified as potential causes of smoking-related diseases. No country to date has adopted ceilings based on an alternative test method or for other smoke constituents, although the concept of “selective constituent reduction” is supported by some public health advocates. At the fifth session of the CoP in November 2012, the working group on FCTC Articles 9 and 10 was tasked with preparing draft guidelines or a progress report, to be presented at the sixth session of the CoP, regarding testing and measuring five selected tobacco contents and nine selected smoke constituents using methods validated by the WHO. It is not certain whether and when actual testing requirements and/or ceilings will be recommended by the CoP and whether individual countries will adopt them. We agree with those scientists who have argued that selectively reducing some constituents in conventional cigarettes will not lead to a meaningful reduction in disease and thus will not benefit public health, yet will mislead consumers into believing that conventional cigarettes with regulated (i.e., reduced) levels of these constituents are safer.

Reduced cigarette ignition propensity standards have been adopted in several of our markets, for instance in Australia, Canada and the EU, and are being considered in several others. At the fifth session of the CoP in November 2012, guidelines were adopted that recommend that Parties introduce the same reduced ignition propensity standards as adopted by the U.S., Canada, Australia and the EU. Reduced ignition propensity standards should be uniform across jurisdictions, technically feasible and apply equally to all manufacturers. However, we believe that the experience from countries that have mandated reduced ignition propensity requirements for several years—namely the U.S. and Canada—should be thoroughly examined to evaluate the effectiveness of such requirements, in particular in terms of reducing the risk of cigarette-ignited fires, before additional countries consider introducing such standards.

● **Restrictions on Public Smoking:** The pace and scope of public smoking restrictions have increased significantly in most of our markets. In the EU, all countries have regulations in place that restrict or ban smoking in public and/or work places, restaurants, bars and nightclubs. Some EU Member States allow narrow exemptions from smoking bans, for instance for separate smoking rooms in the hospitality sector, but others have banned virtually all indoor public smoking. In other regions, many countries have adopted or are likely to adopt regulations introducing substantial public smoking restrictions similar to those in the EU, including Australia, Canada, Hong Kong, Thailand, Turkey and Ukraine. Some public health groups have called for, and some regional governments and municipalities have adopted or proposed, bans on smoking in outdoor places, as well as bans on smoking in cars when minors are present. The FCTC requires Parties to adopt restrictions on public smoking. The

CoP-adopted guidelines on public smoking are based on the premise that any exposure to ETS is harmful. The guidelines call for total bans in all indoor public places, defining “indoor” broadly, and reject any exemptions based on the type of venue (e.g., nightclubs). On private place smoking, such as in cars and homes, the guidelines recommend increased education on the risk of exposure to ETS.

We support a single, consistent public health message on the health effects of exposure to ETS. Our Web site states that “the conclusions of public health authorities on second-hand smoke warrant public health measures that regulate smoking in public places” and that “outright bans are appropriate in many places.” For example, we support banning smoking in schools, playgrounds and other facilities for youth and in indoor public places where general public services are provided, such as public transportation vehicles, supermarkets, public spaces in indoor shopping centers, cinemas, banks and post offices. We believe, however, that governments can and should seek a balance between the desire to protect non-smokers from exposure to ETS and allowing the millions of people who smoke to do so in some public places. In the hospitality sector, such as restaurants, bars, cafés and other entertainment establishments, the law should grant private business owners the flexibility to permit, restrict or prohibit smoking. In the workplace, designated smoking rooms can provide places for adults to smoke. Finally, we oppose legislation that would prohibit smoking outdoors (beyond outdoor places and facilities for children) and in private places such as homes, apartments and cars.

● **Illicit Trade:** Illicit trade may account for as much as 10% of global cigarette consumption; this includes counterfeit, contraband and the growing problem of “illicit whites,” which are unique cigarette brands manufactured predominantly for smuggling. We estimate that illicit trade in the European Union accounted for more than 10% of total cigarette consumption in 2011 and for approximately 11% of total cigarette consumption in 2012. Regulatory measures and related governmental actions to prevent the illicit manufacture and trade of tobacco products are being considered by a number of jurisdictions. At the fifth session of the CoP in November 2012, the Protocol to Eliminate Illicit Trade in Tobacco Products (the “Protocol”) was adopted. The Protocol includes supply chain control measures such as licensing of manufacturers and distributors, enforcement in free trade zones, controls on duty free and internet sales and the implementation of tracking and tracing technologies. In the EU, the European Commission’s proposal for revising the Tobacco Products Directive contains tracking and tracing measures that are based to some extent on the Protocol but, unlike the Protocol, also require tracking at pack level down to retail, which we believe is not only unnecessarily burdensome but not feasible.

It is not possible to predict how long it will take for a sufficient number of Parties to ratify the Protocol such that it enters into force. Nor is it possible to predict when Parties will implement the Protocol’s measures in national legislation or to what extent the measures outlined in the Protocol will be effective in curbing the growth of, or even eliminating, illicit trade. Among other things, the effectiveness of any legislative measure required under the Protocol will depend on whether

and how such measure is adopted and implemented in national legislation across the world, and, critically, the level of actual enforcement of such national legislation.

We support strict regulations and enforcement measures to prevent all forms of illicit trade in tobacco products. Governments agree that illicit trade is an extremely serious issue. It creates a cheap and unregulated source of tobacco, thus undermining efforts to reduce smoking, especially among youth, damages legitimate businesses, stimulates organized crime and results in massive amounts of corruption and lost tax revenue. We therefore believe that in addition to taking direct measures against illicit trade, governments, when assessing proposed regulation, such as display bans, plain packaging, ingredients bans or tax increases, should always carefully consider the potential implications of such regulation on illicit trade.

● **Cooperation Agreements to Combat Illicit Trade of Cigarettes:** In 2004, we entered into an agreement with the European Commission (acting on behalf of the European Community) that provides for broad cooperation with European law enforcement agencies on anti-contraband and anti-counterfeit efforts. All 27 Member States of the EU have signed the agreement. Under the terms of the agreement, we agreed to make financial contributions in the form of 13 payments over 12 years. Commencing in July 2007, we began making payments of approximately \$75 million a year over the final 10 years of the agreement, each of which is to be adjusted based on certain variables, including our market share in the EU in the year preceding payment. We record these payments as an expense in cost of sales when product is shipped. We are also required to pay the excise taxes, VAT and customs duties on qualifying product seizures of up to 90 million cigarettes and are subject to payments of five times the applicable taxes and duties if qualifying product seizures exceed 90 million cigarettes in a given year. To date, our annual payments related to product seizures have been immaterial.

In 2009, our subsidiaries Philip Morris Colombia and Coltabaco entered into an Investment and Cooperation Agreement with the Republic of Colombia, together with the Departments of Colombia and the Capital District of Bogotá, to promote investment in and cooperation on anti-contraband and anti-counterfeit efforts with respect to the Colombian tobacco market. The agreement provides \$200 million in funding to the Colombian governments over a 20-year period to address issues of mutual interest, such as combating the illegal cigarette trade, including the threat of counterfeit tobacco products, and increasing the quality and quantity of locally grown tobacco.

In June 2012, we announced that we will contribute €15 million to INTERPOL over a three-year period to support the agency’s global initiative to combat trans-border crime involving illicit goods, including tobacco products. The contribution to INTERPOL’s Fund For A Safer World will be used for coordination of information gathering, training programs for law enforcement officials, development of product authentication standards and public information campaigns.

● **Labor Conditions for Tobacco Workers:** In July 2010, Human Rights Watch published a report raising issues related to labor conditions for tobacco workers in Kazakhstan, particularly migrant workers. We have undertaken both an internal and third party review of our labor practices and policies in Kazakhstan and subsequently globally. In reviewing our policies and practices, we have sought the advice of local and international non-profit organizations with expertise in the area of fair labor practices. During 2011, we began implementing our comprehensive Agricultural Labor Practices (“ALP”) Code, which strengthens and expands our existing practices and policies. This includes setting additional principles and standards for working conditions on tobacco farms, tailored training programs and regular external assessments to monitor the progress we, our suppliers, and farmers make. To date, over 2,900 field technicians in 30 countries have received in-depth training on the ALP Code, including child labor, forced labor prevention and safe work environment requirements. During 2012, these field technicians communicated our expectations to approximately 497,000 farmers with whom our affiliates or suppliers have contracts. A progress report on our ALP program is available on our Web site at www.pmi.com. The information on our Web site is not, and shall not be deemed to be, a part of this document or incorporated into any filings we make with the SEC.

● **Other Legislation, Regulation or Governmental Action:**

In Argentina, the National Commission for the Defense of Competition issued a resolution in May 2010, in which it found that our affiliate’s establishment in 1997 of a system of exclusive zonified distributors (“EZD”) in Buenos Aires city and region was anticompetitive, despite having issued two prior decisions (in 1997 and 2000) in which it had found the establishment of the EZD system was not anticompetitive. The resolution is not a final decision, and our Argentinean affiliate has opposed the resolution and submitted additional evidence.

In June 2011 in Brazil, the Secretariat of Economic Defense recommended to the Administrative Council for Economic Defense (“CADE”) that it find that the merchandising arrangements of our affiliate and those of a competitor violated the Brazilian Competition Act and that it impose fines of unspecified amounts against each company. In July 2012, our competitor entered into a consent decree with CADE that prohibits certain of the competitor’s merchandising arrangements and in connection therewith agreed to pay R\$2.9 million (approximately \$1.46 million). In January 2013, our subsidiary also entered into a consent decree with CADE that, like our competitor’s consent decree, prohibits certain merchandising arrangements and agreed to pay R\$250,000 (approximately \$126,000). The consent decree suspends CADE’s investigation for 60 months, after which the investigation will be closed without prejudice. The prohibition of certain merchandising arrangements will remain in force permanently.

It is not possible to predict what, if any, additional legislation, regulation or other governmental action will be enacted or implemented relating to the manufacturing, advertising, sale or use of cigarettes, or the tobacco industry generally. It is possible, however, that legislation, regulation or other

governmental action could be enacted or implemented that might materially affect our business, volume, results of operations and cash flows.

Governmental Investigations

From time to time, we are subject to governmental investigations on a range of matters. As part of an investigation by the Department of Special Investigations (“DSI”) of the government of Thailand into alleged under-declaration of import prices by Thai cigarette importers, the DSI proposed to bring charges against our subsidiary, Philip Morris (Thailand) Limited, Thailand Branch (“PM Thailand”) for alleged underpayment of customs duties and excise taxes of approximately \$2 billion covering the period from July 28, 2003, to February 20, 2007. In September 2009, the DSI submitted the case file to the Public Prosecutor for review. The DSI also commenced an informal inquiry alleging underpayment by PM Thailand of customs duties and excise taxes of approximately \$1.8 billion, covering the period 2000–2003. We have been cooperating with the Thai authorities and believe that PM Thailand’s declared import prices are in compliance with the Customs Valuation Agreement of the World Trade Organization (“WTO”) and Thai law. PM Thailand also contends that it reached an agreement with the Thai Customs Department in 2003 regarding valuation methodologies. The Public Prosecutor’s office has issued a non-prosecution order in the 2003–2007 investigation. In August 2011, the Director-General of DSI publicly announced that he disagreed with the non-prosecution order. The matter has now been referred to the Attorney General for resolution. If the Attorney General agrees with the Public Prosecutor’s non-prosecution order, the 2003–2007 investigation will end. If the Attorney General agrees with the Director General of DSI, the matter will be submitted to the Criminal Court.

Additionally, in November 2010, a WTO panel issued its decision in a dispute that began in August 2006 between the Philippines and Thailand concerning a series of Thai customs and tax measures affecting cigarettes imported by PM Thailand into Thailand from the Philippines. The WTO panel decided that Thailand had no basis to find that PM Thailand’s declared customs values and taxes paid were too low, as alleged by the DSI in 2009. While the WTO ruling does not resolve the above-referenced investigation, it should assist the Thai authorities’ review of the matter. Further, the WTO ruling creates obligations for Thailand to revise its laws, regulations, or practices affecting the customs valuation and tax treatment of future cigarette imports. The WTO Dispute Settlement Body (“DSB”) has adopted the WTO panel’s report and also the report by the WTO Appellate Body (following an unsuccessful appeal by Thailand). Thailand agreed in September 2011 to implement VAT-related measures to comply with the DSB’s recommendations and rulings by October 15, 2012, and to implement measures to comply with the rest of the DSB’s recommendations and rulings by May 15, 2012. If a dispute settlement panel determines that Thailand has failed to comply with the DSB’s recommendations and rulings, the Philippines may request authorization to take retaliatory actions against Thailand.

Next Generation Products

One of our strategic priorities is to develop, assess and commercialize a portfolio of innovative products with the potential to reduce the risk of smoking-related diseases in comparison to conventional cigarettes. We refer to these as next generation products (“NGPs”). In the U.S. regulatory context they are referred to as modified-risk tobacco products (“MRTPs”). Our efforts are guided by the following key objectives:

- to develop a series of products that provides adult smokers the taste, sensory experience and smoking ritual characteristics that are as close as possible to those currently provided by conventional cigarettes;
- to substantiate a significant reduction of risk for the individual adult smoker as well as a reduction of harm for the population as a whole, based on robust scientific evidence derived from well-established assessment processes; and
- to advocate for the development of regulatory frameworks for the assessment, approval and commercialization of NGPs, including the communication of substantiated reductions in risk to consumers.

We believe the elimination of combustion via tobacco heating and other innovative systems for aerosol generation is the most promising path to reduce risk, and, accordingly, the NGPs we are developing are based on platforms that do not involve combustion. These platforms are in various stages of development. One platform is in the early stages of clinical trials and industrial scale-up, another is in its final development phase, and the third requires at least one year for further product development. We are also developing other potential platforms.

Our approach to individual risk assessment is to use cessation as the benchmark, because the short-term and long-term effects of smoking cessation are well known, and the closer the clinical data derived from adult smokers who switch to an NGP resemble the data from those who quit, the more confident one can be that the product reduces risk.

Today, only the U.S. has established a regulatory framework for assessing MRTPs under the jurisdiction of the Food and Drug Administration (the “FDA”). Future FDA actions are likely to influence the regulatory approach of other interested governments. In March 2012, the FDA released draft guidance establishing the types and levels of evidence necessary to qualify a product as an MRTP. The draft guidance recommends studies that are generally in line with PMI’s assessment approach, which we have submitted to the FDA. In parallel, we are beginning engagement with regulators in the EU, as well as in a number of Asian markets.

We are also proceeding with all other aspects that lead to commercialization. We are planning to build one or two new factories to produce NGPs in Europe. We anticipate capital expenditures in the range of €500 million to €600 million (\$666 million to \$799 million) over a three-year period to achieve the capacity to produce 30 billion NGP units per year. This expenditure will be close to double the level of a conventional cigarette factory of equivalent output.

We currently expect the first NGP factory to be ready by 2016, final data from clinical studies during the beginning of 2016 and a launch in the first markets between 2016 and 2017. However, there can be no assurance that we will succeed in these efforts or that regulators will permit the marketing of our NGPs with claims of reduced risk or reduced harm.

Acquisitions and Other Business Arrangements

In June 2011, we completed the acquisition of a cigarette business in Jordan, consisting primarily of cigarette manufacturing assets and inventories, for \$42 million. In January 2011, we acquired a cigar business, consisting primarily of trademarks in the Australian and New Zealand markets, for \$20 million. The effects of these and other smaller acquisitions in 2011 were not material to our consolidated financial position, results of operations or cash flows.

Effective January 1, 2011, we established a new business structure with Vietnam National Tobacco Corporation (“Vinataba”) in Vietnam. Under the terms of the agreement, we have further developed our existing joint venture with Vinataba through the licensing of *Marlboro* and the establishment of a PMI-controlled branch for the business building of our brands.

On February 25, 2010, our affiliate, Philip Morris Philippines Manufacturing Inc. (“PMPMI”), and Fortune Tobacco Corporation (“FTC”) combined their respective business activities by transferring selected assets and liabilities of PMPMI and FTC to a new company called PMFTC Inc. (“PMFTC”). PMPMI and FTC hold equal economic interests in PMFTC, while we manage the day-to-day operations of PMFTC and have a majority of its Board of Directors. Consequently, we accounted for the contributed assets and liabilities of FTC as a business combination. The establishment of PMFTC permits both parties to benefit from their respective, complementary brand portfolios, as well as cost synergies from the resulting integration of manufacturing, distribution and procurement, and the further development and advancement of tobacco growing in the Philippines. FTC holds the right to sell its interest in PMFTC to PMI, except in certain circumstances, during the period from February 25, 2015 through February 24, 2018, at an agreed-upon value of \$1.17 billion, which was recorded on PMI’s consolidated balance sheet as a redeemable noncontrolling interest at the date of the business combination.

In June 2010, we announced that our affiliate, Philip Morris Brasil Industria e Comercio Ltda. (“PMB”), will begin directly sourcing tobacco leaf from approximately 17,000 tobacco farmers in Southern Brazil. This initiative enhances PMI’s direct involvement in the supply chain and is expected to provide approximately 10% of PMI’s global leaf requirements. The vertically integrated structure was made possible following separate agreements with two leaf suppliers in Brazil, Alliance One Brasil Exportadora de Tabacos Ltda. (“AOB”) and Universal Leaf Tabacos Ltda. (“ULT”). These agreements resulted in AOB assigning approximately 9,000 contracts with tobacco farmers to PMB and ULT assigning approximately 8,000 contracts with tobacco farmers to PMB. As a result, PMB offered employment to more than 200 employees, most of them agronomy specialists, and acquired

related assets in Southern Brazil. The purchase price for the net assets and the contractual relationships was \$83 million, which was paid in 2010.

See Note 6. *Acquisitions and Other Business Arrangements* to our consolidated financial statements for additional information.

Trade Policy

We are subject to various trade restrictions imposed by the United States and countries in which we do business ("Trade Sanctions"), including the trade and economic sanctions administered by the U.S. Department of the Treasury's Office of Foreign Assets Control ("OFAC") and the U.S. Department of State. It is our policy to fully comply with these Trade Sanctions.

Tobacco products are agricultural products under U.S. law and are not technological or strategic in nature. From time to time we make sales in countries subject to Trade Sanctions, pursuant to either exemptions or licenses granted under the applicable Trade Sanctions.

In April 2012, OFAC granted us licenses to sell cigarettes to customers for import into Iran. To date, we have not made any sales under these licenses.

A subsidiary sells products to distributors that in turn sell those products to duty free customers that supply U.N. peacekeeping forces around the world, including those in the Republic of the Sudan. We do not believe that these exempt sales of our products for ultimate resale in the Republic of the Sudan, which are de minimis in volume and value, present a material risk to our stockholders, our reputation or the value of our shares. We have no employees, operations or assets in the Republic of Sudan.

We do not sell products in Cuba and Syria.

To our knowledge, none of our commercial arrangements result in the governments of any country identified by the U.S. government as a state sponsor of terrorism, nor entities controlled by those governments, receiving cash or acting as intermediaries in violation of U.S. laws.

Certain states have enacted legislation permitting state pension funds to divest or abstain from future investment in stocks of companies that do business with certain countries that are sanctioned by the U.S. We do not believe such legislation has had a material effect on the price of our shares.

2012 compared with 2011

The following discussion compares operating results within each of our reportable segments for 2012 with 2011.

● **European Union:** Net revenues, which include excise taxes billed to customers, decreased \$2.4 billion (8.2%). Excluding excise taxes, net revenues decreased \$686 million (7.4%) to \$8.5 billion. This decrease was due to:

- unfavorable currency (\$716 million) and
- unfavorable volume/mix (\$445 million), partly offset by
- price increases (\$475 million).

The net revenues of the European Union segment include \$1,372 million in 2012 and \$1,235 million in 2011 related to sales of OTP. Excluding excise taxes, OTP net

revenues for the European Union segment were \$475 million in 2012 and \$407 million in 2011.

Operating companies income of \$4.2 billion decreased by \$373 million (8.2%). This decrease was due to:

- unfavorable currency (\$384 million),
- unfavorable volume/mix (\$380 million),
- higher manufacturing costs (\$62 million, mainly related to the mandated conversion to reduced cigarette ignition propensity paper that began in the fourth quarter of 2011) and
- higher marketing, administration and research costs (\$62 million, principally reflecting increased marketing investment behind new brand launches and roll-out of the "Be *Marlboro*" marketing campaign), partly offset by
- price increases (\$475 million) and
- lower pre-tax charges for asset impairment and exit costs (\$40 million).

The total cigarette market in the European Union declined by 6.3% to 520 billion units, due primarily to tax-driven price increases, the unfavorable economic and employment environment, particularly in southern Europe, the growth of the OTP category, and the increased prevalence of illicit trade. Our cigarette shipment volume in the European Union declined by 6.4%, due principally to a lower total market across the region. Our market share in the European Union was essentially flat at 38.1%, as gains, notably in Belgium, Greece, Finland, Hungary and Poland, were offset by declines, primarily in the Czech Republic, France and Portugal.

Shipment volume of *Marlboro* decreased by 4.6%, mainly due to a lower total market. *Marlboro's* market share increased 0.3 share points to 18.3%, reflecting a higher share mainly in Belgium, Greece, Hungary, Italy and Poland, which more than offset lower share mainly in France, the Netherlands, Portugal and Spain.

Shipment volume of *L&M* was down by 4.1%. *L&M's* market share was flat at 6.6%, with gains in Finland, Germany, Poland and the Slovak Republic offset by declines notably in Greece and Portugal.

Shipment volume of *Chesterfield* was up by 4.7%. *Chesterfield's* market share was up by 0.4 share points to 3.7%, driven notably by gains in Austria, the Czech Republic, France, Hungary, Poland, Portugal, Spain and the United Kingdom.

Shipment volume of *Philip Morris* was down by 1.9%. Despite this decline, market share was up by 0.1 share point to 2.1%, with gains, notably in the Czech Republic and Italy, partly offset by a decline in Portugal and Spain.

Our shipment volume of OTP, in cigarette equivalent units, grew by 16.1%, reflecting a higher total market and share. Our OTP total market share was 12.2%, up by 1.1 share points, driven by gains in the fine cut category, notably in Belgium, up by 3.2 share points to 16.3%, France, up by 0.9 share points to 25.2%, Germany, up by 0.7 share points to 14.7%, Greece, up by 4.7 share points to 12.8%, Italy, up by 16.0 share points to 27.9% and Spain, up by 1.1 share points to 11.7%.

In the Czech Republic, the total cigarette market was down by 2.8% to 20.5 billion units in 2012, mainly reflecting the impact of excise tax-driven price increases in the first and second quarters of 2012 and a more than 20% growth of the fine cut category over the full year. Our shipments were down by 7.4%. Market share was down by 2.1 share points to 42.2%, principally reflecting continued share declines for lower-margin local brands, such as *Petra* and *Sparta*, down by a combined 1.2 share points to 6.1%, and *Red & White*, down by 1.2 share points to 11.7%. This decline was partly offset by a higher share for *Marlboro*, *Chesterfield* and *Philip Morris*, up by 0.2, 0.5 and 0.6 share points to 7.4%, 0.8% and 2.9%, respectively. Market share of *L&M* was essentially flat at 7.1%.

In France, the total cigarette market was down by 4.9% to 51.5 billion units, mainly reflecting the impact of price increases in the fourth quarters of 2011 and 2012. Our shipments were down by 7.7%. Our market share was down by 0.9 share points to 39.6%, mainly due to *Marlboro*, down by 0.9 share points to 24.8%, and to *L&M*, down by 0.3 share points to 2.7%. Market share of premium *Philip Morris* was up by 0.1 share point to 8.3% and share of *Chesterfield* was up by 0.2 share points to 3.3%. Our market share of the fine cut category was up by 0.9 share points to 25.2%.

In Germany, the total cigarette market was down by 1.2% to 83.4 billion units, flattered by trade inventory movements of competitors' products in December ahead of the January 2013 excise tax increase. Our shipments were down by 1.5%. Our market share was essentially unchanged at 35.8%, with *Marlboro* essentially flat at 21.3%, *L&M* up by 0.1 share point to 10.5% and *Chesterfield* flat at 2.3%. Our market share of the fine cut category was up by 0.7 share points to 14.7%.

In Italy, the total cigarette market was down by 7.9% to 78.7 billion units, reflecting the impact of price increases in 2011 and March 2012, an unfavorable economic environment, strong growth in the fine cut category, and an increase in illicit trade. Our shipments were down by 7.3%. Our market share was essentially flat at 53.0%, with *Marlboro*, up by 0.6 share points to 23.1%, fueled by the March 2012 and June 2012 launches of *Marlboro Silver* and *Marlboro Pocket Pack*, and *Philip Morris*, up by 0.4 share points to 3.7%, benefiting from the first-quarter 2012 launch of *Philip Morris Selection* in the low-price segment, offset by low-price *Diana*, down by 0.8 share points to 12.4%. Our market share of the fine cut category was up by 16.0 share points to 27.9%.

In Poland, the total cigarette market was down by 6.1% to 52.1 billion units, mainly reflecting the impact of price increases in the first quarter of 2012 and growth in the availability of non-duty paid OTP products. Our shipments were down by 3.1%. Market share was up by 1.1 share points to 36.4%, benefiting from the launch of two new *Marlboro* super slims variants in the second quarter. Market shares of *Marlboro*, *Chesterfield* and *L&M* were up by 0.9, 0.4 and 0.7 share points to 11.3%, 1.8% and 16.6%, respectively. Our market share of the fine cut category was up by 0.5 share points to 17.8%.

In Spain, the total cigarette market was down by 11.7% to 53.5 billion units, mainly reflecting the impact of price increases in the second half of 2011 and second quarter of 2012, the unfavorable economic environment, the growth of

the OTP category and illicit trade. Our shipments were down by 11.4%. Market share was down by 0.3 share points to 30.6%, with higher share of *Chesterfield*, revamped in the first quarter of 2012, up by 0.6 share points to 9.0%, offset by *Marlboro*, down by 0.4 share points to 14.3% and *Philip Morris*, down by 0.3 share points to 0.7%. Market share of *L&M* was down by 0.2 share points to 6.3%. Our market share of the fine cut category was up by 1.1 share points to 11.7%.

● **Eastern Europe, Middle East & Africa:** Net revenues, which include excise taxes billed to customers, increased \$1.8 billion (10.4%). Excluding excise taxes, net revenues increased \$451 million (5.7%) to \$8.3 billion. This increase was due to:

- price increases (\$466 million),
- favorable volume/mix (\$425 million) and
- the impact of acquisitions (\$27 million), partially offset by
- unfavorable currency (\$467 million).

Operating companies income of \$3.7 billion increased by \$497 million (15.4%). This increase was due primarily to:

- price increases (\$466 million),
- favorable volume/mix (\$317 million),
- lower manufacturing costs (\$31 million) and
- lower pre-tax charges for asset impairment and exit costs (\$20 million), partially offset by
- unfavorable currency (\$199 million) and
- higher marketing, administration and research costs (\$142 million, principally related to expenditures in marketing and business infrastructure, mainly in Russia).

Our cigarette shipment volume in EEMA increased by 4.7%, mainly reflecting improved market conditions and higher share in Egypt, a higher market share in Russia, and a higher total market and share in Turkey. Our cigarette shipment volume of premium brands grew by 6.7%, driven by *Marlboro*, up by 3.6%, and by *Parliament*, up by 16.5%.

In Russia, the total cigarette market declined by an estimated 1.3% to 370 billion units. Our shipment volume increased by 3.8%, mainly reflecting a higher market share. Shipment volume of our premium portfolio was up by 7.0%, driven by *Parliament*, up by 15.0%. In the mid-price segment, shipment volume was up by 4.8%, mainly due to *L&M*, up by 20.4%. In the low-price segment, shipment volume was up by 2.3%, driven by *Apollo Soyuz*, *Bond Street* and *Next*, up by 3.7%, 0.5% and 11.7%, respectively. Our market share of 26.3%, as measured by Nielsen, was up by 0.5 share points. Market share of *Parliament* was up by 0.3 share points to 3.2%; *Marlboro* was essentially flat at 1.9%; *L&M* was up by 0.2 share points to 2.6% and *Chesterfield* was flat at 3.4%; *Bond Street* was up by 0.3 share points to 6.5%; *Next* was up by 0.2 share points to 2.9%; and *Apollo Soyuz* and *Optima* were flat at 1.4% and 3.2%, respectively.

In Turkey, the total cigarette market increased by an estimated 8.8% to 99.2 billion units, reflecting: the favorable impact of trade inventory movements in the fourth quarter of 2012 ahead of the January 2013 excise tax increase; a decrease in illicit trade, and a favorable comparison with 2011, which experienced a 10.6% total cigarette market decline in the last three months of the year resulting from excise tax-driven price increases in the fourth quarter. Our shipment volume increased by 12.7%, across each of the premium, mid-price and low-price segments, up by 15.0%, 16.6% and 9.8%, respectively. Our market share, as measured by Nielsen, grew by 0.9 share points to 45.7%, driven by premium *Parliament*, mid-price *Muratti* and low-price *Lark*, up by 0.9, 0.4 and 0.3 share points to 9.0%, 6.6% and 12.2%, respectively, partly offset by a decline in low-price *L&M*, down by 0.3 share points to 8.4%. Market share of *Marlboro* was down by 0.1 share point to 9.2%.

In Ukraine, the total cigarette market declined by an estimated 2.6% to 83.4 billion units. Our shipment volume decreased by 0.6%. Our market share, as measured by Nielsen, was up by 0.2 share points to 32.4%. Share for premium *Parliament* was up by 0.4 share points to 3.2%. Share of *Marlboro* was flat at 5.8%, *Chesterfield* was down by 0.5 share points to 7.0% and *Bond Street* was up by 1.2 share points to 8.4%.

● **Asia:** Net revenues, which include excise taxes billed to customers, increased by \$1.5 billion (7.6%). Excluding excise taxes, net revenues increased \$493 million (4.6%) to \$11.2 billion. This increase was due primarily to:

- price increases (\$551 million) and
- favorable volume/mix (\$57 million), partially offset by
- unfavorable currency (\$116 million).

Operating companies income of \$5.2 billion increased by \$361 million (7.5%). This increase was due to:

- price increases (\$551 million),
- lower manufacturing costs (\$70 million, reflecting favorable shipping costs related to the Japan hurdle) and
- favorable currency (\$39 million), partly offset by
- higher marketing, administration and research costs (\$176 million, including higher marketing and sales investments in Indonesia),
- unfavorable volume/mix (\$99 million, due primarily to the aforementioned Japan hurdle) and
- higher pre-tax charges for asset impairment and exit costs (\$24 million).

Our cigarette shipment volume increased by 4.2%, driven by growth in Indonesia, the Philippines, Thailand and Vietnam, partly offset by a decline in Japan and Korea. Excluding the 2011 Japan hurdle of 6.3 billion units, cigarette shipment volume increased by 6.4%. Shipment volume of *Marlboro* was up by 3.6%, driven by Indonesia, the Philippines and Vietnam, partly offset by Japan and Korea. Shipment volume of *Marlboro* was up by 6.0%, excluding the 2011 Japan hurdle.

In Indonesia, the total cigarette market was up by 8.2% to 302.5 billion units, driven by growth in the premium and mid-price segments. Our shipment volume grew by 17.5%. Our market share was up by 2.8 share points to 35.6%, driven notably by *Sampoerna A* in the premium segment, up by 1.1 share points to 13.8%, and mid-price *U Mild*, up by 1.2 share points to 3.3%. *Marlboro's* market share was up by 0.3 share points to 4.8% and its share of the "white" cigarettes segment increased by 4.9 share points to 71.2%. Market share of *Dji Sam Soe* was essentially flat at 7.8%.

In Japan, the total cigarette market increased by 0.7% to 196.6 billion units, reflecting a favorable comparison with 2011 driven by trade inventory de-loading in the first quarter following the October 2010 excise tax-driven price increase. The estimated underlying decline of the total cigarette market in 2012 was approximately 1%. Our shipment volume was down by 9.7%, or up by 0.6%, excluding the additional hurdle volume of 6.3 billion units associated with 2011. Our market share was down by 3.0 share points to 27.7%, or down by 0.5 share points compared to the 2011 exit share of 28.2%. While share of *Marlboro* was down by 0.7 share points to 12.4%, it was essentially flat compared to its 2011 exit share, supported by the introduction of new *Marlboro* menthol variants during the year, and up by 1.0 share point compared to its pre-earthquake level. Share of *Lark* was down by 1.3 share points to 8.4%, or by 0.2 share points compared to its 2011 exit share of 8.6%. Share of *Philip Morris* was down by 0.5 share points to 2.3%, or by 0.2 share points compared to its 2011 exit share of 2.5%.

In Korea, the total cigarette market was down by 0.9% to 89.3 billion units. Our shipment volume decreased by 4.0%, reflecting the impact of our price increases in February 2012. Our market share of 19.2% was down by 0.6 share points. Market share of *Marlboro* and *Parliament* was down by 0.8 and 0.1 share points to 7.8% and 6.6%, respectively, partly offset by *Virginia Slims*, up by 0.7 share points to 4.1%.

In the Philippines, the total cigarette market increased by 5.0% to 102.2 billion units, reflecting the growth in the low-price segment and trade loading of competitive products ahead of the excise tax-driven price increase in January 2013. Our shipment volume increased by 1.3%. Our market share was down by 3.3 share points to 90.7%, due primarily to share declines of *Champion* and *Hope*. *Marlboro's* market share was down by 0.2 share points to 20.9%. Market share of *Fortune* was up by 2.4 share points to 49.4%.

● **Latin America & Canada:** Net revenues, which include excise taxes billed to customers, increased \$176 million (1.8%). Excluding excise taxes, net revenues increased \$22 million (0.7%) to \$3.3 billion. This increase was due to:

- price increases (\$267 million), partly offset by
- unfavorable currency (\$196 million) and
- unfavorable volume/mix (\$49 million).

Operating companies income of \$1.0 billion increased by \$55 million (5.6%). This increase was due to:

- price increases (\$267 million), partly offset by
- unfavorable volume/mix (\$71 million),

- unfavorable currency (\$63 million),
- higher manufacturing costs (\$55 million, primarily related to distribution infrastructure),
- higher marketing, administration and research costs (\$13 million) and
- higher pre-tax charges for asset impairment and exit costs (\$10 million, mainly related to the restructuring of manufacturing facilities).

Our cigarette shipment volume in Latin America & Canada decreased by 1.6%, mainly due to a lower total market in Argentina, Colombia and Mexico and lower share in Canada. Shipment volume of *Marlboro* increased by 0.7%, mainly reflecting market share growth in Brazil, Colombia and Mexico.

In Argentina, the total cigarette market declined by 0.9% to 43.4 billion units. Our cigarette shipment volume decreased by 0.3%. Our market share was up by 0.9 share points to 74.9%, reflecting growth of mid-price *Philip Morris*, up by 1.4 share points to 39.4%, partly offset by low-price *Next*, down by 0.5 share points to 3.1%. Market share of *Marlboro* was flat at 24.1%.

In Canada, the estimated total tax-paid cigarette market was essentially flat at 32.2 billion units. Our cigarette shipment volume declined by 1.5%. Our market share was down by 0.6 share points to 33.5%, primarily reflecting share losses in the mid-price segment, reflecting fierce price competition. Market share of premium brand *Benson & Hedges* was essentially flat at 2.1%, premium *Belmont* was up by 0.2 share points to 2.0%, and low-price brand *Next* was up by 0.8 share points to 7.7%, offset by mid-price *Number 7* and *Canadian Classics*, and low-price *Accord* and *Quebec Classique*, down by 0.2, 0.3, 0.4 and 0.3 share points, to 3.9%, 8.4%, 3.2% and 2.4%, respectively.

In Mexico, the total cigarette market was down by 2.2% to 33.6 billion units, reflecting the impact of price increases in January 2012 and the continued wide prevalence of illicit products. Our cigarette shipment volume decreased by 0.6%. Our market share grew by 1.2 share points to 73.5%, led by *Marlboro*, up by 1.3 share points to 53.6%. Market share of premium *Benson & Hedges* was up by 0.1 share point to 6.2% while share of low-price *Delicados* decreased by 0.5 share points to 10.4%.

2011 compared with 2010

The following discussion compares operating results within each of our reportable segments for 2011 with 2010.

● **European Union:** Net revenues, which include excise taxes billed to customers, increased \$1.7 billion (6.1%). Excluding excise taxes, net revenues increased \$401 million (4.6%) to \$9.2 billion. This increase was due to:

- favorable currency (\$440 million) and
- price increases (\$298 million), partially offset by
- unfavorable volume/mix (\$337 million).

The net revenues of the European Union segment include \$1,235 million in 2011 and \$1,001 million in 2010 related to sales of OTP. Excluding excise taxes, OTP net revenues for the European Union segment were \$407 million in 2011 and \$320 million in 2010.

Operating companies income of \$4.6 billion increased by \$249 million (5.8%). This increase was due primarily to:

- price increases (\$298 million),
- favorable currency (\$277 million), and
- lower marketing, administration and research costs (\$48 million), partially offset by
- unfavorable volume/mix (\$291 million),
- higher manufacturing costs (\$64 million) and
- higher pre-tax charges for asset impairment and exit costs (\$18 million, representing the restructuring of manufacturing and R&D facilities).

The total cigarette market in the European Union declined by 4.3%, due primarily to the impact of a lower total market: in Greece, mainly reflecting the unfavorable impact of excise tax driven price increases in 2010 and 2011, which drove the retail price of *Marlboro* up by 25% between the first quarter of each year, and the continuing adverse economic environment; in Italy, due primarily to excise tax driven price increases in 2010 and July 2011, and the VAT-driven price increase of September 2011; in Spain, following the cumulative unfavorable impact of price increases in 2010 and 2011, the implementation of stricter indoor public smoking bans in January 2011, unfavorable trade inventory movements, and continuing adverse economic conditions; in Portugal, reflecting both excise tax and VAT-driven price increases in 2010 and January 2011, and the continuing adverse economic environment; the growth of the OTP segment, primarily in Belgium, France, Germany and Italy; and an increase in illicit trade, notably in Greece and Spain. Excluding Spain, which represented almost half of the total regional market decline, we estimate that the total cigarette market in the European Union declined by 2.5%. Our cigarette shipment volume in the European Union declined by 5.1%, due primarily to the aforementioned reasons. Our market share in the European Union was down by 0.3 share points to 38.2%, as gains, notably in Belgium, France, Germany, Greece, Hungary and the Netherlands, were more than offset by declines, mainly in the Czech Republic, Italy, Poland, Portugal and Spain.

Shipment volume of *Marlboro* decreased by 5.1%, mainly due to lower total markets, particularly in Greece and Spain, and to lower share, primarily in Germany, Italy, Portugal and Spain, partially offset by higher share in Belgium and Hungary. *Marlboro*'s market share was down by 0.2 share points to 18.0%, reflecting a higher share mainly in Belgium, the Czech Republic, Greece, Hungary and the Netherlands, which was more than offset by lower share in Germany, Italy and Spain.

Shipment volume of *L&M* was up by 2.7%, driven by higher share in Germany, the Netherlands and Poland. *L&M*'s market share was up by 0.2 share points to 6.6%, driven by gains in Germany, the Netherlands, Poland and Spain.

Shipment volume of *Chesterfield* was up by 8.5%, and market share was up by 0.2 share points to 3.3%, driven primarily by higher share in France, Poland and Portugal.

Our shipment volume of OTP, in cigarette equivalent units, grew by 16.3%, mainly reflecting a higher total market and share in Belgium, France, Germany and Italy.

In the Czech Republic, the total cigarette market was essentially flat in 2011, at 21.1 billion units. Our shipments were down by 7.4%. Market share was down by 3.5 share points to 44.3%, primarily reflecting continued share declines for local brands, such as *Petra* and *Sparta*, down by a combined 2.0 share points. This decline was partly offset by a higher share for *Marlboro*, up by 0.4 share points to 7.2%, benefiting from the April 2011 launch of *Marlboro Core Flavor* and *Marlboro Gold Touch*, and a higher share for *Red & White*, up by 0.3 share points to 12.9%.

In France, the total cigarette market was down by 1.3% to 54.1 billion units. Our shipments were down by 1.7%. Our market share was up slightly by 0.1 share point to 40.5%. While market share of *Marlboro* declined by 0.2 share points to 25.7%, it was more than offset by a higher share for the premium *Philip Morris* brand, up by 0.4 share points to 8.2%, as well as by a higher share for *Chesterfield*, up by 0.3 share points to 3.1%. Our share of the fine-cut market grew by 4.7 share points to 24.3% for the full year, driven by *Philip Morris* and the very successful February 2011 launch of *Marlboro*.

In Germany, the total cigarette market grew by 0.7% to 84.5 billion units. Our shipments were up by 1.8%, and market share grew by 0.4 share points to 35.9%. While share of *Marlboro* was down by 0.5 share points to 21.4%, share of *L&M* was up by 1.1 share points to 10.4%.

In Italy, the total cigarette market was down by 1.8% to 85.5 billion units, reflecting the unfavorable impact of excise tax driven price increases in 2010, price increases in July 2011, and a VAT-driven price increase of €0.20 per pack in September 2011. Our shipments were down by 3.6%, and market share declined by 0.8 share points to 53.1%. *Marlboro's* market share was down by 0.3 share points to 22.5%.

In Poland, the total cigarette market was down by 3.1% to 55.6 billion units, reflecting the unfavorable impact of excise tax driven price increases in the fourth quarter of 2010 and second quarter of 2011, as well as the introduction of an indoor public smoking ban in November of 2010. Our shipments were down by 8.3%. Our market share was down by 2.0 share points to 35.3%, mainly due to lower share of low-price *Red & White*, down by 2.6 share points to 5.1%, partially offset by *L&M*, up by 1.1 share points to 15.9%, supported by the launch of *L&M Forward* in April 2011, and *Chesterfield*, up by 0.6 share points to 1.4%. Market share of *Marlboro* was flat at 10.4%.

In Spain, the total cigarette market was down by 16.7% to 60.6 billion units, largely due to the continuing adverse economic environment and the introduction of a total indoor public smoking ban in January 2011. Our shipments were down by 18.4%, and our market share was down by 0.8 share points to 30.9%. Share of *Marlboro* of 14.7% was down by 0.6 share points, reflecting the additional impact of crossing the €4.00 per pack retail price point during the year.

● **Eastern Europe, Middle East & Africa:** Net revenues, which include excise taxes billed to customers, increased \$1.5 billion (9.6%). Excluding excise taxes, net revenues increased \$472 million (6.4%) to \$7.9 billion. This increase was due to:

- price increases (\$271 million),
- favorable volume/mix (\$127 million),
- favorable currency (\$49 million) and
- the impact of acquisitions (\$25 million).

Operating companies income of \$3.2 billion increased by \$77 million (2.4%). This increase was due primarily to:

- price increases (\$271 million) and
- favorable volume/mix (\$107 million), partially offset by
- higher manufacturing costs (\$109 million),
- unfavorable currency (\$97 million),
- higher marketing, administration and research costs (\$69 million, including costs related to marketing and business infrastructure investment in Russia) and
- the 2011 pre-tax charges for asset impairment and exit costs (\$25 million).

Our cigarette shipment volume in EEMA increased by 0.3%, predominantly due to: the Middle East, primarily Saudi Arabia, mainly reflecting a higher total market; North Africa, primarily Algeria, driven by a higher total market and share growth; and Turkey, reflecting share growth. This increase was partly offset by a decline in Russia and Ukraine, largely due to lower total markets, and Libya, reflecting the imposition of economic sanctions during most of the year.

In Russia, the total cigarette market declined by approximately 2.0% to an estimated 375 billion units. Our shipment volume decreased by 2.3%. While shipment volume of our premium portfolio was down by 5.9%, primarily due to a decline in *Marlboro* of 12.1%, shipment volume of *Parliament* was up by 4.2%. In the mid-price segment, shipment volume was down by 0.7%, mainly due to *Chesterfield*, down by 0.7%, and *L&M*, down by 4.3%. In the low-price segment, shipment volume of *Bond Street* was up by 3.3%. Our market share of 25.8%, as measured by A.C. Nielsen, was up by 0.3 share points. Market share for *Parliament*, in the premium segment, was up slightly by 0.1 share point; *Marlboro*, in the premium segment, was down by 0.2 share points; *L&M* in the mid-price segment was down by 0.3 share points; *Chesterfield* in the mid-price segment was up slightly by 0.1 share point; and *Bond Street* in the low-price segment was up by 0.6 share points.

In Turkey, the total cigarette market was down by 2.3% to 91.2 billion units, due to the unfavorable impact of excise tax driven price increases in the fourth quarter of 2011. Our shipment volume increased by 7.1%. Our market share, as measured by A.C. Nielsen, grew by 2.7 share points to 44.8%, driven by *Parliament*, *Muratti* and *L&M*, up by 0.9, 0.6 and 3.1 share points, respectively, partly offset by declines in

Lark and *Bond Street*, down by 1.0 and 0.6 share points, respectively. Market share of *Marlboro* was down by 0.2 share points to 9.3%.

In Ukraine, the total cigarette market declined by 8.1% to 85.6 billion units, reflecting the unfavorable impact of excise tax driven price increases in 2010 and 2011. Our shipment volume decreased by 10.7%. Our market share, as measured by A.C. Nielsen, was down by 2.5 share points to 32.2%, due to declines in our medium and low-price segments. Share for premium *Parliament* was up by 0.4 share points to 2.8%. Share of *Marlboro* was up by 0.3 share points to 5.8%.

● **Asia:** Net revenues, which include excise taxes billed to customers, increased \$4.4 billion (28.6%). Excluding excise taxes, net revenues increased \$2.8 billion (34.9%) to \$10.7 billion. This increase was due to:

- price increases (\$991 million),
- favorable volume/mix (\$977 million, including increased shipments to Japan in response to in-market shortages of competitors' products),
- favorable currency (\$690 million) and
- the impact of acquisitions (\$112 million, primarily the 2010 business combination in the Philippines).

Operating companies income of \$4.8 billion increased by \$1.8 billion (58.6%). This increase was due primarily to:

- price increases (\$991 million),
- favorable volume/mix (\$765 million),
- favorable currency (\$400 million) and
- the impact of acquisitions (\$28 million), partially offset by
- higher marketing, administration and research costs (\$219 million, partially related to increased marketing investment in Japan) and
- higher manufacturing costs (\$183 million, partially related to the air freight of product to Japan).

Our cigarette shipment volume increased by 11.0%, primarily due to growth in Indonesia, Japan, Korea and the Philippines. The growth was partly offset by a decline in Pakistan of 14.6%, due to the continued growth of illicit products and market share erosion. Shipment volume of *Marlboro* was up by 8.8%, driven by growth in Indonesia, Japan, Korea and Vietnam, partly offset by a decline in the Philippines, reflecting the unfavorable impact of an excise tax driven price increase in January 2011.

In Indonesia, the total cigarette market was up by 9.8% to 279.6 billion units, driven by growth in the low-price and the machine-made LTLN (low "tar," low nicotine) segments. Our shipment volume increased by 16.6%, with all brand families recording growth. Market share was up by 1.9 share points to 32.8%, driven by growth from premium *Sampoerna A*, mid-price *U Mild* and low-price *Vegas Mild* and *Trend Mild*. Although *Marlboro's* market share was down by

0.2 share points to 4.5%, shipments grew by 5.2% and share of the "white" cigarettes segment increased by 4.8 share points to 66.3%.

In Japan, the total cigarette market decreased by 10.8% to 195.3 billion units, reflecting the unfavorable impact of the October 1, 2010, excise tax driven price increases and the underlying market decline. Our shipment volume was up by 24.1%, driven by increased demand following in-market shortages of competitors' products during the year. Our market share of 30.7% was up by 6.3 share points, reflecting growth of *Marlboro*, *Lark*, the *Philip Morris* brand and *Virginia S.* up by 2.1, 3.1, 0.5 and 0.5 share points, to 13.1%, 9.7%, 2.8% and 2.4%, respectively. We exited 2011 with a fourth quarter share of 28.2%, up nearly four share points compared to a full year market share of 24.4% in 2010.

In Korea, the total cigarette market declined by 0.6% to 90.0 billion units. Our shipment volume increased by 16.7%, driven by market share increases. Our market share of 19.8% was up by 2.9 share points, driven by *Marlboro* and *Parliament*, up by 1.7 and 1.1 share points to 8.6% and 6.7%, respectively.

In the Philippines, the total cigarette market declined by 4.0% to 97.4 billion units, mainly reflecting the impact of excise tax driven price increases in January 2011. Our shipment volume was up by 7.5%. Adjusted for the business combination of PMFTC, established on February 25, 2010, shipment volume declined by 4.1%. Our market share reached 94.0%, up by 1.2 share points.

● **Latin America & Canada:** Net revenues, which include excise taxes billed to customers, increased \$1.0 billion (12.2%). Excluding excise taxes, net revenues increased \$246 million (8.1%) to \$3.3 billion. This increase was due to:

- price increases (\$334 million) and
- favorable currency (\$70 million), partially offset by
- unfavorable volume/mix (\$158 million).

Operating companies income of \$988 million increased by \$35 million (3.7%). This increase was due primarily to:

- price increases (\$334 million), partially offset by
- unfavorable volume/mix (\$159 million),
- higher manufacturing costs (\$72 million),
- higher marketing, administration and research costs (\$42 million) and
- the 2011 pre-tax charges for asset impairment and exit costs (\$24 million, primarily related to the closure of manufacturing facilities in Uruguay and Venezuela).

Our cigarette shipment volume decreased by 4.8%, mainly due to Mexico, partly offset by an increase in Argentina. Shipment volume of *Marlboro* decreased by 5.8%, principally due to Mexico, partially offset by growth in Argentina, Brazil and Colombia.

In Argentina, the total cigarette market grew by 2.6% to 43.8 billion units, reflecting growth in the economy. Our cigarette shipment volume increased by 3.8%. Our market share was up by 0.7 share points to 74.0%, reflecting growth of *Marlboro*, up by 0.8 share points to 24.1%, and of the mid-price *Philip Morris* brand, up by 0.4 share points to 38.0%. Share of low-price *Next* was down by 0.2 share points to 3.6%.

In Canada, the total tax-paid cigarette market was down by 0.8% to 32.1 billion units, reflecting a flattening of the return of illicit trade to the legitimate market. Our cigarette shipment volume increased by 1.3%. Our market share grew by 0.8 share points to 34.1%, with premium brand *Belmont* up by 0.1 share point to 1.8% and low-price brand *Next* up by 2.5 share points to 6.9%, partly offset by mid-price *Number 7* and *Canadian Classics*, and low-price *Accord*, down by 0.4, 0.4 and 0.7 share points, to 4.1%, 8.7% and 3.6%, respectively.

In Mexico, the total cigarette market was down by 21.1% to 34.3 billion units, primarily due to the significant January 1, 2011, excise tax increase, which drove a 26.7% increase in the retail price of *Marlboro*, and also fueled a surge in the availability of illicit products. Although our cigarette shipment volume decreased by 18.6%, market share grew by 2.2 share points to 72.3%, led by *Marlboro*, up by 3.2 share points to 52.3%, and *Benson & Hedges*, up by 0.6 share points to 6.1%. Market share of low-price *Delicados* declined by 1.0 share point to 10.9%.

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● **Net Cash Provided by Operating Activities:** Net cash provided by operating activities of \$9.4 billion for the year ended December 31, 2012, decreased by \$1.1 billion from the comparable 2011 period. The decrease was due primarily to an increase in our working capital requirements (\$1.5 billion), partially offset by lower pension contributions (\$328 million) and higher net earnings (\$275 million).

The unfavorable movements in working capital were due primarily to the following:

- less cash provided by accrued liabilities and other current assets (\$874 million), largely due to the timing of payments for excise taxes (primarily related to forestalling);
- more cash used for inventories (\$692 million), primarily clove and the planned replenishment of tobacco leaf inventories, partly offset by lower finished goods inventories;
- less cash provided by accounts payable (\$189 million), primarily due to the timing of payables for leaf and direct materials; and
- more cash used for accounts receivable (\$147 million), primarily due to price increases for our products, the timing of cash collections and higher trade purchases in anticipation of excise-tax driven price changes; partly offset by
- more cash provided by income taxes (\$407 million), primarily due to higher income tax provisions and the timing of payments.

On February 9, 2012, we announced a one-year, gross productivity and cost savings target for 2012 of approximately \$300 million. During 2012, we exceeded this target primarily through the rationalization of tobacco blends and product specifications and other manufacturing and procurement initiatives.

On February 7, 2013, we announced a one-year, gross productivity and cost savings target for 2013 of approximately \$300 million to help offset expected moderate cost increases in leaf and direct materials, as well as higher clove costs.

Net cash provided by operating activities of \$10.5 billion for the year ended December 31, 2011, increased \$1.1 billion from the comparable 2010 period. The increase was due primarily to higher net earnings (\$1.4 billion), partly offset by unfavorable movements in working capital (\$421 million) and higher contributions to pension plans (\$102 million).

The unfavorable movements in working capital were due primarily to the following:

- more cash used for inventories (\$1.1 billion), driven by higher finished goods inventories (primarily due to stock movements related to tax-driven price increases); and
- more cash used for accounts receivable (\$374 million), primarily due to the timing of collections; partly offset by
- more cash provided by accrued liabilities and other current assets (\$650 million), due primarily to the increase in excise tax liabilities associated with inventory movements and the timing of excise and value-added tax (VAT) payments, partially offset by changes in the fair value of financial instruments;
- more cash provided by accounts payable (\$271 million), primarily due to the timing of payables for leaf and direct materials; and
- more cash provided by income taxes (\$139 million), primarily due to higher income tax provisions and the timing of payments.

On February 10, 2011, we announced a one-year, gross productivity and cost savings target for 2011 of approximately \$250 million to be achieved through product specification changes, improved manufacturing performance and various procurement-related initiatives. During 2011, we exceeded this target.

● **Net Cash Used in Investing Activities:** Net cash used in investing activities of \$992 million for the year ended December 31, 2012, decreased by \$40 million from the comparable 2011 period, due primarily to cash spent in 2011 to purchase businesses (\$80 million), and higher cash proceeds from the sale of fixed assets, partially offset by higher capital expenditures (\$159 million).

Net cash used in investing activities of \$1.0 billion for the year ended December 31, 2011, increased \$322 million from the comparable 2010 period, due primarily to higher capital expenditures (\$184 million) and lower cash proceeds from the settlement of derivatives designated as net investment hedges (\$43 million).

In 2011, we acquired a cigar business, consisting primarily of trademarks in the Australian and New Zealand markets, for \$20 million. In 2011, we also completed the acquisition of a cigarette business in Jordan, consisting primarily of cigarette manufacturing assets and inventories, for \$42 million.

In 2010, we spent \$83 million for the net assets and contractual relationships of our current leaf suppliers in Brazil. For further details, see Note 6. *Acquisitions and Other Business Arrangements*.

Our capital expenditures were \$1.1 billion in 2012, \$897 million in 2011 and \$713 million in 2010. The 2012 expenditures were primarily related to investments in productivity-enhancing programs, equipment for new products, the consolidation of our operations in the Philippines and the expansion of our capacity in Indonesia and Russia. We expect total capital expenditures in 2013 of approximately \$1.3 billion, to be funded by operating cash flows.

● **Net Cash Used in Financing Activities:** During 2012, net cash used in financing activities was \$8.1 billion, compared with net cash used in financing activities of \$8.3 billion during 2011 and \$8.6 billion in 2010. During 2012, we used a total of \$15.4 billion to repurchase our common stock, pay dividends, and repay debt. These uses were partially offset by proceeds from our debt offerings and short-term borrowings in 2012 of \$7.6 billion. During 2011, we used a total of \$12.8 billion to repurchase our common stock, pay dividends, and repay debt. These uses were partially offset by proceeds from our debt offerings and short-term borrowings in 2011 of \$4.7 billion. During 2010, we used a total of \$10.1 billion to repurchase our common stock, pay dividends, and repay debt. These uses were partially offset by proceeds from our debt offerings and short-term borrowings in 2010 of \$1.6 billion.

Dividends paid in 2012, 2011 and 2010 were \$5.4 billion, \$4.8 billion and \$4.4 billion, respectively.

● **Debt and Liquidity:**

We define cash and cash equivalents as short-term, highly liquid investments, readily convertible to known amounts of cash that mature within a maximum of three months and have an insignificant risk of change in value due to interest rate or credit risk changes. As a policy, we do not hold any investments in structured or equity-linked products. Our cash and cash equivalents are predominantly held in short-term bank deposits with institutions having a long-term rating of A- or better.

Credit Ratings: The cost and terms of our financing arrangements as well as our access to commercial paper markets may be affected by applicable credit ratings. At December 31, 2012, our credit ratings and outlook by major credit rating agencies were as follows:

	Short-term	Long-term	Outlook
Moody's	P-1	A2	Stable
Standard & Poor's	A-1	A	Stable
Fitch	F1	A	Stable

Credit Facilities: On February 12, 2013, we entered into a 364-day revolving credit facility in the amount of \$2.0 billion.

At February 12, 2013, our committed credit facilities were as follows:

Type (in billions)	Committed Credit Facilities
364-day revolving credit, expiring February 11, 2014	\$2.0
Multi-year revolving credit, expiring March 31, 2015	2.5
Multi-year revolving credit, expiring October 25, 2016	3.5
Total facilities	\$8.0

At February 12, 2013, there were no borrowings under the committed credit facilities, and the entire committed amounts were available for borrowing.

All banks participating in our committed credit facilities have an investment-grade long-term credit rating from the credit rating agencies. We continuously monitor the credit quality of our banking group, and at this time we are not aware of any potential non-performing credit provider.

Each of these facilities requires us to maintain a ratio of consolidated earnings before interest, taxes, depreciation and amortization ("consolidated EBITDA") to consolidated interest expense of not less than 3.5 to 1.0 on a rolling four-quarter basis. At December 31, 2012, our ratio calculated in accordance with the agreements was 16.0 to 1.0. These facilities do not include any credit rating triggers, material adverse change clauses or any provisions that could require us to post collateral. We expect to continue to meet our covenants. The terms "consolidated EBITDA" and "consolidated interest expense," both of which include certain adjustments, are defined in the facility agreements previously filed with the U.S. Securities and Exchange Commission.

In addition to the committed credit facilities discussed above, certain of our subsidiaries maintain short-term credit arrangements to meet their respective working capital needs. These credit arrangements, which amounted to approximately \$2.0 billion at December 31, 2012, and \$1.9 billion at December 31, 2011, are for the sole use of our subsidiaries. Borrowings under these arrangements amounted to \$447 million at December 31, 2012, and \$247 million at December 31, 2011.

Commercial Paper Program: We have commercial paper programs in place in the U.S. and in Europe. At December 31, 2012 and 2011, we had \$2.0 billion and \$1.3 billion, respectively, of commercial paper outstanding.

The existence of the commercial paper program and the committed credit facilities, coupled with our operating cash flows, will enable us to meet our liquidity requirements.

Debt: Our total debt was \$22.8 billion at December 31, 2012, and \$18.5 billion at December 31, 2011. Fixed-rate debt constituted approximately 88% of our total debt at December 31, 2012, and 90% of our total debt at December 31, 2011. The weighted-average all-in financing cost of our total debt was 4.0% in 2012, compared to 4.4% in 2011. See Note 16. *Fair Value Measurements* to our consolidated financial statements for a discussion of our disclosures related to the fair value of debt. The amount of debt that we can issue is subject to approval by our Board of Directors.

On February 28, 2011, we filed a new shelf registration statement with the U.S. Securities and Exchange Commission under which we may from time to time sell debt securities and/or warrants to purchase debt securities over a three-year period.

Our debt offerings in 2012 were as follows:

(in millions)				
Type	Face Value	Interest Rate	Issuance	Maturity
U.S. dollar notes ^(a)	\$700	4.500%	March 2012	March 2042
U.S. dollar notes ^(a)	\$550	1.625	March 2012	March 2017
Euro notes ^(b)	€750	2.125	May 2012	May 2019
	(approximately \$951)			
Euro notes ^(b)	€600	2.875	May 2012	May 2024
	(approximately \$761)			
U.S. dollar notes ^(c)	\$750	1.125	August 2012	August 2017
U.S. dollar notes ^(c)	\$750	2.500	August 2012	August 2022
U.S. dollar notes ^(c)	\$750	3.875	August 2012	August 2042
Swiss franc notes ^(d)	CHF 325	1.000	September 2012	September 2020
	(approximately \$334)			

(a) Interest on these notes is payable semiannually, and the first payment was made in September 2012.

(b) Interest on these notes is payable annually beginning in May 2013.

(c) Interest on these notes is payable semiannually beginning in February 2013.

(d) Interest on these notes is payable annually beginning in September 2013.

The net proceeds from the sale of the securities listed in the table above were used to meet our working capital requirements, to repurchase our common stock, to refinance debt and for general corporate purposes.

As a result of the debt issuances shown in the table above, the weighted-average time to maturity of our long-term debt has increased from 8.2 years at the end of 2011 to 10.1 years at the end of 2012.

In February 2013, we launched and priced a bond offering in the amount of CHF 200 million (approximately \$218 million). These bonds will have a fixed interest rate of 0.875% and a maturity date of March 2019. The transaction is scheduled to close in March 2013.

• **Off-Balance Sheet Arrangements and Aggregate Contractual Obligations:** We have no off-balance sheet arrangements, including special purpose entities, other than guarantees and contractual obligations that are discussed below.

Guarantees: At December 31, 2012, we were contingently liable for \$0.7 billion of guarantees of our own performance, which were primarily related to excise taxes on the shipment of our products. In accordance with U.S. GAAP, there is no liability in the consolidated financial statements associated with these guarantees. At December 31, 2012, our third-party guarantees were insignificant.

Aggregate Contractual Obligations: The following table summarizes our contractual obligations at December 31, 2012:

(in millions)	Payments Due				
	Total	2013	2014-2015	2016-2017	2018 and Thereafter
Long-term debt ⁽¹⁾	\$20,598	\$2,781	\$2,251	\$3,899	\$11,667
RBH Legal Settlement ⁽²⁾	227	39	74	80	34
Colombian Investment and Cooperation Agreement ⁽³⁾	125	8	16	15	86
Interest on borrowings ⁽⁴⁾	7,993	791	1,322	1,035	4,845
Operating leases ⁽⁵⁾	851	218	261	146	226
Purchase obligations ⁽⁶⁾ : Inventory and production costs	2,576	1,780	581	150	65
Other	1,849	1,182	544	103	20
	4,425	2,962	1,125	253	85
Other long-term liabilities ⁽⁷⁾	366	42	48	37	239
	\$34,585	\$6,841	\$5,097	\$5,465	\$17,182

(1) Amounts represent the expected cash payments of our long-term debt and capital lease obligations.

(2) Amounts represent the estimated future payments due under the terms of the settlement agreement. See Note 19. *RBH Legal Settlement*, to our consolidated financial statements for more details regarding this settlement.

(3) Amounts represent the expected cash payments under the terms of the Colombian Investment and Cooperation Agreement. See Note 18. *Colombian Investment and Cooperation Agreement* to our consolidated financial statements for more details regarding this agreement.

(4) Amounts represent the expected cash payments of our interest expense on our long-term debt, including the current portion of long-term debt. Interest on our fixed-rate debt is presented using the stated interest rate. Interest on our variable rate debt is estimated using the rate in effect at December 31, 2012. Amounts exclude the amortization of debt discounts, the amortization of loan fees and fees for lines of credit that would be included in interest expense in the consolidated statements of earnings.

(5) Amounts represent the minimum rental commitments under non-cancelable operating leases.

(6) Purchase obligations for inventory and production costs (such as raw materials, indirect materials and supplies, packaging, co-manufacturing arrangements, storage and distribution) are commitments for projected needs to be utilized in the normal course of business. Other purchase obligations include commitments for marketing, advertising, capital expenditures, information technology and professional services. Arrangements are considered purchase obligations if a contract specifies all significant terms, including fixed or minimum quantities to be purchased, a pricing structure and approximate timing of the transaction. Amounts represent the minimum commitments under non-cancellable contracts. Any amounts reflected on the consolidated balance sheet as accounts payable and accrued liabilities are excluded from the table above.

(7) Other long-term liabilities consist primarily of postretirement health care costs and accruals established for employment costs. The following long-term liabilities included on the consolidated balance sheet are excluded from the table above: accrued pension and postemployment costs, tax contingencies, insurance accruals and other accruals. We are unable to estimate the timing of payments (or contributions in the case of accrued pension costs) for these items. Currently, we anticipate making pension contributions of approximately \$220 million in 2013, based on current tax and benefit laws (as discussed in Note 13. *Benefit Plans* to our consolidated financial statements).

The E.C. agreement payments discussed below are excluded from the table above, as the payments are subject to adjustment based on certain variables including our market share in the EU.

E.C. Agreement: In 2004, we entered into an agreement with the European Commission (acting on behalf of the European Community) that provides for broad cooperation with European law enforcement agencies on anti-contraband and anti-counterfeit efforts. This agreement has been signed by all 27 Member States. This agreement calls for payments that are to be adjusted based on certain variables, including our market share in the European Union in the year preceding payment. Because future additional payments are subject to these variables, we record these payments as an expense in cost of sales when product is shipped. In addition, we are also responsible to pay the excise taxes, VAT and customs duties on qualifying product seizures of up to 90 million cigarettes and are subject to payments of five times the applicable taxes and duties if qualifying product seizures exceed 90 million cigarettes in a given year. To date, our annual payments related to product seizures have been immaterial. Total charges related to the E.C. Agreement of \$78 million, \$86 million and \$91 million were recorded in cost of sales in 2012, 2011 and 2010, respectively.

Other: In addition to the contractual obligations noted above, we entered into separate agreements with Grupo Carso, S.A.B. de C.V. (“Grupo Carso”) in 2007 and FTC in 2010, which relate to the potential purchase of the noncontrolling interest in our Mexican and Philippines tobacco businesses by PMI. See Note 4. *Related Party Information* to our consolidated financial statements for a discussion of our agreement with Grupo Carso and Note 6. *Acquisitions and Other Business Arrangements* to our consolidated financial statements for a discussion of our agreement with FTC.

● **Equity and Dividends:** As discussed in Note 9. *Stock Plans* to our consolidated financial statements, during 2012, we granted 3.2 million shares of deferred stock awards at a weighted-average grant date fair value of \$79.59. Equity awards generally vest three or more years after the date of the award, subject to earlier vesting on death or disability or normal retirement, or separation from employment by mutual agreement after reaching age 58.

In May 2012, our stockholders approved the Philip Morris International Inc. 2012 Performance Incentive Plan (the “2012 Plan”). The 2012 Plan replaced the 2008 Performance Incentive Plan (the “2008 Plan”), and, as a result, there will be no additional grants under the 2008 Plan. Under the 2012 Plan, we may grant to eligible employees restricted stock, restricted stock units and deferred stock units, performance-based cash incentive awards and performance-based equity awards. While the 2008 Plan authorized incentive stock options, non-qualified stock options and stock appreciation rights, the 2012 Plan does not authorize any grants of stock options or stock appreciation rights. Up to 30 million shares of our common stock may be issued under the 2012 Plan.

On May 1, 2008, we began a \$13.0 billion two-year share repurchase program. On April 30, 2010, we completed this \$13.0 billion share repurchase program by purchasing, in total, 277.6 million shares at an average price of \$46.83 per share.

On May 1, 2010, we began repurchasing shares under a three-year \$12.0 billion share repurchase program that was authorized by our Board of Directors in February 2010. On July 31, 2012, we completed this share repurchase program ahead of schedule. In total, we purchased 179.1 million shares for \$12.0 billion under this program.

On August 1, 2012, we began repurchasing shares under a new three-year \$18.0 billion share repurchase program that was authorized by our Board of Directors in June 2012. From August 1, 2012, through December 31, 2012, we repurchased 32.2 million shares of our common stock at a cost of \$2.9 billion under this new repurchase program. During 2012, we repurchased 74.9 million shares at a cost of \$6.5 billion.

On February 7, 2013, we announced that our forecast includes a share repurchase target amount for 2013 of \$6.0 billion.

Dividends paid in 2012 were \$5.4 billion. During the third quarter of 2012, our Board of Directors approved a 10.4% increase in the quarterly dividend to \$0.85 per common share. As a result, the present annualized dividend rate is \$3.40 per common share.

Market Risk

● **Counterparty Risk:** We predominantly work with financial institutions with strong short and long-term credit ratings as assigned by Standard & Poor’s and Moody’s. These banks are also part of a defined group of relationship banks. Non-investment grade institutions are only used in certain emerging markets to the extent required by local business needs. We have a conservative approach when it comes to choosing financial counterparties and financial instruments. As such we do not invest or hold investments in any structured or equity-linked products. The majority of our cash and cash equivalents is currently invested in bank deposits maturing within less than 30 days.

We continuously monitor and assess the credit worthiness of all our counterparties.

● **Derivative Financial Instruments:** We operate in markets outside of the United States, with manufacturing and sales facilities in various locations throughout the world. Consequently, we use certain financial instruments to manage our foreign currency exposure. We use derivative financial instruments principally to reduce our exposure to market risks resulting from fluctuations in foreign exchange rates by creating offsetting exposures. We are not a party to leveraged derivatives and, by policy, do not use derivative financial instruments for speculative purposes.

See Note 15. *Financial Instruments* and Note 16. *Fair Value Measurements* to our consolidated financial statements for further details on our derivative financial instruments.

● **Value at Risk:** We use a value at risk computation to estimate the potential one-day loss in the fair value of our interest-rate-sensitive financial instruments and to estimate the potential one-day loss in pre-tax earnings of our foreign currency price-sensitive derivative financial instruments. This computation includes our debt, short-term investments, and foreign currency forwards, swaps and options. Anticipated transactions, foreign currency trade payables and receivables, and net investments in foreign subsidiaries, which the foregoing instruments are intended to hedge, were excluded from the computation.

The computation estimates were made assuming normal market conditions, using a 95% confidence interval. We use a “variance/co-variance” model to determine the observed interrelationships between movements in interest rates and various currencies. These interrelationships were determined by observing interest rate and forward currency rate movements over the preceding quarter for determining value at risk at December 31, 2012 and 2011, and over each of the four preceding quarters for the calculation of average value at risk amounts during each year. The values of foreign currency options do not change on a one-to-one basis with the underlying currency and were valued accordingly in the computation.

The estimated potential one-day loss in fair value of our interest-rate-sensitive instruments, primarily debt, under normal market conditions and the estimated potential one-day loss in pre-tax earnings from foreign currency instruments under normal market conditions, as calculated in the value at risk model, were as follows:

(in millions)	Pre-Tax Earnings Impact			
	At 12/31/12	Average	High	Low
Instruments sensitive to:				
Foreign currency rates	\$20	\$32	\$50	\$20

(in millions)	Fair Value Impact			
	At 12/31/12	Average	High	Low
Instruments sensitive to:				
Interest rates	\$70	\$71	\$76	\$66

(in millions)	Pre-Tax Earnings Impact			
	At 12/31/11	Average	High	Low
Instruments sensitive to:				
Foreign currency rates	\$49	\$74	\$90	\$49

(in millions)	Fair Value Impact			
	At 12/31/11	Average	High	Low
Instruments sensitive to:				
Interest rates	\$57	\$55	\$69	\$45

The value at risk computation is a risk analysis tool designed to statistically estimate the maximum probable daily loss from adverse movements in interest and foreign currency rates under normal market conditions. The computation does not purport to represent actual losses in fair value or earnings to be incurred by us, nor does it consider the effect of favorable changes in market rates. We cannot predict actual future movements in such market rates and do not present these results to be indicative of future movements in market rates or to be representative of any actual impact that future changes in market rates may have on our future results of operations or financial position.

Contingencies

See Note 21. *Contingencies* to our consolidated financial statements for a discussion of contingencies.

Cautionary Factors That May Affect Future Results

Forward-Looking and Cautionary Statements

We may from time to time make written or oral forward-looking statements, including statements contained in filings with the SEC, in reports to stockholders and in press releases and investor webcasts. You can identify these forward-looking statements by use of words such as “strategy,” “expects,” “continues,” “plans,” “anticipates,” “believes,” “will,” “estimates,” “intends,” “projects,” “goals,” “targets” and other words of similar meaning. You can also identify them by the fact that they do not relate strictly to historical or current facts.

We cannot guarantee that any forward-looking statement will be realized, although we believe we have been prudent in our plans and assumptions. Achievement of future results is subject to risks, uncertainties and inaccurate assumptions. Should known or unknown risks or uncertainties materialize, or should underlying assumptions prove inaccurate, actual results could vary materially from those anticipated, estimated or projected. Investors should bear this in mind as they consider forward-looking statements and whether to invest in or remain invested in our securities. In connection with the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995, we are identifying important factors that, individually or in the aggregate, could cause actual results and outcomes to differ materially from those contained in any forward-looking statements made by us; any such statement is qualified by reference to the following cautionary statements. We elaborate on these and other risks we face throughout this document, particularly in the “Business Environment” section. You should understand that it is not possible to predict or identify all risk factors. Consequently, you should not consider the following to be a complete discussion of all potential risks or uncertainties. We do not undertake to update any forward-looking statement that we may make from time to time except in the normal course of our public disclosure obligations.

Risks Related to Our Business and Industry

● **Cigarettes are subject to substantial taxes. Significant increases in cigarette-related taxes have been proposed or enacted and are likely to continue to be proposed or enacted in numerous jurisdictions. These tax increases may disproportionately affect our profitability and make us less competitive versus certain of our competitors.**

Tax regimes, including excise taxes, sales taxes and import duties, can disproportionately affect the retail price of manufactured cigarettes versus other tobacco products, or disproportionately affect the relative retail price of our manufactured cigarette brands versus cigarette brands manufactured by certain of our competitors. Because our portfolio is weighted toward the premium-price manufactured cigarette category, tax regimes based on sales price can place us at a competitive disadvantage in certain markets. As a result, our volume and profitability may be adversely affected in these markets.

Increases in cigarette taxes are expected to continue to have an adverse impact on our sales of cigarettes, due to resulting lower consumption levels, a shift in sales from manufactured cigarettes to other tobacco products and from the premium-price to the mid-price or low-price cigarette categories, where we may be under-represented, from local sales to legal cross-border purchases of lower price products, or to illicit products such as contraband, counterfeit and illicit whites.

● **Our business faces significant governmental action aimed at increasing regulatory requirements with the goal of reducing or preventing the use of tobacco products.**

Governmental actions, combined with the diminishing social acceptance of smoking and private actions to restrict smoking, have resulted in reduced industry volume in many of our markets, and we expect that such factors will continue to reduce consumption levels and will increase downtrading and the risk of counterfeiting, contraband and cross-border purchases. Significant regulatory developments will take place over the next few years in most of our markets, driven principally by the World Health Organization's Framework Convention on Tobacco Control ("FCTC"). The FCTC is the first international public health treaty on tobacco, and its objective is to establish a global agenda for tobacco regulation. The FCTC has led to increased efforts by tobacco control advocates and public health organizations to reduce the palatability and attractiveness of tobacco products to adult smokers. Regulatory initiatives that have been proposed, introduced or enacted include:

- restrictions on or licensing of outlets permitted to sell cigarettes;
- the levying of substantial and increasing tax and duty charges;
- restrictions or bans on advertising, marketing and sponsorship;
- the display of larger health warnings, graphic health warnings and other labeling requirements;
- restrictions on packaging design, including the use of colors, and plain packaging;

- restrictions on packaging and cigarette formats and dimensions;
- restrictions or bans on the display of tobacco product packaging at the point of sale and restrictions or bans on cigarette vending machines;
- requirements regarding testing, disclosure and performance standards for tar, nicotine, carbon monoxide and other smoke constituents;
- disclosure, restrictions, or bans of tobacco product ingredients;
- increased restrictions on smoking in public and work places and, in some instances, in private places and outdoors;
- elimination of duty free sales and duty free allowances for travelers; and
- encouraging litigation against tobacco companies.

Our operating income could be significantly affected by regulatory initiatives resulting in a significant decrease in demand for our brands, in particular requirements that lead to a commoditization of tobacco products, as well as any significant increase in the cost of complying with new regulatory requirements.

● **Litigation related to tobacco use and exposure to environmental tobacco smoke ("ETS") could substantially reduce our profitability and could severely impair our liquidity.**

There is litigation related to tobacco products pending in certain jurisdictions. Damages claimed in some tobacco-related litigation are significant and, in certain cases in Brazil, Canada, Israel and Nigeria, range into the billions of U.S. dollars. We anticipate that new cases will continue to be filed. The FTC encourages litigation against tobacco product manufacturers. It is possible that our consolidated results of operations, cash flows or financial position could be materially affected in a particular fiscal quarter or fiscal year by an unfavorable outcome or settlement of certain pending litigation. Please see Note 21. *Contingencies* to our consolidated financial statements for a discussion of tobacco-related litigation.

● **We face intense competition, and our failure to compete effectively could have a material adverse effect on our profitability and results of operations.**

We compete primarily on the basis of product quality, brand recognition, brand loyalty, taste, innovation, packaging, service, marketing, advertising and price. We are subject to highly competitive conditions in all aspects of our business. The competitive environment and our competitive position can be significantly influenced by weak economic conditions, erosion of consumer confidence, competitors' introduction of lower-price products or innovative products, higher tobacco product taxes, higher absolute prices and larger gaps between retail price categories, and product regulation that diminishes the ability to differentiate tobacco products. Competitors include three large international tobacco companies and several regional and local tobacco companies and, in some instances, state-owned tobacco enterprises,

principally in Algeria, China, Egypt, Taiwan, Thailand and Vietnam. Industry consolidation and privatizations of state-owned enterprises have led to an overall increase in competitive pressures. Some competitors have different profit and volume objectives and some international competitors are susceptible to changes in different currency exchange rates.

● **Because we have operations in numerous countries, our results may be influenced by economic, regulatory and political developments or natural disasters in many countries.**

Some of the countries in which we operate face the threat of civil unrest and can be subject to regime changes. In others, nationalization, terrorism, conflict and the threat of war may have a significant impact on the business environment. Economic, political, regulatory or other developments or natural disasters could disrupt our supply chain, manufacturing capabilities or our distribution capabilities. In addition, such developments could lead to loss of property or equipment that are critical to our business in certain markets and difficulty in staffing and managing our operations, which could reduce our volumes, revenues and net earnings. In certain markets, we are dependent on governmental approvals of various actions such as price changes.

In addition, despite our high ethical standards and rigorous control and compliance procedures aimed at preventing and detecting unlawful conduct, given the breadth and scope of our international operations, we may not be able to detect all potential improper or unlawful conduct by our employees and international partners.

● **We may be unable to anticipate changes in consumer preferences or to respond to consumer behavior influenced by economic downturns.**

Our tobacco business is subject to changes in consumer preferences, which may be influenced by local economic conditions. To be successful, we must:

- promote brand equity successfully;
- anticipate and respond to new consumer trends;
- develop new products and markets and broaden brand portfolios;
- improve productivity; and
- be able to protect or enhance margins through price increases.

In periods of economic uncertainty, consumers may tend to purchase lower-price brands, and the volume of our premium-price and mid-price brands and our profitability could suffer accordingly. Such downtrading trends may be reinforced by regulation that limits branding, communication and product differentiation.

● **We lose revenues as a result of counterfeiting, contraband and cross-border purchases.**

Large quantities of counterfeit cigarettes are sold in the international market. We believe that *Marlboro* is the most heavily counterfeited international cigarette brand, although we cannot quantify the revenues we lose as a result of this activity. In addition, our revenues are reduced by contraband and legal cross-border purchases.

● **From time to time, we are subject to governmental investigations on a range of matters.**

Investigations include allegations of contraband shipments of cigarettes, allegations of unlawful pricing activities within certain markets, allegations of underpayment of customs duties and/or excise taxes, allegations of false and misleading usage of descriptors such as “lights” and “ultra lights” and allegations of unlawful advertising. We cannot predict the outcome of those investigations or whether additional investigations may be commenced, and it is possible that our business could be materially affected by an unfavorable outcome of pending or future investigations. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Operating Results by Business Segment—Business Environment—Governmental Investigations” for a description of governmental investigations to which we are subject.

● **We may be unsuccessful in our attempts to produce products with the potential to reduce the risk of smoking-related diseases compared to conventional cigarettes.**

We continue to seek ways to develop commercially viable new product technologies that may reduce the risk of smoking-related diseases. Our goal is to develop products whose potential for risk reduction can be substantiated and provide adult smokers the taste, sensory experience and smoking ritual characteristics that are as close as possible to those currently provided by conventional cigarettes. We may not succeed in these efforts. If we do not succeed, but others do, we may be at a competitive disadvantage. Furthermore, we cannot predict whether regulators will permit the marketing of tobacco products with claims of reduced risk and harm, which could significantly undermine the commercial viability of these products.

● **Our reported results could be adversely affected by unfavorable currency exchange rates, and currency devaluations could impair our competitiveness.**

We conduct our business primarily in local currency and, for purposes of financial reporting, the local currency results are translated into U.S. dollars based on average exchange rates prevailing during a reporting period. During times of a strengthening U.S. dollar, our reported net revenues and operating income will be reduced because the local currency will translate into fewer U.S. dollars. During periods of local economic crises, foreign currencies may be devalued significantly against the U.S. dollar, reducing our margins. Actions to recover margins may result in lower volume and a weaker competitive position.

● **The repatriation of our foreign earnings, changes in the earnings mix, and changes in U.S. tax laws may increase our effective tax rate. Our ability to receive payments from foreign subsidiaries or to repatriate royalties and dividends could be restricted by local country currency exchange controls.**

Because we are a U.S. holding company, our most significant source of funds is distributions from our non-U.S. subsidiaries. Under current U.S. tax law, in general we do not pay U.S. taxes on our foreign earnings until they are repatriated to the U.S. as distributions from our non-U.S. subsidiaries. These distributions may result in a residual U.S. tax cost. It may be advantageous to us in certain circumstances to significantly increase the amount of such distributions, which could result in a material increase in our overall effective tax rate. Additionally, the Obama Administration has indicated that it favors changes in U.S. tax law that would fundamentally change how our earnings are taxed in the U.S. If enacted and depending upon its precise terms, such legislation could increase our overall effective tax rate. Certain countries in which we operate have adopted or could institute currency exchange controls that limit or prohibit our local subsidiaries' ability to make payments outside the country.

● **Our ability to grow may be limited by our inability to introduce new products, enter new markets or to improve our margins through higher pricing and improvements in our brand and geographic mix.**

Our profitability may suffer if we are unable to introduce new products or enter new markets successfully, to raise prices or maintain an acceptable proportion of our sales of higher margin products and sales in higher margin geographies.

● **We may be unable to expand our brand portfolio through successful acquisitions and the development of strategic business relationships.**

One element of our growth strategy is to strengthen our brand portfolio and market positions through selective acquisitions and the development of strategic business relationships. Acquisition and strategic business development opportunities are limited and present risks of failing to achieve efficient and effective integration, strategic objectives and anticipated revenue improvements and cost savings. There is no assurance that we will be able to acquire attractive businesses on favorable terms, or that future acquisitions or strategic business developments will be accretive to earnings.

● **Government mandated prices, production control programs, shifts in crops driven by economic conditions and the impacts of climate change may increase the cost or reduce the quality of the tobacco and other agricultural products used to manufacture our products.**

As with other agricultural commodities, the price of tobacco leaf and cloves can be influenced by imbalances in supply and demand, and crop quality can be influenced by variations in weather patterns, including those caused by climate change. Tobacco production in certain countries is subject to a variety of controls, including government mandated prices and production control programs. Changes in the patterns of demand for agricultural products could cause farmers to plant less tobacco. Any significant change in tobacco leaf and clove prices, quality and quantity could affect our profitability and our business.

● **Our ability to implement our strategy of attracting and retaining the best global talent may be impaired by the decreasing social acceptance of cigarette smoking.**

The tobacco industry competes for talent with consumer products and other companies that enjoy greater societal acceptance. As a result, we may be unable to attract and retain the best global talent.

● **The failure of our information systems to function as intended or their penetration by outside parties with the intent to corrupt them could result in business disruption, loss of revenue, assets or personal or other sensitive data.**

We use information systems to help manage business processes, collect and interpret business data and communicate internally and externally with employees, suppliers, customers and others. Some of these information systems are managed by third-party service providers. We have backup systems and business continuity plans in place, and we take care to protect our systems and data from unauthorized access. Nevertheless, failure of our systems to function as intended, or penetration of our systems by outside parties intent on extracting or corrupting information or otherwise disrupting business processes, could result in loss of revenue, assets or personal or other sensitive data, cause damage to our reputation and that of our brands and result in significant remediation and other costs to us.

● **We may be required to replace third party contract manufacturers or service providers with our own resources.**

In certain instances, we contract with third parties to manufacture some of our products or product parts or to provide other services. We may be unable to renew these agreements on satisfactory terms for numerous reasons, including government regulations; accordingly, our costs may increase significantly if we must replace such third parties with our own resources.