

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.

Philip Morris International Inc. is 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.

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, 2013, from the comparable 2012 amounts, were as follows:

| | Diluted EPS | % Growth |
|---|-------------|----------|
| For the year ended December 31, 2012 | \$ 5.17 | |
| 2012 Asset impairment and exit costs | 0.03 | |
| 2012 Tax items | 0.02 | |
| Subtotal of 2012 items | 0.05 | |
| 2013 Asset impairment and exit costs | (0.12) | |
| 2013 Tax items | (0.02) | |
| Subtotal of 2013 items | (0.14) | |
| Currency | (0.34) | |
| Interest | (0.05) | |
| Change in tax rate | (0.01) | |
| Impact of lower shares outstanding and share-based payments | 0.23 | |
| Operations | 0.35 | |
| For the year ended December 31, 2013 | \$ 5.26 | 1.7% |

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 2013, we recorded pre-tax asset impairment and exit costs of \$309 million (\$202 million after tax and noncontrolling interests, or \$0.12 per share) related to the termination of distribution agreements in the Eastern Europe, Middle East & Africa and Asia segments, as well as the restructuring of our global and regional functions based in Switzerland and Australia. 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. For further details, see Note 5. *Asset Impairment and Exit Costs* to our consolidated financial statements.

● **Income Taxes**—The 2013 effective tax rate was unfavorably impacted by the additional expense associated with the enactment of the American Taxpayer Relief Act of 2012 (the “Act”) (\$17 million) and the enactment of tax law changes in Mexico (\$14 million). 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 Group, Inc.’s (“Altria”) consolidated tax returns for the years 2004–2006, partially offset by a \$40 million benefit from a tax accounting method change in Germany. Prior to March 28, 2008, we were a wholly owned subsidiary of Altria. The special tax items discussed in this paragraph decreased our diluted EPS by \$0.02 per share in 2013, and \$0.02 per share in 2012. Excluding the impact of these special tax items, the change in tax rate that decreased our diluted EPS by \$0.01 per share in 2013 was primarily due to earnings mix and repatriation cost differences.

● **Currency**—The unfavorable currency impact during 2013 was due primarily to the Argentine peso, Australian dollar, Indonesian rupiah, Japanese yen, Russian ruble, Swiss franc and Turkish lira, partially offset by the Euro.

● **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 \$0.35 from our operations was due to the following segments:

- EEMA: Higher pricing, partially offset by unfavorable volume/mix, higher marketing, administration and research costs and higher manufacturing costs; and
- Latin America & Canada: Higher pricing and lower marketing, administration and research costs, partially offset by unfavorable volume/mix and higher manufacturing costs; partially offset by
- Asia: Unfavorable volume/mix and higher manufacturing costs, partially offset by higher pricing and lower marketing, administration and research costs; and
- European Union: Unfavorable volume/mix and higher manufacturing costs, partially offset by higher pricing and lower marketing, administration and research costs.

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

● **2014 Forecasted Results**—On February 6, 2014, we announced our forecast for 2014 full-year reported diluted EPS to be in a range of \$5.02 to \$5.12, at prevailing exchange rates at that time, versus \$5.26 in 2013. Excluding an unfavorable currency impact, at then prevailing rates, of approximately \$0.71 per share for the full-year 2014, the reported diluted earnings per share range represents an increase of 6% to 8% versus adjusted diluted earnings per share of \$5.40 in 2013. The forecast includes a productivity and cost savings target of \$300 million and a share repurchase target of \$4.0 billion.

We calculated 2013 adjusted diluted EPS as reported diluted EPS of \$5.26, plus the \$0.02 per share charge related to discrete tax items, and the \$0.12 per share charge related to asset impairment and exit costs.

Adjusted diluted EPS is not a measure under the accounting principles generally accepted in the United States of America (“U.S. GAAP”). 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.

This 2014 guidance excludes the impact of future acquisitions, unanticipated asset impairment and exit cost charges, future changes in currency exchange rates 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.

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 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, 2013, our discount rate was 4.80% for our U.S. pension plans and 4.95% for our U.S. postretirement plans. These rates were 75 basis points and 90 basis points higher than our 2012 discount rate of 4.05% for U.S. pension and postretirement plans. Our weighted-average discount rate assumption for our non-U.S. pension plans increased to 3.09%, from 2.38% at December 31, 2012. Our weighted-average discount rate assumption for our non-U.S. postretirement plans was 5.07% at December 31, 2013, and 4.59% at December 31, 2012. We anticipate that assumption changes, coupled with decreased amortization of deferred losses, will decrease 2014 pre-tax U.S. and non-U.S. pension and postretirement expense to approximately \$204 million as compared with approximately \$330 million in 2013, excluding amounts related to early retirement programs. A fifty-basis-point decrease in our discount rate would increase our 2014 pension and postretirement expense by approximately \$50 million, and a fifty-basis-point increase in our discount rate would decrease our 2014 pension and postretirement expense by approximately \$45 million. Similarly, a fifty-basis-point decrease (increase) in the expected return on plan assets would increase (decrease) our 2014 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, 2013, applicable United States federal income taxes and foreign withholding taxes have not been provided on approximately \$20 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 due to the complexity of the U.S. foreign tax credit regime, as well as differences between earnings determined for book and tax purposes mainly resulting from intercompany transactions, purchase accounting and currency fluctuations.

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 that 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.

● **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 35 to 38 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) | 2013 | 2012 | 2011 |
|--------------------------------------|---------|---------|---------|
| Cigarette Volume | | | |
| European Union | 185,096 | 197,966 | 211,493 |
| Eastern Europe, Middle East & Africa | 296,462 | 303,828 | 290,250 |
| Asia | 301,324 | 326,582 | 313,282 |
| Latin America & Canada | 97,287 | 98,660 | 100,241 |
| Total cigarette volume | 880,169 | 927,036 | 915,266 |

| (in millions) | 2013 | 2012 | 2011 |
|--------------------------------------|----------|----------|----------|
| Net Revenues | | | |
| European Union | \$28,303 | \$27,338 | \$29,768 |
| Eastern Europe, Middle East & Africa | 20,695 | 19,272 | 17,452 |
| Asia | 20,987 | 21,071 | 19,590 |
| Latin America & Canada | 10,044 | 9,712 | 9,536 |
| Net revenues | \$80,029 | \$77,393 | \$76,346 |

| (in millions) | 2013 | 2012 | 2011 |
|--------------------------------------|----------|----------|----------|
| Excise Taxes on Products | | | |
| European Union | \$19,707 | \$18,812 | \$20,556 |
| Eastern Europe, Middle East & Africa | 11,929 | 10,940 | 9,571 |
| Asia | 10,486 | 9,873 | 8,885 |
| Latin America & Canada | 6,690 | 6,391 | 6,237 |
| Excise taxes on products | \$48,812 | \$46,016 | \$45,249 |

| (in millions) | 2013 | 2012 | 2011 |
|--|----------|----------|----------|
| Operating Income | | | |
| Operating companies income: | | | |
| European Union | \$ 4,238 | \$ 4,187 | \$ 4,560 |
| Eastern Europe, Middle East & Africa | 3,779 | 3,726 | 3,229 |
| Asia | 4,622 | 5,197 | 4,836 |
| Latin America & Canada | 1,134 | 1,043 | 988 |
| Amortization of intangibles | (93) | (97) | (98) |
| General corporate expenses | (187) | (210) | (183) |
| Less: | | | |
| Equity (income)/loss in unconsolidated subsidiaries, net | 22 | 17 | 10 |
| Operating income | \$13,515 | \$13,863 | \$13,342 |

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, excluding general corporate expenses and amortization of intangibles, plus equity (income)/loss in unconsolidated subsidiaries, net. 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 2013, 2012 and 2011 affected the comparability of our statement of earnings amounts:

● **Asset Impairment and Exit Costs**—For the years ended December 31, 2013, 2012 and 2011, pre-tax asset impairment and exit costs by segment were as follows:

| (in millions) | 2013 | 2012 | 2011 |
|--------------------------------------|-------|------|-------|
| Separation programs: | | | |
| European Union | \$ 13 | \$ — | \$ 35 |
| Eastern Europe, Middle East & Africa | 14 | — | 6 |
| Asia | 19 | 13 | 7 |
| Latin America & Canada | 5 | 29 | 15 |
| Total separation programs | 51 | 42 | 63 |
| Contract termination charges: | | | |
| Eastern Europe, Middle East & Africa | 250 | — | 12 |
| Asia | 8 | 13 | — |
| Total contract termination charges | 258 | 13 | 12 |
| 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 | \$309 | \$83 | \$109 |

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

● **Acquisitions and Other Business Arrangements**—For further details, see Note 6. *Acquisitions and Other Business Arrangements* to our consolidated financial statements.

2013 compared with 2012

The following discussion compares our consolidated operating results for the year ended December 31, 2013, with the year ended December 31, 2012.

Our cigarette shipment volume of 880.2 billion units decreased by 5.1% or 46.9 billion units, driven by a total industry tax-paid volume decline. The decline in our cigarette shipment volume mainly reflected:

- in the European Union, the unfavorable impact of excise tax-driven price increases, the weak economic and employment environment, the growth of the other tobacco products ("OTP") category, and the prevalence of e-cigarettes and non-duty paid products;
- in EEMA, the impact of price increases in Russia and Ukraine, an increase in illicit trade in Russia, Turkey and Ukraine, and a weaker economy in Russia;
- in Asia, the unfavorable impact of the disruptive January 2013 excise tax increase and a surge in the prevalence of domestic non-duty paid products in the Philippines, and lower share in Japan and Pakistan, partly offset by Indonesia; and
- in Latin America & Canada, primarily due to a lower total cigarette market, primarily in Brazil.

Excluding the Philippines, our cigarette shipment volume was down by 2.7%, and our total tobacco volume (including OTP in cigarette equivalent units) was down by 2.4%.

Our market share grew in a number of key markets, including Algeria, Argentina, Belgium, Brazil, Canada, Colombia, Egypt, France, Germany, Greece, Indonesia, Italy, Korea, the Netherlands, Poland, Portugal, Saudi Arabia, Spain, Thailand, Ukraine and the United Kingdom.

Total cigarette shipments of *Marlboro* of 291.1 billion units decreased by 3.5%, due primarily to declines in: the European Union, notably France, Poland and Spain, partly offset by Italy; EEMA, primarily Romania, Russia, Turkey and Ukraine, largely offset by North Africa; Asia, predominantly Japan and the Philippines, partly offset by Indonesia; and Latin America & Canada, mainly Argentina and Brazil, partly offset by Colombia and Mexico. Excluding the Philippines, total cigarette shipments of *Marlboro* declined by 1.3%.

Total cigarette shipments of *L&M* of 95.0 billion units were up by 1.4%, driven notably by Egypt, Russia and Saudi Arabia, partly offset by Turkey. Total cigarette shipments of *Bond Street* of 44.9 billion units decreased by 4.2%, due primarily to Russia and Ukraine. Total cigarette shipments of *Parliament* of 44.7 billion units were up by 2.9%, due primarily to Turkey, partly offset by Japan. Total cigarette shipments of *Philip Morris* of 35.0 billion units decreased by 7.9%, due primarily to Italy and the Philippines, partly offset by Argentina. Total cigarette shipments of *Chesterfield* of 34.4 billion units were down by 3.2%, due primarily to Russia and Ukraine, partly offset by Germany and Turkey. Total cigarette shipments of *Lark* of 28.8 billion units decreased by 10.2%, due predominantly to Japan and Turkey.

Our OTP primarily include tobacco for roll-your-own and make-your-own cigarettes, pipe tobacco, cigars and cigarillos. Total shipment volume of OTP, in cigarette equivalent units, grew by 4.9% to 32.7 billion cigarette equivalent units, primarily reflecting growth in the European Union, notably in Belgium, France, Hungary and Italy.

Total shipment volume for cigarettes and OTP combined was down by 4.7%.

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

| (in millions) | 2013 | 2012 | Variance | % |
|--|-----------------|----------|----------|--------|
| Net revenues | \$80,029 | \$77,393 | \$2,636 | 3.4% |
| Excise taxes on products | 48,812 | 46,016 | 2,796 | 6.1% |
| Net revenues, excluding excise taxes on products | \$31,217 | \$31,377 | \$ (160) | (0.5)% |

Currency movements decreased net revenues by \$1.4 billion and net revenues, excluding excise taxes on products, by \$765 million. The \$765 million decrease was due primarily to the Argentine peso, Australian dollar, Brazilian real, Indonesian rupiah, Japanese yen, Russian ruble and Turkish lira, partially offset by the Euro and Mexican peso.

Net revenues shown in the table above include \$1,876 million in 2013 and \$1,709 million in 2012 related to sales of OTP. These net revenue amounts include excise taxes billed to customers. Excluding excise taxes, net revenues for OTP were \$739 million in 2013 and \$676 million in 2012.

Net revenues, which include excise taxes billed to customers, increased by \$2.6 billion (3.4%). Excluding excise taxes, net revenues decreased by \$160 million (0.5%) to \$31.2 billion. This decrease was due to:

- unfavorable volume/mix (\$1.5 billion) and
- unfavorable currency (\$765 million), partly offset by
- price increases (\$2.1 billion, including gains related to inventory movements, notably in the Philippines).

Excise taxes on products increased by \$2.8 billion (6.1%), due to:

- higher excise taxes resulting from changes in retail prices and tax rates (\$5.1 billion), partly offset by
- volume/mix (\$1.6 billion) and
- favorable currency (\$637 million).

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) | 2013 | 2012 | Variance | % |
|--|-----------------|----------|----------|--------|
| Cost of sales | \$10,410 | \$10,373 | \$ 37 | 0.4% |
| Marketing, administration and research costs | 6,890 | 6,961 | (71) | (1.0)% |
| Operating income | 13,515 | 13,863 | (348) | (2.5)% |

Cost of sales increased \$37 million (0.4%), due to:

- higher manufacturing costs (\$398 million, principally in Indonesia), partly offset by
- volume/mix (\$266 million) and
- favorable currency (\$95 million).

With regard to tobacco leaf prices, we continue to expect modest increases going forward, broadly in line with sourcing country inflation, as the market has now stabilized. However, we also anticipate some cost pressure in 2014, driven in large measure by historical leaf tobacco price changes 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 decreased by \$71 million (1.0%), due to:

- lower expenses (\$42 million, primarily lower marketing expenses) and
- favorable currency (\$29 million).

Operating income decreased by \$348 million (2.5%). This decrease was due primarily to:

- unfavorable volume/mix (\$1.2 billion),
- unfavorable currency (\$640 million),
- higher manufacturing costs (\$398 million) and
- higher pre-tax charges for asset impairment and exit costs (\$226 million), partly offset by
- price increases (\$2.1 billion) and
- lower marketing, administration and research costs (\$42 million).

Interest expense, net, of \$973 million increased \$114 million, due primarily to higher average debt levels, partially offset by lower average interest rates on debt.

Our effective tax rate decreased by 0.2 percentage points to 29.3%. The effective tax rate is based on our full-year geographic earnings mix and cash repatriation plans. The 2013 effective tax rate was unfavorably impacted by the additional expense associated with the Act (\$17 million) and the enactment of tax law changes in Mexico (\$14 million). 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. 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, 2013, and our cash repatriation plans, we estimate that our 2014 effective tax rate will be approximately 29%.

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 12 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 \$8.6 billion decreased \$224 million (2.5%). This decrease was due primarily to an unfavorable currency impact on operating income and higher interest expense, net, partially offset by a lower effective tax rate. Diluted and basic EPS of \$5.26 increased by 1.7%. Excluding an unfavorable currency impact of \$0.34, diluted EPS increased by 8.3%.

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 37.1%, up by 0.5 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%.

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).

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 | 6,961 | 6,870 | 91 | 1.3% |
| Operating income | 13,863 | 13,342 | 521 | 3.9% |

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

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

Marketing, administration and research costs increased \$91 million (1.3%), due primarily to:

- higher expenses (\$417 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 \$521 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 (\$417 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).

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%.

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 and our business face 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:

- fiscal challenges, such as excise tax increases and discriminatory tax structures;
 - actual and proposed extreme regulatory requirements, including regulation of the packaging, marketing and sale of tobacco products, as well as the products themselves, that may reduce our competitiveness, eliminate our ability to communicate with adult smokers, ban certain of our products, limit our ability to differentiate our products from those of our competitors, and interfere with our intellectual property rights;
 - illicit trade in cigarettes and other tobacco products, including counterfeit, contraband and so-called “illicit whites”;
 - intense competition, including from non-tax paid volume by local manufacturers;
 - pending and threatened litigation as discussed in Note 21. *Contingencies*; and
 - governmental investigations.
- **FCTC:** The World Health Organization’s (“WHO”) Framework Convention on Tobacco Control (“FCTC”), an international public health treaty with the objective of reducing tobacco use, drives much of the regulation that shapes the business environment in which we operate. The treaty, to which 176 countries and the European Union are Parties, requires Parties to have in place various tobacco control measures and recommends others.

We support many of the FCTC regulatory policies, including measures that strictly prohibit the sale of tobacco products to minors, limit public smoking, require health warnings on tobacco packaging, regulate product content to prevent increased adverse health effects of smoking and establish a regulatory framework for reduced-risk products. We also support the use of tax and price policies to achieve public health objectives, as long as tax increases are not excessive, disruptive or discriminatory and do not result in increased illicit trade.

However, the FCTC governing body, the Conference of the Parties ("CoP"), has adopted non-binding guidelines and policy recommendations to certain articles of the FCTC, some of which we strongly oppose, including such extreme measures as point-of-sale display bans, plain packaging, bans on all forms of communications with adult smokers and ingredient restrictions or bans based on the concepts of palatability or attractiveness. Among other things, these measures would limit our ability to differentiate our products and disrupt competition, are not based on sound evidence of a public health benefit, are likely to lead to adverse consequences, such as increased illicit trade and, in some cases, result in the expropriation of our trademarks and violate international treaties.

It is not possible to predict whether or to what extent measures recommended in the FCTC guidelines will be implemented. In some instances where these extreme measures have been adopted, we have commenced legal proceedings challenging them.

- **Excise Taxes:** Excessive and disruptive tax increases and discriminatory tax structures are expected to continue to have an adverse impact on our sales of cigarettes, due to lower consumption and consumer down-trading from premium to non-premium, discount, other low-price or low-taxed tobacco products, such as fine cut tobacco and illicit products. In addition, in certain jurisdictions, our products are subject to tax structures that discriminate against premium-price products and manufactured cigarettes. We oppose such extreme tax measures. We believe that they undermine public health by encouraging consumers to turn to the illicit trade for cheaper tobacco products and ultimately undercut government revenue objectives, disrupt the competitive environment and encourage criminal activity.

- **EU Tobacco Products Directive:** In December 2013, the European Commission, the Council of Ministers and the European Parliament reached a preliminary agreement on the text of a significantly revised EU Tobacco Products Directive that provides for:

- health warnings covering 65% of the front and back panels of packs with specific health warning dimensions that will in effect prohibit certain pack formats, such as smaller packs for slim cigarettes, even though the agreed text does not ban slim cigarettes. Member States would also have the option to further standardize tobacco packaging, including, under certain conditions, by introducing plain packaging;
- a ban on packs of fewer than 20 cigarettes;
- a ban on characterizing flavors, including menthol, in tobacco products with a four-year transition period from the date the revised directive is transposed into national law by each Member State;
- tracking and tracing measures requiring tracking at pack level down to retail, which we believe is not feasible and will provide no incremental benefit in the fight against illicit trade; and

- a framework for the regulation of e-cigarettes and novel tobacco products allowing some categories of e-cigarettes to be regulated under the Medicinal Products Directive or the Medical Device Directive. Other e-cigarettes and novel tobacco products would be subject to regulation requiring health warnings and information leaflets, prohibiting product packaging text related to reduced risk, and introducing notification requirements in advance of commercialization.

The legislative text must be finalized and approved by a vote of the Parliament and formally adopted by the Council to enter into force. Thereafter, Member States will have 24 months to implement the directive. We expect the directive to enter into force in mid-2014 and to be implemented by the Member States by mid-2016.

- **Plain Packaging:** Australia's plain packaging regulation, which came into force in December 2012, bans the use of branding, logos and colors on packaging of all tobacco products other than the brand name and variant, which may be printed only in specified locations and in a uniform font. The remainder of the pack is reserved for health warnings and government messages about cessation. The branding of individual cigarettes is also prohibited under this regulation.

To date, only Australia has implemented plain packaging, although a few other countries are considering it. For example, the U.K. has commissioned a further independent review of the plain packaging evidence base that is likely to be completed in March 2014. Also, in February 2014, the U.K. Parliament passed legislation that allows the Secretary of State for Health to implement plain packaging via regulations if he determines it may contribute to reducing the risk of harm or promoting the health or welfare of people. However, there is no indication whether or when such regulations may be issued. In February 2014, draft plain packaging legislation in New Zealand had its first reading in Parliament and is now being considered by a Parliamentary Health Committee, although the government has indicated that the legislation is unlikely to be passed until the legal challenges to Australia's plain packaging law are resolved. In Ireland, the government has announced its intention to formally introduce plain packaging legislation. It is not possible to predict whether other plain packaging legislation will be enacted.

Australia's plain packaging legislation triggered three legal challenges. First, major tobacco manufacturers, including our Australian subsidiary, challenged the legislation's constitutionality in the High Court of Australia. Although the High Court found the legislation constitutional, a majority of the Justices concluded that plain packaging deprives tobacco manufacturers of their property, raising serious questions about the legality of similar proposals in other jurisdictions. Second, our Hong Kong subsidiary has initiated arbitration proceedings against the Australian government pursuant to the Hong Kong-Australia Bilateral Investment Treaty and is seeking substantial compensation for the deprivation of its investments in Australia. Third, several countries have initiated World Trade Organization ("WTO") dispute settlement proceedings against Australia. The ongoing legal challenges may take several years to complete, and it is not possible to predict their outcome.

We oppose plain packaging because it expropriates our valuable intellectual property by taking away our trademarks and moves the industry much closer to a commodity business where there is no distinction between brands and, therefore, the ability to compete for adult smoker market share is greatly reduced. Early data from Australia appear to confirm that with plain packaging, adult smokers down-trade to lower price and lower margin brands and illicit products but do not quit or smoke less. According to recent industry-commissioned studies, illicit trade in Australia has increased since the implementation of plain packaging, with a significant shift towards branded illicit products (away from unbranded loose tobacco), while the data show no decline in smoking prevalence.

● **Restrictions and Bans on the Use of Ingredients:**

Currently, the WHO and some others in the public health community recommend restrictions or total bans on the use of some or all ingredients in tobacco products, including menthol. Some regulators have considered and rejected such proposals, while others have proposed and, in a few cases, adopted restrictions or bans. In particular, as mentioned above, the European Union intends to ban the use of menthol and other characterizing flavors in tobacco products, subject to a four-year transition period, while sweeping ingredient bans have been adopted only by Canada (with an exemption for menthol) and Brazil.

However, the Brazil ingredients ban, which, as originally drafted, would prohibit the use of virtually all ingredients with flavoring or aromatic properties, is not in force due to a legal challenge by a tobacco industry union, of which our Brazilian subsidiary is a member. It is not possible to predict the outcome of this legal proceeding.

Broad restrictions and bans on the use of ingredients would require us to reformulate our American Blend tobacco products and could reduce our ability to differentiate these products in the market in the long term. Menthol bans would eliminate the entire product category. We oppose broad bans or sweeping restrictions on the use of ingredients, as they are often based on the subjective and scientifically unsupported notion that ingredients make tobacco products more “attractive” or “palatable” and therefore could encourage tobacco consumption, and also because prohibiting entire categories of cigarettes, such as menthol, will lead to a massive increase in illicit trade.

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.

● **Bans on Display of Tobacco Products at Retail:** In a few of our markets, governments have banned or propose to ban the display of tobacco products at the point of retail sale. Other countries have rejected display ban proposals. We oppose display bans because they restrict competition by favoring established brands and encourage illicit trade, while not reducing smoking or otherwise benefiting public health. In some markets, our subsidiaries and, in some cases, individual retailers have commenced legal proceedings to overturn display bans.

● **Health Warning Requirements:** In most countries, governments require large and often graphic health warnings covering at least 30% of the front and back of cigarette packs (the size mandated by the FCTC). A growing number of countries require warnings covering 50% of the front and back of the pack, and a small number of countries require larger warnings, such as Australia (75% front and 90% back), Mexico (30% front and 100% back), Uruguay (80% front and back) and Canada (75% front and back).

Most recently, the Ministry of Public Health in Thailand mandated health warnings covering 85% of the front and back of cigarette packs. In August 2013, following legal challenges by two of our affiliates, the Administrative Court of Bangkok granted an injunction suspending the 85% health warning requirement pending a full hearing of the dispute. The Ministry of Public Health appealed and also sought to have the injunction lifted pending the appeal. In January 2014, the Supreme Administrative Court denied in part the request to lift the injunction, leaving suspension of the 85% health warning requirement in place. It is not possible to predict the outcome of these proceedings.

We support health warning requirements designed to inform consumers of the risks of smoking. In fact, where health warnings are not required, we place them on packaging voluntarily in the official language or languages of the country. We defer to governments on the content of warnings except for content that vilifies tobacco companies or does not fairly represent the actual effects of smoking. However, we oppose excessively large health warnings, i.e., 50% or larger. The data show that disproportionately increasing the size of health warnings does not effectively reduce tobacco consumption. Yet, such health warnings impede our ability to compete in the market by leaving insufficient space for our distinctive trademarks and pack designs.

● **Other Packaging Restrictions:** Some governments have passed, or are seeking to pass, restrictions on packaging and labeling, including standardizing the shape, format and layout of packaging, as well as imposing broad restrictions on how the space left for branding and product descriptions can be used. Examples include prohibitions on (1) the use of colors that are alleged to suggest that one 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. We oppose broad packaging restrictions because they unnecessarily limit brand and product differentiation, are anticompetitive, prevent us from providing consumers with information about our

products, unduly restrict our intellectual property rights, and violate international trade agreements. In some instances, we have commenced litigation challenging such regulations. It is not possible to predict the outcome of these proceedings.

● **Bans and Restrictions on Advertising, Marketing, Promotions and Sponsorships:** For many years, the FCTC has called for, and countries have imposed, partial or total bans on tobacco advertising, marketing, promotions and sponsorships, including bans and restrictions on advertising on radio and television, in print and on the Internet. The FCTC also requires disclosure of expenditures on advertising, promotion and sponsorship where such activities are not prohibited. The CoP guidelines recommend that governments adopt extreme and sweeping prohibitions, including all forms of communications to adult smokers. Where restrictions on advertising prevent us from communicating directly and effectively with adult smokers, they impede our ability to compete in the market. For this reason and because we believe that the available evidence does not show that marketing restrictions effectively reduce smoking, we oppose complete bans on advertising and communications that do not allow manufacturers to communicate directly and effectively with adult smokers.

● **Restrictions on Product Design:** Tobacco control advocates and some regulators are calling for the further standardization of tobacco products 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 because they limit our ability to differentiate our products and because we believe that there is no correlation, let alone a causal link, between product design variations and smoking rates, nor is there any scientific evidence that these restrictions would improve public health.

Reduced cigarette ignition propensity standards are recommended by the FCTC guidelines, have been adopted in several of our markets (e.g., Australia, Canada, Korea and the EU) and are being considered in several others. We believe that due to the costs to manufacturers of implementing such standards, their effectiveness at reducing the risk of cigarette-ignited fires in countries where they have been implemented should be examined before additional countries consider them.

● **Restrictions on Public Smoking:** The pace and scope of public smoking restrictions have increased significantly in most of our markets. Many countries around the world have adopted or are likely to adopt regulations that restrict or ban smoking in public and/or work places, restaurants, bars and nightclubs. 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 (typically when minors are present) and private homes. The FCTC requires Parties to adopt restrictions on public smoking, and the guidelines call for broad bans in all indoor public places but limit their recommendations on private place smoking, such as in cars and homes, to increased education on the risk of exposure to environmental tobacco smoke.

While we believe outright bans are appropriate in many public places, such as schools, playgrounds, youth facilities, and many indoor public places, governments can and should seek a balance between the desire to protect non-smokers from environmental tobacco smoke and allowing adults who choose to smoke to do so. Owners of restaurants, bars, cafes, and other entertainment establishments should have the flexibility to permit, restrict, or prohibit smoking, and workplaces should be permitted to provide designated smoking rooms for adult smokers. Finally, we oppose bans on smoking outdoors (beyond places and facilities for children) and in private places.

● **Other Regulatory Issues:** Encouraged by the public health community, some regulators are considering, or in some cases have adopted, regulatory measures designed to reduce the supply of tobacco. These include regulations intended to reduce the number of retailers selling tobacco by, for example, reducing the overall number of tobacco retail licenses available. We oppose such measures because they stimulate illicit trade and could arbitrarily deprive individuals of their livelihood with no indication that they would improve public health.

Regulators in a few countries have also called for the exclusion of tobacco from free trade agreements, such as the Trans-Pacific Partnership, which is under negotiation, as well as the elimination of dispute settlement mechanisms from investment treaties, which could limit our ability to protect investments and intellectual property through legal proceedings. We oppose such measures because they unfairly discriminate against a legal industry and are at odds with fundamental principles of global trade.

In a limited number of markets, most notably Japan, we are dependent on governmental approvals that may limit our pricing flexibility.

● **Illicit Trade:** Illicit tobacco trade creates a cheap and unregulated source of tobacco products, undermines efforts to reduce smoking, especially among youth, damages legitimate businesses, stimulates organized crime and increases corruption and lost tax revenue. 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.

A number of jurisdictions are considering regulatory measures and government action to prevent illicit trade. In November 2012, the CoP adopted the Protocol to Eliminate Illicit Trade in Tobacco Products (the “Protocol”), which 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. The Protocol will come into force once the 40th country ratifies it, after which countries must implement its measures via national legislation. It is not possible to predict whether this will happen.

Additionally, we and our subsidiaries have entered into cooperation agreements with governments and authorities to support their anti-illicit trade efforts. For example, in 2004 we entered into a 12-year cooperation agreement with the EU and its member states (except Croatia) that provides for cooperation with European law enforcement agencies on anti-contraband and on anti-counterfeit efforts. Under the terms of this agreement we make financial contributions of approximately \$75 million per year (recorded as an expense in cost of sales when product is shipped) to support these efforts. We are also required to pay the excise taxes, VAT and customs duties in qualifying seizures of up to 90 million genuine PMI products in the EU in a given year, and five times the applicable taxes and duties if seizures exceed 90 million cigarettes in a given year. To date, our payments for product seizures have been immaterial.

In 2009, our Colombian subsidiaries entered into an Investment and Cooperation Agreement with the national and regional governments to promote investment in and cooperation on anti-contraband and anti-counterfeit efforts. The agreement provides \$200 million in funding over a 20-year period to address issues such as combating the illegal cigarette trade and increasing the quality and quantity of locally grown tobacco.

In June 2012, we committed €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. This initiative funds the coordination of information gathering, training programs for law enforcement officials, development of product authentication standards and public information campaigns.

● **Reduced-Risk 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 cigarettes. We refer to these as reduced-risk products ("RRPs"). The use of this term applies to tobacco-containing products and other nicotine-containing products that have the potential to reduce individual risk and population harm. We draw upon a team of world-class scientists from a broad spectrum of scientific disciplines and our efforts are guided by the following three key objectives:

- to develop RRP products that provide adult smokers the taste, sensory experience, nicotine delivery profile and ritual characteristics that are similar to those currently provided by cigarettes;
- to substantiate the reduction of risk for the individual adult smoker and the reduction of harm to the population as a whole, based on robust scientific evidence derived from well-established assessment processes; and
- to advocate for the development of science-based regulatory frameworks for the approval and commercialization of RRP products, including the communication of substantiated health benefits to adult smokers.

Our product development is based on the elimination of combustion via tobacco heating and other innovative systems for aerosol generation, which we believe is the most promising path to reduce risk.

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 RRP resemble the data from those who quit, the more confident one can be that the product reduces risk.

Three RRP platforms are being developed and are in various stages of commercialization readiness:

- *Platform 1* uses a precisely controlled heating device into which a specially designed tobacco product is inserted to generate an aerosol. Eight clinical trials for Platform 1 were initiated in 2013, and the results will be available in 2014.
- *Platform 2* also uses a controlled heating mechanism to generate an aerosol via the heating of tobacco and has the format and ritual of a cigarette. This platform is in the pre-clinical testing phase and early stages of industrial scale-up. We estimate that the launch of Platform 2 will start approximately one year after that of Platform 1.
- *Platform 3* is based on technology we acquired from Professor Jed Rose of Duke University and other co-inventors in May 2011. It uses a chemical reaction to generate a nicotine-containing aerosol. This platform is currently in the product development phase and early stages of pre-clinical assessment.

We are also developing other potential platforms and are working on developing the next generation of e-cigarette technology. In December 2013, we established a strategic framework with Altria under which Altria will make available its e-cigarette products exclusively to us for commercialization outside the United States, and we will make available two of our candidate reduced-risk tobacco products exclusively to Altria for commercialization in the United States. The agreements also provide for cooperation on the scientific assessment of these products and for the sharing of improvements to the existing generation of RRP products.

We are proceeding with the commercialization of RRP products. In January 2014, we announced an investment of up to €500 million in our first manufacturing facility in the European Union and an associated pilot plant near Bologna, Italy, to produce our RRP products. We plan for the factory to initially manufacture Platform 1 and, when fully operational by 2016, and together with the pilot plant, to reach an annual production capacity of up to 30 billion units.

In the United States an established regulatory framework for assessing "Modified Risk Tobacco Products" ("MRTPs") exists under the jurisdiction of the Food and Drug Administration ("FDA"). We expect that 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 of evidence necessary to qualify a product as an MRTP. Our assessment approach and the studies conducted to date reflect the rigorous evidentiary

standards set forth in the FDA's Draft Guidance. We have shared our approach and studies with the FDA's Center for Tobacco Products. In parallel, we have begun to engage with regulators in several EU member countries, as well as in a number of other countries.

We expect to launch RRP (including tobacco-based products and e-cigarettes) with several commercial pilot city tests in the second half of 2014 and the first national launch in 2015. There can be no assurance that we will succeed in our efforts or that regulators will permit the marketing of our RRP with substantiated claims of reduced exposure, risk or harm.

● **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 ("EZDs") 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 Germany, in October 2013, the Administrative District Office Munich, acting under the policy supervision of the Bavarian Ministry of Health and Environment, sent our German affiliate an order alleging that certain components of its *Marlboro* advertising campaign do not comply with the applicable tobacco advertising law, which required our affiliate to stop this particular campaign throughout Germany and remove all outdoor advertisements within one month from the effective date of the order and point-of-sale materials within three months. Our affiliate does not believe the allegations properly reflect the facts and the law and filed a challenge in the Munich Administrative Court against the order, including summary proceedings against the immediate enforceability of the order. In December 2013, the court of first instance issued its decision in the summary proceeding, which allows our affiliate to use certain words of the campaign slogan, as well as new texts and motifs, but not the current campaign visuals pending a decision in the main proceeding. Our affiliate has appealed the decision.

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 tobacco products, 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, cash flows and financial position.

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 underdeclaration 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 ("2003–2007 Investigation"). 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. In early 2011, the Public Prosecutor's office 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. Thus the matter was referred to the Attorney General for resolution. In October 2013, a press report indicated that the Attorney General issued a prosecution order. Based on what is known to PM Thailand at this stage, it is probable that criminal charges will be filed. PM Thailand has been cooperating with the Thai authorities and believes that its declared import prices are in compliance with the Customs Valuation Agreement of the WTO and Thai law.

Additionally, in November 2010, a WTO panel issued its decision in a dispute relating to facts that arose from 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. The decision also created obligations for Thailand to revise its laws, regulations, or practices affecting the customs valuation and tax treatment of future cigarette imports. Thailand agreed in September 2011 to comply with the decision by October 2012. Although the Philippines contends that to date Thailand has not fully complied, the parties remain engaged in consultations to address the outstanding issues. At the June and August 2013 WTO meetings, the Philippines expressed concerns with ongoing investigations by Thailand of PM Thailand, noting that these investigations appear to be based on grounds not supported by WTO customs valuation rules and inconsistent with several decisions already taken by Thai Customs and other Thai governmental agencies.

Acquisitions and Other Business Arrangements

In the fourth quarter of 2013, as part of our initiative to enhance profitability and growth in North African and Middle Eastern markets, we decided to restructure our business in Egypt. The new business model entails a new contract manufacturing agreement with our long-standing, strategic business partner, Eastern Company S.A.E., the creation of a new PMI affiliate in Egypt and a new distribution agreement with Trans Business for Trading and Distribution LLC. To accomplish this restructuring and to ensure a smooth transition to

the new model, we recorded, in the fourth quarter of 2013, a charge to our 2013 full-year reported diluted EPS of approximately \$0.10 to reflect the discontinuation of existing contractual arrangements.

In May 2013, we announced that Grupo Carso, S.A.B. de C.V. ("Grupo Carso") would sell to us its remaining 20% interest in our Mexican tobacco business. The sale was completed on September 30, 2013, for \$703 million. As a result, we now own 100% of the Mexican tobacco business. A director of PMI has an affiliation with Grupo Carso. The final purchase price is subject to a potential adjustment based on the actual performance of the Mexican tobacco business over the three-year period ending two fiscal years after the closing of the purchase. In addition, upon declaration, we will pay a dividend of approximately \$38 million to Grupo Carso related to the earnings of the Mexican tobacco business for the nine months ended September 30, 2013. The purchase of the remaining 20% interest resulted in a decrease in our additional paid-in capital of \$672 million.

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.

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

Investments in Unconsolidated Subsidiaries

On December 12, 2013, we acquired from Megapolis Investment BV a 20% equity interest in Megapolis Distribution BV, the holding company of CJSC TK Megapolis ("Megapolis"), our distributor in Russia, for a purchase price of \$750 million. An additional payment of up to \$100 million, which is contingent on Megapolis's operational performance over the four fiscal years following the closing of the transaction, will also be made by us if the performance criteria are satisfied. We have also agreed to provide Megapolis Investment BV with a \$100 million interest-bearing loan. We and Megapolis Investment BV have agreed to set off any future contingent payments owed by us against the future repayments due under the loan agreement. Any loan repayments in excess of the contingent consideration earned by the performance of Megapolis are due to be repaid, in cash, on March 31, 2017. At December 31, 2013, we have recorded a \$100 million asset related to the loan receivable and a discounted liability of \$86 million related to the contingent consideration. The initial investment in Megapolis was recorded at cost and is included in investments in unconsolidated subsidiaries on the

consolidated balance sheet at December 31, 2013. We project this equity investment to be accretive to our earnings per share as of the first quarter of 2014.

On September 30, 2013, we acquired a 49% equity interest in United Arab Emirates-based Arab Investors-TA (FZC) ("AITA") for approximately \$625 million. As a result of this transaction, we hold an approximate 25% economic interest in Société des Tabacs Algéro-Emiratie ("STAEM"), an Algerian joint venture that is 51% owned by AITA and 49% by the Algerian state-owned enterprise Société Nationale des Tabacs et Allumettes SpA. STAEM manufactures and distributes under license some of our brands. The initial investment in AITA was recorded at cost and is included in investments in unconsolidated subsidiaries on the consolidated balance sheet at December 31, 2013. We project this equity investment in AITA to be accretive to our earnings per share as of 2014.

See Note 4. *Investments in Unconsolidated Subsidiaries* 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 2013, OFAC granted us a license to sell cigarettes to customers for import into the Iran duty free market. To date, we have not made any sales under this license.

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 shareholders, 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 within the U.S. 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.

2013 compared with 2012

The following discussion compares operating results within each of our reportable segments for 2013 with 2012.

● **European Union:** Net revenues, which include excise taxes billed to customers, increased \$965 million (3.5%). Excluding excise taxes, net revenues increased \$70 million (0.8%) to \$8.6 billion. This increase was due to:

- price increases (\$348 million) and
- favorable currency (\$205 million), partly offset by
- unfavorable volume/mix (\$483 million).

The net revenues of the European Union segment include \$1,524 million in 2013 and \$1,372 million in 2012 related to sales of OTP. Excluding excise taxes, OTP net revenues for the European Union segment were \$543 million in 2013 and \$475 million in 2012.

Operating companies income of \$4.2 billion increased by \$51 million (1.2%). This increase was due primarily to:

- price increases (\$348 million),
- favorable currency (\$92 million) and
- lower marketing, administration and research costs (\$44 million), partly offset by
- unfavorable volume/mix (\$403 million),
- higher manufacturing costs (\$21 million) and
- higher pre-tax charges for asset impairment and exit costs (\$8 million).

The total cigarette market of 482.4 billion units decreased by 7.5%, due primarily to the impact of tax-driven price increases, the unfavorable economic and employment environment and the prevalence of non-duty paid products. Although our cigarette shipment volume of 185.1 billion units decreased by 6.5%, predominantly reflecting a lower total market across the Region, our market share increased by 0.5 share points to 38.5%. The total OTP market in the European Union of 162.7 billion cigarette equivalent units increased by 0.3%, reflecting a larger total fine cut market, up by 0.2% to 141.6 billion cigarette equivalent units.

While shipment volume of *Marlboro* of 91.3 billion units decreased by 3.7%, mainly due to a lower total market, market share increased by 0.4 share points to 19.0%, driven notably by Germany, Greece, the Netherlands, Italy and Spain. While shipment volume of *L&M* decreased by 4.0% to 32.9 billion units, market share increased by 0.2 share points to 6.8%, driven notably by the Czech Republic, Germany and Poland. Shipment volume of *Chesterfield* of 19.0 billion units increased by 5.1%, and market share increased by 0.2 share points to 4.0%, driven notably by the Czech Republic, Poland, Portugal and the United Kingdom. Although shipment volume of *Philip Morris* of 9.6 billion units decreased by 10.4%, due predominantly to Italy, reflecting the morphing of certain brand variants into *Marlboro*, market share increased by 0.3 share points to 2.0%.

Our shipment volume of OTP of 21.5 billion cigarette equivalent units increased by 6.7%, driven principally by higher share. Our OTP total market share was 13.1%, up by 0.9 share points, reflecting gains in the fine cut category, notably in France, up by 1.8 share points to 27.0%; Italy, up by 9.8 share points to 37.7%; Poland, up by 3.2 share points to 21.0%; Portugal, up by 11.5 share points to 31.9%, and Spain, up by 2.0 share points to 13.8%.

In France, the total cigarette market of 47.5 billion units decreased by 7.6%, mainly reflecting the unfavorable impact of price increases in the fourth quarter of 2012 and July 2013, an increase in the prevalence of non-duty paid products, growth of the fine cut category, and a weak economy. Our shipments of 19.1 billion units decreased by 5.3%, including a favorable trade inventory comparison driven by the timing of shipments in the second half of 2012 in anticipation of price increases in the fourth quarter of 2012. Our market share was up by 0.6 share points to 40.2%, mainly driven by the resilience of premium *Philip Morris*, up by 0.8 share points to 9.1%, and the growth of *Chesterfield*, up by 0.1 share point to 3.4%. Market share of *Marlboro* and *L&M* decreased by 0.1 and 0.2 share points to 24.7% and 2.5%, respectively. The total industry fine cut category of 13.9 billion cigarette equivalent units increased by 3.6% in 2013. Our market share of the category increased by 1.8 share points to 27.0%.

In Germany, the total cigarette market of 79.6 billion units decreased by 4.6% in 2013, mainly reflecting the impact of price increases in the second quarter of 2013. While our shipments of 28.8 billion units decreased by 3.4%, market share increased by 0.4 share points to 36.2%, driven by *Marlboro* and *L&M*, up by 0.7 and 0.4 share points to 22.0% and 10.9%, respectively, partly offset by *Chesterfield*, down by 0.6 share points to 1.7%. The total industry fine cut category of 41.6 billion cigarette equivalent units increased by 0.7% in 2013. Our market share of the category decreased by 0.5 share points to 14.2%.

In Italy, the total cigarette market of 74.0 billion units decreased by 6.0% in 2013, reflecting an unfavorable economic and employment environment and the prevalence of illicit trade and substitute products. Our shipments of 38.9 billion units decreased by 7.0%, including an unfavorable comparison with 2012, which benefited from trade inventory movements ahead of the morphing of certain variants of *Philip Morris* into *Marlboro* as of the first quarter of 2013. Our market share increased by 0.1 share point to 53.1%, driven by *Marlboro*, up by 0.5 share points to 25.9%, and *Philip Morris*, up by 1.1 share points to 2.4%, partially offset by *Chesterfield*, down by 0.1 share point to 3.5%, and *Diana* in the low-price segment, down by 1.1 share points to 11.3%, the latter impacted by the growth of the super-low price segment and the availability of non-duty paid products. The total industry fine cut category of 6.0 billion cigarette equivalent units decreased by 3.6%, reflecting the 2012 excise tax-driven reduction of the price gap differential with cigarettes. Our market share of the category increased by 9.8 share points to 37.7%.

In Poland, the total cigarette market of 46.6 billion units decreased by 10.6% in 2013, mainly reflecting the unfavorable impact of price increases in the first quarter of 2013 and the availability of non-duty paid OTP. Although our shipments of 17.1 billion units decreased by 10.1%, our market share increased by 0.2 share points to 36.6%, driven by *Marlboro*, up by 0.2 share points to 11.5%, and by *L&M* and *Chesterfield*, up by 1.2 and 0.6 share points to 17.8% and 2.4%, respectively. While the total industry fine cut category of 3.3 billion cigarette equivalent units decreased by 11.2%, reflecting the prevalence of non-duty paid OTP, our market share of the category increased by 3.2 share points to 21.0%.

In Spain, the total cigarette market of 47.7 billion units decreased by 11.1% in 2013, mainly due to the impact of price increases in the first and third quarters of 2013, the unfavorable economic and employment environment and the growth of the fine cut category. Our shipments of 14.6 billion units decreased by 11.5%, including an unfavorable comparison with 2012, which benefited from trade inventory movements in the fourth quarter ahead of price increases in January 2013. Market share increased by 0.7 share points to 31.2%, driven by a higher share of *Marlboro*, up by 0.5 share points to 14.8%. Our market share of *Chesterfield* was up by 0.3 share points to 9.3%, share of *L&M* was flat at 6.3% and share of *Philip Morris* was down by 0.1 share point to 0.6%. The total industry fine cut category of 10.8 billion cigarette equivalent units increased by 6.9%, partly reflecting switching from pipe tobacco as a result of an excise tax increase on the category in 2012. Our market share of the fine cut category increased by 2.0 share points to 13.8% in 2013.

● **Eastern Europe, Middle East & Africa:** Net revenues, which include excise taxes billed to customers, increased \$1.4 billion (7.4%). Excluding excise taxes, net revenues increased \$434 million (5.2%) to \$8.8 billion. This increase was due to:

- price increases (\$767 million), partly offset by
- unfavorable volume/mix (\$235 million) and
- unfavorable currency (\$98 million).

Operating companies income of \$3.8 billion increased by \$53 million (1.4%). This increase was due primarily to:

- price increases (\$767 million), partly offset by
- higher pre-tax charges for asset impairment and exit costs (\$259 million, including charges associated with the termination of distribution agreements resulting from a new business model in Egypt),
- unfavorable volume/mix (\$168 million),
- unfavorable currency (\$122 million),
- higher marketing, administration and research costs (\$86 million, notably related to the annualization of expenditures to expand our business infrastructure in Russia) and
- higher manufacturing costs (\$76 million).

Our cigarette shipment volume in EEMA of 296.5 billion units decreased by 2.4%, mainly due to Russia, Serbia and Turkey, partly offset by the Middle East and North Africa. Cigarette shipment volume of our premium brands increased by 0.3%, driven by *Parliament*, up by 5.0% to 33.0 billion units, partly offset by *Marlboro*, down by 0.9% to 85.8 billion units.

In North Africa, defined as Algeria, Egypt, Libya, Morocco and Tunisia, the total cigarette market increased by 0.7% to an estimated 138.7 billion units in 2013, driven notably by Algeria and Egypt, partially offset by Morocco and Tunisia. Our shipment volume of 36.8 billion units increased by 17.0%, principally reflecting a higher total market and share. Our market share increased by 3.9 share points to 26.5%, driven by gains in all five markets, notably Algeria, up by 0.8 share points to 41.1%, and Egypt, up by 4.7 share points to 22.9%. Share of *Marlboro* and *L&M* in North Africa increased by 2.1 and 1.5 share points to 15.3% and 9.1%, respectively.

In Russia, the total cigarette market declined by 7.6% to an estimated 342.0 billion units in 2013, mainly due to the unfavorable impact of tax-driven price increases, illicit trade and a weak economy. Our shipment volume of 88.0 billion units decreased by 6.7%. Shipment volume of our premium portfolio was down by 6.0%, mainly due to *Marlboro*, down by 20.4%, partially offset by *Parliament*, up by 1.0%. In the mid-price segment, shipment volume decreased by 9.5%, mainly due to *Chesterfield*, down by 17.5%. In the low-price segment, shipment volume decreased by 5.7%, mainly due to *Bond Street*, *Optima* and *Apollo Soyuz*, down by 4.1%, 12.7% and 18.0%, respectively. Our market share of 26.1% in 2013, as measured by Nielsen, was down 0.3 share points. Market share of *Parliament* increased by 0.2 share points to 3.4%, *L&M* increased by 0.2 share points to 2.8%, *Marlboro* decreased by 0.2 share points to 1.7%, *Chesterfield* decreased by 0.4 share points to 3.0% and *Bond Street* was flat at 6.5%.

In Turkey, the total cigarette market declined by 7.6% to an estimated 91.7 billion units in 2013, primarily reflecting the renewed growth of illicit trade and an unfavorable comparison with trade inventory movements in 2012. Excluding the impact of these inventory movements, the total cigarette market was estimated to have declined by 3.5% in 2013. Our shipment volume of 45.2 billion units decreased by 7.1%. Our market share, as measured by Nielsen, decreased by 0.2 share points to 45.5% in 2013, mainly due to *Marlboro*, down by 0.3 share points to 8.9%, and low-price *L&M*, down by 1.1 share points to 7.3%, partly offset by premium *Parliament* and mid-price *Muratti*, up by 1.0 share point and 0.3 share points to 10.0% and 6.9%, respectively.

In Ukraine, the total cigarette market declined by 9.9% to an estimated 75.1 billion units in 2013, mainly reflecting the impact of price increases in 2013 and an increase in illicit trade. Although our 2013 shipment volume of 25.5 billion units decreased by 5.5%, our market share, as measured by Nielsen, increased by 1.0 share point to 33.5%, mainly reflecting growth from our low-price segment brands of *Bond Street*, *Optima* and *President*. Share for premium *Parliament* was up by 0.1 share point to 3.3%. Market share of *Marlboro* decreased by 0.3 share points to 5.5%.

● **Asia:** Net revenues, which include excise taxes billed to customers, decreased by \$84 million (0.4%). Excluding excise taxes, net revenues decreased \$697 million (6.2%) to \$10.5 billion. This decrease was due to:

- unfavorable currency (\$726 million) and
- unfavorable volume/mix (\$670 million, primarily due to the Philippines and Japan), partly offset by
- price increases (\$699 million).

Operating companies income of \$4.6 billion decreased by \$575 million (11.1%). This decrease was due primarily to:

- unfavorable currency (\$548 million),
- unfavorable volume/mix (\$536 million) and
- higher manufacturing costs (\$240 million, principally in Indonesia driven mainly by higher clove prices), partly offset by
- price increases (\$699 million),
- lower marketing, administration and research costs (\$39 million) and
- lower pre-tax charges for asset impairment and exit costs (\$12 million).

Our cigarette shipment volume of 301.3 billion units decreased by 7.7%, due primarily to the lower total market and share in the Philippines, and lower share in Japan and Pakistan, partly offset by share growth in Indonesia. Excluding the Philippines, our cigarette shipment volume decreased by 0.4%. Shipment volume of *Marlboro* of 75.3 billion units was down by 7.1%. Excluding the Philippines, shipment volume of *Marlboro* increased by 2.0%, primarily reflecting market share growth in Indonesia and Vietnam.

In Indonesia, the total cigarette market increased by 1.9% to 308.3 billion units in 2013. Our shipment volume of 111.3 billion units increased by 3.4%. Our market share increased by 0.5 share points to 36.1%, driven notably by *Sampoerna A* in the premium segment, up by 0.6 share points to 14.4%, and mid-price *U Mild*, up by 1.1 share points to 4.4%. Market share of the hand-rolled, full-flavor *Dji Sam Soe* in the premium segment decreased by 1.0 share point to 6.8%, mainly due to a retail price change ahead of competition. *Marlboro's* market share was up by 0.4 share points to 5.2%, and its share of the "white" cigarettes segment, representing 6.8% of the total cigarette market, increased by 5.7 share points to 77.0%.

In Japan, the total cigarette market decreased by 2.0% to 192.6 billion units. Our shipment volume of 53.0 billion units was down by 5.3%, principally due to a lower total market and share. Our market share decreased by 1.0 share point to 26.7%, reflecting the impact of our principal competitor's brand launches and significant promotional activities in 2013. Market share of *Marlboro*, *Lark* and *Philip Morris* decreased by 0.3, 0.4 and 0.2 share points to 12.1%, 8.0% and 2.1%, respectively, and share of *Virginia S.* was down by 0.1 share point to 2.0%.

In Korea, the total cigarette market decreased by 1.0% to 88.4 billion units in 2013. Although our shipment volume of 17.2 billion units was essentially flat, market share increased by 0.2 share points to 19.4%, with share of *Parliament* up by 0.3 share points to 6.9%, partly offset by *Marlboro*, down 0.1 share point to 7.7%. Share of *Virginia S.* was flat at 4.1%.

In the Philippines, the total industry cigarette volume decreased by 15.6% to an estimated 86.3 billion units in 2013, primarily reflecting the unfavorable impact of the disruptive excise tax increase in January 2013 and a surge in the prevalence of domestic non-duty paid products. Our shipment volume of 68.5 billion units decreased by 26.2%, primarily reflecting the unfavorable impact of the aforementioned tax increase and the underdeclaration of tax-paid volume by our main local competitor. Our market share decreased by 11.4 share points to 79.3%, primarily due to down-trading to competitors' brands. *Marlboro's* market share decreased by 4.2 share points to 16.7%. Share of *Fortune* decreased by 17.8 share points to 31.6%, partly offset by gains from our other local brands.

● **Latin America & Canada:** Net revenues, which include excise taxes billed to customers, increased \$332 million (3.4%). Excluding excise taxes, net revenues increased \$33 million (1.0%) to \$3.4 billion. This increase was due to:

- price increases (\$252 million), partly offset by
- unfavorable currency (\$146 million) and
- unfavorable volume/mix (\$73 million).

Operating companies income of \$1.1 billion increased by \$91 million (8.7%). This increase was due to:

- price increases (\$252 million),
- lower pre-tax charges for asset impairment and exit costs (\$29 million) and
- lower marketing, administration and research costs (\$23 million), partly offset by
- unfavorable volume/mix (\$88 million),
- unfavorable currency (\$64 million) and
- higher manufacturing costs (\$61 million, including higher leaf costs).

Our cigarette shipment volume in Latin America & Canada of 97.3 billion units decreased by 1.4%, principally due to a lower total market, predominantly in Brazil, partly offset by higher share, notably in Argentina and Brazil, and trade inventory movements in Mexico. While shipment volume of *Marlboro* of 38.7 billion units decreased by 1.4%, market share was up, notably in Brazil and Colombia by 0.7 and 0.9 share points, respectively.

In Argentina, the total cigarette market decreased by 1.8% to 42.6 billion units in 2013. While our cigarette shipment volume of 32.4 billion units decreased by 0.8%, market share increased by 0.7 share points to a record 75.6%, driven by mid-price *Philip Morris*, up by 2.1 share points to 41.5%, reflecting the positive impact of its capsule variants, partly offset by low-price *Next*, down by 0.6 share points to 2.5%. Share of *Marlboro* decreased by 0.3 share points to 23.8%.

In Canada, the total cigarette market decreased by 1.2% to 28.9 billion units in 2013. While our cigarette shipment volume of 10.8 billion units was flat, market share increased by 0.3 share points to 37.2%, with premium brands *Benson & Hedges* and *Belmont* up by 0.1 share point each to 2.4% and 2.6%, respectively. Market share of low-price brand *Next* was up by 1.7 share points to 9.9%, partly offset by mid-price *Number 7* and low-price *Accord*, down by 0.3 and 0.4 share points, to 4.2% and 2.9%, respectively. Market share of mid-price *Canadian Classics* was flat at 10.1%.

In Mexico, the total cigarette market increased by 3.0% to 34.6 billion units in 2013, primarily reflecting a favorable comparison of price-driven trade inventory movements compared to 2012. Our cigarette shipment volume in 2013 of 25.4 billion units increased by 3.0%. Our market share was flat at 73.5%. While market share of *Marlboro* and *Benson & Hedges* was down by 1.3 and 0.7 share points to 52.3% and 5.5%, respectively, reflecting consumer down-trading, our share of the premium price segment was up by 1.0 share point to 90.7%. Market share of *Delicados*, the second-best-selling brand in the market, increased by 0.8 share points to 11.2%.

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 primarily 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 (\$61 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 6.1% to 521.2 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 down by 0.2 share points to 38.0%, as gains, notably in Belgium, Greece, Finland, Hungary and Poland, were more than 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 0.2 share points to 18.6%, 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 3.8%, 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 1.7%, 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 3.0 share points to 16.1%; 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 1.2 share points to 11.8%.

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 of *Marlboro*, *Chesterfield*, *L&M* and *Philip Morris*, up by 0.2, 0.5, 0.1 and 0.6 share points to 7.4%, 0.8%, 7.1% and 2.9%, respectively.

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 0.4 share points to 25.4%, fueled by the March 2012 and June 2012 launches of *Marlboro Silver* and *Marlboro Pocket Pack*, and *Philip Morris*, up by 0.5 share points to 1.3%, 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 11.4% to 53.7 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 0.4 share points to 30.5%, 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 1.2 share points to 11.8%.

● **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 (\$141 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 26.4%, as measured by Nielsen, was up by 0.6 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 0.8 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 0.3 share points to 32.5%. 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 0.4 share points to 7.1% and *Bond Street* was up by 1.2 share points to 8.4%.

● **Asia:** Net revenues, which include excise taxes billed to customers, increased \$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 primarily 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 (\$172 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 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 primarily 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 (\$12 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 increased by 0.9% to 29.3 billion units. Our cigarette shipment volume declined by 1.5%. Our market share was down by 0.9 share points to 36.9%, primarily reflecting share losses in the mid-price segment, reflecting fierce price competition. Market share of premium brand *Belmont* was up by 0.2 share points to 2.5%, and low-price brand *Next* was up by 0.9 share points to 8.2%, offset by premium brand *Benson & Hedges*, mid-price *Number 7* and *Canadian Classics*, and low-price *Accord* and *Quebec Classique*, down by 0.2, 0.3, 0.3, 0.5 and 0.2 share points, to 2.3%, 4.5%, 10.1%, 3.3% and 2.3%, 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 at 6.2% while share of low-price *Delicados* decreased by 0.5 share points to 10.4%.

Financial Review

● **Net Cash Provided by Operating Activities:** Net cash provided by operating activities of \$10.1 billion for the year ended December 31, 2013, increased by \$714 million from the comparable 2012 period. The increase was due primarily to a decrease in our working capital requirements (\$451 million) and lower pension contributions (\$57 million).

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

- more cash provided by accrued liabilities and other current assets (\$2.1 billion), largely due to the timing of payments for excise taxes; partly offset by
- more cash used for income taxes (\$969 million), primarily related to the timing of payments, and
- more cash used for inventories (\$685 million), primarily related to the timing of inventory purchases.

On February 7, 2013, we announced a one-year, gross productivity and cost savings target for 2013 of approximately \$300 million. During 2013, we exceeded this target primarily through the rationalization of tobacco blends and product specifications and other manufacturing and procurement initiatives.

On February 6, 2014, we announced a one-year gross productivity and cost savings target for 2014 of approximately \$300 million. Achievement of the productivity and cost savings target will enable us to offset some of the annual cost increases that are driven by inflation.

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.

● **Net Cash Used in Investing Activities:** Net cash used in investing activities of \$2.7 billion for the year ended December 31, 2013, increased by \$1.7 billion from the comparable 2012 period, due primarily to higher cash spent on investments in unconsolidated subsidiaries (\$1.4 billion) and higher capital expenditures (\$144 million).

Net cash used in investing activities of \$992 million for the year ended December 31, 2012, decreased \$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).

As previously discussed, on September 30, 2013, we acquired a 49% equity interest in United Arab Emirates-based Arab Investors-TA (FZC) for approximately \$625 million. On December 12, 2013, we acquired from Megapolis Investment BV a 20% equity interest in Megapolis Distribution BV, the holding company of CJSC TK Megapolis, our distributor in Russia, for a purchase price of \$750 million. For further details, see Note 4. *Investments in Unconsolidated Subsidiaries* to our consolidated financial statements.

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.

Our capital expenditures were \$1.2 billion in 2013, \$1.1 billion in 2012 and \$897 million in 2011. The 2013 expenditures were primarily related to investments in reduced-risk products, productivity-enhancing programs, equipment for new products and the expansion of our capacity in Indonesia. We expect total capital expenditures in 2014 of approximately \$1.2 billion (including additional capital expenditures related to our ongoing investment in reduced-risk products), to be funded by operating cash flows.

● **Net Cash Used in Financing Activities:** During 2013, net cash used in financing activities was \$8.2 billion, compared with net cash used in financing activities of \$8.1 billion during 2012 and \$8.3 billion in 2011. During 2013, we used a total of \$17.1 billion to repurchase our common stock, pay dividends, repay debt and purchase subsidiary shares from noncontrolling interests. These uses were partially offset by proceeds from our debt offerings and short-term borrowings in 2013 of \$9.2 billion. 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.

In May 2013, we announced that Grupo Carso would sell us its remaining 20% interest in our Mexican tobacco business. The sale was completed on September 30, 2013, with the approval of the Mexican antitrust authority, for \$703 million. As a result, we now own 100% of our Mexican tobacco business. For further details, see Note 6. *Acquisitions and Other Business Arrangements* to our consolidated financial statements.

Dividends paid in 2013, 2012 and 2011 were \$5.7 billion, \$5.4 billion and \$4.8 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 February 11, 2014, 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 January 31, 2014, we extended the term of our existing \$2.0 billion 364-day revolving credit facility until February 10, 2015. At February 11, 2014, our committed credit facilities were as follows:

| Type (in billions) | Committed Credit Facilities |
|--|-----------------------------------|
| 364-day revolving credit, expiring February 10, 2015 | \$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 11, 2014, there were no borrowings under the committed credit facilities, and the entire committed amounts were available for borrowing.

On January 7, 2014, we launched a \$2.5 billion revolving credit facility with certain financial institutions to replace our \$2.5 billion multi-year revolving credit facility, expiring March 31, 2015. The transaction, which is expected to close on February 28, 2014, would extend the credit facility to February 28, 2019.

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, 2013, our ratio calculated in accordance with the agreements was 14.6 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 \$2.4 billion at December 31, 2013, and \$2.0 billion at December 31, 2012, are for the sole use of our subsidiaries. Borrowings under these arrangements amounted to \$1.0 billion at December 31, 2013, and \$447 million at December 31, 2012.

Commercial Paper Program: We have commercial paper programs in place in the U.S. and in Europe. At December 31, 2013 and 2012, we had \$1.4 billion and \$2.0 billion, respectively, of commercial paper outstanding.

Effective April 19, 2013, our commercial paper program in the U.S. was increased by \$2.0 billion. As a result, our commercial paper programs in place in the U.S. and in Europe currently have an aggregate issuance capacity of \$8.0 billion.

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 \$27.7 billion at December 31, 2013, and \$22.8 billion at December 31, 2012. Fixed-rate debt constituted approximately 90% of our total debt at December 31, 2013, and 88% of our total debt at December 31, 2012. The weighted-average all-in financing cost of our total debt was 3.5% in 2013, compared to 4.0% in 2012. 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 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. During February 2014, we plan to file a new shelf registration statement with the Securities and Exchange Commission.

Our debt offerings in 2013 were as follows:

(in millions)

| Type | Face Value | Interest Rate | Issuance | Maturity |
|-------------------------------------|-----------------------------------|---------------|---------------|---------------|
| U.S. dollar notes ^(a) | \$400 | Floating | March 2013 | February 2015 |
| U.S. dollar notes ^(b) | \$600 | 2.625% | March 2013 | March 2023 |
| U.S. dollar notes ^(b) | \$850 | 4.125 | March 2013 | March 2043 |
| U.S. dollar notes ^(c) | \$750 | 1.875 | November 2013 | January 2019 |
| U.S. dollar notes ^(d) | \$500 | 3.600 | November 2013 | November 2023 |
| U.S. dollar notes ^(d) | \$750 | 4.875 | November 2013 | November 2043 |
| EURO notes ^{(e)(g)} | €1,250 (approximately \$1,621) | 1.750 | March 2013 | March 2020 |
| EURO notes ^{(e)(g)} | €750 (approximately \$972) | 2.750 | March 2013 | March 2025 |
| EURO notes ^{(f)(g)} | €500 (approximately \$648) | 3.125 | June 2013 | June 2033 |
| Swiss franc notes ^{(e)(g)} | CHF200 (approximately \$217) | 0.875 | March 2013 | March 2019 |

(a) Interest on these notes is payable quarterly in arrears beginning in May 2013. The notes will bear interest from date of issuance at a rate per annum, reset quarterly, equal to three-month LIBOR plus 0.05%.

(b) Interest on these notes is payable semiannually in arrears beginning in September 2013.

(c) Interest on these notes is payable semiannually in arrears beginning in July 2014.

(d) Interest on these notes is payable semiannually in arrears beginning in May 2014.

(e) Interest on these notes is payable annually in arrears beginning in March 2014.

(f) Interest on these notes is payable annually in arrears beginning in June 2014.

(g) USD equivalents for foreign currency notes were calculated based on exchange rates on the date of issuance.

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 10.1 years at the end of 2012 to 10.8 years at the end of 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 discussed below.

Guarantees: At December 31, 2013, we were contingently liable for \$0.8 billion of guarantees of our own performance, which were primarily related to excise taxes on the shipment of our products. There is no liability in the consolidated financial statements associated with these guarantees. At December 31, 2013, our third-party guarantees were insignificant.

Aggregate Contractual Obligations: The following table summarizes our contractual obligations at December 31, 2013:

| (in millions) | Payments Due | | | | |
|---|--------------|---------|-----------|-----------|---------------------|
| | Total | 2014 | 2015-2016 | 2017-2018 | 2019 and Thereafter |
| Long-term debt ⁽¹⁾ | \$25,539 | \$1,255 | \$4,093 | \$3,804 | \$16,387 |
| RBH Legal Settlement ⁽²⁾ | 175 | 36 | 77 | 62 | — |
| Colombian Investment and Cooperation Agreement ⁽³⁾ | 117 | 8 | 16 | 13 | 80 |
| Interest on borrowings ⁽⁴⁾ | 10,690 | 890 | 1,591 | 1,311 | 6,898 |
| Operating leases ⁽⁵⁾ | 846 | 218 | 284 | 133 | 211 |
| Purchase obligations ⁽⁶⁾ : | | | | | |
| Inventory and production costs | 4,153 | 1,677 | 1,118 | 583 | 775 |
| Other | 2,010 | 1,100 | 579 | 328 | 3 |
| | 6,163 | 2,777 | 1,697 | 911 | 778 |
| Other long-term liabilities ⁽⁷⁾ | 434 | 67 | 118 | 39 | 210 |
| | \$43,964 | \$5,251 | \$7,876 | \$6,273 | \$24,564 |

- (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, 2013. 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-cancelable 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 \$171 million in 2014, 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 \$81 million, \$78 million and \$86 million were recorded in cost of sales in 2013, 2012 and 2011, respectively.

● **Equity and Dividends:** As discussed in Note 9. *Stock Plans* to our consolidated financial statements, during 2013, we granted 2.8 million shares of deferred stock awards to eligible employees at a weighted-average grant date fair value of \$88.43 per share. 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. At December 31, 2013, shares available for grant under the 2012 plan were 27,211,610.

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, 2013, we repurchased 99.4 million shares of our common stock at a cost of \$8.9 billion under this new repurchase program. During 2013, we repurchased 67.2 million shares at a cost of \$6.0 billion.

On February 6, 2014, we announced that our forecast includes a share repurchase target amount for 2014 of \$4.0 billion.

Dividends paid in 2013 were \$5.7 billion. During the third quarter of 2013, our Board of Directors announced a 10.6% increase in the quarterly dividend to \$0.94 per common share. As a result, the present annualized dividend rate is \$3.76 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 and interest rate 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*, Note 16. *Fair Value Measurements* and Note 22. *Balance Sheet Offsetting* to our consolidated financial statements for further details on our derivative financial instruments and the related collateral arrangements.

● **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, 2013 and 2012, 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 12/31/13 | Average | High | Low |
| Instruments sensitive to: | | | | |
| Foreign currency rates | \$16 | \$27 | \$43 | \$16 |

| (in millions) | Fair Value Impact | | | |
|---------------------------|-------------------|---------|-------|------|
| | At 12/31/13 | Average | High | Low |
| Instruments sensitive to: | | | | |
| Interest rates | \$60 | \$75 | \$111 | \$56 |

| (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 |

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 down-trading and the risk of counterfeiting, contraband, “illicit whites” 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 FCTC 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 down-trading trends may be reinforced by regulation that limits branding, communication and product differentiation.

- **We lose revenues as a result of counterfeiting, contraband, cross-border purchases and non-tax paid volume by local manufacturers.**

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, legal cross-border purchases and non-tax paid volume by local manufacturers.

- **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 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 certain 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 cigarettes.**

We continue to seek ways to develop commercially viable new product technologies that may reduce the risk of smoking-related diseases in comparison to cigarettes. Our goal is to develop products whose potential for exposure, risk and harm reduction can be substantiated and provide adult smokers the taste, sensory experience, nicotine delivery profile and ritual characteristics that are similar to those currently provided by 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 exposure, risk or 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 translates 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 or 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 impact 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.