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# THE STAHL REPORT

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March 10, 2011

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## Lorillard, Inc.

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(BUY)

<b>Price:</b>	\$79.38	<b>Ticker:</b>	LO
<b>52-Week Range:</b>	\$70.24-\$89.71	<b>Dividend:</b>	\$4.50
<b>Shares Outstanding:</b>	148.8m	<b>Yield:</b>	5.7%
<b>Market Capitalization:</b>	\$11,812m		

Data as of 3/10/2011

Valuations within this text are based on a \$77.91 share price



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Exclusive Marketers of  
The Stahl Report

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## Investment Thesis

### Preface

The current report should be read in conjunction with a recent recommendation of Phillip Morris International<sup>1</sup>. As a manufacturer of tobacco products, Lorillard shares many of the same fundamental attributes that are worthy of consideration by the value investor. Namely, in an industry with a limited degree of premium brand competition, Lorillard has considerable pricing power that allows it to not only withstand declining industry volumes and ever increasing consumption taxes, but actually expand the company's free cash flow at a fairly decent annual rate. This cash flow, in turn, is generally returned to shareholders in its entirety through dividend payments and share repurchases, resulting in a very high economic yield to the investor.

However, there are some key dissimilarities from Phillip Morris International. Specifically, Lorillard is mostly non-diversified, in that 90% of its revenues are produced from one brand of menthol cigarettes. This has become problematic, as menthol cigarettes have come under scrutiny by the Food and Drug Administration ("FDA"). As well, the company has no international business, and thus is confined to the U.S. tobacco market, which is generally declining, in consumption terms, at a higher rate than in other nations. These risks, though, appear well discounted in the company's share price, which will be discussed throughout this report.

### Lorillard Investment Thesis

Lorillard is the third largest manufacturer of cigarettes in the U.S., behind Altria and Reynolds American. Being the smallest of the premium brand manufacturers, it maintains a 12.3% share of the U.S. market. This position is due almost entirely to the company's leading brand of menthol cigarettes, Newport, which maintains a 35% share of the overall menthol market.

Over the last few years, Lorillard has actually been expanding its volume slightly. Obviously, in an industry in which consumption has been declining by about 5% per annum recently, Lorillard is capturing market share from its two main competitors. In this regard, the company's reliance on one product brand has been a benefit rather than a detriment.

However, there is some regulatory risk involved, even beyond the ordinary risk that is associated with a tobacco company. In June 2009, the U.S. Congress passed the Family Smoking Prevention and Tobacco Control Act, which essentially grants the FDA authority to regulate tobacco products. As part of the legislation, the FDA will present a recommendation as to the potential for heightened risks of menthol cigarettes. The possibility of an adverse outcome caused great concern among Lorillard investors for

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<sup>1</sup> Phillip Morris International was recommended in *The Stahl Report* dated February 24, 2011.

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obvious reasons. The elimination of menthol cigarettes from the market would erase all but about 10% of the company's revenues. It very well could be a fatal event for the company.

However, it should be noted that the current p/e ratio is 10.5x this year's estimated earnings. Naturally, investors do not expect a draconian outcome. A few days ago, a preliminary recommendation was presented to the FDA, which stated that menthol cigarettes do not pose undue health risks as compared to non-menthol cigarettes, but that the attractiveness of menthol may well entice the youth population to consume tobacco products. It appears that a likely outcome could be an alteration to the packaging or limited marketing of menthol products, but a complete ban appears rather extreme to assume at the moment.

Since Lorillard trades at a 16% discount to Altria and a 20% discount to Reynolds American, the latter two being diversified companies presumably more capable of withstanding any menthol-related volume pressure, it is worth considering the impact of a favorable outcome for Lorillard. In other words, if the FDA decision-related risk were eliminated, and the shares were to trade commensurately with Altria at a 12.5x multiple, the share price would be \$93.13, representing a 19.5% increase from the current level.

While the multiple expansion optionality is rather attractive, it should not be considered as an isolated variable, but within the overall framework of one's potential return. As a base estimate, the current dividend of \$4.50 per share appears quite sustainable. This amounts to a 5.8% yield presently. The company's remaining free cash flow, which will be calculated later in this report, will likely be used to continue the current share repurchase program. This \$434 million amounts to 3.7% of the \$11.5 billion market capitalization. Hence, the going-in economic yield of these two forms of return of capital is 9.5%.

In addition to this, Lorillard is expanding its free cash flow at a rate of approximately 4.6% per annum, or roughly two percentage points above normal inflation, which is attributed mostly to product price increases. As to the sustainability of this pricing pattern, recognizing that continued price inflation above the general inflation rate ultimately could render tobacco products unaffordable to its users, the inflation-adjusted price-per-pack of cigarettes has expanded by about 2.4% per annum since 1970. Interestingly, then, cigarettes have remained affordable in this sense over a period of decades, although a more recent period suggests higher price inflation.

Thusly, one could take one of two approaches. First, if Lorillard is able to maintain the 4%-5% price increase-driven free cash flow growth rate, even over a nearer-term period of perhaps 3-5 years, the share price should rise in commensurate fashion, providing the investor with a 14.1% base annual return. However, if one is more pessimistically inclined, it may be argued that the company's organic growth rate could revert to a historical mean that is no higher than normal inflation. This implies a more conservative

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11.9% total rate of return. Yet, this still comfortably exceeds the return of common stocks over the long term.

Moreover, if the reader also considers the valuation optionality, or a possible two point or so expansion in the p/e multiple from the current discounted level, the Lorillard shares appear quite attractively priced. Assuming that one can tolerate some degree of regulatory risk, provided that the assumption of this risk yields a 15%-plus possible annualized return, the shares deserve consideration for purchase.

## **Company Description**

### *History*

Lorillard is actually the oldest tobacco firm in the United States, having been founded by Pierre Lorillard in 1760. The past several decades of the company's history were defined by its status under the Loews corporate umbrella, which purchased Lorillard in 1967. In an effort to separate the valuation of Lorillard from the company's other non-tobacco assets, Loews created a tracking stock in 2002 called Carolina Group. The tracking stock remained in existence until June 2008, at which time Loews officially spun out Lorillard as an independent entity, thereby converting the Carolina Group shares into Lorillard stock.

### *Tobacco Market Considerations*

The U.S. tobacco market is quite challenged in many regards. Due mainly to health consequences and regulatory restrictions, consumption of cigarettes has been in decline for many decades. According to the Center for Disease Control ("CDC"), there were approximately 525 billion cigarettes consumed in 1990. In the last year data was recorded by the CDC, consumption had fallen to 364 billion units in 2007. By utilizing more recent data provided by Lorillard, industry-wide consumption has fallen even further to 303.7 billion units in 2010. Hence, on an annualized basis, cigarette consumption has declined at a rate of approximately 2.7% over the last two decades. Although, it appears that the rate of erosion has accelerated recently, as the data over a five-year period from 2006-2010 indicates a 5.2% annual decline. For reasons evident to any reader, the U.S. population is consuming fewer cigarettes than at any point in recent history.

While the contraction of the cigarette market is probably inexorable, it has not been sudden. This slow and steady decline is dramatically different from a product displacement in, say, the technology industry. In those cases, margin erosion can be swift and competitive forces very fierce. The elimination or displacement of a product altogether is always a danger inherent to rapidly changing industries.

The tobacco industry is not really changing, in that the product lifecycles are very long, and competition somewhat contained. It is merely the case that demand for cigarettes is

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eroding at a modest pace. The manufacturers, of which there are really only three in the U.S., have had many years to prepare for and cope with this reality. Most often, these companies have the ability to raise prices, and also apply pressure to their tobacco leaf suppliers. For instance, Lorillard's largest supplier of leaves is Alliance One. This company, although it operates as a duopoly with Universal Corp., has had difficulty reaching a profit margin above 5%, while the margin capabilities of Universal Corp. are not much better. Thus, the cigarette manufacturers utilize these coping mechanisms to withstand lower consumption rates. As described momentarily, this has proved very effective in the cash flow sense.

### Lorillard Operating Characteristics

Despite this undeniably negative industry pattern, it might surprise the reader that Lorillard has actually expanded its U.S. shipment volume since 2006, albeit only by 3.6% cumulatively. The industry, as noted, has experienced declines in each and every year, as has Altria, which is the largest producer in the U.S. The logical conclusion is that Lorillard has increased its market share.

**Table 2: Lorillard Versus the Tobacco Industry and Altria**

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Lorillard			Vs. Altria	Vs. U.S. Industry
Year	U.S. Unit Volume	% change	% change	% change
2010	37.4	5.1%	-3.9%	-3.8%
2009	35.6	-3.8%	-12.2%	-8.6%
2008	37.0	3.4%	-3.3%	-3.3%
2007	35.8	-0.8%	-4.5%	-5.0%
2006	36.1			

\*Volume in billions

Based on 37 billion units shipped in 2008, Lorillard recorded a market share of 10.7%. While only a 1.1% increase was recorded over the next two years, industry volume declined, such that the company's market share rose to the present 12.3% level. This represents a 15% improvement in market share.

This relative success is due almost entirely to the Newport Brand. In 2010, Newport represented 83.5% of the company's total volume, and 90% of revenues. Other brands such as Kent, True, Max, Old Gold, and Maverick are not meaningless, but are not

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necessarily vital to the company's health. Nevertheless, Newport is the leading menthol cigarette in the U.S., with a reported 35% market share. As compared to the total industry (i.e. menthol and non-menthol), Newport has a 10.5% share, which is up from 9.7% in 2008.

The attentive reader might determine, given very modest (i.e. <1%) increases in annual shipment volume, that Lorillard has recorded similar revenue growth. Such is not the case. On a net revenue basis, which excludes excise taxes, revenues have expanded at a compound annualized rate of 7.3% per annum. This reveals the company's pricing power, both against its competition, and an ever-increasing consumption taxation rate. This is actually somewhat remarkable.

**Table 2: Lorillard Five-Year Revenue Growth Record**

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Year	Gross Revenues	Excise Taxes	Net Revenues	% change
2010	\$5,932	\$1,879	\$4,053	10.0%
2009	\$5,233	\$1,547	\$3,686	5.6%
2008	\$4,204	\$712	\$3,492	6.4%
2007	\$3,969	\$688	\$3,281	7.4%
2006	\$3,755	\$699	\$3,056	
			<i>Ann'l'zd %:</i>	7.3%

In order to truly appreciate this pricing power, let us examine for the moment the net margins of the industry participants. During the recession-impacted period of 2006-2010, Altria managed to mostly maintain an approximate 16% profit margin, despite a temporary decline to 13.6% in 2009. Reynolds American is slightly less profitable on a relative basis, but nonetheless manifests the same degree of invariability. Its range of profitability has been 10.3%-12.9% during this time frame.

When officially separated from Loews in 2008, Lorillard produced a net margin in excess of 22%. However, it had no balance sheet leverage at the time, which virtually every tobacco company employs, considering the stability of their cash flows. Thus, as Lorillard began to issue debt in 2009, its net margin contracted due to the added interest expense. The current net margin is 17.3%. With an interest coverage ratio of over 18x, it is reasonable to assume that Lorillard may undertake new debt offerings, perhaps to fund share repurchases. This would lower the profit margin even further, but likely increase earnings per share.

Perhaps the more appropriate measure of the Lorillard profitability, then, is the EBIT margin. Towards this end, the company's margin has declined somewhat from 33% in

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2006 to the current 29% level. Clearly, the industry is not immune to margin pressure. Yet, in consideration of a deep recessionary environment, declining volumes, higher excise taxes, and a certain level of competition, the margins of these companies are actually fairly durable when viewed in this light.

**Table 3: U.S. Tobacco Companies Net Margin Comparison**

Year	Lorillard	Altria	Reynolds American (1)
2010	17.3%	16.0%	10.3%
2009	18.1%	13.6%	11.1%
2008	21.4%	16.0%	12.9%
2007	22.6%	16.8%	12.2%
2006	22.3%	16.9%	11.2%

(1) Excludes restructuring charges; net margin is reported gross of excise taxes in order to be consistent with the reported net margins of MO and LO

The ability of Lorillard to implement product price increases while mostly maintaining its margins also can be expressed through the company's free cash flow. It is noted that the production of tobacco products requires very little capital expenditure, such that net earnings are almost entirely free cash flow. In the table below, the reader will observe that Lorillard has expanded its free cash flow available for share repurchases and dividends at an annual rate of 4.6%.

**Table 4: Lorillard Free Cash Flow Progression, 2006-2010**

	2010	2009	2008	2007	2006	Ann'l'zd %:
Net Income	\$1,029	\$948	\$899	\$898	\$839	5.2%
D&A	\$35	\$32	\$32	\$40	\$47	
Cash Earnings	\$1,064	\$980	\$931	\$938	\$886	4.7%
Less: CAPEX	\$40	\$51	\$44	\$51	\$30	
<b>FCF (available for share repurchases &amp; dividends)</b>	<b>\$1,024</b>	<b>\$929</b>	<b>\$887</b>	<b>\$887</b>	<b>\$856</b>	<b>4.6%</b>
<b>FCF per share (1)</b>	<b>\$6.75</b>	<b>\$5.66</b>	<b>\$5.15</b>	<b>\$5.10</b>	<b>\$4.92</b>	<b>8.2%</b>
<i>FCF Margin</i>	17.3%	17.8%	21.1%	22.3%	22.8%	

(1) Prior to the company's listing as an independent company in June 2008, the shares outstanding of 173.9m were held constant during 2007 and 2006 in order to calculate the 5-year annualized per share growth rate

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## Balance Sheet Comments

Perhaps another reason for the company's low valuation, apart from the FDA-related risk described below, is that Lorillard has no shareholders' equity. The mathematical consequence of a large share repurchase program and substantial dividend payments is a declining shareholders' equity base. At the moment, the company has a negative book value of \$225 million.

However, it is not heavily indebted. Against \$1.8 billion of debt is an available cash balance of \$2.1 billion, resulting in a net cash position of \$294 million. Though, one might include the accrued settlement liabilities of \$1.1 billion, which would create net liabilities of \$766 million. Ergo, in the liquidation sense, Lorillard is not viewed in a very positive light.

Nevertheless, the company's ability to service its existing debt is not in question. Lorillard produced \$1.7 billion of operating income during 2010, which exceeded annual interest expense of \$94 million by 18.4x. While it would increase the company's credit risk, the addition of more debt to the balance sheet is clearly manageable from a cash flow perspective. The reader may appropriately wish to view the balance sheet from a maintenance standpoint rather than on a tangible equity basis. If considered in this fashion, Lorillard is a well capitalized company.

## The Menthol-Related Risk

Under the Family Smoking Prevention and Tobacco Control Act signed into law in June 2009, the FDA established the Tobacco Products Scientific Advisory Committee in order to study the issues surrounding the use of menthol as a flavoring or ingredient in cigarettes. The Advisory Committee is to produce a non-binding recommendation to the FDA by March 23<sup>rd</sup> of this year.

The goal of the study is to determine if menthol cigarettes present an increased health risk as compared to non-menthol cigarettes. An initial draft of the Committee's recommendation was presented to the FDA a few days ago, in which it was determined that menthol cigarettes are not more disease-causing than non-menthol tobacco products. However, the Committee did note that the presence of menthol could mask the harshness of smoking and make it more attractive to young smokers.

Here, one is presented with somewhat of an analytical conundrum. That is, regulatory decisions such as this cannot be predicted with any degree of accuracy. It very well could be the case that more stringent restrictions could be placed on menthol products, such as packaging warnings or advertisement disclosures. It is already not permissible to market products with fruit flavorings or other ingredients that may entice younger individuals to smoke.

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However, one may make broad use of historical considerations. For several decades, the population has been informed that the use of tobacco products is quite harmful to one's health. The tobacco companies have been embroiled in litigation during the entire time. Yet, consumption of cigarettes is only in modest decline. One could subjectively reason, given historical precedent, that more health warnings and advertising restrictions might not severely impact the use of menthol products. Of course, if such products were banned, Lorillard would be in a severely compromised position, and would undoubtedly appeal this decision for many years. At this point, though, it does not appear that the company's primary Newport brand faces this extreme level of risk.

## Valuation

### *The P/E Experience Since 2008*

The Lorillard shares ended trading in 2008 at a 10.9x p/e ratio, which is more or less the current figure. It is noteworthy that Lorillard now trades at the same valuation as it did during the depths of the Credit Crisis – December 2008 being a rather bleak period indeed.

The share price rose from that \$56 level to roughly \$80 in 2009 and 2010. The company's earnings per share, though, increased from \$5.15 to \$6.78, such that the valuation expanded only modestly to 12.1x earnings by the end of 2010.

It is hard to argue that equity valuations were unsustainably high in 2009 and 2010 when the company's earnings multiple was 12.1x and 13.9x, or considerably higher than the current level. The present 10.5x p/e ratio based on the consensus earnings estimates for 2011 is a rather noticeable discount to the two other public U.S. tobacco firms. It could certainly be reasoned that a modest 12.5x p/e ratio is appropriate for a well-capitalized and managed tobacco company. For instance, Altria – the largest U.S. tobacco company - trades at 12.5x this year's earnings estimate. Reynolds American actually trades at a slight premium to this at 13.1x earnings. Therefore, it must logically follow that the 16%-20% discount at which Lorillard trades is largely a reflection of the company's perceived regulatory risk.

It is also wise to consider the after-tax earnings yield here of 9.5%, and 10.5% on a forward year basis, in the current environment of 2%-2.5% pre-tax yields on five-year Treasuries. For accepting the equity-related risk, one can earn well over 5x-6x the after-tax yield equivalent of a risk-free bond.

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## How Does Lorillard Compare to Other High ROA Companies?

In general, it is rare to find a larger capitalization company (i.e. >\$5 billion) that produces a return on assets in excess of 20%. One of the most popular examples is Microsoft, which recently generated a 26.1% ROA. Many would argue though that this company's margins are in jeopardy. Hence, it trades at 10.2x the consensus 2011 earnings estimate.

Others included on the list below such as MasterCard, Apple, or Google all have enduring brand franchises. Yet, each one encounters some degree of risk that could jeopardize the current high level of profitability. The p/e ratios of these companies are all above 14.8x.

Lorillard produced a 31.2% return on assets in 2010. It is one of the most profitable companies in the S&P 500; yet, it trades at 10.5x earnings. One must really question if the risks facing this company, whether real or perceived, are considerably greater than the technological displacement risk that surrounds certain of the companies below, all of which trade at substantial premiums to Lorillard. Stated differently, one receives a fair amount of capital loss protection with Lorillard care of an extremely low valuation.

**Table 5: Comparison of High ROA Companies**

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	ROA	2011 P/E
Microsoft (1)	26.1%	10.2x
MasterCard	20.9%	14.8x
Apple	18.6%	15.4x
Priceline.com	18.2%	23.8x
Starbucks	14.8%	21.5x
Google	14.7%	17.5x
Nike (2)	14.1%	19.9x
Lorillard	31.2%	10.5x

(1) Run-rate, based on July -Dec. period in 2010

(2) Run-rate, based on June-Nov. 30 period

## Base Assumptions for the Going-in Return

A large part of the return outcome is based on the utilization of the company's cash flow. Lorillard currently maintains a \$1.125 quarterly dividend, which amounts to \$4.50 per annum. Based on the 2011 consensus earnings estimate of \$7.45 per share, the company is paying out 60.4% of its net earnings in dividends. Since net capital expenditures (CAPEX minus non-cash depreciation and amortization expense) are likely to be only \$5 million, or \$0.03 per share, Lorillard could raise its dividend considerably without exhausting its free cash flow. Alternatively, it could keep the dividend constant and raise the level of share

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repurchase activity over time. Shown in the table below is the effective economic yield of approximately 9.5%, resulting from dividends and potential share repurchases.

**Table 6: Lorillard Cash Flow-Based Economic Yield**

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2011 Consensus Earnings Estimate	\$7.45	
Shares Outstanding	<u>148.8</u>	
2011 Estimated Net Income	\$1,109	
Add: Depreciation & Amortization	<u>\$35</u>	
2011 Estimated Cash Earnings	\$1,144	
Less: Capital Expenditures	<u>\$40</u>	
Free Cash Flow	\$1,104	
		<b>Yield Equiv.</b>
Dividends	\$670	<b>5.8%</b>
Available for Share Repurchases	\$434	<b>3.7%</b>
	<b>Total</b>	<b>9.5%</b>

Many times, the free cash flow used to approximate a yield that is possible from share repurchases is only theoretical, in that a company may actually utilize its cash flow for other purposes. Lorillard, though, has been a persistent acquirer of its own shares. Since the 2<sup>nd</sup> quarter of 2008, the company has retired over 14% of its outstanding share base. Thus, in reality Lorillard has been acquiring its shares well over the 3.7% annual capacity suggested in the above table. Its repurchase activity is listed on the following page.

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**Table 7: Lorillard Share Repurchase History**

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<b>Period</b>	<b>Shares Out</b>	<b>% Change</b>
4Q 2010	148.8	-1.8%
3Q 2010	151.5	-0.5%
2Q 2010	152.2	-1.6%
1Q 2010	154.7	-2.6%
4Q 2009	158.9	-2.9%
3Q 2009	163.7	-2.4%
2Q 2009	167.8	-0.2%
1Q 2009	168.2	-0.1%
4Q 2008	168.3	-2.4%
3Q 2008	172.5	-0.8%
2Q 2008	173.9	
<i>Cumulative:</i>		<i>-14.4%</i>

With a going-in return of 9.5%, one has to account for the underlying earnings growth rate. It will be recalled that Lorillard has been expanding its cash flow at a rate of 4.6% per annum. To assume this as a constant future variable over a period of say, five years, is not wildly optimistic, as it merely represents two percentage points above normalized inflation.

Along these lines, one might make use of the following data provided by the CDC. In 1970, the average price for a pack of cigarettes in the U.S. was \$0.38. If adjusted for inflation, the price per pack was about \$2.08 in real terms. By 2009, the price had risen to \$5.33 per pack. Hence, the rate of price inflation over this 40 year period was about 2.4% annually. This annualized approach obviously serves to eliminate the volatility associated with sharp price movements in certain years, which have occurred during time. For instance, it does appear that price increases have become more rapid since 1995, which could justifiably create doubt in one's mind as to the sustainability of tobacco price inflation at an above-normal rate. In other words, at what point do cigarettes become unaffordable to the average tobacco consumer? If such a 5%-plus price increase program were maintained by Lorillard, demand is almost certain to decline as a result of this over the long term. Ergo, one could take a more cautious position, thereby assuming perhaps a more sustainable annual earnings (i.e. cash flow) growth rate in the range of 2%-3%.

At the more optimistic end, if even over a period of 3-5 years the more recent 4.6% free cash flow growth rate is repeatable, and not met with any valuation improvement, the return one could expect might be 14.1% per year (4.6% + 9.5%). As a frame of reference, the consensus 2012 earnings estimate of \$8.22 per share represents a 10.3% increase over

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the 2011 figure. Adding in the dividend yield would provide a consensus-based return of 16.1%.

Of course, subtracting two percentage points from the growth assumption to account for a multi-decade historical tobacco product inflation rate would lower the return expectation to 13.9%. Yet, many investors might gladly accept even this lower return compared to the historical 9%-10% return of large capitalization stocks over time.

Lastly, it will be recalled that there is also multiple expansion potential from the current 10.5x p/e, to perhaps 12.5x, such that one's profit could increase due to an additional 19% or so of valuation-related return, which should not be ignored in the final analysis.

## **Investment Summary**

Formerly known as Carolina Group under past ownership by Loews Corp., Lorillard is the third-largest tobacco manufacturer in the United States. Since its complete separation from Loews in 2008, the company has traveled down a path that is consistent with the corporate strategy of nearly every tobacco company in the world. That is to say, absent the need to reinvest the substantial cash flow generated by these businesses, shareholders can expect a considerable dividend payment every year alongside aggressive share repurchases. In the case of Lorillard, these policies create a going-in economic yield of 9.5%.

Lorillard, though, has a few deficiencies, one of which is the potential for increased regulation of its menthol cigarettes. Based on preliminary reports presented to the FDA, any future regulation that may be enacted appears to be far less severe than is widely anticipated, or at least that which is discounted in the current valuation. A mostly positive outcome, then, would not only potentially provide the investor with nearly 20% of appreciation due to multiple expansion, but a base annual return over a 3-5 year time horizon of perhaps 14% or more vis-à-vis the dividend yield, share repurchases, and the continuance of a modest historical cash flow growth rate. Such a return is not without its risks; however, much of this is reflected in the current 10.5x p/e ratio. Therefore, the shares are recommended for purchase.

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## LORILLARD, INC. AND SUBSIDIARIES

### CONSOLIDATED BALANCE SHEETS

December 31,  
2010      2009  
(In millions)

<b>ASSETS:</b>		
Cash and cash equivalents	\$ 2,063	\$ 1,384
Accounts receivable, less allowances of \$3 and \$3	9	9
Other receivables	68	41
Inventories	277	281
Deferred income taxes	503	466
Other current assets	15	—
Total current assets	<u>2,935</u>	<u>2,181</u>
Plant and equipment, net	243	237
Prepaid pension assets	66	60
Deferred income taxes	6	48
Other assets	46	49
Total assets	<u>\$ 3,296</u>	<u>\$ 2,575</u>

### LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT):

Accounts and drafts payable	\$ 27	\$ 23
Accrued liabilities	333	318
Settlement costs	1,060	982
Income taxes	6	14
Total current liabilities	<u>1,426</u>	<u>1,337</u>
Long-term debt	1,769	722
Postretirement pension, medical and life insurance benefits	284	300
Other liabilities	42	129
Total liabilities	<u>3,521</u>	<u>2,488</u>
Commitments and Contingent Liabilities		
Shareholders' Equity (Deficit):		
Preferred stock, \$0.01 par value, authorized 10 million shares	—	—
Common stock:		
Authorized — 600 million shares; par value — \$.01 per share		
Issued — 174 million and 174 million shares		
Outstanding — 147 million and 156 million shares	2	2
Additional paid-in capital	242	234
Retained earnings	1,666	1,282
Accumulated other comprehensive loss	(109)	(121)
Treasury stock at cost, 27 million and 18 million shares	<u>(2,026)</u>	<u>(1,310)</u>
Total shareholders' equity (deficit)	<u>(225)</u>	<u>87</u>
Total liabilities and shareholders' equity (deficit)	<u>\$ 3,296</u>	<u>\$ 2,575</u>

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## LORILLARD, INC. AND SUBSIDIARIES

### CONSOLIDATED STATEMENTS OF INCOME

	Year Ended December 31,		
	2010	2009	2008
	(In millions, except per share data)		
Net sales (including excise taxes of \$1,879, \$1,547 and \$712)	\$ 5,932	\$ 5,233	\$ 4,204
Cost of sales	3,809	3,327	2,434
Gross profit	2,123	1,906	1,770
Selling, general and administrative	398	365	355
Operating income	1,725	1,541	1,415
Investment income	4	5	20
Interest expense	(94)	(27)	(1)
Income before income taxes	1,635	1,519	1,434
Income taxes	606	571	547
Net income	<u>\$ 1,029</u>	<u>\$ 948</u>	<u>\$ 887</u>
Earnings per share:			
Basic	\$ 6.78	\$ 5.76	\$ 5.15
Diluted	\$ 6.78	\$ 5.76	\$ 5.15
Weighted average number of shares outstanding:			
Basic	151.59	164.48	172.09
Diluted	151.79	164.62	172.21