

10-Q 1pm-033117x10qxdoc.htm 10-Q

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q

(Mark One)

(X) QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2017

OR

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 001-33708

## Philip Morris International Inc.

(Exact name of registrant as specified in its charter)

Virginia

13-3435103

(State or other jurisdiction of  
incorporation or organization)(I.R.S. Employer  
Identification No.)120 Park Avenue  
New York, New York

10017

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code

(917) 663-2000

Former name, former address and former fiscal year, if changed since last report

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

 (Do not check if a smaller reporting company)

Smaller reporting company

Emerging growth company 

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

At April 24, 2017, there were 1,553,143,195 shares outstanding of the registrant's common stock, no par value per share.

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## PHILIP MORRIS INTERNATIONAL INC.

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In this report, "PMI," "we," "us" and "our" refer to Philip Morris International Inc. and its subsidiaries.

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## PART I-FINANCIAL INFORMATION

## Item 1. Financial Statements.

Philip Morris International Inc. and Subsidiaries  
Condensed Consolidated Balance Sheets  
(in millions of dollars)  
(Unaudited)

	March 31, 2017	December 31, 2016
<b>ASSETS</b>		
Cash and cash equivalents	\$ 5,076	\$ 4,239
Receivables (less allowances of \$42 in 2017 and \$42 in 2016)	3,090	3,499
Inventories:		
Leaf tobacco	2,683	2,498
Other raw materials	1,531	1,569
Finished product	3,793	4,950
	<u>8,007</u>	<u>9,017</u>
Other current assets	711	853
	<u>16,884</u>	<u>17,608</u>
Property, plant and equipment, at cost	12,862	12,360
Less: accumulated depreciation	6,598	6,296
	<u>6,264</u>	<u>6,064</u>
Goodwill (Note 4)	7,485	7,324
Other intangible assets, net (Note 4)	2,517	2,470
Investments in unconsolidated subsidiaries (Note 14)	1,079	1,011
Deferred income taxes	834	859
Other assets	1,564	1,515
<b>TOTAL ASSETS</b>	<u>\$ 36,627</u>	<u>\$ 36,851</u>

See notes to condensed consolidated financial statements.

Continued

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Philip Morris International Inc. and Subsidiaries  
Condensed Consolidated Balance Sheets (Continued)  
(in millions of dollars, except share data)  
(Unaudited)

	March 31, 2017	December 31, 2016
<b>LIABILITIES</b>		
Short-term borrowings (Note 10)	\$ 1,004	\$ 643
Current portion of long-term debt (Note 10)	1,754	2,573
Accounts payable	1,746	1,666
Accrued liabilities:		
Marketing and selling	576	575
Taxes, except income taxes	4,275	6,204
Employment costs	719	800
Dividends payable	1,622	1,621
Other	1,329	1,553
Income taxes	330	832
Total current liabilities	<u>13,355</u>	<u>16,467</u>
Long-term debt (Note 10)	28,588	25,851
Deferred income taxes	1,739	1,897
Employment costs	2,840	2,800
Other liabilities	662	736
Total liabilities	<u>47,184</u>	<u>47,751</u>
Contingencies (Note 8)		
<b>STOCKHOLDERS' (DEFICIT) EQUITY</b>		
Common stock, no par value (2,109,316,331 shares issued in 2017 and 2016)		
Additional paid-in capital	1,892	1,964
Earnings reinvested in the business	30,367	30,397
Accumulated other comprehensive losses	(9,265)	(9,559)
	<u>22,994</u>	<u>22,802</u>
Less: cost of repurchased stock (556,175,692 and 557,930,784 shares in 2017 and 2016, respectively)	35,386	35,490
Total PMI stockholders' deficit	<u>(12,392)</u>	<u>(12,688)</u>
Noncontrolling interests	1,835	1,788
Total stockholders' deficit	<u>(10,557)</u>	<u>(10,900)</u>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' (DEFICIT) EQUITY</b>	<u>\$ 36,627</u>	<u>\$ 36,851</u>

See notes to condensed consolidated financial statements.



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Philip Morris International Inc. and Subsidiaries  
Condensed Consolidated Statements of Earnings  
(in millions of dollars, except per share data)  
(Unaudited)

	For the Three Months Ended March 31,	
	2017	2016
Net revenues	\$ 16,556	\$ 16,788
Cost of sales	2,177	2,096
Excise truces on products	10,492	10,705
Gross profit	3,887	3,987
Marketing, administration and research costs	1,469	1,496
Amortization of intangibles	22	18
Operating income	2,396	2,473
Interest expense, net	219	247
Earnings before income taxes	2,177	2,226
Provision for income taxes	541	630
Equity (income) loss in unconsolidated subsidiaries, net	(22)	(9)
Net earnings	1,658	1,605
Net earnings attributable to noncontrolling interests	68	75
Net earnings attributable to PMI	\$ 1,590	\$ 1,530
Per share data (Note 6):		
Basic earnings per share	\$ 1.02	\$ 0.98
Diluted earnings per share	\$ 1.02	\$ 0.98
Dividends declared	\$ 1.04	\$ 1.02

See notes to condensed consolidated financial statements.



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Philip Morris International Inc. and Subsidiaries  
 Condensed Consolidated Statements of Comprehensive Earnings  
 (in millions of dollars)  
 (Unaudited)

	For the Three Months Ended Month 31,	
	2017	2016
Net earnings	\$ 1,658	\$ 1,605
Other comprehensive earnings (losses), net of income taxes:		
Change in currency translation adjustments:		
Unrealized gains (losses), net of income taxes of \$156 in 2017 and \$162 in 2016	303	538
Change in net loss and prior service cost:		
Net losses and prior service costs, net of income taxes of \$-in 2017 and \$3 in 2016		(10)
Amortization of net losses, prior service costs and net transition costs, net of income taxes of (\$9) in 2017 and (\$8) in 2016	56	55
Change in fair value of derivatives accounted for as hedges:		
Gains (losses) recognized, net of income taxes of \$11 in 2017 and \$17 in 2016	(75)	(62)
(Gains) losses transferred to earnings, net of income taxes of \$2 in 2017 and (\$1) in 2016	5	(7)
Total other comprehensive earnings	289	514
Total comprehensive earnings	1,947	2,119
Less comprehensive earnings attributable to:		
Noncontrolling interests	63	101
Comprehensive earnings attributable to PMI	\$ 1,884	\$ 2,018

See notes to condensed consolidated financial statements

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Philip Morris International Inc. and Subsidiaries  
Condensed Consolidated Statements of Stockholders' (Deficit) Equity  
For the Three Months Ended March 31, 2017 and 2016  
(in millions of dollars, except per share amounts)  
(Unaudited)

PMI Stockholders' (Deficit) Equity							
	Common Stock	Additional Paid-in Capital	Earnings Reinvested in the Business	Accumulated Other Comprehensive Losses	Cost of Repurchased Stock	Noncontrolling Interests	Total
Balances, January 1, 2016	\$	\$ 1,929	\$ 29,842	\$ (9,402)	\$ (35,613)	\$ 1,768	\$(11,476)
Net earnings			1,530			75	1,605
Other comprehensive earnings (losses), net of income taxes				488		26	514
Issuance of stock awards		(56)			115		59
Dividends declared (\$1.02 per share)			(1,587)				(1,587)
Payments to noncontrolling interests						(12)	(12)
Other						2	3
Balances, March 31, 2016	\$	\$ 1,874	\$ 29,785	\$ (8,914)	\$ (35,498)	\$ 1,859	\$(10,894)
Balances, January 1, 2017	\$	\$ 1,964	\$ 30,397	\$ (9,559)	\$ (35,490)	\$ 1,788	\$(10,900)
Net earnings			1,590			68	1,658
Other comprehensive earnings (losses), net of income taxes				294		(5)	289
Issuance of stock awards		(71)			104		33
Dividends declared (\$1.04 per share)			(1,620)				(1,620)
Payments to noncontrolling interests						(17)	(17)
Other		(1)				1	
Balances, March 31, 2017	\$	\$ 1,892	\$ 30,367	\$ (9,265)	\$ (35,386)	\$ 1,835	\$(10,557)

See notes to condensed consolidated financial statements.



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Philip Morris International Inc. and Subsidiaries  
Condensed Consolidated Statements of Cash Flows  
(in millions of dollars)  
(Unaudited)

	For the Three Months Ended March 31,	
	2017	2016
<b>CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES</b>		
Net earnings	\$ 1,658	\$ 1,605
Adjustments to reconcile net earnings to operating cash flows:		
Depreciation and amortization	197	175
Deferred income tax provision	27	10
Asset impairment and exit costs, net of cash paid	(2)	(14)
Cash effects of changes:		
Receivables, net	504	(175)
Inventories	1,243	49
Accounts payable	84	223
Income taxes	(510)	(485)
Accrued liabilities and other current assets	(2,207)	(922)
Pension plan contributions	(18)	(52)
Other	(133)	48
Net cash provided by operating activities	<u>843</u>	<u>462</u>
<b>CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES</b>		
Capital expenditures	(292)	(226)
Investments in unconsolidated subsidiaries	(5)	(7)
Other	(282)	(186)
Net cash used in investing activities	<u>(579)</u>	<u>(419)</u>

See notes to condensed consolidated financial statements.

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Philip Morris International Inc. and Subsidiaries  
Condensed Consolidated Statements of Cash Flows (Continued)  
(in millions of dollars)  
(Unaudited)

	For the Three Months Ended March 31,	
	2017	2016
<b>CASH PROVIDED BY (USED IN) FINANCING ACTIVITIES</b>		
Short-term borrowing activity by original maturity:		
Net issuances (repayments) -maturities of 90 days or less	\$ 374	\$ (136)
Long-term debt proceeds	2,482	1,978
Long-term debt repaid	(814)	(827)
Dividends paid	(1,618)	(1,585)
Sale (purchase) of subsidiary shares to/(from) noncontrolling interests		6
Other	(83)	(29)
Net cash provided by (used in) financing activities	341	(593)
Effect of exchange rate changes on cash and cash equivalents	232	77
Cash and cash equivalents:		
Increase (Decrease)	837	(473)
Balance at beginning of period	4,239	3,417
Balance at end of period	\$ 5,076	\$ 2,944

See notes to condensed consolidated financial statements.



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Philip Morris International Inc. and Subsidiaries  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)

**Note 1. Background and Basis of Presentation:***Background*

Philip Morris International Inc. is a holding company incorporated in Virginia, U.S.A., whose subsidiaries and affiliates, and their licensees, are engaged in the manufacture and sale of cigarettes, other tobacco products and other nicotine-containing products in markets outside of the United States of America. Throughout these financial statements, the term "PMI" refers to Philip Morris International Inc. and its subsidiaries.

*Basis of Presentation*

The interim condensed consolidated financial statements of PMI are unaudited. These interim condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and such principles are applied on a consistent basis. It is the opinion of PMI's management that all adjustments necessary for a fair statement of the interim results presented have been reflected therein. All such adjustments were of a normal recurring nature. Net revenues and net earnings attributable to PMI for any interim period are not necessarily indicative of results that may be expected for the entire year.

These statements should be read in conjunction with the audited consolidated financial statements and related notes, which appear in PMI's Annual Report on Form 10-K for the year ended December 31, 2016.

**Note 2. Stock Plans:**

In May 2012, PMI's shareholders approved the Philip Morris International Inc. 2012 Performance Incentive Plan (the "2012 Plan"). Under the 2012 Plan, PMI may grant to eligible employees restricted stock, restricted stock units and deferred stock units (collectively referred to as restricted share units), performance-based cash incentive awards and performance-based equity awards. Up to 30 million shares of PMI's common stock may be issued under the 2012 Plan. At March 31, 2017, shares available for grant under the 2012 Plan were 19,191,050.

In 2008, PMI adopted the Philip Morris International Inc. 2008 Stock Compensation Plan for Non-Employee Directors (the "Non-Employee Directors Plan"). A non-employee director is defined as a member of the PMI Board of Directors who is not a full-time employee of PMI or of any corporation in which PMI owns, directly or indirectly, stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote in the election of directors in such corporation. Up to 1 million shares of PMI common stock may be awarded under the Non-Employee Directors Plan. At March 31, 2017, shares available for grant under the plan were 677,539.

PMI's accounting policy is to estimate the number of awards expected to be forfeited and adjust the expense when it is no longer probable that the employee will fulfill the service condition.

*Restricted share unit (RSU) awards*

During the three months ended March 31, 2017 and 2016, shares granted to eligible employees, the weighted-average grant date fair value per share and the recorded compensation expense related to RSU awards were as follows:

	Number of Shares Granted	Weighted-Average Grant Date Fair Value Per RSU Award Granted	Compensation Expense Related to RSU Awards (in millions)
2017	1,202,060	\$ 98.47	\$ 35
2016	1,212,050	\$ 89.02	\$ 41



As of March 31, 2017, PMI had \$186 million of total unrecognized compensation cost related to non-vested RSU awards. The cost is recognized over the original restriction period of the awards, which is typically three years after the date of the award, or upon death, disability or reaching the age of 58.

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Philip Morris International Inc. and Subsidiaries  
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During the three months ended March 31, 2017, 1,938,610 shares of PMI RSU awards vested. The grant date fair value of all the vested shares was approximately \$151 million. The total fair value of RSU awards that vested during the three months ended March 31, 2017 was approximately \$198 million.

*Performance share unit (PSU) awards*

During the three months ended March 31, 2017 and 2016, PMI granted PSU awards to certain executives. The PSU awards require the achievement of certain performance factors, which are predetermined at the time of grant, over a three-year performance cycle. PMI's performance metrics consist of PMI's Total Shareholder Return (TSR) relative to a predetermined peer group, PMI's currency-neutral compound annual adjusted operating companies income growth rate, excluding acquisitions, and PMI's performance against specific measures of PMI's innovation and transformation. The aggregate of the weighted performance factors for the three metrics determines the percentage of PSUs that will vest at the end of the three-year performance cycle. Each vested PSU entitles the participant to one share of common stock. An aggregate weighted PSU performance factor of 100 will result in the targeted number of PSUs being vested. The minimum percentage of PSUs that can vest is zero, with a maximum percentage of 200. At the end of the performance cycle, participants are entitled to an amount equivalent to the accumulated dividends paid on common stock during the performance cycle for the number of shares earned.

During the three months ended March 31, 2017 and 2016, shares granted to eligible employees, the grant date fair value per share and the recorded compensation expense related to PSU awards were as follows:

	Number of Shares Granted	Grant Date Fair Value Subject to TSR Performance Factor Per Share <sup>(a)</sup>	Grant Date Fair Value Subject to Other Performance Factors Per Share <sup>(b)</sup>	Compensation Expense Related to PSU Awards (in millions)
2017	393,460	\$ 128.72	\$ 98.29	\$ 17
2016	428,400	\$ 104.60	\$ 89.02	\$ 12

<sup>(a)</sup> The grant date fair value of the PSU awards subject to the TSR performance factor was determined by using the Monte Carlo simulation model.

<sup>(b)</sup> The grant date fair value of the PSU awards subject to the other performance factors was determined by using the average of the high and low market price of PMI's stock at the date of grant.

As of March 31, 2017, PMI had \$52 million of total unrecognized compensation cost related to non-vested PSU awards. The cost is recognized over the performance cycle of the awards, or upon death, disability or reaching the age of 58.

During the three months ended March 31, 2017, there were no PSU awards that vested.

**Note 3. Benefit Plans:**

Pension coverage for employees of PMI's subsidiaries is provided, to the extent deemed appropriate, through separate plans, many of which are governed by local statutory requirements. In addition, PMI provides health care and other benefits to substantially all U.S. retired employees and certain non-U.S. retired employees. In general, health care benefits for non-U.S. retired employees are covered through local government plans.

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Philip Morris International Inc. and Subsidiaries  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)

*Pension Plans*

## Components of Net Periodic Benefit Cost

Net periodic pension cost consisted of the following:

(in millions)	U.S. Plans		Non-U.S. Plans	
	For the Three Months Ended March 31,		For the Three Months Ended March 31,	
	2017	2016	2017	2016
Service cost	\$ 1	\$ 1	\$ 50	\$ 50
Interest cost	3	4	23	31
Expected return on plan assets	(3)	(3)	(76)	(81)
Amortization:				
Net loss		1	44	44
Prior service cost	2	1	1	1
Net periodic pension cost	\$ 3	\$ 4	\$ 42	\$ 45

## Employer Contributions

PMI makes, and plans to make, contributions, to the extent that they are tax deductible and to meet specific funding requirements of its funded U.S. and non-U.S. plans. Employer contributions of \$18 million were made to the pension plans during the three months ended March 31, 2017. Currently, PMI anticipates making additional contributions during the remainder of 2017 of approximately \$50 million to its pension plans, based on current tax and benefit laws. However, this estimate is subject to change as a result of changes in tax and other benefit laws, as well as asset performance significantly above or below the assumed long-term rate of return on pension assets, or changes in interest and currency rates.

Note 4. Goodwill and Other Intangible Assets, net:

Goodwill and other intangible assets, net, by segment were as follows:

(in millions)	Goodwill		Other Intangible Assets, net	
	March 31, 2017	December 31, 2016	March 31, 2017	December 31, 2016
	European Union	\$ 1,278	\$ 1,238	\$ 473
Eastern Europe, Middle East & Africa	388	372	199	200
Asia	3,626	3,596	1,079	1,074
Latin America & Canada	2,193	2,118	766	717
Total	\$ 7,485	\$ 7,324	\$ 2,517	\$ 2,470

Goodwill primarily reflects PMI's acquisitions in Canada, Colombia, Greece, Indonesia, Mexico, Pakistan and Serbia, as well as the business combination in the Philippines. The movements in goodwill from December 31, 2016, were as follows:

(in millions)	European Union	Eastern Europe, Middle East & Africa	Asia	Latin America & Canada	Total
	Balances, December 31, 2016	\$ 1,238	\$ 372	\$ 3,596	\$ 2,118

Changes due to:

Currency		40		16		30		75		161
Balances, March 31,2017	\$	1,278	\$	388	\$	3,626	\$	2,193	\$	7,485

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Philip Morris International Inc. and Subsidiaries  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)

Additional details of other intangible assets were as follows:

(in millions)	March 31, 2017		December 31, 2016	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Non-amortizable intangible assets	\$ 1,356		\$ 1,455	
Amortizable intangible assets	1,773	\$ 612	1,598	\$ 583
<b>Total other intangible assets</b>	<b>\$ 3,129</b>	<b>\$ 612</b>	<b>\$ 3,053</b>	<b>\$ 583</b>

Non-amortizable intangible assets substantially consist of trademarks from PMI's acquisitions in Indonesia in 2005 and Mexico in 2007. Amortizable intangible assets primarily consist of certain trademarks and distribution networks associated with business combinations. During the first quarter of 2017, PMI reclassified three trademarks with a gross carrying amount of \$153 million from non-amortizable intangible assets to amortizable intangible assets. The gross carrying amount, the range of useful lives as well as the weighted-average remaining useful life of amortizable intangible assets at March 31, 2017, were as follows:

(dollars in millions)	Gross Carrying Amount	Initial Estimated Useful Lives	Weighted-Average Remaining Useful Life
Trademarks	\$ 1,535	2 -40 years	19 years
Distribution networks	150	5 -30 years	10 years
Other (including farmer contracts and intellectual property rights)	88	4 - 17 years	9 years
	<u>\$ 1,773</u>		

Pre-tax amortization expense for intangible assets during the three months ended March 31, 2017 and 2016 was \$22 million and \$18 million, respectively. Amortization expense for each of the next five years is estimated to be \$86 million or less, assuming no additional transactions occur that require the amortization of intangible assets.

The increase in the gross carrying amount of other intangible assets from December 31, 2016, was due to currency movements.

#### Note 5. Financial Instruments:

##### *Overview*

PMI operates in markets outside of the United States of America, with manufacturing and sales facilities in various locations around the world. PMI utilizes certain financial instruments to manage foreign currency and interest rate exposure. Derivative financial instruments are used by PMI principally to reduce exposures to market risks resulting from fluctuations in foreign currency exchange and interest rates by creating offsetting exposures. PMI is not a party to leveraged derivatives and, by policy, does not use derivative financial instruments for speculative purposes. Financial instruments qualifying for hedge accounting must maintain a specified level of effectiveness between the hedging instrument and the item being hedged, both at inception and throughout the hedged period. PMI formally documents the nature and relationships between the hedging instruments and hedged items, as well as its risk-management objectives, strategies for undertaking the various hedge transactions and method of assessing hedge effectiveness. Additionally, for hedges of forecasted transactions, the significant characteristics and expected terms of the forecasted transaction must be specifically identified, and it must be probable that each forecasted transaction will occur. If it were deemed probable that the forecasted transaction would not occur, the gain or loss would be recognized in earnings. PMI reports its net transaction gains or losses in marketing, administration and research costs on the condensed consolidated statements of earnings.

PMI uses deliverable and non-deliverable forward foreign exchange contracts, foreign currency swaps and foreign currency options, collectively referred to as foreign exchange contracts ("foreign exchange contracts"), and interest rate contracts to mitigate its exposure to changes in exchange and interest rates from third-party and intercompany actual and forecasted transactions. The primary currencies to which PMI is exposed include the Australian dollar, Euro, Indonesian rupiah, Japanese yen, Mexican peso, Russian ruble, Swiss franc and Turkish lira. At March 31, 2017, PMI had contracts with aggregate notional amounts of \$31.0 billion of which

\$4.6 billion related to cash flow hedges, \$11.1 billion related to hedges of net investments in foreign operations and \$15.3 billion related to other derivatives that primarily offset currency exposures on intercompany financing.

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Philip Morris International Inc. and Subsidiaries  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)

The fair value of PMI's foreign exchange contracts included in the condensed consolidated balance sheets as of March 31, 2017 and December 31, 2016, were as follows:

(in millions)	Balance Sheet Classification	Asset Derivatives		Liability Derivatives		
		Fair Value		Balance Sheet Classification	Fair Value	
		At March 31, 2017	At December 31, 2016		At March 31, 2017	At December 31, 2016
Foreign exchange contracts designated as hedging instruments	Other current assets	\$ 82	\$ 207	Other accrued liabilities	\$ 10	\$ 66
	Other assets	291	436	Other liabilities	101	36
Foreign exchange contracts not designated as hedging instruments	Other current assets	106	161	Other accrued liabilities	96	61
	Other assets	1	9	Other liabilities		
<b>Total derivatives</b>		<b>\$ 480</b>	<b>\$ 813</b>		<b>\$ 207</b>	<b>\$ 163</b>

For the three months ended March 31, 2017 and 2016, PMrs cash flow and net investment hedging instruments impacted the condensed consolidated statements of earnings and comprehensive earnings as follows:

(pre-tax, millions)	For the Three Months Ended March 31,				
	Amount of Gain/(Loss) Recognized in Other Comprehensive Earnings/(Losses) on Derivatives		Statement of Earnings Classification of Gain/(Loss) Reclassified from Other Comprehensive Earnings/(Losses) into Earnings	Amount of Gain/(Loss) Reclassified from Other Comprehensive Earnings/(Losses) into Earnings	
	2017	2016		2017	2016
Derivatives in Cash Flow Hedging Relationship					
Foreign exchange contracts	\$ (86)	\$ (79)			
			Net revenues	\$ 9	\$ 5
			Cost of sales		14
			Marketing, administration and research costs	(9)	4
			Interest expense, net	(3)	(17)
Derivatives in Net Investment Hedging Relationship					
Foreign exchange contracts	(249)	(197)			
<b>Total</b>	<b>\$ (335)</b>	<b>\$ (276)</b>		<b>\$ (3)</b>	<b>\$ 6</b>

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*Cash Flow Hedges*

PMI has entered into foreign exchange contracts to hedge the foreign currency exchange and interest rate risks related to certain forecasted transactions. The effective portion of gains and losses associated with qualifying cash flow hedge contracts is deferred as a component of accumulated other comprehensive losses until the underlying hedged transactions are reported in PMI's condensed consolidated statements of earnings. During the three months ended March 31, 2017 and 2016, ineffectiveness related to cash flow hedges was not material. As of March 31, 2017, PMI has hedged forecasted transactions for periods not exceeding the next twenty-one months with the exception of one foreign exchange contract that expires in May 2024. The impact of these hedges is primarily included in operating cash flows on PMI's condensed consolidated statements of cash flows.

*Hedges of Net Investments in Foreign Operations*

PMI designates certain foreign currency denominated debt and foreign exchange contracts as net investment hedges of its foreign operations. For the three months ended March 31, 2017 and 2016, these hedges of net investments resulted in losses, net of income taxes, of \$294 million and \$267 million, respectively. These losses were reported as a component of accumulated other comprehensive losses within currency translation adjustments. For the three months ended March 31, 2017 and 2016, ineffectiveness related to net investment hedges was not material. Other investing cash flows on PMI's condensed consolidated statements of cash flows include the premiums paid for, and settlements of; net investment hedges.

*Other Derivatives*

PMI has entered into foreign exchange contracts to hedge the foreign currency exchange and interest rate risks related to intercompany loans between certain subsidiaries, and third-party loans. While effective as economic hedges, no hedge accounting is applied for these contracts; therefore, the unrealized gains (losses) relating to these contracts are reported in PMI's condensed consolidated statements of earnings. For the three months ended March 31, 2017 and 2016, the gains (losses) from contracts for which PMI did not apply hedge accounting were \$(39) million and \$91 million, respectively. The gains (losses) from these contracts substantially offset the losses and gains generated by the underlying intercompany and third-party loans being hedged.

For the three months ended March 31, 2017 and 2016, the net impact of these contracts on the condensed consolidated statements of earnings was not material.

*Qualifying Hedging Activities Reported in Accumulated Other Comprehensive Losses*

Derivative gains or losses reported in accumulated other comprehensive losses are a result of qualifying hedging activity. Transfers of these gains or losses to earnings are offset by the corresponding gains or losses on the underlying hedged item. Hedging activity affected accumulated other comprehensive losses, net of income taxes, as follows:

(in millions)	For the Three Months Ended March 31,	
	2017	2016
Gain as of January 1,	\$ 97	\$ 59
Derivative (gains) losses transferred to earnings	5	(7)
Change in fair value	(75)	(62)
<b>Gain/(loss) as of March 31,</b>	<b>\$ 27</b>	<b>\$ (10)</b>

At March 31, 2017, PMI expects \$9 million of derivative gains that are included in accumulated other comprehensive losses to be reclassified to the condensed consolidated statement of earnings within the next 12 months. These gains are expected to be substantially offset by the statement of earnings impact of the respective hedged transactions.

*Contingent Features*

PMI's derivative instruments do not contain contingent features.

*Credit Exposure and Credit Risk*



PMI is exposed to credit loss in the event of non-performance by counterparties. While PMI does not anticipate non-performance, its risk is limited to the fair value of the financial instruments less any cash collateral received or pledged. PMI actively monitors

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its exposure to credit risk through the use of credit approvals and credit limits, and by selecting and continuously monitoring a diverse group of major international banks and financial institutions as counterparties.

*Fair Value*

See Note 11. *Fair Value Measurements* and Note 13. *Balance Sheet Offsetting* for additional discussion of derivative financial instruments.

## Note 6. Earnings Per Share;

Basic and diluted earnings per share ("EPS") were calculated using the following:

(in millions)	For the Three Months Ended March 31,	
	2017	2016
Net earnings attributable to PMI	\$ 1,590	\$ 1,530
Less distributed and undistributed earnings attributable to share-based payment awards	3	5
Net earnings for basic and diluted EPS	\$ 1,587	\$ 1,525
Weighted-average shares for basic EPS	1,552	1,550
Plus contingently issuable performance stock units (PSUs)	1	
Weighted-average shares for diluted EPS	1,553	1,550

Unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents are participating securities and therefore are included in PMI's earnings per share calculation pursuant to the two-class method.

For the 2017 and 2016 computations, there were no antidilutive stock awards.

Note 7. Segment Reporting:

PMI's subsidiaries and affiliates are engaged in the manufacture and sale of cigarettes, other tobacco products and other nicotine-containing products in markets outside of the United States of America. Reportable segments for PMI are organized and managed by geographic region. PMI's reportable segments are the European Union; Eastern Europe, Middle East & Africa; Asia; and Latin America & Canada. PMI reconciles net revenues and operating companies income to its segments based upon the geographic area in which the customer resides.

PMI's management evaluates segment performance and allocates resources based on operating companies income, which PMI defines as operating income, excluding general corporate expenses and amortization of intangibles, plus equity (income) loss in unconsolidated subsidiaries, net. Interest expense, net, and provision for income taxes are centrally managed and, accordingly, such items are not presented by segment since they are excluded from the measure of segment profitability reviewed by management.

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Segment data were as follows:

(in millions)	For the Three Months Ended March 31,	
	2017	2016
Net revenues:		
European Union	\$ 5,889	\$ 6,143
Eastern Europe, Middle East & Africa	3,695	3,997
Asia	4,838	4,689
Latin America & Canada	2,134	1,959
Net revenues	\$ 16,556	\$ 16,788
Earnings before income taxes:		
Operating companies income:		
European Union	\$ 772	\$ 906
Eastern Europe, Middle East & Africa	690	633
Asia	852	778
Latin America & Canada	177	229
Amortization of intangibles	(22)	(18)
General corporate expenses	(51)	(46)
Less:		
Equity (income)/loss in unconsolidated subsidiaries, net	(22)	(9)
Operating income	2,396	2,473
Interest expense, net	(219)	(247)
Earnings before income taxes	\$ 2,177	\$ 2,226

Note 8. Contingencies:

*Tobacco-Related Litigation*

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. Our indemnitees include distributors, licensees, and others that have been named as parties in certain cases and that we have agreed to defend, as well as to pay costs and some or all of judgments, if any, that may be entered against them. Pursuant to the terms of the Distribution Agreement between Altria Group, Inc. ("Altria") and PMI, PMI will indemnify Altria and Philip Morris USA Inc. ("PM USA"), a U.S. tobacco subsidiary of Altria, for tobacco product claims based in substantial part on products manufactured by PMI or contract manufactured for PMI by PM USA, and PM USA will indemnify PMI for tobacco product claims based in substantial part on products manufactured by PM USA, excluding tobacco products contract manufactured for PMI.

It is possible that there could be adverse developments in pending cases against us and our subsidiaries. An unfavorable outcome or settlement of pending tobacco-related litigation could encourage the commencement of additional litigation.

Damages claimed in some of the tobacco-related litigation are significant and, in certain cases in Brazil, Canada and Nigeria, range into the billions of U.S. dollars. 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. However, as discussed below, we have to date been largely successful in defending tobacco-related litigation.

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. 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

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loss has been accrued in the consolidated financial statements for unfavorable outcomes in these cases, if any. Legal defense costs are expensed as incurred.

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. Nevertheless, although litigation is subject to uncertainty, we and each of our subsidiaries named as a defendant believe, and each has been so advised by counsel handling the respective cases, that we have valid defenses to the litigation pending against us, as well as valid bases for appeal of adverse verdicts. All such cases are, and will continue to be, vigorously defended. However, we and our subsidiaries may enter into settlement discussions in particular cases if we believe it is in our best interests to do so.

To date, no tobacco-related case has been finally resolved in favor of a plaintiff against us, our subsidiaries or indemnitees.

The table below lists the number of tobacco-related cases pending against us and/or our subsidiaries or indemnitees as of April 25, 2017, April 22, 2016 and April 30, 2015:

Type of Case	Number of Cases Pending as of April 25, 2017	Number of Cases Pending as of April 22, 2016	Number of Cases Pending as of April 30, 2015
Individual Smoking and Health Cases	63	66	61
Smoking and Health Class Actions	11	11	11
Health Care Cost Recovery Actions	16	16	16
Lights Class Actions			
Individual Lights Cases	1	3	2
Public Civil Actions	2	3	2

Since 1995, when the first tobacco-related litigation was filed against a PMI entity, 459 Smoking and Health, Lights, Health Care Cost Recovery, and Public Civil Actions in which we and/or one of our subsidiaries and/or indemnitees were a defendant have been terminated in our favor. Thirteen cases have had decisions in favor of plaintiffs. Nine of these cases have subsequently reached final resolution in our favor and four remain on appeal.

The table below lists the verdict and significant post-trial developments in the four pending cases where a verdict was returned in favor of the plaintiff:

Date	Location of Court/Name of Plaintiff	Type of Case	Verdict	Post-Trial Developments
February 2004	Brazil/The Smoker Health Defense Association	Class Action	The Civil Court of São Paulo found defendants liable without hearing evidence. In April 2004, the court awarded "moral damages" of R\$1,000 (approximately \$318) per smoker per full year of smoking plus interest at the rate of 1% per month, as of the date of the ruling. The court did not assess actual damages, which were to be assessed in a second phase of the case. The size of the	Defendants appealed to the São Paulo Court of Appeals, which annulled the ruling in November 2008, finding that the trial court had inappropriately ruled without hearing evidence and returned the case to the trial court for further proceedings. In May 2011, the trial court dismissed the claim. Plaintiff appealed the decision. In February 2015, the appellate court unanimously dismissed plaintiffs appeal. In September 2015, plaintiff appealed to the Superior Court of Justice. In addition, the defendants filed a constitutional appeal to the

class was not defined in the ruling.

Federal Supreme Tribunal on the basis that plaintiff did not have standing to bring the lawsuit. This appeal is still pending.

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Date	Location of Court/Name of Plaintiff	Type of Case	Verdict	Post-Trial Developments
May 27, 2015	Canada/Cecilia Letourneau	Class Action	<p>On May 27, 2015, the Superior Court of the District of Montreal, Province of Quebec ruled in favor of the <i>Letourneau</i> class on liability and awarded a total of CAD 131 million (approximately \$97 million) in punitive damages, allocating CAD 46 million (approximately \$34 million) to our subsidiary. The trial court ordered defendants to pay the full punitive damage award into a trust within 60 days. The court did not order the payment of compensatory damages.</p>	<p>In June 2015, our subsidiary commenced the appellate process with the Court of Appeal of Quebec. Our subsidiary also filed a motion to cancel the trial court's order for payment into a trust notwithstanding appeal. In July 2015, the Court of Appeal granted the motion to cancel and overturned the trial court's ruling that our subsidiary make the payment into a trust. In August 2015, plaintiffs filed a motion for security with the Court of Appeal covering both the <i>Letourneau</i> case and the <i>Blais</i> case described below. In October 2015, the Court of Appeal granted the motion and ordered our subsidiary to furnish security totaling CAD 226 million (approximately \$167 million) to cover both the <i>Letourneau</i> and <i>Blais</i> cases. The hearing for the merits appeal took place in November 2016. (See below for further detail.)</p>

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Date	Location of Court/Name of Plaintiff	Type of Case	Verdict	Post-Trial Developments
May 27, 2015	Canada/Conseil Quebecois Sur Le Tabac Et La Sante and Jean-Yves Blais	Class Action	<p>On May 27, 2015, the Superior Court of the District of Montreal, Province of Quebec ruled in favor of the <i>Blais</i> class on liability and found the class members' compensatory damages totaled approximately CAD 15.5 billion (approximately \$11.4 billion), including pre-judgment interest. The trial court awarded compensatory damages on a joint and several liability basis, allocating 20% to our subsidiary (approximately CAD 3.1 billion including pre-judgment interest (approximately \$2.3 billion)). The trial court awarded CAD 90,000 (approximately \$66,300) in punitive damages, allocating CAD 30,000 (approximately \$22,100) to our subsidiary. The trial court ordered defendants to pay CAD 1 billion (approximately \$737 million) of the compensatory damage award, CAD 200 million (approximately \$147 million) of which is our subsidiary's portion, into a trust within 60 days.</p>	<p>In June 2015, our subsidiary commenced the appellate process with the Court of Appeal of Quebec. Our subsidiary also filed a motion to cancel the trial court's order for payment into a trust notwithstanding appeal. In July 2015, the Court of Appeal granted the motion to cancel and overturned the trial court's ruling that our subsidiary make the payment into a trust. In August 2015, plaintiffs filed a motion for security with the Court of Appeal. In October 2015, the Court of Appeal granted the motion and ordered our subsidiary to furnish security totaling, together with the <i>Letourneau</i> case, CAD 226 million (approximately \$167 million). The hearing for the merits appeal took place in November 2016. (See below for further detail.)</p>



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Date	Location of Court/Name of Plaintiff	Type of Case	Verdict	Post-Trial Developments
August 5, 2016	Argentina/Hugo Lespada	Individual Action	On August 5, 2016, the Civil Court No.14 - Mar del Plata, issued a verdict in favor of plaintiff: an individual smoker, and awarded him ARS 110,000 (approximately \$7,100), plus interest, in compensatory and moral damages. The Court found that our subsidiary failed to warn plaintiff of the risk of becoming addicted to cigarettes.	On August 23, 2016, our subsidiary filed its notice of appeal.

Pending claims related to tobacco products generally fall within the following categories:

*Smoking and Health Litigation:* These cases primarily allege personal injury and are brought by individual plaintiffs or on behalf of a class or purported class of individual plaintiffs. Plaintiffs' allegations of liability in these cases are based on various theories of recovery, including negligence, gross negligence, strict liability, fraud, misrepresentation, design defect, failure to warn, breach of express and implied warranties, violations of deceptive trade practice laws and consumer protection statutes. Plaintiffs in these cases seek various forms of relief: including compensatory and other damages, and injunctive and equitable relief. Defenses raised in these cases include licit activity, failure to state a claim, lack of defect, lack of proximate cause, assumption of the risk, contributory negligence, and statute of limitations.

As of April 25, 2017, there were a number of smoking and health cases pending against us, our subsidiaries or indemnitees, as follows:

- 63 cases brought by individual plaintiffs in Argentina (35), Brazil (14), Canada (2), Chile (5), Costa Rica (2), Italy (2), the Philippines (1), Russia (1) and Scotland (1), compared with 66 such cases on April 22, 2016, and 61 cases on April 30, 2015; and
- 11 cases brought on behalf of classes of individual plaintiffs in Brazil (2) and Canada (9), compared with 11 such cases on April 22, 2016 and 11 such cases on April 30, 2015.

In the first class action pending in Brazil, *The Smoker Health Defense Association (ADESF) v. Souza Cruz, S.A. and Philip Morris Marketing, S.A., Nineteenth Lower Civil Court of the Central Courts of the Judiciary District of São Paulo, Brazil*, filed July 25, 1995, our subsidiary and another member of the industry are defendants. The plaintiff: a consumer organization, is seeking damages for all addicted smokers and former smokers, and injunctive relief. In 2004, the trial court found defendants liable without hearing evidence and awarded "moral damages" of R\$1,000 (approximately \$318) per smoker per full year of smoking plus interest at the rate of 1% per month, as of the date of the ruling. The court did not award actual damages, which were to be assessed in the second phase of the case. The size of the class was not estimated. Defendants appealed to the São Paulo Court of Appeals, which annulled the ruling in November 2008, finding that the trial court had inappropriately ruled without hearing evidence and returned the case to the trial court for further proceedings. In May 2011, the trial court dismissed the claim. In February 2015, the appellate court unanimously dismissed plaintiff's appeal. In September 2015, plaintiff appealed to the Superior Court of Justice. In February 2017, the Chief Justice of the Supreme Court of Justice denied plaintiff's appeal. In March 2017, plaintiff filed an *en banc* appeal to the Supreme Court of Justice. In addition, the defendants previously filed a constitutional appeal to the Federal Supreme Tribunal on the basis that plaintiff did not have standing to bring the lawsuit. Both appeals are still pending.

In the second class action pending in Brazil, *Public Prosecutor of São Paulo v. Philip Morris Brasil Industria e Comercio Ltda., Civil Court of the City of São Paulo, Brazil*, filed August 6, 2007, our subsidiary is a defendant. The plaintiff the Public Prosecutor of the

State of SãO Paulo, is seeking (i) damages on behalf of all smokers nationwide, former smokers, and their relatives; (ii) damages on behalf of people exposed to environmental tobacco smoke nationwide, and their relatives; and (iii) reimbursement of the health care costs allegedly incurred for the treatment of tobacco-related diseases by all Brazilian States and Municipalities,

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and the Federal District. In an interim ruling issued in December 2007, the trial court limited the scope of this claim to the State of Sao Paulo only. In December 2008, the Seventh Civil Court of Sao Paulo issued a decision declaring that it lacked jurisdiction because the case involved issues similar to the *ADESF* case discussed above and should be transferred to the Nineteenth Lower Civil Court in Sao Paulo where the *ADESF* case is pending. The court further stated that these cases should be consolidated for the purposes of judgment. In April 2010, the Sao Paulo Court of Appeals reversed the Seventh Civil Court's decision that consolidated the cases, finding that they are based on different legal claims and are progressing at different stages of proceedings. This case was returned to the Seventh Civil Court of Sao Paulo, and our subsidiary filed its closing arguments in December 2010. In March 2012, the trial court dismissed the case on the merits. In January 2014, the Sao Paulo Court of Appeals rejected plaintiff's appeal and affirmed the trial court decision. In July 2014, plaintiff appealed to the Superior Court of Justice.

In the first class action pending in Canada, *Cecilia Letourneau v. Imperial Tobacco Ltd., Rothmans, Benson & Hedges Inc. and J'fl Macdonald Corp., Quebec Superior Court, Canada*, filed in September 1998, our subsidiary and other Canadian manufacturers (Imperial Tobacco Canada Ltd. and m-MacDonald Cotp.) are defendants. The plaintiff, an individual smoker, sought compensatory and punitive damages for each member of the class who is deemed addicted to smoking. The class was certified in 2005. Trial began in March 2012 and concluded in December 2014. The trial court issued its judgment on May 27, 2015. The trial court found our subsidiary and two other Canadian manufacturers liable and awarded a total of CAD 131 million (approximately \$97 million) in punitive damages, allocating CAD 46 million (approximately \$34 million) to our subsidiary. The trial court found that defendants violated the Civil Code of Quebec, the Quebec Charter of Human Rights and Freedoms, and the Quebec Consumer Protection Act by failing to warn adequately of the dangers of smoking. The trial court also found that defendants conspired to prevent consumers from learning the dangers of smoking. The trial court further held that these civil faults were a cause of the class members' addiction. The trial court rejected other grounds of fault advanced by the class, holding that: (i) the evidence was insufficient to show that defendants marketed to youth, (ii) defendants' advertising did not convey false information about the characteristics of cigarettes, and (iii) defendants did not commit a fault by using the descriptors light or mild for cigarettes with a lower tar delivery. The trial court estimated the size of the addiction class at 918,000 members but declined to award compensatory damages to the addiction class because the evidence did not establish the claims with sufficient accuracy. The trial court ordered defendants to pay the full punitive damage award into a trust within 60 days and found that a claims process to allocate the awarded damages to individual class members would be too expensive and difficult to administer. The trial court ordered a briefing on the proposed process for the distribution of sums remaining from the punitive damage award after payment of attorneys' fees and legal costs. In June 2015, our subsidiary commenced the appellate process by filing its inscription of appeal of the trial court's judgment with the Court of Appeal of Quebec. Our subsidiary also filed a motion to cancel the trial court's order for payment into a trust within 60 days notwithstanding appeal. In July 2015, the Court of Appeal granted the motion to cancel and overturned the trial court's ruling that our subsidiary make the payment into a trust within 60 days. In August 2015, plaintiffs filed a motion with the Court of Appeal seeking security in both the *Letourneau* case and the *Blais* case described below. In October 2015, the Court of Appeal granted the motion and ordered our subsidiary to furnish security totaling CAD 226 million (approximately \$167 million), in the form of cash into a court trust or letters of credit, in six equal consecutive quarterly installments of approximately CAD 37.6 million (approximately \$27.7 million) beginning in December 2015 through March 2017. See the *Blais* description for further detail concerning the security order. The Court of Appeal heard oral arguments on the merits appeal in November 2016. Our subsidiary and PMI believe that the findings of liability and damages were incorrect and should ultimately be set aside on any one of many grounds, including the following: (i) holding that defendants violated Quebec law by failing to warn class members of the risks of smoking even after the court found that class members knew, or should have known, of the risks, (ii) finding that plaintiffs were not required to prove that defendants' alleged misconduct caused injury to each class member in direct contravention of binding precedent, (iii) creating a factual presumption, without any evidence from class members or otherwise, that defendants' alleged misconduct caused all smoking by all class members, (iv) holding that the addiction class members' claims for punitive damages were not time-barred even though the case was filed more than three years after a prominent addiction warning appeared on all packages, and (v) awarding punitive damages to punish defendants without proper consideration as to whether punitive damages were necessary to deter future misconduct.

In the second class action pending in Canada, *Conseil Quebecois Sur Le Tabac Et La Sante and Jean-Illes Blais v. Imperial Tobacco Ltd., Rothmans, Benson & Hedges Inc. and J'fl Macdonald Corp., Quebec Superior Court, Canada*, filed in November 1998, our subsidiary and other Canadian manufacturers (Imperial Tobacco Canada Ltd. and m-MacDonald Cotp.) are defendants. The plaintiffs, an anti-smoking organization and an individual smoker, sought compensatory and punitive damages for each member of the class who allegedly suffers from certain smoking-related diseases. The class was certified in 2005. Trial began in March 2012 and concluded in December 2014. The trial court issued its judgment on May 27, 2015. The trial court found our subsidiary and two other Canadian manufacturers liable and found that the class members' compensatory damages totaled approximately CAD 15.5 billion, including pre-judgment interest (approximately \$1.4 billion). The trial court awarded compensatory damages on a joint and several liability basis, allocating 20% to our subsidiary (approximately CAD 3.1 billion, including pre-judgment



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interest (approximately \$2.3 billion)). In addition, the trial court awarded CAD 90,000 (approximately \$66,300) in punitive damages, allocating CAD 30,000 (approximately \$22,100) to our subsidiary and found that defendants violated the Civil Code of Quebec, the Quebec Charter of Human Rights and Freedoms, and the Quebec Consumer Protection Act by failing to warn adequately of the dangers of smoking. The trial court also found that defendants conspired to prevent consumers from learning the dangers of smoking. The trial court further held that these civil faults were a cause of the class members' diseases. The trial court rejected other grounds of fault advanced by the class, holding that: (i) the evidence was insufficient to show that defendants marketed to youth, (ii) defendants' advertising did not convey false information about the characteristics of cigarettes, and (iii) defendants did not commit a fault by using the descriptors light or mild for cigarettes with a lower tar delivery. The trial court estimated the disease class at 99,957 members. The trial court ordered defendants to pay CAD 1 billion (approximately \$737 million) of the compensatory damage awarded into a trust within 60 days, CAD 200 million (approximately \$147 million) of which is our subsidiary's portion and ordered briefing on a proposed claims process for the distribution of damages to individual class members and for payment of attorneys' fees and legal costs. In June 2015, our subsidiary commenced the appellate process by filing its inscription of appeal of the trial court's judgment with the Court of Appeal of Quebec. Our subsidiary also filed a motion to cancel the trial court's order for payment into a trust within 60 days notwithstanding appeal. In July 2015, the Court of Appeal granted the motion to cancel and overturned the trial court's ruling that our subsidiary make an initial payment within 60 days. In August 2015, plaintiffs filed a motion with the Court of Appeal seeking an order that defendants place irrevocable letters of credit totaling CAD 5 billion (approximately \$3.7 billion) into trust, to secure the judgments in both the *Letourneau* and *Blais* cases. Plaintiffs subsequently withdrew their motion for security against JTI-MacDonald Corp. and proceeded only against our subsidiary and Imperial Tobacco Canada Ltd. In October 2015, the Court of Appeal granted the motion and ordered our subsidiary to furnish security totaling CAD 226 million (approximately \$167 million) to cover both the *Letourneau* and *Blais* cases. Such security may take the form of cash into a court trust or letters of credit, in six equal consecutive quarterly installments of approximately CAD 37.6 million (approximately \$27.7 million) beginning in December 2015 through March 2017. The Court of Appeal ordered Imperial Tobacco Canada Ltd. to furnish security totaling CAD 758 million (approximately \$559 million) in seven equal consecutive quarterly installments of approximately CAD 108 million (approximately \$80 million) beginning in December 2015 through June 2017. In March 2017, our subsidiary made its sixth and final quarterly installment of security for approximately CAD 37.6 million (approximately \$27.7 million) into a court trust. This payment is included in other assets on the condensed consolidated balance sheets and in cash used in operating activities in the condensed consolidated statements of cash flows. The Court of Appeal ordered that the security is payable upon a final judgment of the Court of Appeal affirming the trial court's judgment or upon further order of the Court of Appeal. The Court of Appeal heard oral arguments on the merits appeal in November 2016. Our subsidiary and PMI believe that the findings of liability and damages were incorrect and should ultimately be set aside on any one of many grounds, including the following: (i) holding that defendants violated Quebec law by failing to warn class members of the risks of smoking even after the court found that class members knew, or should have known, of the risks, (ii) finding that plaintiffs were not required to prove that defendants' alleged misconduct caused injury to each class member in direct contravention of binding precedent, (iii) creating a factual presumption, without any evidence from class members or otherwise, that defendants' alleged misconduct caused all smoking by all class members, (iv) relying on epidemiological evidence that did not meet recognized scientific standards, and (v) awarding punitive damages to punish defendants without proper consideration as to whether punitive damages were necessary to deter future misconduct.

In the third class action pending in Canada, *Kunta v. Canadian Tobacco Manufacturers' Council, et al., The Queen's Bench, Winnipeg, Canada*, filed June 12, 2009, we, our subsidiaries, and our indemnitees (PM USA and Altria), and other members of the industry are defendants. The plaintiff, an individual smoker, alleges her own addiction to tobacco products and chronic obstructive pulmonary disease ("COPD"), severe asthma, and mild reversible lung disease resulting from the use of tobacco products. She is seeking compensatory and punitive damages on behalf of a proposed class comprised of all smokers, their estates, dependents and family members, as well as restitution of profits, and reimbursement of government health care costs allegedly caused by tobacco products. In September 2009, plaintiff's counsel informed defendants that he did not anticipate taking any action in this case while he pursues the class action filed in Saskatchewan (see description of *Adams*, below).

In the fourth class action pending in Canada, *Adams v. Canadian Tobacco Manufacturers' Council, et al., The Queen's Bench, Saskatchewan, Canada*, filed July 10, 2009, we, our subsidiaries, and our indemnitees (PM USA and Altria), and other members of the industry are defendants. The plaintiff, an individual smoker, alleges her own addiction to tobacco products and COPD resulting from the use of tobacco products. She is seeking compensatory and punitive damages on behalf of a proposed class comprised of all smokers who have smoked a minimum of 25,000 cigarettes and have allegedly suffered, or suffer, from COPD, emphysema, heart disease, or cancer, as well as restitution of profits. Preliminary motions are pending.

In the fifth class action pending in Canada, *Semple v. Canadian Tobacco Manufacturers' Council, et al., The Supreme Court (trial court), Nova Scotia, Canada*, filed June 18, 2009, we, our subsidiaries, and our indemnitees (PM USA and Altria), and other members of the industry are defendants. The plaintiff, an individual smoker, alleges his own addiction to tobacco products and



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COPD resulting from the use of tobacco products. He is seeking compensatory and punitive damages on behalf of a proposed class comprised of all smokers, their estates, dependents and family members, as well as restitution of profits, and reimbursement of government health care costs allegedly caused by tobacco products. No activity in this case is anticipated while plaintiff's counsel pursues the class action filed in Saskatchewan (see description of *Adams*, above).

In the sixth class action pending in Canada, *Dorion v. Canadian Tobacco Manufacturers' Council, et al., The Queen's Bench, Alberta, Canada*, filed June 15, 2009, we, our subsidiaries, and our indemnitees (PM USA and Altria), and other members of the industry are defendants. The plaintiff: an individual smoker, alleges her own addiction to tobacco products and chronic bronchitis and severe sinus infections resulting from the use of tobacco products. She is seeking compensatory and punitive damages on behalf of a proposed class comprised of all smokers, their estates, dependents and family members, restitution of profits, and reimbursement of government health care costs allegedly caused by tobacco products. To date, we, our subsidiaries, and our indemnitees have not been properly served with the complaint. No activity in this case is anticipated while plaintiff's counsel pursues the class action filed in Saskatchewan (see description of *Adams*, above).

In the seventh class action pending in Canada, *McDermid v. Imperial Tobacco Canada Limited, et al., Supreme Court, British Columbia, Canada*, filed June 25, 2010, we, our subsidiaries, and our indemnitees (PM USA and Altria), and other members of the industry are defendants. The plaintiff: an individual smoker, alleges his own addiction to tobacco products and heart disease resulting from the use of tobacco products. He is seeking compensatory and punitive damages on behalf of a proposed class comprised of all smokers who were alive on June 12, 2007, and who suffered from heart disease allegedly caused by smoking, their estates, dependents and family members, plus disgorgement of revenues earned by the defendants from January 1, 1954, to the date the claim was filed.

In the eighth class action pending in Canada, *Bourassa v. Imperial Tobacco Canada Limited, et al., Supreme Court, British Columbia, Canada*, filed June 25, 2010, we, our subsidiaries, and our indemnitees (PM USA and Altria), and other members of the industry are defendants. The plaintiff: the heir to a deceased smoker, alleges that the decedent was addicted to tobacco products and suffered from emphysema resulting from the use of tobacco products. She is seeking compensatory and punitive damages on behalf of a proposed class comprised of all smokers who were alive on June 12, 2007, and who suffered from chronic respiratory diseases allegedly caused by smoking, their estates, dependents and family members, plus disgorgement of revenues earned by the defendants from January 1, 1954, to the date the claim was filed. In December 2014, plaintiff filed an amended statement of claim.

In the ninth class action pending in Canada, *Suzanne Jacklin v. Canadian Tobacco Manufacturers' Council, et al., Ontario Superior Court of Justice*, filed June 20, 2012, we, our subsidiaries, and our indemnitees (PM USA and Altria), and other members of the industry are defendants. The plaintiff: an individual smoker, alleges her own addiction to tobacco products and COPD resulting from the use of tobacco products. She is seeking compensatory and punitive damages on behalf of a proposed class comprised of all smokers who have smoked a minimum of 25,000 cigarettes and have allegedly suffered, or suffer, from COPD, heart disease, or cancer, as well as restitution of profits. Plaintiff's counsel has indicated that he does not intend to take any action in this case in the near future.

*Health Care Cost Recovery Litigation:* These cases, brought by governmental and non-governmental plaintiffs, seek reimbursement of health care cost expenditures allegedly caused by tobacco products. Plaintiffs' allegations of liability in these cases are based on various theories of recovery including unjust enrichment, negligence, negligent design, strict liability, breach of express and implied warranties, violation of a voluntary undertaking or special duty, fraud, negligent misrepresentation, conspiracy, public nuisance, defective product, failure to warn, sale of cigarettes to minors, and claims under statutes governing competition and deceptive trade practices. Plaintiffs in these cases seek various forms of relief including compensatory and other damages, and injunctive and equitable relief. Defenses raised in these cases include lack of proximate cause, remoteness of injury, failure to state a claim, adequate remedy at law, "unclean hands" (namely, that plaintiffs cannot obtain equitable relief because they participated in, and benefited from, the sale of cigarettes), and statute of limitations.

As of April 25, 2017, there were 16 health care cost recovery cases pending against us, our subsidiaries or indemnitees in Canada (IO), Korea (1) and Nigeria (5), compared with 16 such cases on April 22, 2016 and 16 such cases on April 30, 2015.

In the first health care cost recovery case pending in Canada, *Her Majesty the Queen in Right of British Columbia v. Imperial Tobacco Limited, et al., Supreme Court, British Columbia, Vancouver Registry, Canada*, filed January 24, 2001, we, our subsidiaries, our indemnitee (PM USA), and other members of the industry are defendants. The plaintiff: the government of the province of British Columbia, brought a claim based upon legislation enacted by the province authorizing the government to file a direct action against cigarette manufacturers to recover the health care costs it has incurred, and will incur, resulting from a "tobacco related





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wrong." The Supreme Court of Canada has held that the statute is constitutional. We and certain other non-Canadian defendants challenged the jurisdiction of the court. The court rejected the jurisdictional challenge. Pre-trial discovery is ongoing.

In the second health care cost recovery case filed in Canada, *Her Majesty the Queen in Right of New Brunswick v. Rothmans Inc., et al., Court of Queen's Bench of New Brunswick, 1st Court, New Brunswick, Fredericton, Canada*, filed March 13, 2008, we, our subsidiaries, our indemnitees (PM USA and Altria), and other members of the industry are defendants. The claim was filed by the government of the province of New Brunswick based on legislation enacted in the province. This legislation is similar to the law introduced in British Columbia that authorizes the government to file a direct action against cigarette manufacturers to recover the health care costs it has incurred, and will incur, as a result of a "tobacco related wrong." Pre-trial discovery is ongoing. In September 2016, the trial court entered a consent order establishing a discovery timetable that contemplates the province of New Brunswick applying by September 2017 for a trial date.

In the third health care cost recovery case filed in Canada, *Her Majesty the Queen in Right of Ontario v. Rothmans Inc., et al., Ontario Superior Court of Justice, Toronto, Canada*, filed September 29, 2009, we, our subsidiaries, our indemnitees (PM USA and Altria), and other members of the industry are defendants. The claim was filed by the government of the province of Ontario based on legislation enacted in the province. This legislation is similar to the laws introduced in British Columbia and New Brunswick that authorize the government to file a direct action against cigarette manufacturers to recover the health care costs it has incurred, and will incur, as a result of a "tobacco related wrong." Pre-trial discovery is ongoing.

In the fourth health care cost recovery case filed in Canada, *Attorney General of Newfoundland and Labrador v. Rothmans Inc., et al., Supreme Court of Newfoundland and Labrador, St. Johns, Canada*, filed February 8, 2011, we, our subsidiaries, our indemnitees (PM USA and Altria), and other members of the industry are defendants. The claim was filed by the government of the province of Newfoundland and Labrador based on legislation enacted in the province that is similar to the laws introduced in British Columbia, New Brunswick and Ontario. The legislation authorizes the government to file a direct action against cigarette manufacturers to recover the health care costs it has incurred, and will incur, as a result of a "tobacco related wrong." Pre-trial discovery is ongoing.

In the fifth health care cost recovery case filed in Canada, *Attorney General of Quebec v. Imperial Tobacco Limited, et al., Superior Court of Quebec, Canada*, filed June 8, 2012, we, our subsidiary, our indemnitee (PM USA), and other members of the industry are defendants. The claim was filed by the government of the province of Quebec based on legislation enacted in the province that is similar to the laws enacted in several other Canadian provinces. The legislation authorizes the government to file a direct action against cigarette manufacturers to recover the health care costs it has incurred, and will incur, as a result of a "tobacco related wrong." Pre-trial discovery is ongoing.

In the sixth health care cost recovery case filed in Canada, *Her Majesty in Right of Alberta v. Altria Group, Inc., et al., Supreme Court of Queen's Bench Alberta, Canada*, filed June 8, 2012, we, our subsidiaries, our indemnitees (PM USA and Altria), and other members of the industry are defendants. The claim was filed by the government of the province of Alberta based on legislation enacted in the province that is similar to the laws enacted in several other Canadian provinces. The legislation authorizes the government to file a direct action against cigarette manufacturers to recover the health care costs it has incurred, and will incur, as a result of a "tobacco related wrong." Pre-trial discovery is ongoing.

In the seventh health care cost recovery case filed in Canada, *Her Majesty the Queen in Right of the Province of Manitoba v. Rothmans, Benson & Hedges, Inc., et al., The Queen's Bench, Winnipeg Judicial Centre, Canada*, filed May 31, 2012, we, our subsidiaries, our indemnitees (PM USA and Altria), and other members of the industry are defendants. The claim was filed by the government of the province of Manitoba based on legislation enacted in the province that is similar to the laws enacted in several other Canadian provinces. The legislation authorizes the government to file a direct action against cigarette manufacturers to recover the health care costs it has incurred, and will incur, as a result of a "tobacco related wrong." Defendants filed their defenses in September 2014. Pre-trial discovery is ongoing.

In the eighth health care cost recovery case filed in Canada, *The Government of Saskatchewan v. Rothmans, Benson & Hedges Inc., et al., Queen's Bench, Judicial Centre of Saskatchewan, Canada*, filed June 8, 2012, we, our subsidiaries, our indemnitees (PM USA and Altria), and other members of the industry are defendants. The claim was filed by the government of the province of Saskatchewan based on legislation enacted in the province that is similar to the laws enacted in several other Canadian provinces. The legislation authorizes the government to file a direct action against cigarette manufacturers to recover the health care costs it has incurred, and will incur, as a result of a "tobacco related wrong." Defendants filed their defenses in February 2015. Discovery is scheduled to begin in 2017.



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In the ninth health care cost recovery case filed in Canada, *Her Majesty the Queen in Right of the Province of Prince Edward Island v. Rothmans, Benson & Hedges Inc., et al., Supreme Court of Prince Edward Island (General Section), Canada*, filed September 10, 2012, we, our subsidiaries, our indemnitees (PM USA and Altria), and other members of the industry are defendants. The claim was filed by the government of the province of Prince Edward Island based on legislation enacted in the province that is similar to the laws enacted in several other Canadian provinces. The legislation authorizes the government to file a direct action against cigarette manufacturers to recover the health care costs it has incurred, and will incur, as a result of a "tobacco related wrong." Defendants filed their defenses in February 2015. Discovery is scheduled to begin in 2017.

In the tenth health care cost recovery case filed in Canada, *Her Majesty the Queen in Right of the Province of Nova Scotia v. Rothmans, Benson & Hedges Inc., et al., Supreme Court of Nova Scotia, Canada*, filed January 2, 2015, we, our subsidiaries, our indemnitees (PM USA and Altria), and other members of the industry are defendants. The claim was filed by the government of the province of Nova Scotia based on legislation enacted in the province that is similar to the laws enacted in several other Canadian provinces. The legislation authorizes the government to file a direct action against cigarette manufacturers to recover the health care costs it has incurred, and will incur, as a result of a "tobacco related wrong." Defendants filed their defenses in July 2015. Discovery is scheduled to begin in 2017.

In the first health care cost recovery case in Nigeria, *The Attorney General of Lagos State v. British American Tobacco (Nigeria) Limited, et al., High Court of Lagos State, Lagos, Nigeria*, filed March 13, 2008, we and other members of the industry are defendants. Plaintiff seeks reimbursement for the cost of treating alleged smoking-related diseases for the past 20 years, payment of anticipated costs of treating alleged smoking-related diseases for the next 20 years, various forms of injunctive relief: plus punitive damages. We are in the process of making challenges to service and the court's jurisdiction. Currently, the case is stayed in the trial court pending the appeals of certain co-defendants relating to service objections.

In the second health care cost recovery case in Nigeria, *The Attorney General of Kano State v. British American Tobacco (Nigeria) Limited, et al., High Court of Kano State, Kano, Nigeria*, filed May 9, 2007, we and other members of the industry are defendants. Plaintiff seeks reimbursement for the cost of treating alleged smoking-related diseases for the past 20 years, payment of anticipated costs of treating alleged smoking-related diseases for the next 20 years, various forms of injunctive relief: plus punitive damages. We are in the process of making challenges to service and the court's jurisdiction. Currently, the case is stayed in the trial court pending the appeals of certain co-defendants relating to service objections.

In the third health care cost recovery case in Nigeria, *The Attorney General of Gombe State v. British American Tobacco (Nigeria) Limited, et al., High Court of Gombe State, Gombe, Nigeria*, filed October 17, 2008, we and other members of the industry are defendants. Plaintiff seeks reimbursement for the cost of treating alleged smoking-related diseases for the past 20 years, payment of anticipated costs of treating alleged smoking-related diseases for the next 20 years, various forms of injunctive relief: plus punitive damages. In February 2011, the court ruled that the plaintiff had not complied with the procedural steps necessary to serve us. As a result of this ruling, plaintiff must re-serve its claim. We have not yet been re-served.

In the fourth health care cost recovery case in Nigeria, *The Attorney General of Oyo State, et al., v. British American Tobacco (Nigeria) Limited, et al., High Court of Oyo State, Ibadan, Nigeria*, filed May 25, 2007, we and other members of the industry are defendants. Plaintiffs seek reimbursement for the cost of treating alleged smoking-related diseases for the past 20 years, payment of anticipated costs of treating alleged smoking-related diseases for the next 20 years, various forms of injunctive relief: plus punitive damages. We challenged service as improper. In June 2010, the court ruled that plaintiffs did not have leave to serve the writ of summons on the defendants and that they must re-serve the writ. We have not yet been re-served.

In the fifth health care cost recovery case in Nigeria, *The Attorney General of Ogun State v. British American Tobacco (Nigeria) Limited, et al., High Court of Ogun State, Abeokuta, Nigeria*, filed February 26, 2008, we and other members of the industry are defendants. Plaintiff seeks reimbursement for the cost of treating alleged smoking-related diseases for the past 20 years, payment of anticipated costs of treating alleged smoking-related diseases for the next 20 years, various forms of injunctive relief: plus punitive damages. In May 2010, the trial court rejected our service objections. We have appealed.

In the health care cost recovery case in Korea, the *National Health Insurance Service v. KT&G, et al.*, filed April 14, 2014, our subsidiary and other Korean manufacturers are defendants. Plaintiff alleges that defendants concealed the health hazards of smoking, marketed to youth, added ingredients to make their products more harmful and addictive, and misled consumers into believing that *Lights* cigarettes are safer than regular cigarettes. The National Health Insurance Service seeks to recover approximately \$53.7 million allegedly incurred in treating 3,484 patients with small cell lung cancer, squamous cell lung cancer, and squamous cell laryngeal cancer from 2003 to 2012. The case is now in the evidentiary phase.



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*lights Cases:* These cases, brought by individual plaintiffs, allege that the use of the term "lights" constitutes fraudulent and misleading conduct. Plaintiffs' allegations of liability in these cases are based on various theories of recovery including misrepresentation, deception, and breach of consumer protection laws. Plaintiffs seek various forms of relief including restitution, injunctive relief, and compensatory and other damages. Defenses raised include lack of causation, lack of reliance, assumption of the risk, and statute of limitations.

As of April 25, 2017, there was 1 lights case brought by an individual plaintiff pending against our subsidiaries or indemnitees in Italy (1), compared with 3 such cases on April 22, 2016, and 2 such cases on April 30, 2015.

*Public Civil Actions:* Claims have been filed either by an individual, or a public or private entity, seeking to protect collective or individual rights, such as the right to health, the right to information or the right to safety. Plaintiffs' allegations of liability in these cases are based on various theories of recovery including product defect, concealment, and misrepresentation. Plaintiffs in these cases seek various forms of relief including injunctive relief such as banning cigarettes, descriptors, smoking in certain places and advertising, as well as implementing communication campaigns and reimbursement of medical expenses incurred by public or private institutions.

As of April 25, 2017, there were 2 public civil actions pending against our subsidiaries in Argentina (1) and Venezuela (1), compared with 3 such cases on April 22, 2016, and 2 such cases on April 30, 2015.

In the public civil action in Argentina, *Asociacion Argentina de Derecho de Danos v. Massa/in Particulares S.A., et al., Civil Court of Buenos Aires, Argentina*, filed February 26, 2007, our subsidiary and another member of the industry are defendants. The plaintiff, a consumer association, seeks the establishment of a relief fund for reimbursement of medical costs associated with diseases allegedly caused by smoking. Our subsidiary filed its answer in September 2007. In March 2010, the case file was transferred to the Federal Court on Administrative Matters after the Civil Court granted plaintiffs request to add the national government as a co-plaintiff in the case. The case is currently in the evidentiary stage.

In the public civil action in Venezuela, *Federation of Consumers and Users Associations ("FEVACU", et al. v. National Assembly of Venezuela and the Venezuelan Ministry of Health, Constitutional Chamber of the Venezuelan Supreme Court*, filed April 29, 2008, we were not named as a defendant, but the plaintiffs published a notice pursuant to court order, notifying all interested parties to appear in the case. In January 2009, our subsidiary appeared in the case in response to this notice. The plaintiffs purport to represent the right to health of the citizens of Venezuela and claim that the government failed to protect adequately its citizens' right to health. The claim asks the court to order the government to enact stricter regulations on the manufacture and sale of tobacco products. In addition, the plaintiffs ask the court to order companies involved in the tobacco industry to allocate a percentage of their "sales or benefits" to establish a fund to pay for the health care costs of treating smoking-related diseases. In October 2008, the court ruled that plaintiffs have standing to file the claim and that the claim meets the threshold admissibility requirements. In December 2012, the court admitted our subsidiary and BAT's subsidiary as interested third parties. In February 2013, our subsidiary answered the complaint.

#### *Other Litigation*

The Department of Special Investigations of the government of Thailand ("DSI") conducted an investigation into alleged underpayment by our subsidiary, Philip Morris (Thailand) Limited ("PM Thailand"), of customs duties and excise taxes relating to imports from the Philippines covering the period 2003-2007. On January 18, 2016, the Public Prosecutor filed charges against our subsidiary and seven former and current employees in the Bangkok Criminal Court alleging that PM Thailand and the individual defendants jointly and with the intention to defraud the Thai government, under-declared import prices of cigarettes to avoid full payment of taxes and duties in connection with 272 import entries of cigarettes from the Philippines during the period of July 2003 to June 2006. The government is seeking a fine of approximately THB 80.8 billion (approximately \$2.35 billion). The case is in the pre-trial evidentiary phase. Trial is scheduled to begin during the last quarter of 2017. PM Thailand believes that its declared import prices are in compliance with the Customs Valuation Agreement of the World Trade Organization and Thai law and that the allegations of the Public Prosecutor are inconsistent with several decisions already taken by Thai Customs and other Thai governmental agencies.

The DSI also conducted an investigation into alleged underpayment by PM Thailand of customs duties and excise taxes relating to imports from Indonesia covering the period 2000-2003. On January 26, 2017, the Public Prosecutor filed charges against PM Thailand and its former Thai employee in the Bangkok Criminal Court alleging that PM Thailand and its former employee jointly and with the intention to defraud the Thai government under-declared import prices of cigarettes to avoid full payment of taxes



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and duties in connection with 780 import entries during the period from January 2002 to July 2003. The government is seeking a fine of approximately THB 19.8 billion (approximately \$575 million). The case is in pre-trial proceedings and has not yet been set for trial. PM Thailand believes that its declared import prices are in compliance with the Customs Valuation Agreement of the World Trade Organization and Thai law, and that the allegations of the Public Prosecutor are inconsistent with several decisions already taken by Thai Customs and a Thai court.

The South Korean Board of Audit and Inspection ("BAI") conducted an audit of certain Korean government agencies and the tobacco industry into whether inventory movements ahead of the January 1, 2015 increase of cigarette-related taxes by tobacco companies, including Philip Morris Korea Inc. ("PM Korea"), our South Korean affiliate, were in compliance with South Korean tax laws. In November 2016, the tax authorities completed their audit and assessed allegedly undeclared taxes and penalties. In order to avoid nonpayment financial costs, PM Korea paid approximately KRW 272 billion (approximately \$240 million), of which KRW 100 billion (approximately \$88 million) was paid in 2016 and KRW 172 billion (approximately \$152 million) was paid in 2017. These amounts are included in other assets in the condensed consolidated balance sheets and in cash used in operating activities in the condensed consolidated statements of cash flows. PM Korea is appealing the assessments. The tax authorities have also referred the matter to the Public Prosecutor, who will further investigate and decide whether to file criminal charges against PM Korea and/or other alleged co-offenders. If the Public Prosecutor decides to prosecute, it may seek up to three times the undeclared tax for company criminal penalties and up to five times the undeclared tax for individual criminal penalties. PM Korea believes that it has paid cigarette-related taxes in compliance with the South Korean tax laws. In addition, the South Korean Ministry of Strategy and Finance ("MOSF") filed a criminal complaint with the Public Prosecutor against PM Korea and its managing director. In its criminal complaint, the MOSF alleged that PM Korea exceeded the monthly product withdrawal limits that the MOSF had set in its notice. The Public Prosecutor will investigate the MOSF's criminal complaint and decide whether to prosecute. PM Korea disagrees with the MOSF's allegations.

We are also involved in additional litigation arising in the ordinary course of our business. While the outcomes of these proceedings are uncertain, management does not expect that the ultimate outcomes of other litigation, including any reasonably possible losses in excess of current accruals, will have a material adverse effect on our consolidated results of operations, cash flows or financial position.

#### Note 9. Income Taxes:

Income tax provisions for jurisdictions outside the United States of America, as well as state and local income tax provisions, were determined on a separate company basis, and the related assets and liabilities were recorded in PMI's condensed consolidated balance sheets.

PMI's effective tax rates for the three months ended March 31, 2017 and 2016 were 24.9% and 28.3%, respectively. PMI estimates that its full-year 2017 effective tax rate will be approximately 28%. The effective tax rate for the three months ended March 31, 2017, was favorably impacted by the tax benefit of a legal entity restructuring (\$61 million). Excluding the effect of the legal entity restructuring, the change in the effective tax rate for the three months ended March 31, 2017, as compared to the three months ended March 31, 2016, was primarily due to earnings mix by taxing jurisdiction and repatriation cost differences.

The effective tax rates are based on PMI's full-year earnings mix projections by taxing jurisdiction and cash repatriation plans. Changes in currency exchange rates, earnings mix by taxing jurisdiction, or cash repatriation plans could have an impact on the effective tax rates, which PMI monitors each quarter. Significant judgment is required in determining income tax provisions and in evaluating tax positions.

PMI is regularly examined by tax authorities around the world and is currently under examination in a number of jurisdictions. The U.S. federal statute of limitations remains open for the years 2013 and onward. Foreign and U.S. state jurisdictions have statutes of limitations generally ranging from three to five years.

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 change cannot be made at this time.

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## Note 10. Indebtedness:

*Short-term Borrowings:*

At March 31, 2017 and December 31, 2016, PMI's short-term borrowings, consisting of bank loans to certain PMI subsidiaries, had a carrying value of \$1,004 million and \$643 million, respectively. The fair value of PMI's short-term borrowings, based on current market interest rates, approximates carrying value.

*Long-term Debt:*

At March 31, 2017 and December 31, 2016, PMI's long-term debt consisted of the following:

(in millions)	March 31, 2017	December 31, 2016
U.S. dollar notes, 1.125% to 6.375% (average interest rate 3.520%), due through 2044	\$ 21,796	\$ 19,857
Foreign currency obligations:		
Euro notes, 1.750% to 3.125% (average interest rate 2.402%), due through 2036	7,032	6,828
Swiss franc notes, 0.750% to 2.000% (average interest rate 1.269%), due through 2024	1,354	1,312
Other (average interest rate 3.586%), due through 2024	160	427
	30,342	28,424
Less current portion of long-term debt	1,754	2,573
	\$ 28,588	\$ 25,851

Other foreign currency debt above includes mortgage debt in Switzerland and capital lease obligations at March 31, 2017 and December 31, 2016. Other foreign currency debt above also includes a bank loan in the Philippines at December 31, 2016.

PMI's debt issuances in the first three months of 2017 were as follows:

(in millions)

Type	Face Value	Interest Rate	Issuance	Maturity
U.S. dollar notes <sup>(a)</sup>	\$700	1.625%	February 2017	February 2019
U.S. dollar notes <sup>(b)</sup>	\$300	Floating	February 2017	February 2020
U.S. dollar notes <sup>(a)</sup>	\$1,000	2.000%	February 2017	February 2020
U.S. dollar notes <sup>(c)</sup>	\$500	2.625%	February 2017	February 2022

(a) Interest on these notes is payable semi-annually in arrears beginning in August 2017.

(b) Interest on these notes is payable quarterly in arrears beginning in May 2017.

The net proceeds from the sale of the securities listed in the table above have been and will be used for general corporate purposes.



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*Credit Facilities:*

On January 27, 2017, PMI entered into an agreement to extend the term of its \$2.0 billion 364-day revolving credit facility from February 7, 2017 to February 6, 2018.

At March 31, 2017, PMI's total committed credit facilities were as follows:

(in billions)

Type	Committed Credit Facilities
364-day revolving credit, expiring February 6, 2018	\$ 2.0
Multi-year revolving credit, expiring February 28, 2021	2.5
Multi-year revolving credit, expiring October 1, 2020 <sup>(1)</sup>	3.5
Total facilities	\$ 8.0

<sup>(1)</sup> On August 30, 2016, PMI entered into an agreement, effective October 1, 2016, to extend the term of its multi-year revolving credit facility, for an additional year covering the period October 1, 2020 to October 1, 2021 in the amount of \$3.35 billion.

At March 31, 2017, there were no borrowings under these committed credit facilities, and the entire committed amounts were available for borrowing.

**Note 11. Fair Value Measurement;**

The authoritative guidance defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The guidance also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The guidance describes three levels of input that may be used to measure fair value, which are as follows:

- Level 1 - Quoted prices in active markets for identical assets or liabilities;
- Level 2 - Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; and
- Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

PM's policy is to reflect transfers between hierarchy levels at the end of the reporting period.

*Derivative Financial Instruments*

PM assesses the fair value of its foreign exchange contracts and interest rate contracts using standard valuation models that use, as their basis, readily observable market inputs. The fair value of PMI's foreign exchange forward contracts is determined by using the prevailing foreign exchange spot rates and interest rate differentials, and the respective maturity dates of the instruments. The fair value of PMI's currency options is determined by using a Black-Scholes methodology based on foreign exchange spot rates and interest rate differentials, currency volatilities and maturity dates. PMI's derivative financial instruments have been classified within Level 2 in the table shown below. See Note 5. *Financial Instruments* for additional discussion of derivative financial instruments.



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*Debt*

The fair value of PMI's outstanding debt, which is utilized solely for disclosure purposes, is determined using quotes and market interest rates currently available to PMI for issuances of debt with similar terms and remaining maturities. The aggregate carrying value of PMI's debt, excluding short-term borrowings and \$13 million of capital lease obligations, was \$30,329 million at March 31, 2017. The fair value of PMI's outstanding debt, excluding the aforementioned short-term borrowings and capital lease obligations, was classified within Level 1 and Level 2 in the table shown below.

The aggregate fairvalues of PMI's derivative financial instruments and debt as of March 31, 2017, were as follows:

(in millions)	Fair Value at March 31, 2017	Quoted Prices in Active Markets for Identical Assets/Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets:</b>				
Foreign exchange contracts	\$ 480	\$	\$ 480	\$
Total assets	\$ 480	\$	\$ 480	\$
<b>Liabilities:</b>				
Debt	\$ 32,005	\$ 31,834	\$ 171	\$
Foreign exchange contracts	207		207	
Total liabilities	\$ 32,212	\$ 31,834	\$ 378	\$

**Note 12. Accumulated Other Comprehensive Losses;**

PMI's accumulated other comprehensive losses, net of taxes, consisted of the following:

(in millions)	At March 31, 2017	At December 31, 2016	At March 31, 2016
Currency translation adjustments	\$ (5,783)	\$ (6,091)	\$ (5,617)
Pension and other benefits	(3,509)	(3,565)	(3,287)
Derivatives accounted for as hedges	27	97	(10)
Total accumulated other comprehensive losses	\$ (9,265)	\$ (9,559)	\$ (8,914)

*Reclassifications from Other Comprehensive Earnings*

The movements in accumulated other comprehensive losses and the related tax impact, for each of the components above, that are due to current period activity and reclassifications to the income statement are shown on the condensed consolidated statements of comprehensive earnings for the three months ended March 31, 2017 and 2016. For additional information, see Note 3. *Benefit Plans* and Note 5. *Financial Instruments* for disclosures related to PMI's pension and other benefits, and derivative financial instruments, respectively.

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## Note 13. Balance Sheet Offsetting:

*Derivative Financial Instruments*

PM uses foreign exchange contracts and interest rate contracts to mitigate its exposure to changes in exchange and interest rates from third-party and intercompany actual and forecasted transactions. Substantially all of PMI's derivative financial instruments are subject to master netting arrangements, whereby the right to offset occurs in the event of default by a participating party. While these contracts contain the enforceable right to offset through close-out netting rights, PM elects to present them on a gross basis in the condensed consolidated balance sheets. Collateral associated with these arrangements is in the form of cash and is unrestricted. See Note 5. *Financial Instruments* for disclosures related to PM's derivative financial instruments.

The effects of these derivative financial instrument assets and liabilities on PM's condensed consolidated balance sheets were as follows:

(in millions)	Gross Amounts Recognized	Gross Amount Offset in the Condensed Consolidated Balance Sheet	Net Amounts Presented in the Condensed Consolidated Balance Sheet	Gross Amounts Not Offset in the Condensed Consolidated Balance Sheet		Net Amount
				Financial Instruments	Cash Collateral Received/Pledged	
<b>At March 31, 2017</b>						
<b>Assets</b>						
Foreign exchange contracts \$	480 \$		\$ 480 \$	(170) \$	(258) \$	52
<b>Liabilities</b>						
Foreign exchange contracts \$	207 \$	— \$	\$ 207 \$	(170) \$	(11) \$	26
<b>At December 31, 2016</b>						
<b>Assets</b>						
Foreign exchange contracts \$	813 \$		\$ 813 \$	(126) \$	(607) \$	80
<b>Liabilities</b>						
Foreign exchange contracts \$	163 \$	— \$	\$ 163 \$	(126) \$	(31) \$	6

## Note 14. Investments in Unconsolidated Subsidiaries:

At March 31, 2017 and December 31, 2016, PMI had total investments in unconsolidated subsidiaries of \$1,079 million and \$1,011 million, respectively, which were accounted for under the equity method of accounting. Equity method investments are initially recorded at cost. Under the equity method of accounting, the investment is adjusted for PM's proportionate share of earnings or losses and movements in currency translation adjustments. The carrying value of our equity method investments at March 31, 2017 and December 31, 2016 exceeded our share of the unconsolidated subsidiaries' book value by \$900 million and \$867 million, respectively. The difference between the investment carrying value and the amount of underlying equity in net assets, excluding \$844 million and \$810 million attributable to goodwill as of March 31, 2017 and December 31, 2016, respectively, is being amortized on a straight-line basis over the underlying assets' estimated useful lives of 4 to 20 years. At March 31, 2017, PMI received no year-to-date dividends from unconsolidated subsidiaries. At December 31, 2016, PMI received year-to-date dividends from unconsolidated subsidiaries of \$117 million.

PM holds a 49% equity interest in United Arab Emirates-based Emirati Investors-TA (FZC) ("EITA"). PMI holds an approximate 25% economic interest in Societe des Tabacs Algero-Emiratie ("STAEM"), an Algerian joint venture that is 51% owned by EITA and 49% by the Algerian state-owned enterprise Societe Nationale des Tabacs et Allumettes SpA. STAEM manufactures and distributes under license some of PMI's brands.

PM holds a 20% equity interest in Megapolis Distribution BV, the holding company of CJSC TK Megapolis C'Megapolis", PMI's distributor in Russia.



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Philip Morris International Inc. and Subsidiaries  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)

The initial investments in EITA and Megapolis Distribution BV were recorded at cost and are included in investments in unconsolidated subsidiaries on the condensed consolidated balance sheets.

PMI's earnings activity from unconsolidated subsidiaries was as follows:

(in millions)	For the Three Months Ended March 31,	
	2017	2016
Net revenues	\$ 840	\$ 777

PMI's balance sheet activity related to unconsolidated subsidiaries was as follows:

(in millions)	At March 31, 2017	At December 31, 2016
Receivables	\$ 394	\$ 289

The activity primarily related to agreements with PMI's unconsolidated subsidiaries within the Eastern Europe, Middle East & Africa segment. These agreements, which are in the ordinary course of business, are primarily for distribution, contract manufacturing and licenses. PMI eliminated its respective share of all significant intercompany transactions with the equity method investees.

**Note 15. Sale of Accounts Receivable:**

To mitigate risk and enhance cash and liquidity management PMI sells trade receivables to unaffiliated financial institutions. These arrangements allow PMI to sell, on an ongoing basis, certain trade receivables without recourse. The trade receivables sold are generally short-term in nature and are removed from the condensed consolidated balance sheets. PMI sells trade receivables under two types of arrangements, servicing and non-servicing. For servicing arrangements, PMI continues to service the sold trade receivables on an administrative basis and does not act on behalf of the unaffiliated financial institutions. When applicable, a servicing liability is recorded for the estimated fair value of the servicing. The amounts associated with the servicing liability were not material as of March 31, 2017 and March 31, 2016. Under the non-servicing arrangements, PMI does not provide any administrative support or servicing after the trade receivables have been sold to the unaffiliated financial institutions.

Cumulative trade receivables sold, including excise taxes, for the three months ended March 31, 2017 and 2016, were \$2,092 million and \$1,946 million, respectively. PMI's operating cash flows were positively impacted by the amount of the trade receivables sold and derecognized from the condensed consolidated balance sheets, which remained outstanding with the unaffiliated financial institutions. The trade receivables sold that remained outstanding under these arrangements as of March 31, 2017 and March 31, 2016, were \$561 million, and \$589 million, respectively. The net proceeds received are included in cash provided by operating activities in the condensed consolidated statements of cash flows. The difference between the carrying amount of the trade receivables sold and the sum of the cash received is recorded as a loss on sale of trade receivables within marketing, administration and research costs in the condensed consolidated statements of earnings. For the three months ended March 31, 2017 and 2016, the loss on sale of trade receivables was immaterial.

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Philip Morris International Inc. and Subsidiaries  
Notes to Condensed Consolidated Financial Statements  
(Unaudited)

Note 16. New Accounting Standards:

On February 25, 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ASU 2016-02, "Leases" ("ASU 2016-02"). ASU 2016-02 requires organizations that lease assets to recognize on the balance sheet the assets and liabilities for the rights and obligations created by those leases. Additionally, ASU 2016-02 modifies current guidance for lessors' accounting. ASU 2016-02 is effective for interim and annual reporting periods beginning on or after January 1, 2019, with early adoption permitted. PMI is currently assessing the impact that the adoption of ASU 2016-02 will have on its financial position and results of operations.

On January 5, 2016, the FASB issued Accounting Standard Update ASU 2016-01, "Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities" ("ASU 2016-01"). ASU 2016-01 will require equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. Additionally, ASU 2016-01 also changes certain disclosure requirements and other aspects of current U.S. GAAP. ASU 2016-01 is effective for interim and annual reporting periods beginning on or after January 1, 2018. PMI is currently assessing its cost method investments and the impact that the adoption of ASU 2016-01 will have on its financial position and results of operations.

On May 28, 2014, the FASB issued Accounting Standards Update ASU 2014-09, "Revenue from Contracts with Customers" ("ASU 2014-09"). ASU 2014-09 contains principles that an entity will need to apply to determine the measurement of revenue and timing of when it is recognized. The underlying principle is that an entity will recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Entities can apply the final standard using one of the following two methods:

1. retrospectively to each prior period presented; or
2. retrospectively, with the cumulative effect of initially applying ASU 2014-09 recognized at the date of initial application, with additional disclosures in reporting periods that include the date of initial application.

ASU 2014-09 is effective for interim and annual reporting periods beginning on or after January 1, 2017. In July 2015, the FASB approved a proposal which allows for a deferral of the implementation until January 1, 2018, and permits early application, but not before the original effective date of January 1, 2017. PMI plans to adopt ASU 2014-09 on January 1, 2018, and does not expect the adoption to have a material impact on its consolidated financial position or results of operations. Following the release of ASU 2016-12 in May 2016, which provided some practical expedients to the original standard, PMI is continuing to assess the standard's policy election for gross versus net presentation of excise taxes and, related to this assessment, the method of adoption.

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Item. 2.

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, other tobacco products and other nicotine-containing 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. In addition to the manufacture and sale of cigarettes and other tobacco products, we are engaged in the development and commercialization of reduced-risk products ("RRPs"). RRPs is the term we use to refer to products that present, are likely to present, or have the potential to present less risk of harm to smokers who switch to these products versus continued smoking. We have a range of RRPs in various stages of development, scientific assessment and commercialization. Because our RRPs do not burn tobacco, they produce significantly lower levels of harmful or potentially harmful constituents than found in cigarette smoke.

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.



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## Executive Summary

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

*Consolidated Operating Results for the 1h-ree Months Ended March 31, 2017* – The changes in our reported diluted earnings per share 'diluted EPS' for the three months ended March 31, 2017, from the comparable 2016 amounts, were as follows:

	Diluted EPS	% Growth
For the three months ended March 31, 2016	\$ 0.98	
2016 Asset impairment and exit costs		
2016 Tax items		
Subtotal of 2016 items		
2017 Asset impairment and exit costs		
2017 Tax items	0.04	
Subtotal of 2017 items	0.04	
Currency		
Interest	0.02	
Change in tax rate	0.01	
Operations	(0.03)	
For the three months ended March 31, 2017	\$ 1.02	4.1%

*Currency* – There was no currency impact during the reporting period as favorable currency impact from the Indonesian rupiah, Japanese yen, Russian ruble and Swiss franc were offset by the negative effect related to the Egyptian pound, Mexican peso and Turkish lira.

*Interest* – The favorable impact of interest was due primarily to lower effective interest rates on debt and higher interest income.

*Income Taxes* – Our effective income tax rate for the three months ended March 31, 2017 decreased by 3.4 percentage points to 24.9%. The 2017 tax item that increased our diluted EPS by \$0.04 per share in the table above was due to a legal entity restructuring (\$61 million). The change in the effective tax rate that increased our diluted EPS by \$0.01 per share in the table above was primarily due to earnings mix by taxing jurisdiction and repatriation cost differences. We estimate that our full-year 2017 effective tax rate will be approximately 28%.

*Operations* – The decrease in diluted EPS of \$0.03 from our operations in the table above was due primarily to the following segments:

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

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

*2017 Forecasted Results* – On April 20, 2017, we increased, for a favorable discrete tax item of \$0.04 only, our 2017 full-year reported diluted EPS to a range of \$4.84 to \$4.99, at prevailing exchange rates at that time, versus \$4.48 in 2016. Excluding an unfavorable

currency impact, at then-prevailing exchange rates, of approximately \$0.08 per share for the full-year 2017, as well as the tax item of \$0.04 recorded in the first quarter, the forecast range represents a projected increase of approximately 9% to

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12% versus adjusted diluted earnings per share of \$4.48 in 2016. This forecast assumes net revenue growth, excluding excise taxes, in excess of our current annual growth target range of 4% to 6%, excluding currency and acquisitions. This forecast does not include any share repurchases in 2017.

Our 2016 reported and adjusted diluted EPS was \$4.48. During 2016, we did not have an EPS impact related to asset impairment and exit costs, and discrete tax items.

Adjusted diluted EPS is not a measure under 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 2017 guidance excludes the impact of any 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

Consolidated Operating Results

See pages 66-70 for a discussion of our "Cautionary Factors That May Affect Future Results." Our net revenues, excise taxes on products and operating companies income by segment are shown in the table below:

(in millions)	For the Three Months Ended March 31,	
	2017	2016
Net revenues:		
European Union	\$ 5,889	\$ 6,143
Eastern Europe, Middle East & Africa	3,695	3,997
Asia	4,838	4,689
Latin America & Canada	2,134	1,959
Net revenues	\$ 16,556	\$ 16,788
Excise taxes on products:		
European Union	\$ 4,149	\$ 4,280
Eastern Europe, Middle East & Africa	2,218	2,395
Asia	2,597	2,721
Latin America & Canada	1,528	1,309
Excise taxes on products	\$ 10,492	\$ 10,705
Operating income:		
Operating companies income:		
European Union	\$ 772	\$ 906
Eastern Europe, Middle East & Africa	690	633
Asia	852	778
Latin America & Canada	177	229
Amortization of intangibles	(22)	(18)
General corporate expenses	(51)	(46)
Less:		
Equity (income) loss in unconsolidated subsidiaries, net	(22)	(9)
Operating income	\$ 2,396	\$ 2,473



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As discussed in Note 7. *Segment Reporting* to our condensed 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.

Our shipment volume by segment for cigarettes and heated tobacco units is shown in the table below:

## PMI Shipment Volume (Million Units)

	For the Three Months Ended March 31,	
	2017	2016
<b>Cigarettes</b>		
European Union	42,540	45,993
Eastern Europe, Middle East & Africa	56,574	63,126
Asia	55,142	65,222
Latin America & Canada	19,296	21,700
<b>Total Cigarettes</b>	<b>173,552</b>	<b>196,041</b>
<b>Heated Tobacco Units</b>		
European Union	184	16
Eastern Europe, Middle East & Africa	105	2
Asia	4,145	435
Latin America & Canada	1	
<b>Total Heated Tobacco Units</b>	<b>4,435</b>	<b>453</b>
<b>Cigarettes and Heated Tobacco Units</b>		
European Union	42,724	46,009
Eastern Europe, Middle East & Africa	56,679	63,128
Asia	59,287	65,657
Latin America & Canada	19,297	21,700
<b>Total Cigarettes and Heated Tobacco Units</b>	<b>177,987</b>	<b>196,494</b>

Heated tobacco units is the term we use to refer to our heat-not-burn consumables, which include *HEETS*, *HEETS Marlboro* and *HEETS FROM MARLBORO*, defined collectively as *HEETS*, as well as *Marlboro HeatSticks* and *Parliament HeatSticks*.

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Our net revenues by product category, which include excise taxes billed to customers, are shown in the table below:

PMI Net Revenues by Product Category

(in millions)	For the Three Months Ended March 31,	
	2017	2016
<b>Combustible Products</b>		
European Union	\$ 5,852	\$ 6,134
Eastern Europe, Middle East & Africa	3,687	3,998
Asia	4,442	4,642
Latin America & Canada	2,134	1,958
<b>Total Combustible Products</b>	<b>\$ 16,116</b>	<b>\$ 16,732</b>
<b>Reduced-Risk Products</b>		
European Union	\$ 36	\$ 9
Eastern Europe, Middle East & Africa	8	(1)
Asia	396	47
Latin America & Canada		1
<b>Total Reduced-Risk Products</b>	<b>\$ 440</b>	<b>\$ 56</b>
<b>Total PMI Net Revenues</b>	<b>\$ 16,556</b>	<b>\$ 16,788</b>

Note: Sum of product categories or Regions might not foot to total PMI due to rounding.

Net revenues related to combustible products refer to the operating revenues generated from the sale of these products, net of sales and promotion incentives. These net revenue amounts consist of the sale of our cigarettes and other tobacco products combined. Other tobacco products primarily include roll-your-own and make-your-own cigarettes, pipe tobacco, cigars and cigarillos and do not include reduced-risk products.

Net revenues related to reduced-risk products refer to the operating revenues generated from the sale of these products, net of sales and promotion incentives. These net revenue amounts consist of the sale of our heated tobacco units, *IQOS* devices and related accessories, and other nicotine-containing products, which primarily include our e-vapor products.

References to total international market, defined as worldwide cigarette and our heated tobacco unit volume excluding the United States, total industry, total market and market shares throughout this "Discussion and Analysis" are our tax-paid estimates based on the latest available data from a number of internal and external sources.

*Consolidated Operating Results for the Three Months Ended March 31, 2017*

The following discussion compares our consolidated operating results for the three months ended March 31, 2017, with the three months ended March 31, 2016.

Our total shipment volume for cigarettes and heated tobacco units decreased by 94%, or by 7.8% excluding net estimated inventory movements, reflecting a challenging comparison with the first quarter of 2016, which declined by a more modest 1.1%, as well as ongoing declines of primarily low-price volumes in specific markets, such as Pakistan and the Philippines. The first quarter of 2016 also benefited from the favorable estimated impact of the leap year.

Our cigarette volume decreased by 11.5% due to:

- European Union, principally Italy and Spain, partly offset by Poland;
- EEMA, mainly North Africa, primarily Egypt and Tunisia, as well as Russia and Ukraine;
- Asia, principally Indonesia, Japan, Korea, Pakistan and the Philippines; and
- Latin America & Canada, principally Argentina, Canada and Mexico.



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Our cigarette shipment volume by brand and heated tobacco unit shipment volume are shown in the table below:

PMI Shipment volume by Brand <Million Units>

	<u>2017</u>	First-Quarter 2016	Change
Cigarettes			
<i>Marlboro</i>	62,399	67,985	(8.2)%
<i>L&amp;M</i>	21,913	23,690	(7.5)%
<i>Chesterfield</i>	11,544	10,176	134 %
<i>Parliament</i>	9,199	10,137	(9.3)%
<i>Bond Street</i>	8,485	9,721	(12.7)%
<i>Philip Morris</i>	10,608	9,209	152 %
<i>lark</i>	6,526	6,501	0.4 %
Others	42,878	58,622	(26.9)%
Total Cigarettes	173,552	196,041	(11.5)%
Heated Tobacco Units	4,435	453	+100%
Total Cigarettes and Heated Tobacco Units	177,987	196,494	(9.4)%

Cigarette shipment volume of *Marlboro* decreased in: the European Union, mainly due to Italy and Spain; EEMA, mainly due to Saudi Arabia and Tunisia, partly offset by Algeria; Asia, mainly due to Japan, principally reflecting out-switching to *Marlboro HeatSticks*; and Latin America & Canada, mainly due to Argentina and Mexico.

Cigarette shipment volume of *L&M* decreased, mainly due to Egypt, as well as Russia, Turkey and Ukraine, partly offset by Kazakhstan and Saudi Arabia.

Cigarette shipment volume of *Chesterfield* increased, mainly driven by Argentina and Turkey, partly offset by Italy and Russia. Cigarette shipment volume of *Parliament* decreased, mainly due to Russia. Cigarette shipment volume of *Bond Street* decreased, mainly due to Russia and Ukraine. Cigarette shipment volume of *Philip Morris* increased, driven by Russia and Ukraine, partly offset by Argentina and Italy. Cigarette shipment volume of *lark* increased, principally driven by Japan and Korea, partly offset by Turkey. Cigarette shipment volume of "Others" decreased, mainly due to local, low-margin brands in Pakistan, the Philippines, Russia and Ukraine.

The decline in our cigarette shipment volume was partly offset by higher heated tobacco unit shipment volume of 4.4 billion units, up from 453 million units in the first quarter of 2016, driven by Japan.

Our market share increased in a number of markets, including Algeria, Belgium, France, Germany, Hong Kong, Japan, Kazakhstan, Kuwait, Poland, Saudi Arabia, Switzerland and the United Arab Emirates.

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

(in millions)	For the Three Months Ended March 31,			
	2017	2016	Variance	%
Net revenues	\$ 16,556	\$ 16,788	\$ (232)	(1.4)%
Excise taxes on products	10,492	10,705	(213)	(2.0)%
Net revenues, excluding excise taxes on products	\$ 6,064	\$ 6,083	\$ (19)	(0.3)%

Net revenues, which include excise taxes billed to customers, decreased by \$232 million. Excluding excise taxes, net revenues decreased by \$19 million due to:



- unfavorable volume/mix (\$307 million) and
- unfavorable currency (\$120 million), partly offset by

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- price increases (\$408 million).

The unfavorable currency was due primarily to the Egyptian pound, Euro and Turkish lira, partially offset by the Japanese yen and Russian ruble.

Net revenues include \$440 million in 2017 and \$56 million in 2016 related to sale of RRP's, mainly driven by Japan. These amounts include excise taxes billed to customers. Excluding excise taxes, net revenues for RRP's were \$435 million in 2017 and \$55 million in 2016. In some jurisdictions, including Japan, we are not responsible for collecting excise taxes.

Excise taxes on products decreased by \$213 million due to:

- lower excise taxes resulting from volume/mix (\$881 million) and
- favorable currency (\$666 million), partly offset by
- higher excise taxes resulting from changes in retail prices and tax rates (\$1.3 billion).

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

(in millions)	For the Three Months Ended March 31,		Variance	%
	2017	2016		
Cost of sales	\$ 2,177	\$ 2,096	\$ 81	3.9%
Marketing, administration and research costs	1,469	1,496	(27)	(1.8)%
Operating income	2,396	2,473	(77)	(3.1)%

Cost of sales increased by \$81 million due to:

- higher cost of sales resulting from volume/mix (\$68 million) and
- higher manufacturing costs (\$36 million), partly offset by
- favorable currency (\$23 million).

Marketing, administration and research costs decreased by \$27 million due to:

- favorable currency (\$86 million), partly offset by
- higher expenses (\$59 million, largely reflecting increased support behind reduced-risk products).

Operating income decreased by \$77 million due primarily to:

- unfavorable volume/mix (\$375 million),
- higher marketing, administration and research costs (\$59 million),
- higher manufacturing costs (\$36 million) and
- unfavorable currency (\$11 million), partly offset by
- price increases (\$408 million).

Our effective tax rate decreased by 3.4 percentage points to 24.9%. We estimate that our full-year 2017 effective tax rate will be approximately 28%. The effective tax rate for the three months ended March 31, 2017, was favorably impacted by a legal entity restructuring (\$61 million). The effective tax rate is based on our full-year earnings mix by taxing jurisdiction and cash repatriation plans. Changes in currency exchange rates, earnings mix by taxing jurisdiction, or 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.

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



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unrecognized tax benefits along with related interest and penalties. An estimate of any possible change cannot be made at this time.

Interest expense, net, of \$219 million decreased by \$28 million (11.3%), due primarily to lower effective interest rates on debt and higher interest income.

Net earnings attributable to PMI of \$1.6 billion increased by \$60 million (3.9%). This increase was primarily due to a lower effective tax rate and lower interest expense, net, partially offset by lower operating income as discussed above. Diluted and basic EPS of \$1.02 increased by 4.1%.

Operating Results by Business


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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:

- regulatory restrictions on our products, including restrictions on the packaging, marketing, and sale of tobacco or other nicotine-containing products that could reduce our competitiveness, eliminate our ability to communicate with adult smokers, or even ban certain of our products;
- fiscal challenges, such as excise tax increases and discriminatory tax structures;
- 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 certain local manufacturers;
- pending and threatened litigation as discussed in Note 8. *Contingencies*; and
- governmental investigations.

Regulatory Restrictions. The tobacco industry operates in a highly regulated environment. The well-known risks of smoking have led regulators to impose significant restrictions and high excise taxes on cigarettes.

We support a comprehensive regulatory framework for tobacco products based on the principle of harm reduction, including mandated health warnings, minimum age laws, restrictions on advertising, and public place smoking restrictions. We also support regulatory measures that help reduce illicit trade.

Much of the regulation that shapes the business environment in which we operate is driven by the World Health Organization's ("WHO") Framework Convention on Tobacco Control ("FCTC"), which entered into force in 2005. The FCTC is the first international public health treaty and has as its main objective to establish a global agenda for tobacco regulation, with the purpose of reducing tobacco use. To date, 179 countries and the European Union are Parties to the FCTC. The treaty requires Parties to have in place various tobacco control measures and recommends others. The FCTC governing body, the Conference of the Parties ("CoP"), has also adopted non-binding guidelines and policy recommendations related to certain articles of the FCTC that go beyond the text of the treaty.

We have opposed certain measures and continue to engage in a dialogue with regulators with respect to those measures that we do not believe would protect public health and, if implemented, could disrupt competition, severely limit our ability to market and sell our products to adult smokers, or increase illicit trade. Certain measures are discussed in more detail below. It is not possible to predict whether or to what extent measures recommended in the FCTC guidelines will be implemented.

Fiscal Challenges. Excessive and disruptive excise, sales and other tax increases and discriminatory tax structures are expected to continue to have an adverse impact on our profitability, due to lower consumption and consumer down-trading to non-premium, discount, other low-price or low-taxed combustible tobacco products such as fine cut tobacco and illicit cigarettes. In addition, in certain jurisdictions, some of our combustible products are subject to tax structures that discriminate against premium-price products and manufactured cigarettes. We believe that such tax policies undermine public health by encouraging consumers to turn to the

illicit trade, and ultimately undercut government revenue objectives, disrupt the competitive environment, and encourage



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criminal activity. Other jurisdictions have imposed, or are seeking to impose, levies or other taxes specifically on tobacco companies, such as taxes on revenues and/or profits.

**EU Tobacco Products Directive:** In April 2014, the EU adopted the text of a significantly revised EU Tobacco Products Directive (TPD), which entered into force in May 2016. To date, 25 Member States and Norway have adopted laws transposing the TPD, while the remaining ones are concluding the national transposition. The TPD sets forth a comprehensive set of regulatory requirements for tobacco products, including:

- health warnings covering 65% of the front and back panels of cigarette packs, with an option for Member States to further standardize tobacco packaging, including the introduction of plain packaging;
- ban on characterizing flavors in some tobacco products, with a transition period for menthol expiring in May 2020;
- security features and tracking and tracing measures some of which could increase operational expenses depending on the scope of the implementing regulation; and
- a framework for the regulation of novel tobacco products and e-cigarettes, including requirements for health warnings and information leaflets, a prohibition on product packaging text related to reduced risk, and the introduction of notification requirements or authorization procedures in advance of commercialization.

***Plain Packaging and Other Packaging Restrictions:*** Plain packaging legislation bans the use of branding, logos and colors on packaging other than the brand name and variant that may be printed only in specified locations and in a uniform font. To date, Australia, France, Hungary, Ireland, New Zealand, Norway, Slovenia and the U.K., have adopted plain packaging legislation. In Australia, plain packaging has been implemented since December 2012. In France, plain packaging has been fully implemented since January 2017, and in the U.K., full compliance is required as of May 2017. In Hungary, full compliance is required immediately for new product launches and no later than May 2019 for other products. In Ireland, the law will go into effect in September 2017, and in Slovenia, full compliance is required as of January 2020. No implementation date has yet been set in New Zealand or Norway.

Several countries have initiated World Trade Organization ("WTO") dispute settlement proceedings against Australia related to Australia's plain packaging legislation. The matter is still pending before the WTO panel.

Other countries are also considering adopting plain packaging legislation, including, but not limited to, Canada, Turkey, Singapore and South Africa.

Some countries have adopted, or are considering adopting, packaging restrictions that could have an impact similar to plain packaging. Examples of such restrictions include standardizing the shape and size of packages, prohibiting certain colors or the use of certain descriptive phrases on packaging, and requiring very large graphic health warnings that leave little space for branding.

***Restrictions and Bans on the Use of Ingredients:*** The WHO and others in the public health community have recommended restrictions or total bans on the use of some or all ingredients in tobacco products, including menthol. Broad restrictions and ingredient bans 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 category of mentholated tobacco products. The European Union has banned flavored tobacco products, subject to an exemption until May 2020 for menthol. Other countries may follow the EU's approach. For instance, Turkey has banned menthol as of May 2020. More sweeping ingredient bans have been adopted by Canada and Brazil. While the Canadian ingredient ban currently exempts menthol at the national level, the majority of Canadian provinces have adopted or are in the process of adopting menthol bans. The Canadian federal government also recently published draft regulations that would prohibit menthol in cigarettes. The Brazil ingredients ban, which 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. Other lawsuits are also pending against the Brazil ingredients ban. It is not possible to predict the outcome of these legal proceedings.

***Bans on Display of Tobacco Products at Retail:*** In a number of our markets, including, but not limited to, Australia, Canada, Norway, Russia, and Singapore, governments have banned the display of tobacco products at the point of sale. Other countries are also considering similar bans.

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*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's non-binding guidelines recommend that governments prohibit all forms of communication with adult smokers.

*Restrictions on Product Design:* Some members of the public health community are calling for the further standardization of tobacco products by requiring, for example, that cigarettes have a certain minimum diameter, which would amount to a ban on slim cigarettes, or requiring the use of standardized filter and cigarette paper designs. In addition, at its meeting in November 2016, the CoP adopted non-binding guidelines recommending that countries regulate product design features that increase the attractiveness of tobacco products, such as the diameter of cigarettes and the use of flavor capsules. Reduced cigarette ignition propensity ("RCIP") standards previously recommended by the FCTC guidelines have been adopted in several of our markets (e.g., Australia, Canada, South Africa, South Korea, and the EU), and are being considered in others.

*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 countries, 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.

*Other Regulatory Issues:* Some regulators are considering, or in some cases have adopted, regulatory measures designed to reduce the supply of tobacco products. These include regulations intended to reduce the number of retailers selling tobacco products by, for example, reducing the overall number of tobacco retail licenses available or banning the sale of tobacco products within arbitrary distances of certain public facilities.

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

*Illicit Trade:* The illicit tobacco trade creates a cheap and unregulated supply of tobacco products, undermines efforts to reduce smoking, especially among youth, damages legitimate businesses, stimulates organized crime, increases corruption and reduces government 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 cigarettes legally produced in one jurisdiction for the sole purpose of being exported and illegally sold in another jurisdiction where they have no legitimate market. We estimate that illicit trade in the European Union accounted for slightly less than 10% of total cigarette consumption in 2016.

A number of jurisdictions are considering actions to prevent illicit trade. In November 2012, the FCTC 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. To date, 54 Parties have signed the Protocol, and 26 Parties, including the European Union, have ratified it. The Protocol will come into force once the fortieth country ratifies it, after which countries must implement its measures via national legislation. We expect, and welcome, that other Parties will ratify the Protocol.

In 2009, our Colombian subsidiaries entered into an Investment and Cooperation Agreement with the national and regional governments of Colombia 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 May 2016, PMI launched PMI IMPACT, a new global initiative that supports third-party projects dedicated to fighting illegal trade and related crimes such as corruption, organized criminal networks and money laundering. The centerpiece of PMI IMPACT is a council of external independent experts with impeccable credentials in the fields of law, anti-corruption and law enforcement. The experts are responsible for evaluating and approving funding proposals for PMI IMPACT grants. PMI has pledged \$100 million to fund projects within PMI IMPACT during a three-year period. We expect that the first round of grants will be awarded in the second quarter of 2017.

In November 2016, PMI signed a joint Declaration of Intent to Prevent the Maritime Transportation of Counterfeit Goods together with eight other global brand owners and five of the world's largest shipping companies. This commitment was a result of a dialogue with the International Chamber of Commerce's Business Action to Stop Counterfeiting and Piracy. The signatories aim to tackle the infiltration of shipping services by criminal networks that exploit vessels to transport counterfeit goods, including "illicit whites," across the oceans.





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*Reduced-Risk Products*

*Our All-Proach to RRPs:* We recognize that smoking cigarettes causes serious diseases and that the best way to avoid the bans of smoking is never to start, or to quit. Nevertheless, it is predicted that over the next decade the number of smokers will remain largely unchanged from the current estimate of 1.1 billion, despite the considerable efforts to discourage smoking.

Cigarettes burn tobacco, which produces smoke. As a result of the combustion process, the smoker inhales various toxic substances. In contrast, RRPs do not burn tobacco and produce significantly lower levels of harmful or potentially harmful constituents ("HPHCs") than found in cigarette smoke.

For smokers who would otherwise continue to smoke, we believe that RRPs offer a much better choice. Accordingly, our key strategic priorities are: to develop and commercialize products that present less risk of harm to adult smokers who switch to those products versus continued smoking; and to convince current adult smokers who would otherwise continue to smoke to switch to those products.

We recognize that this transition from cigarettes to RRPs will take time and that the speed of transition will depend in part upon factors beyond our control, such as the willingness of governments, regulators and other policy groups to embrace RRPs as a desired alternative to continued cigarette smoking. We also recognize that our part in this transition must be funded from our existing cigarette business. For as long as a significant number of adult smokers continues to smoke, it is critical that the industry be led by responsible and ethical manufacturers. Therefore, during the transformation, we intend to remain the leading international cigarette manufacturer.

We have a range of RRPs in various stages of development, scientific assessment and commercialization. We conduct rigorous scientific assessments of our RRP platforms to substantiate that they reduce exposure to HPHCs and, ultimately, that these products present, are likely to present, or have the potential to present less risk of harm to adult smokers who switch to them versus continued smoking. We draw upon a team of expert scientists and engineers from a broad spectrum of scientific disciplines and our extensive learnings of adult consumer preferences to develop and assess our RRPs. Our efforts are guided by the following key objectives:

- to develop RRPs that adult smokers who would otherwise continue to smoke find to be satisfying alternatives to smoking;
- for those adult smokers, our goal is to offer RRPs with a scientifically substantiated risk-reduction profile that approaches as closely as possible that associated with smoking cessation;
- to substantiate the reduction of risk for the individual adult smoker and the reduction of harm to the population as a whole, based on scientific evidence of the highest standard that is made available for scrutiny and review by external independent scientists and relevant regulatory bodies; and
- to advocate for the development of science-based regulatory frameworks for the development and commercialization of RRPs, including the communication of scientifically substantiated information to enable adult consumers to make better health choices.

*Our RRP Platforms:* 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 providing a better choice for those who would otherwise continue to smoke. We recognize that no single product will appeal to all adult smokers. Therefore, we are developing a portfolio of products intended to appeal to a variety of distinct adult consumer preferences.

Four RRP platforms are in various stages of development and commercialization readiness:

*Platform 1* uses a precisely controlled heating device that we are commercializing under the *IQOS* brand name, into which a specially designed and proprietary tobacco unit is inserted and heated to generate an aerosol (collectively referred to as heated tobacco units). Eight clinical studies have been completed (including two with an exposure period of three months). The study results show a substantial reduction in relevant biomarkers of exposure to HPHCs in those adult smokers who switched completely to *IQOS* compared to those who continued to smoke cigarettes for the duration of the study. These reductions approached those that were observed in study participants who quit smoking for the duration of the study. While these reduced exposure clinical studies were primarily designed to focus on biomarkers of exposure, we also measured six clinical risk markers. These clinical risk markers are associated with disease mechanisms known to be affected by smoking and to reverse upon cessation. The results are generally consistent with the expected direction of change that is observed upon quitting and indicate that switching completely to *IQOS* led to an overall improvement of clinical risk markers affected by smoking after only three months. We also initiated a 6+6 month

exposure response study in December 2014 and expect the results regarding the first six-month term in the third quarter of 2017. To further improve the consumer experience, we introduced a new version of *IQOS* in the first quarter of 2017.

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*Platform 2* uses a pressed carbon heat source, which when ignited, generates an aerosol by heating tobacco. A pharmacokinetic study and a five-day reduced-exposure study with *Platform 2* have now been completed. In the pharmacokinetic study, we observed that the nicotine pharmacokinetic profile and the subjective effects are comparable to smoking cigarettes, indicating that this platform could be an acceptable substitute for adult smokers who want to continue to use tobacco products but seek an alternative to cigarettes. The results of the reduced exposure study show a substantial reduction in relevant biomarkers of exposure to HPHCs in those who switched completely to *Platform 2* compared to those who continued to smoke cigarettes over a five-day period. The clinical phase of a three-month reduced-exposure study has also been completed, and we expect the results to be available by the end of 2017.

*Platform 3* creates an aerosol of nicotine salt formed by the chemical reaction of nicotine with a weak organic acid. We are exploring two routes for this platform, one with electronics and one without. We have begun pre-clinical and clinical testing of this platform, and have completed a pharmacokinetic study in New Zealand for the electronic version. The study assessed the nicotine pharmacokinetic profile in comparison to a nicotine inhalator. The study showed that nicotine absorption with this product reached peak levels six times faster than with the inhalator. This is in line with the nicotine pharmacokinetic profile of a cigarette, suggesting a significantly higher potential for acceptance by adult smokers. We have also completed the clinical phase of a pharmacodynamics study in the U.S. and expect final results in the first half of 2017. We expect to commence a safety and efficacy study in the first half of 2017.

*Platform 4* covers e-vapor products, which are battery-powered devices that produce an aerosol by vaporizing a nicotine-containing liquid solution. Our e-vapor products comprise devices using current generation technology, and we are well advanced in the development and commercialization of our new e-vapor mesh technology that addresses certain challenges presented by some e-vapor products currently on the market. Our *MESH* products are designed to ensure the consistency and quality of the generated aerosol. We have commenced non-clinical studies, and our planned clinical assessment includes a pharmacokinetic study scheduled to start in 2017 and a reduced-exposure study that we expect to start in 2018.

We are also developing other potential product platforms.

Commercialization of RRP's. In 2014, we introduced the *IQOS* system in pilot city launches in Nagoya, Japan, and in Milan, Italy. Since then, we have expanded our commercialization activities to include all of Japan, as well as multiple cities in Italy. To-date, *IQOS* is available for sale nationwide in Japan and in key cities – in a total of 24 markets, and approximately 18 million adult consumers have stopped smoking and converted to *IQOS*. We expect to expand *IQOS* nationally in many of these markets in 2017 as capacity for heated tobacco units increases. By the end of 2017, we expect *IQOS* to be in 30 to 35 key cities or nationwide as capacity permits.

On the basis of our experience in Japan and Italy, we estimate that only a very small percentage of adult smokers who convert to *IQOS* switch back to cigarettes.

In the first quarter of 2016, we started the large scale commercial production of heated tobacco units. To date, we have experienced supply shortages resulting from stronger-than-anticipated demand, primarily in Japan, and expect capacity limitations to ease as 2017 unfolds. Our 2016 year-end installed capacity was approximately 15 billion heated tobacco units, and we expect that our 2017 year-end installed capacity will reach approximately 50 billion units. This installed capacity is expected to allow us to produce approximately 32 billion units in 2017, up from 7 billion in 2016. For 2018, we are expecting to reach installed annual capacity of 100 billion units at year end, translating to approximately 75 billion units in total capacity available for commercialization in 2018.

We are expanding our supplier base for *IQOS* devices. Our *IQOS* devices are subject to product warranties for a period of 12 months from the date of purchase or such other periods as required by law. Warranty claims for these devices have not had a material impact on our consolidated financial position, results of operations or cash flows in any of the periods presented, although they may become more significant as the number of devices sold increases.

We currently market our e-vapor products in several markets, including Ireland, Israel, Spain and the U.K. In November 2016, we began the city test of *MESH*, our Platform 4 product, in Birmingham, U.K. We also expect to conduct market tests of our Platform 2 and Platform 3 products in 2017.

*RRP Relation and Taxation:* RRP's contain nicotine and are not risk-free. We therefore support science-based regulation and taxation of RRP's. Regulation and taxation should differentiate between cigarettes and products that present, are likely to present, or

have the potential to present less risk of harm to adult smokers who switch to these products versus continued smoking. Regulation should provide minimum standards for RRP and specific rules for, among other things, ingredients, labelling and

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consumer communication, and should ensure that the public is informed about the health risks of all tobacco and nicotine-containing products. Regulation, as well as tobacco industry activities, should reflect the fact that youth should not consume nicotine in any form.

Some governments have banned or are seeking to ban or severely restrict emerging tobacco and nicotine-containing products such as our RRP. These regulations might foreclose or unreasonably restrict adult consumer access even to products that might be shown to be a better health choice than continuing to smoke. We oppose such blanket bans and unreasonable restrictions of products that have the potential to present less risk of harm compared to continued smoking. By contrast, we support regulation that sets clear standards and propels innovation to benefit adult smokers.

In the United States, an established regulatory framework for assessing "Modified Risk Tobacco Products" and "New Tobacco Products" exists under the jurisdiction of the Food and Drug Administration (FDA). Future FDA actions may influence the regulatory approach of other interested governments. We submitted to the FDA a Modified Risk Tobacco Product Application for Platform 1 in December 2016, and a Premarket Tobacco Product Application for Platform 1 in March 2017.

In the EU, a majority of Member States have transposed the EU Tobacco Products Directive, including the provisions on Novel Tobacco Products, such as heated tobacco units and e-cigarettes. Most of the EU Member States require a notification submitted six months before the intended placing on the market of a Novel Tobacco Product, while some require pre-market authorizations for the introduction of such products. To date, we have filed a comprehensive dossier summarizing our scientific assessment of Platform 1 in 16 Member States.

There can be no assurance that we will succeed in our efforts to replace cigarettes with RRPs or that regulation will allow us to commercialize RRPs in all markets or treat RRPs differently from combustible tobacco products such as cigarettes.

*Our RRP Business Development Initiatives:* In December 2013, we established a strategic framework with Altria Group, Inc. ("Altria") under which Altria will make available its e-vapor products exclusively to us for commercialization outside the United States, and we will make available two of our RRPs exclusively to Altria for commercialization in the United States. In March 2015, we launched *Solaris*, a Platform 4 e-vapor product licensed from Altria, in Spain. In December 2015, we introduced *Solaris* in Israel.

In July 2015, we extended the strategic framework with Altria to include a Joint Research, Development and Technology Sharing Agreement. The additional agreement provides the framework under which PMI and Altria will collaborate to develop the next generation of e-vapor products for commercialization in the United States by Altria and in markets outside the United States by PMI. The collaboration between PMI and Altria in this endeavor is enabled by exclusive technology cross licenses and technical information sharing. The agreements also provide for cooperation on the scientific assessment of: and for the sharing of improvements to, the existing generation of licensed products.

### *Governmental Investigations*

From time to time, we are subject to governmental investigations on a range of matters. We describe certain matters pending in Thailand and South Korea in Note 8. *Contingencies*.

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 (see Note 8. *Contingencies* for additional information). The WTO panel decision, which was upheld by the WTO Appellate Body, concluded 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 fully comply with the decision by October 2012. The Philippines contends that to date Thailand has not fully complied and commenced formal proceedings at the WTO to address the outstanding issues. The Philippines has repeatedly expressed concerns with ongoing investigations by Thailand of PM Thailand, including those that led to the criminal charges described in Note 8. *Contingencies*, 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.

### *Investments in Unconsolidated Subsidiaries*

We discuss our investments in unconsolidated subsidiaries in Note 14. *Investments in Unconsolidated Subsidiaries* to our condensed consolidated financial statements.



[Table of Contents](#)*Trade Policy*

We are subject to various trade restrictions imposed by the United States of America 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 and the U.S. Department of State. It is our policy to comply fully 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, either where such sanctions do not apply to our business or pursuant to exemptions or licenses.

To our knowledge, none of our commercial arrangements results 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.

Currently, we do not sell products in Iran, Sudan, North Korea, Cuba and Syria. We are exploring opportunities to sell our products in Cuba, as permitted by law.

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.

**Operating Results- For the Three Months Ended March 31, 2017**

The following discussion compares operating results within each of our reportable segments for the three months ended March 31, 2017, with the three months ended March 31, 2016.

Unless otherwise stated, references to total industry, total market, our shipment volume and our market share performance reflect cigarettes and our heated tobacco units for those markets that have commercial sales of *IQOS*.

**European Union:**

European Union (in millions)	For the Three Months Ended March 31,		Variance	%
	2017	2016		
Net revenues	\$ 5,889	\$ 6,143	\$ (254)	(4.1)%
Excise taxes on products	4,149	4,280	(131)	(3.1)%
Net revenues, excluding excise taxes on products	1,740	1,863	(123)	(6.6)%
Operating companies income	772	906	(134)	(14.8)%

For the three months ended March 31, 2017, net revenues decreased by \$254 million. Excluding excise taxes, net revenues decreased by \$123 million due to:

- unfavorable volume/mix (\$115 million) and
- unfavorable currency (\$55 million), partly offset by price increases (\$47 million).

The net revenues of the European Union segment include \$36 million in 2017 and \$9 million in 2016 related to the sale of RRP's. Excluding excise taxes, net revenues for RRP's were \$31 million in 2017 and \$9 million in 2016.

Operating companies income decreased by \$134 million during the three months ended March 31, 2017. This decrease was due primarily to:

- unfavorable volume/mix (\$109 million),
- higher marketing, administration and research costs (\$41 million, primarily related to increased investment behind reduced-



risk products) and

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- unfavorable currency (\$28 million), partially offset by
- price increases (\$47 million).

*European Union - Total Market*

The estimated total market in the European Union decreased by 2.8% to 112.1 billion units, partly reflecting a challenging comparison to the first quarter of 2016, which increased by 0.8%, benefiting from a lower prevalence of illicit trade and e-vapor products and, in certain geographies, the estimated favorable impact of immigration. The decline of the estimated total market also reflected the impact of price increases and the implementation of elements of the Tobacco Products Directive, notably in Italy and the United Kingdom. The net impact of inventory movements on the estimated total market was immaterial.

*European Union - PMI Shipment Volume and Market Share Commentaries*

Shipment volume and market share performance by brand for cigarettes and heated tobacco units are shown in the tables below:

**European Union PMI Shipment Volume <Million Units****First-Quarter**

			Change
Cigarettes	42,540	45,993	(7.5)%
Heated Tobacco Units	184	16	+100%
Total European Union	42,724	46,009	(7.1)%

**European Union Shipment Volume by Brand (Million Units)****First-Quarter**

Cigarettes:	2017	2016	Change
<i>Marlboro</i>	20,924	22,700	(7.8)%
<i>L&amp;M</i>	7,933	8,188	(3.1)%
<i>Chesterfield</i>	6,496	7,148	(9.1)%
<i>Philip Morris</i>	3,696	4,054	(8.8)%
Others	3,491	3,903	(10.6)%
Total Cigarettes	42,540	45,993	(7.5)%
Heated Tobacco Units	184	16	+100%
Total European Union	42,724	46,009	(7.1)%

**European Union Market Shares by Brand****First-Quarter**

	2017	2016	Change
<i>Marlboro</i>	18.8%	19.0%	(0.2)
<i>L&amp;M</i>	7.0%	6.9%	0.1
<i>Chesterfield</i>	6.1%	5.9%	0.2
<i>Philip Morris</i>	3.2%	3.3%	(0.1)
Others*	3.4%	3.5%	(0.1)
Total European Union	38.5%	38.6%	(0.1)

*\*Includes heated tobacco units.*

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Our total shipment volume decreased by 7.1% to 42.7 billion units, mainly due to cigarette volume declines in Italy and Spain, partly offset by Poland. Excluding estimated inventory movements, principally associated with distributor cigarette inventory movements in Italy and Spain, our total shipment volume decreased by 2.9%. The decrease in cigarette shipment volume of *Marlboro* was mainly due to Italy and Spain. The decrease in cigarette shipment volume of *L&M* was mainly due to Romania and Spain. The decrease in cigarette shipment volume of *Chesterfield* was mainly due to Italy and Spain, partly offset by Poland and the United Kingdom. The decrease in cigarette shipment volume of *Philip Morris* was mainly due to Italy. The decrease in cigarette shipment volume of "Others" was mainly due to *Merit* and *Muratti* in Italy.

Our total market share decreased by 0.1 point to 38.5%, with declines, mainly in Italy and Spain, partly offset by gains, notably in France, Germany and Poland.

*European Union - Key Market Commentaries*

In France, estimated industry size, our shipment volume and market share performance, shown in the table below, include cigarettes and our heated tobacco units.

	France Key Market Data		
	1Q11	First-Quarter	
		2Q11	Change %/DJ11
Total Market (billion units)	10.8	10.7	1.4%
PMI Shipments (million units)	4,726	4,779	(1.1)%
PMI Market Share			
<i>Marlboro</i>	26.6%	26.1%	0.5
<i>Philip Morris</i>	10.3%	10.1%	0.2
<i>Chesterfield</i>	3.1%	3.1%	
Others*	2.8%	2.8%	
Total	42.8o/o	42.1o/o	0.7

\*Includes heated tobacco units (in MOI Co).

The estimated total market increased by 14%. Excluding net estimated distributor cigarette inventory movements largely associated with the implementation of the Tobacco Products Directive at the beginning of 2016, our shipment volume increased by 2.8%, reflecting the higher total market, as well as higher market share.

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In Germany, estimated industry size, our shipment volume and market share performance, shown in the table below, include cigarettes and our heated tobacco units.

	Germany Key Market Data		
	First-Quarter		Change % 1DJ11
		IV.11	
Total Market (billion units)	175	17.8	(2.2)%
PMI Shipments (million units)	6,662	6,767	(1.6)%
<b>PMI Market Share</b>			
<i>Marlboro</i>	23.4%	22.9%	0.5
<i>L&amp;M</i>	11.7%	11.8%	(0.1)
<i>Chesterfield</i>	1.6%	1.6%	
Others*	1.5%	1.6%	(0.1)
<b>Total</b>	<b>38.1o/o</b>	<b>37.9o/o</b>	<b>0.3</b>

\*Includes heated tobacco units.

The estimated total market decreased by 2.2%, partly reflecting the lapsed contribution of filterable filters in 2016, including a lower prevalence of illicit trade. The decrease in our shipment volume was mainly due to the lower total market. The increase in our market share was driven by *Marlboro*.

In Italy, estimated industry size, our shipment volume and market share performance, shown in the table below, include cigarettes and our heated tobacco units.

	Italy Key Market Data		
	First-Quarter		Change % 1or11.
		IV.11	
Total Market (billion units)	162	17.1	(5.2)%
PMI Shipments (million units)	7,801	9,853	(20.8)%
<b>PMI Market Share</b>			
<i>Marlboro</i>	23.5%	24.4%	(0.9)
<i>Chesterfield</i>	11.3%	11.6%	(0.3)
<i>Philip Morris</i>	7.9%	9.0%	(1.1)
<i>HEEIS</i>	0.5%	-%	0.5
Others	8.5%	8.5%	
<b>Total</b>	<b>51.7o/o</b>	<b>53.5o/o</b>	<b>(1.8)</b>

The estimated total market decreased by 5.2%, or by 6.5% excluding the net impact of trade inventory movements, mainly due to the implementation of elements of the Tobacco Products Directive, notably the ban on pack sizes of ten cigarettes, which fueled growth in cheaper alternatives such as fine cut, cigarillos, e-vapor and illicit products. The decline of the total market also reflected a challenging comparison with the first quarter of 2016, which grew by 3.9%. The decline of our shipments, down by 7.9% excluding the net impact of distributor inventory movements, mainly reflected the lower total market, as well as lower cigarette market share, notably due to: *Marlboro*, as a result of its price increase in the second quarter of 2016, the ban on pack sizes of ten cigarettes, and out-switching to *HEEIS*; and low-price *Philip Morris*, impacted by the growth of the super-low price segment.



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In Poland, estimated cigarette industry size, our cigarette shipment volume and cigarette market share performance are shown in the table below.

	Poland Key Market Data		
	First-Quarter		Change %/ P.P.
	2017	2016	
Total Cigarette Market (billion units)	102	101	1.5%
PMI Cigarette Shipments (million units)	4,302	4,145	3.8%
PMI Cigarette Market Share			
<i>Marlboro</i>	102%	11.2%	(LO)
<i>L&amp;M</i>	18.8%	18.5%	0.3
<i>Chesterfield</i>	9.9%	8.6%	1.3
Others	3.2%	2.9%	0.3
Total	42.1%	41.2%	0.9

The estimated total cigarette market increased by 1.5%, despite a challenging comparison with the first quarter of 2016, which grew by 3.1%. The increase in our cigarette shipment volume primarily reflected the higher total cigarette market, as well as higher cigarette market share, mainly reflecting higher share of *Chesterfield*, driven by brand support, partly offset by *Marlboro*, unfavorably impacted by the estimated trade inventory movements.

In Spain, estimated industry size, our shipment volume and market share performance, shown in the table below, include cigarettes and our heated tobacco units.

	Spain Key Market Data		
	First-Quarter		Change %/ g.g.
	2017	2016	
Total Market (billion units)	9.9	10.4	(4.7)%
PMI Shipments (million units)	3,185	4,022	(20.8)%
PMI Market Share			
<i>Marlboro</i>	16.2%	17.7%	(1.5)
<i>L&amp;M</i>	5.5%	5.6%	(0.1)
<i>Chesterfield</i>	8.7%	8.9%	(0.2)
Others	1.8%	1.9%	(0.1)
Total	32.2%	34.1%	(1.9)

\*includes heated tobacco units.

The estimated total market decreased by 4.7%, or by 0.3% excluding the impact of estimated inventory reductions following increases ahead of retail price increases in December 2016. The decline of our shipments, down by 8.8% excluding the net impact of distributor inventory movements, mainly associated with the replenishment in the first quarter of 2016 of low inventory levels at the end of 2015, was mainly due to the lower total market and lower market share, principally due to *Marlboro*, reflecting the impact of price increases, particularly past the round €5.00 per pack price point in the vending channel, as well as a challenging comparison with the first quarter of 2016 in which the market share of *Marlboro* grew by 16 points.





[Table of Contents](#)Eastern Europe, Middle East & Africa:

Eastern Europe, Middle East & Africa (in million\$)	For the Three Months Ended March 31,		Variance	%
	2017	2016		
Net revenues	\$ 3,695	\$ 3,997	\$ (302)	(7.6)%
Excise taxes on products	2,218	2,395	(177)	(7.4)%
Net revenues, excluding excise taxes on products	1,477	1,602	(125)	(7.8)%
Operating companies income	690	633	57	9.0%

For the three months ended March 31, 2017, net revenues decreased by \$302 million. Excluding excise taxes, net revenues decreased by \$125 million due to:

- unfavorable volume/mix (\$179 million) and
- unfavorable currency (\$99 million), partly offset by
- price increases (\$153 million).

Operating companies income increased by \$57 million during the three months ended March 31, 2017. This increase was primarily due to:

- price increases (\$153 million) and
- lower marketing, administration and research costs (\$30 million), partly offset by
- unfavorable volume/mix (\$135 million).

*Eastern Europe, Middle East & Africa -PMI Shipment Volume Commentaries*

## EEMA PMI Shipment Volume (Million Units)

First-Quarter

			<b>Change</b>
Cigarettes	56,574	63,126	(10.4)%
Heated Tobacco Units	105	2	+100%
Total EEMA	56,679	63,128	(10.2)o/o

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## EEMA PMI Shipment Volume by Brand &lt;Million Units)

First-Quarter

	2017	2016	Change
Cigarettes			
<i>Marlboro</i>	16,116	17,532	(8.1)%
<i>L&amp;M</i>	11,489	12,865	(10.7)%
<i>Bond Street</i>	8,133	9,250	(12.1)%
<i>Parliament</i>	6,542	7,302	(10.4)%
Others	14,294	16,177	(11.6)%
Total Cigarettes	56,574	63,126	(10.4)o/o
Heated Tobacco Units	105	2	+100%
Total EEMA	56,679	63,128	(10.1)o/o

As shown in the table above, our total shipment volume decreased by 10.2% to 56.7 billion units, mainly due to cigarette volume declines in North Africa, primarily Egypt associated with continuity of supply, Tunisia associated with the timing of shipments, Russia and Ukraine.

The decrease in cigarette shipment volume of *Marlboro* was mainly due to Saudi Arabia and Tunisia, partly offset by Algeria. The decrease in cigarette shipment volume of *L&M* was mainly due to Egypt, Russia, Turkey and Ukraine, partly offset by Kazakhstan and Saudi Arabia. The decrease in cigarette shipment volume of *Bond Street* was mainly due to Russia and Ukraine. The decrease in cigarette shipment volume of *Parliament* was mainly due to Russia. The decrease in cigarette shipment volume of "Others" was mainly due to largely local, lower-margin brands in Russia and Ukraine.

*Eastern Europe, Middle East & Africa -Key Market Commentaries*

In North Africa (defined as Algeria, Egypt, Libya, Morocco and Tunisia), estimated cigarette industry size, our cigarette shipment volume and cigarette market share performance are shown in the table below.

	North Africa Key Market Data		
	First-Quarter		
	2017	2016	Change o/o /p.p.
Total Cigarette Market (billion units)	33.1	34.4	(3.5)%
PMI Cigarette Shipments (million units)	8,780	10,230	(14.2)%
PMI Cigarette Market Share			
<i>Marlboro</i>	8.3%	7.3%	1.0
<i>L&amp;M</i>	12.1%	14.1%	(2.0)
Others	2.7%	3.1%	(0.4)
Total	23.1o/o	24.5o/o	(1.4)

The estimated total cigarette market decreased by 3.5%, mainly due to Egypt, reflecting the impact of price increases since the third quarter of 2016. The decrease in our cigarette shipment volume, down by 7.9% excluding estimated distributor inventory movements, was mainly due to the lower total cigarette market, as well as lower cigarette market share, notably of *L&M* in Egypt as a result of widening price gaps with competitors' brands, partly offset by the recovery of *Marlboro* in Algeria following the lower-than-anticipated acceptance of Architecture 2.0 in 2016.



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In Russia, estimated industry size and our shipment volume, shown in the table below, include cigarettes and our heated tobacco units. Our February quarter-to-date market share performance, as measured by Nielsen and shown in the table below, reflects that of cigarettes.

	Russia Key Market Data		
	First-Quarter		Change % / g.g.
	2017	2016	
Total Market (billion units)	54.7	59.4	(7.9)%
PMI Shipments (million units)	14,839	17,811	(16.7)%
PMI Cigarette Market Share			
<i>Marlboro</i>	13%	14%	(0.1)
<i>Parliament</i>	3.6%	3.9%	(0.3)
<i>Bond Street</i>	9.3%	8.4%	0.9
Others	13.2%	14.1%	(0.9)
Total	27.4%	27.8%	(0.4)

The estimated total market decreased by 7.9%, reflecting the impact of excise tax-driven price increases. Excluding the net impact of estimated distributor inventory movements, mainly associated with the replenishment in the first quarter of 2016 of low inventory levels at the end of 2015, our shipment volume decreased by 7.5%, mainly due to the lower total market. The decrease of our cigarette market share was mainly due to: *Parliament*, reflecting the impact of price increases; *Chesterfield*, *L&M* and *Next/Dubli* in "Others," primarily reflecting slower-than-anticipated retail price penetration of competitors' brands; partly offset by *Bond Street*; and the growth of recently-launched *Philip Morris* in "Others," reflecting the successful ongoing molding of super-low price *Optima* and *Apollo Soyuz*.

In Turkey, estimated cigarette industry size, our cigarette shipment volume and February quarter-to-date cigarette market share performance, as measured by Nielsen, are shown in the table below.

	Turkey Key Market Data		
	First-Quarter		Change % / g.g.
	2017	2016	
Total Cigarette Market (billion units)	22.6	22.4	0.8%
PMI Cigarette Shipments (million units)	9,830	10,345	(5.0)%
PMI Cigarette Market Share			
<i>Marlboro</i>	9.9%	10.0%	(0.1)
<i>Parliament</i>	11.3%	11.5%	(0.2)
<i>Lark</i>	6.8%	7.8%	(1.0)
Others	14.9%	14.6%	0.3
Total	42.9%	43.9%	(1.0)

The estimated total cigarette market increased by 0.8%. Excluding the impact of estimated trade inventory movements associated with the comparative timing of purchases ahead of anticipated price increases, the estimated total cigarette market declined by 5.4%, mainly reflecting the impact of price increases and a higher prevalence of illicit trade. The decrease in our shipments was mainly due to lower cigarette market share, reflecting the impact of price increases and, in the case of low-price *Lark*, competitive pressure from super-low price alternatives.



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In Ukraine, estimated industry size and our shipment volume, shown in the table below, include cigarettes and our heated tobacco units. Our February quarter-to-date market share performance, as measured by Nielsen and shown in the table below, reflects that of cigarettes.

	Ukraine Key Market Data		
	First-Quarter		Change % / g.g.
	2017	2016	
Total Market (billion units)	149	17.3	(14.2)%
PMI Shipments (million units)	4,110	5,648	(27.2)%
PMI Cigarette Market Share			
<i>Marlboro</i>	3.1%	3.3%	(0.2)
<i>Parliament</i>	3.1%	2.8%	0.3
<i>Bond Street</i>	9.2%	10.1%	(0.9)
Others	12.0%	13.4%	(1.4)
<b>Total</b>	<b>27.4%</b>	<b>29.6%</b>	<b>(2.2)</b>

The estimated total market decreased by 14.2%, mainly due to the impact of price increases and a challenging comparison with the first quarter of 2016, which grew by 17.3%. The decrease in our shipment volume was mainly due to the lower total market, as well as lower cigarette market share, primarily of low-price *Bond Street*, as well as *President*, down by 3.0 points to 1.4%, and *Chesterfield*, down by 0.7 points to 2.1%, in "Others," largely reflecting the impact of price increases. The decline in our cigarette market share was partly offset by *Parliament*, as well as *L&M*, up by 19 points to 6.5%, in "Others."

Asia (in millions)	For the Three Months Ended March 31,			
	2017	2016	Variance	%
Net revenues	\$ 4,838	\$ 4,689	\$ 149	3.2 %
Excise taxes on products	2,597	2,721	(124)	(4.6)%
Net revenues, excluding excise taxes on products	2,241	1,968	273	13.9 %
Operating companies income	852	778	74	9.5 %

For the three months ended March 31, 2017, net revenues increased by \$149 million. Excluding excise taxes, net revenues increased by \$273 million due to:

- price increases (\$143 million),
- favorable volume/mix (\$74 million) and
- favorable currency (\$56 million).

The net revenues of the Asia segment include \$396 million in 2017 and \$47 million in 2016 related to sale of RRP, mainly driven by Japan. Excluding excise taxes, net revenues for RRP were \$396 million in 2017 and \$47 million in 2016. In some jurisdictions, including Japan, we are not responsible for collecting excise taxes.

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Operating companies income increased by \$74 million during the three months ended March 31, 2017. This increase was due primarily to:

- price increases (\$143 million) and
- favorable currency (\$54 million), partly offset by
- unfavorable volume/mix (\$56 million),
- higher marketing, administration and research costs (\$45 million, primarily related to increased investment behind reduced-risk products, notably in Japan) and
- higher manufacturing costs (\$23 million).

*Asia - PMI Shipment Volume Commentaries*

## Asia PMI Shipment Volume (Million Units)

		First-Quarter	Change
Cigarettes	55,142	65,222	(15.5)%
Heated Tobacco Units	4,145	435	+100%
Total Asia	59,287	65,657	(9.7)%

Asia PMI Shipment Volume by Brand (Million Units)

	Q1 2017	Q1 2016	Change
Cigarettes			
<i>Marlboro</i>	17,734	18,873	(6.0)%
<i>Lark</i>	4,566	4,302	6.1 %
<i>Parliament</i>	2,326	2,410	(3.5)%
Others	30,516	39,637	(23.0)%
Total Cigarettes	55,142	65,222	(15.5)%
Heated Tobacco Units	4,145	435	+100%
Total Asia	59,287	65,657	(9.7)%

As shown in the table above, our total shipment volume decreased by 9.7% to 59.3 billion units, mainly due to cigarette volume declines in: Indonesia; Japan; Korea; Pakistan, reflecting the impact of excise tax-driven price increases and an increase in the prevalence of illicit trade; and the Philippines; partly offset by higher heated tobacco units volume in Japan.

The decrease in cigarette shipment volume of *Marlboro* was mainly due to Japan, primarily reflecting out-switching to *Marlboro HeatSticks*. The increase in cigarette shipment volume of *Lark* was driven by Japan and Korea. The decrease in cigarette shipment volume of *Parliament* was mainly due to Japan. The decrease in cigarette shipment volume of "Others" was mainly due to local, low-margin brands in Pakistan and the Philippines.

[Table of Contents](#)*Asia -Key Market Commentaries*

In Indonesia, estimated cigarette industry size, our cigarette shipment volume, cigarette market share and segmentation performance are shown in the tables below.

	Indonesia Key Market Data		
	Firm-Quart		Change % / Pt
	2017	2016	
Total Cigarette Market (billion units)	71.0	75.2	(5.5)%
PMI Cigarette Shipments (million units)	23,399	25,142	(6.9)%
PMI Cigarette Market Share			
<i>Sampoerna A</i>	13.9%	14.3%	(0.4)
<i>Dji Sam Soe</i>	6.3%	6.6%	(0.3)
<i>Sampoerna U</i>	5.0%	4.5%	0.5
Others	7.8%	8.1%	(0.3)
Total	33.0%	33.5%	(0.5)

	Indonesia Segmentation Data		
	Firm-Quart		Change % / Pt
	2017	2016	
Segment % of Total Market			
<i>Hand-Rolled Kretek (SK1)</i>	18.2%	18.8%	(0.6)
<i>Machine-Made Kretek (SKM)</i>	76.3%	75.2%	1.1
<i>Whites (SPM)</i>	5.5%	6.0%	(0.5)
Total	100.0%	100.0%	
PMI % Share of Segment			
<i>Hand-Rolled Kretek (SK1)</i>	38.0%	38.1%	(0.1)
<i>Machine-Made Kretek (SKM)</i>	28.6%	28.5%	0.1
<i>Whites (SPM)</i>	76.5%	81.3%	(4.8)

The estimated total cigarette market decreased by 5.5%, primarily reflecting the impact of tax-driven price increases. The decrease in our cigarette shipments was mainly due to the lower estimated total market. The decline of our cigarette market share mainly reflected the decline of our share of the SPM segment and the soft performance of our SKT portfolio, broadly in line with industry trends.



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In Japan, estimated industry size, our shipment volume and market share performance, shown in the table below, include cigarettes and our heated tobacco units.

	Japan Key Market Data		Change % / pd).
	First Quarter		
Total Market (billion units)	40.6	43.9	(7.4)%
PMI Shipments (million units)			
Cigarettes	10,701	11,551	(7.4)%
Heated Tobacco Units	4,145	435	+100%
Total	14,846	11,986	23.9 %
PMI Market Share			
<i>Marlboro</i>	100%	10.6%	(0.6)
<i>Marlboro HeatSticks</i>	7.1%	0.8%	6.3
<i>Parliament</i>	2.2%	2.3%	(0.1)
<i>Lo.rk</i>	9.2%	9.2%	
Others	15%	1.7%	(0.2)
Total	30.0%	24.6%	5.4

The estimated total market decreased by 7.4%, or by 4.3% excluding the net impact of estimated trade inventory movements mainly associated with our principal competitor's products in the first quarter of 2016 ahead of its retail price increases. Our shipment volume increased by 11.6%, excluding the net impact of distributor inventory movements primarily associated with the timing of *Marlboro HeatSticks* in transit to Japan, mainly reflecting higher share driven by *Marlboro HeatSticks*.

In Korea, estimated cigarette industry size, our cigarette shipment volume and cigarette market share performance are shown in the table below.

	Korea Key Market Data		Change % / JM ·
	First-Quarter		
	2017	2016	
Total Cigarette Market (billion units)	16.1	17.0	(5.2)%
PMI Cigarette Shipments (million units)	3,049	3,543	(13.9)%
PMI Cigarette Market Share			
<i>Marlboro</i>	8.7%	9.4%	(0.7)
<i>Parliament</i>	8.0%	7.5%	0.5
<i>Virginia S.</i>	2.0%	3.4%	(1.4)
Others	0.4%	0.6%	(0.2)
Total	19.1%	20.9%	(1.8)

The estimated total cigarette market decreased by 5.2%, primarily reflecting a challenging comparison with the first quarter of 2016 which increased by 40.9%. The decrease in our cigarette shipment volume was due to the lower total market, as well as lower cigarette market share, which was unfavorably impacted by the estimated trade inventory movements.



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In the Philippines, estimated cigarette industry size, our cigarette shipment volume and cigarette market share performance are shown in the table below.

	Philippines Key Market Data		
	First-Quarter		Change 1DJlz
		IV. II	
Total Cigarette Market (billion units)	16.6	19.6	(15.6)%
PMI Cigarette Shipments (million units)	10,955	14,474	(24.3)%
PMI Cigarette Market Share			
<i>Marlboro</i>	32.5%	27.5%	5.0
<i>Fortune</i>	17.4%	25.0%	(7.6)
<i>Jackpot</i>	5.9%	9.0%	(3.1)
Others	10.3%	12.2%	(1.9)
Total	66.1o/o	73.7o/o	(7.6)

The estimated total cigarette market decreased by 156%, mainly due to the impact of excise tax-driven price increases, including those on our full brand portfolio in the fourth quarter of 2016, as well as a high prevalence of illicit trade. The decline in our cigarette shipment volume was due to the lower total cigarette market, as well as lower cigarette market share, particularly of our low and super-low price brands as a result of the timing of competitors' price increases, and widened price gaps to our principal competitor's discounted brands, partly offset by *Marlboro*, which benefited from in-switching from lower-priced brands.

Latin America & Caoadai

Latin America & Canada (in millions)	For the Three Months Ended March 31,			
	2017	2016	Variance	%
Net revenues	\$ 2,134	\$ 1,959	\$ 175	8.9%
Excise taxes on products	1,528	1,309	219	16.7 %
Net revenues, excluding excise taxes on products	606	650	(44)	(6.8)%
Operating companies income	177	229	(52)	(22.7)%

For the three months ended March 31, 2017, net revenues increased by \$175 million. Excluding excise taxes, net revenues decreased by \$44 million due to:

- unfavorable volume/mix (\$87 million) and
- unfavorable currency (\$22 million), partly offset by price increases (\$65 million).

Operating companies income decreased by \$52 million during the three months ended March 31, 2017 due primarily to:

- unfavorable volume/mix (\$75 million),
- unfavorable currency (\$26 million) and
- higher manufacturing costs (\$17 million), partly offset by price increases (\$65 million).



[Table of Contents](#)*Latin America & Canada - PMI Shipment Volume Commentaries*

## Latin America &amp; Canada PMI Shipment Volume (Million Units)

	First-Quarter		
	IV.11	III.11	Ch3nge
Cigarettes	19,296	21,700	(11.1)%
Heated Tobacco Units	1		-9%
Total Latin America & Canada	19,297	21,700	(11.1)o/o

Latin America & Canada PMI Shipment Volume by Brand (Million Units)

	First-Quarter		
	2017	2016	Change
Cigarettes			
<i>Marlboro</i>	7,625	8,880	(14.1)%
<i>Philip Morris</i>	3,440	4,631	(25.7)%
<i>Chesterfield</i>	1,887	171	+100.0%
Others	6,344	8,018	(20.9)%
Total Cigarettes	19,296	21,700	(11.1)o/o
Heated Tobacco Units	1		-9%
Total Latin America & Canada	19,297	21,700	(11.1)o/o

As shown in the table above, our total shipment volume decreased by 11.1% to 19.3 billion units, mainly due to cigarette volume declines in Argentina, Canada and Mexico.

The decrease in cigarette shipment volume of *Marlboro* was mainly due to Argentina and Mexico. The decrease in cigarette shipment volume of *Philip Morris* was mainly due to Argentina. The increase in cigarette shipment volume of *Chesterfield* was driven by Argentina, Colombia and Venezuela. The decrease in cigarette shipment volume of "Others" was mainly due to largely local, lower-margin brands in Canada, Colombia and Mexico.

[Table of Contents](#)*Latin America & Canada - Key Market Commentaries*

In Argentina, estimated cigarette industry size, our cigarette shipment volume and cigarette market share performance are shown in the table below.

	Argentina Key Market Data		
	First Quarter		Change % / p.p.
	2017	2016	
Total Cigarette Market (billion units)	9.3	9.8	(4.3)%
PMI Cigarette Shipments (million units)	6,948	7,526	(7.7)%
PMI Cigarette Market Share			
<i>Marlboro</i>	20.2%	24.0%	(3.8)
<i>Chesterfield</i>	14.5%	1.6%	12.9
<i>Philip Morris</i>	33.9%	44.6%	(10.7)
Others	5.9%	7.0%	(1.1)
<b>Total</b>	<b>74.5%</b>	<b>77.2%</b>	<b>(2.7)</b>

The estimated total cigarette market decreased by 4.3%, primarily reflecting the impact of excise tax increases in May 2016, which drove a more than 50% increase in average industry retail prices, as well as retail price increases in the first quarter of 2017. The decrease in our cigarette shipment volume was mainly due to the lower total market, as well as lower cigarette market share, impacted by down-trading of *Marlboro* and mid-price *Philip Morris*, partly offset by low-price *Chesterfield* that also benefited from its successful migration from *Next*.

In Canada, estimated industry size, our shipment volume and market share performance, shown in the table below, include cigarettes and our heated tobacco units.

	Canada Key Market Data		
	First Quarter		Change % / p.p.
	2017	2016	
Total Market (billion units)	4.9	5.6	(12.4)%
PMI Shipments (million units)	1,776	2,184	(18.7)%
PMI Market Share			
<i>Belmont</i>	3.6%	3.7%	(0.1)
<i>Canadian Classics</i>	8.9%	10.7%	(1.8)
<i>Next</i>	10.9%	11.6%	(0.7)
Others*	11.5%	13.2%	(1.7)
<b>Total</b>	<b>34.9%</b>	<b>39.2%</b>	<b>(4.3)</b>

\*Includes heated tobacco units.

The estimated total market decreased by 12.4%, mainly reflecting a difficult comparison with the first quarter of 2016, which grew by 1.4%. Excluding the impact of estimated trade inventory movements associated with retail price increases in January 2017, the total market decreased by 8.8%. The decrease in our shipment volume was mainly due to the lower total market, as well as lower cigarette market share, which largely reflected the unfavorable impact of the estimated trade inventory movements.



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In Mexico, estimated cigarette industry size, our cigarette shipment volume and cigarette market share performance are shown in the table below.

	Mexico Key Market Data		
	First-Quarter		Change 1Q/16
	2017	2016	
Total Cigarette Market (billion units)	7.9	8.9	(11.3)%
PMI Cigarette Shipments (million units)	5,059	5,982	(15.4)%
PMI Cigarette Market Share			
<i>Marlboro</i>	46.0%	47.5%	(1.5)
<i>Delicados</i>	8.2%	9.9%	(1.7)
<i>Benson &amp; Hedges</i>	4.9%	4.2%	0.7
Others	5.2%	5.9%	(0.7)
Total	64.30/o	67.50/o	(3.2)

The estimated total cigarette market decreased by 11.3%. Excluding the impact of estimated trade inventory movements associated with industry retail price increases in January 2017, the estimated total cigarette market increased by 1.8%. The decrease in our cigarette shipment volume mainly reflected the lower total cigarette market. The decline of our cigarette market share largely reflected the unfavorable impact of the estimated trade inventory movements.

#### Financial Review

##### Net Cash Provided by Operating Activities

During the first quarter of 2017, net cash provided by operating activities of \$843 million increased by \$381 million compared with the first quarter of 2016. Excluding unfavorable currency movements of \$118 million, the change was primarily due to lower working capital requirements, partially offset by the 2017 payment in the South Korean tax matter (see Note 8. *Contingencies* for additional information).

Excluding currency, the favorable variance in working capital was due primarily to the following:

- more cash provided by inventories, primarily due to lower finished goods inventories and lower leaf purchases; and
- more cash provided by accounts receivable, primarily due to the timing of sales and cash collections; partially offset by more cash used for accrued liabilities and other current assets, primarily due to the timing of payments for excise taxes.

##### Net Cash Used in Investing Activities

During the first quarter of 2017, net cash used in investing activities was \$579 million, compared with net cash used in investing activities of \$419 million during the first quarter of 2016. This change was due principally to cash collateral movements, primarily from derivatives designated as net investment hedges, and higher capital expenditures.

Our capital expenditures were \$292 million and \$226 million during the three months ended March 31, 2017 and 2016, respectively. The 2017 expenditures were primarily related to our ongoing investments in RRP's to support capacity expansion (notably for heated tobacco units). In support of our plans to increase heated tobacco unit production, we announced on April 20, 2017 that we are increasing our planned capital expenditures in 2017 to \$1.6 billion, from the \$1.5 billion previously communicated.

##### Net Cash Provided by (Used in) Financing Activities

During the first quarter of 2017, net cash provided by financing activities was \$341 million, compared with net cash used of \$593 million during the first quarter of 2016. The change was due primarily to higher proceeds from long-term debt (primarily the \$2.5 billion proceeds in the first quarter of 2017 versus the \$2.0 billion proceeds in the first quarter of 2016 from our U.S. dollar debt issuances) and higher net proceeds from short-term borrowings.



Dividends paid in the first quarter of 2017 and 2016 were \$1,618 million and \$1,585 million, respectively.

[Table of Contents](#)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 demand deposits with institutions that have investment-grade long-term credit rating.

*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 March 31, 2017, 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	Negative
Fitch	F1	A	Negative

*Credit Facilities* – On January 27, 2017, we entered into an agreement to extend our \$2.0 billion 364-day revolving credit facility from February 7, 2017 to February 6, 2018.

At March 31, 2017, our committed credit facilities and commercial paper outstanding were as follows:

(in billions)

Type	Committed Credit Facilities	Commercial Paper
364-day revolving credit, expiring February 6, 2018	\$ 2.0	
Multi-year revolving credit, expiring February 28, 2021		2.5
Multi-year revolving credit, expiring October 1, 2020 <sup>(1)</sup>		3.5
<b>Total facilities</b>	<b>\$ 8.0</b>	
Commercial paper outstanding		\$

(1) On August 30, 2016, we entered into an agreement, effective October 1, 2016, to extend the term of our multi-year revolving credit facility, for an additional year covering the period October 1, 2020 to October 1, 2021 in the amount of \$3.35 billion.

At March 31, 2017, there were no borrowings under the committed credit facilities, and the entire committed amounts were available for borrowing.

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

Each of these facilities requires us to maintain a ratio of consolidated earnings before interest, taxes, depreciation and amortization ("consolidated EBITDA") to consolidated interest expense of not less than 3.5 to 1.0 on a rolling four-quarter basis. At March 31, 2017, our ratio calculated in accordance with the agreements was 10.6 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 \$32 billion at March 31, 2017 and \$2.9 billion at December 31, 2016, are for the sole use of our subsidiaries. Borrowings under these arrangements amounted to \$1.0 billion at March 31, 2017, and \$643 million at December 31, 2016.

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*Commercial Paper Program* – We have commercial paper programs in place in the U.S. and in Europe. Our commercial paper programs in place in the U.S. and in Europe currently have an aggregate issuance capacity of \$8.0 billion. At March 31, 2017 and December 31, 2016, we had no commercial paper outstanding.

We expect that 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.

*Sale of Accounts Receivable* – To mitigate credit risk and enhance cash and liquidity management we sell trade receivables to unaffiliated financial institutions. These arrangements allow us to sell, on an ongoing basis, certain trade receivables without recourse. The trade receivables sold are generally short-term in nature and are removed from the condensed consolidated balance sheets. We sell trade receivables under two types of arrangements, servicing and non-servicing.

Our operating cash flows were positively impacted by the amount of the trade receivables sold and derecognized from the condensed consolidated balance sheets, which remained outstanding with the unaffiliated financial institutions. The trade receivables sold that remained outstanding under these arrangements as of March 31, 2017, and March 31, 2016 were \$561 million and \$589 million, respectively. The net proceeds received are included in cash provided by operating activities in the condensed consolidated statements of cash flows.

For further details, see Note 15. *Sale of Accounts Receivable* to our condensed consolidated financial statements.

*Debt* – Our total debt was \$31.3 billion at March 31, 2017 and \$29.1 billion at December 31, 2016.

On February 14, 2017, 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.

Our debt issuances in the first quarter of 2017 were as follows:

(m millions)					
Type	Face Value	Interest Rate	Issuance	Maturity	
U.S. dollar notes <sup>(a)</sup>	\$700	1.625%	February 2017	February 2019	
U.S. dollar notes <sup>(b)</sup>	\$300	Floating	February 2017	February 2020	
U.S. dollar notes <sup>(a)</sup>	\$1,000	2.000%	February 2017	February 2020	
U.S. dollar notes <sup>(a)</sup>	\$500	2.625%	February 2017	February 2022	

(a) Interest on these notes is payable semi-annually in arrears beginning in August 2017.

(b) Interest on these notes is payable quarterly in arrears beginning in May 2017.

The net proceeds from the sale of the securities listed in the table above have been and will be used for general corporate purposes.

*Guarantees* – At March 31, 2017, we were contingently liable for \$0.7 billion of guarantees of our own performance, which were primarily related to excise taxes on the shipment of our products. There is no liability in the condensed consolidated financial statements associated with these guarantees. At March 31, 2017, our third-party guarantees were insignificant.

Equity and Dividends

We discuss our stock awards as of March 31, 2017 in Note 2. *Stock Plans* to our condensed consolidated financial statements.

During 2016, we did not repurchase any shares under a share repurchase program and we do not presently intend to repurchase shares of our common stock in 2017.

Dividends paid in the first three months of 2017 were \$1.6 billion. During the third quarter of 2016, our Board of Directors approved a 2.0% increase in the quarterly dividend to \$1.04 per common share. As a result, the present annualized dividend rate is \$4.16 per common share.



[Table of Contents](#)**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 demand 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 of America, 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 5. *Financial Instruments*, Note 11. *Fair Value Measurements*, and Note 13. *Balance Sheet Offsetting* to our condensed consolidated financial statements for further details on our derivative financial instruments and the related collateral arrangements.

**Contingencies**

See Note 8. *Contingencies* to our condensed 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.

[Table of Contents](#)*Risks Related to Our Business and Industry*

Consumption of tax-paid cigarettes continues to decline in many of our markets.

This decline is due to multiple factors, including increased taxes and pricing, governmental actions, the diminishing social acceptance of smoking, continuing economic and geopolitical uncertainty, and the continuing prevalence of illicit products. These factors and their potential consequences are discussed more fully below and in the "Business Environment" section.

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 cigarettes versus other tobacco products, or disproportionately affect the relative retail price of our cigarette brands versus cigarette brands manufactured by certain of our competitors. Because our portfolio is weighted toward the premium-price 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 legal 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 promote increasingly restrictive regulatory measures on the marketing and sale 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;
- restrictions on the sale of novel tobacco or nicotine-containing products;
- elimination of duty free sales and duty free allowances for travelers; and
- encouraging litigation against tobacco companies.

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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 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 and Nigeria, range into the billions of U.S. dollars. We anticipate that new cases will continue to be filed. The FTC encourages litigation against tobacco product manufacturers. It is possible that our consolidated results of operations, cash flows or financial position could be materially affected in a particular fiscal quarter or fiscal year by an unfavorable outcome or settlement of certain pending litigation. Please see Note 8. *Contingencies* to our condensed consolidated financial statements for a discussion of pending 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, the PRC, 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, natural disasters or conflicts.

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 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, and failure to obtain such approvals could impair growth in our profitability.

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

- promote brand equity successfully;
- anticipate and respond to new adult consumer trends;
- develop new products and markets and broaden brand portfolios;  
improve productivity;
- ensure adequate production capacity to meet demand for our products; and  
be able to protect or enhance margins through price increases.





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In periods of economic uncertainty, adult 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 produced 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 produced 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 introduce Reduced-Risk Products, and regulators may not permit the commercialization of these products or health-related claims.

Our key strategic priorities are: to develop and commercialize products that present less risk of harm to adult smokers who switch to those products versus continued smoking; and to convince current adult smokers who would otherwise continue to smoke to switch to those RRP. For our efforts to be successful, we must: develop RRP that such adult smokers find acceptable alternatives to smoking; conduct rigorous scientific studies to substantiate that they reduce exposure to harmful and potentially harmful constituents in smoke and, ultimately, that these products present, are likely to present, or have the potential to present less risk of harm to adult smokers who switch to them versus continued smoking; and effectively advocate for the development of science-based regulatory frameworks for the development and commercialization of RRP, including communication of scientifically substantiated information to enable adult consumers to make better health choices. We might not succeed in our 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 sale and/or marketing of RRP with health-related claims. Such restrictions could limit the success of our RRP.

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 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 under current U.S. tax law. Furthermore, our effective tax rate could be increased due to changes in the earnings mix or applicable tax laws. In addition, certain countries in which we operate have adopted or could institute currency exchange controls that limit or prohibit our local subsidiaries' ability to convert local currency into U.S. dollars or to make payments outside the country. This could subject us to the risks of local currency devaluation and business disruption.

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

Our profit growth may suffer if we are unable to introduce new products or enter new markets successfully, to raise prices or to improve the proportion of our sales of higher margin products and 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 produce less tobacco or cloves. 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, litigation and regulatory action, and 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 place us at a competitive disadvantage, result in a loss of revenue, assets or personal or other sensitive data, litigation and regulatory action, 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.

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## Item 4. Controls and Procedures.

PMI carried out an evaluation, with the participation of PMI's management, including PMI's Chief Executive Officer and Chief Financial Officer, of the effectiveness of PMI's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based upon that evaluation, PMI's Chief Executive Officer and Chief Financial Officer concluded that PMI's disclosure controls and procedures are effective. There have been no changes in PMI's internal control over financial reporting during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, PMI's internal control over financial reporting.

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Part II-OTHER INFORMATION

Item 1. Legal Proceedings.

See Note 8. *Contingencies* of the Notes to the Condensed Consolidated Financial Statements included in Part I- Item 1 of this report for a discussion of legal proceedings pending against Philip Morris International Inc. and its subsidiaries.

Item 1A. Risk Factors.

Information regarding Risk Factors appears in "MD&A – Cautionary Factors That May Affect Future Results," in Part I – Item 2 of this Form 10-Q and in Part I – Item 1A. Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2016. There have been no material changes to the risk factors disclosed in our Annual Report on Form 10-K.

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## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

Our share repurchase activity for each of the three months in the quarter ended March 31, 2017 was as follows:

Period	Total Number of Shares Repurchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs
January 1, 2017 – January 31, 2017 (1)		\$		\$
February 1, 2017 – February 28, 2017 (1)		\$		\$
March 1, 2017 – March 31, 2017 (1)		\$		\$
Pursuant to Publicly Announced Plans or Programs		\$		
January 1, 2017 – January 31, 2017 (2)	234	\$ 91.48		
February 1, 2017 – February 28, 2017 (2)	181,890	\$ 102.24		
March 1, 2017 – March 31, 2017 (2)	1,394	\$ 108.10		
For the Quarter Ended March 31, 2017	183,518	\$ 102.27		

(1) During this reporting period, we did not have an authorized share repurchase program.

(2) Shares repurchased represent shares tendered to us by employees who vested in restricted share unit awards and used shares to pay all, or a portion of, the related taxes.

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## Item 6. Exhibits.

- 3.1 Amended and Restated By-Laws of Philip Morris International Inc. (incorporated by reference to Exhibit 3.1 to the Current Report on Form 8-K filed December 9, 2016).
- 10.1 Extension Agreement, effective February 7, 2017, to the Credit Agreement, dated as of February 12, 2013, among Philip Morris International Inc., the lenders named therein, Citibank Europe PLC, UK Branch (formerly, Citibank International Limited), as Administrative Agent (incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed January 30, 2017).
- 10.2 Form of Restricted Stock Unit Agreement (incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed February 7, 2017).
- 10.3 Form of Performance Share Unit Agreement (incorporated by reference to Exhibit 10.2 to the Current Report on Form 8-K filed February 7, 2017).
- 10.4 Amendment to Employment Agreement with Andre Calantzopoulos.
- 10.5 Amendment to Employment Agreement with Man: S. Firestone.
- 10.6 Amendment to Employment Agreement with Martin King.
- 10.7 Amendment to Employment Agreement with Jacek Olczak.
- 10.8 Amendment to Employment Agreement with Miroslaw Zielinski.
- 12 Statement regarding computation of ratios of earnings to fixed charges.
- 31.1 Certification of the Registrant's Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Registrant's Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of the Registrant's Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of the Registrant's Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101.INS XBRL Instance Document.
- 101.SCH XBRL Taxonomy Extension Schema.
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase.
- 101.DEF XBRL Taxonomy Extension Definition Linkbase.
- 101.LAB XBRL Taxonomy Extension Label Linkbase.
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase.

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Signature

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

PHILIPMORRISINTERNATIONALINC.

*/s/JACEK OLCZAK*

Jacek Olczak  
Chief Financial Officer

April 27, 2017

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