

Second Party Opinion

Philip Morris International's Business Transformation-Linked Financing Framework

Aug. 27, 2021

Philip Morris International (PMI) is a tobacco company engaged in the manufacturing of cigarettes, as well as smoke-free and other nicotine-containing products. PMI is incorporated in the U.S., but operates outside the country, mostly in the E.U. (37% of 2020 net revenue), and Asia and Australia (34%). Its reduced-risk portfolio consists largely of smoke-free products that are designed to release nicotine-containing aerosol without burning tobacco (about 24% of 2020 net revenue). PMI's heated tobacco system IQOS is its flagship smoke-free product.

In our view, PMI's Business Transformation-Linked Financing Framework, published on Aug. 27, 2021, is aligned with:

- Sustainability-Linked Bond Principles (SLBP), ICMA, 2020
- Sustainability-Linked Loan Principles (SLLP), LMA/LSTA/APLMA, 2021

PMI's Sustainability Objectives

PMI aims to reduce the negative impacts of its products on the health of its consumers by transitioning to selling less harmful smoke-free alternatives in place of its current core product range. Its goal is to become a predominantly smoke-free company based on net revenue within the next five years. To support this transformation, PMI has developed a business transformation-linked financing framework that links its corporate strategy to social objectives.

PMI's primary objective is to improve health outcomes for adults who smoke and those who wish to continue consuming nicotine by providing its new smoke-free IQOS technology as an alternative to cigarettes. IQOS heats tobacco to release nicotine, but does not allow it to combust.

In July 2020, PMI received authorization to market IQOS as a modified risk tobacco product with reduced exposure to harmful chemicals from the U.S. Food and Drug Administration (FDA). This authorization supports PMI's view that cigarette smokers can reduce their exposure to harmful chemicals by switching to IQOS and discontinuing cigarette use. Based on evidence in the framework, we understand that 73% of smokers who use IQOS stopped smoking cigarettes, and that IQOS has low levels of youth uptake.

Selected Key Performance Indicators (KPIs) And Sustainability Performance Targets (SPTs)

KPI	SPT	Baseline	2020 Performance
Smoke-free/total net revenue percentage	Increase full-year 2025 net revenue from smoke-free products to more than 50% of total from baseline	23.8% (2020)	23.8%
No. of markets where its smoke-free products are available for sale	Increase the number of markets where its smoke-free products are available for sale to 100 by end-2025	64 (2020)	64

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Second Party Opinion Overview

Selection of key performance indicators (KPIs)

Alignment  PMI's Business Transformation-Linked Financing Framework is aligned with this component of the SLLP and SLBP.

KPI 1 Smoke-free/total net revenue percentage

Satisfactory

Strong

Advanced

KPI 2 Number of markets where its smoke-free products are available for sale

Satisfactory

Strong

Advanced

Calibration of sustainability performance targets (SPTs)

Alignment  PMI's Business Transformation-Linked Financing Framework is aligned with this component of the SLLP and SLBP.

SPT 1 Increase full-year 2025 net revenue from smoke-free products to more than 50% of total from 23.8%

Satisfactory

Strong

Advanced

SPT 2 Increase the number of markets where its smoke-free products are available for sale to 100 by end-2025 from 64

Satisfactory

Strong

Advanced

Instrument characteristics

Alignment  PMI's Business Transformation-Linked Financing Framework is aligned with this component of the SLLP and SLBP.

Instruments under the framework will be subject to a step-up margin amount, margin adjustment, or premium/discount amount, subject to the achievement of the applicable SPT(s). The specific mechanism will be specified in the respective instrument's documentation including, where needed, any fallback mechanism.

Reporting

Alignment  PMI's Business Transformation-Linked Financing Framework is aligned with this component of the SLLP and SLBP.

Score

Satisfactory

Strong

Advanced

We consider PMI's reporting practices to be satisfactory. These include explanation of key drivers of performance and sustainability impacts, where possible.

Post-issuance review

Alignment  PMI's Business Transformation-Linked Financing Framework is aligned with this component of the SLLP and SLBP.

PMI commits to have independent and external verification in the form of limited assurance of the performance level against the SPTs for the stated KPIs. The reports will feature limited assurance of PMI's KPI performance versus the relevant SPT.

Second Party Opinion Assessment

Selection of key performance indicators (KPIs)

The Principles make optional recommendations for stronger structuring practices, which informs our relevancy opinion as ‘satisfactory’, ‘strong’, or ‘advanced’. For each KPI, we consider how relevant the KPI is for sustainability by exploring the clarity and characteristics of the defined KPI; its significance for the issuer’s sustainability disclosures; and how material it is to the issuer’s industry and strategy.

- PMI's Business Transformation-Linked Financing Framework is aligned with this component of the SLLP and SLBP.

We believe the KPIs address efforts in the product transformation of phasing-out cigarettes and support PMI's strategy to become a predominantly smoke-free company within the next five years by reducing negative health impacts for adults addicted to smoking or those who wish to continue to consume nicotine.

KPI 1 Smoke-free/total net revenue percentage

Satisfactory

Strong

Advanced

The KPI is aligned with the SLBP and SLLP. The definition is clear and relevant for PMI's main sustainability objective, and we believe it addresses the most material ESG-related issue facing the industry, namely the health impact of smoking, based on the FDA's authorization to market the IQOS heated tobacco system as a modified risk tobacco product with reduced exposure claims. However, this revenue-based KPI has only an indirect link to measuring positive health impacts.

The KPI definition and method of calculation are well articulated, with a clear definition of “smoke-free” products, and use internationally recognized accounting standards (U.S. GAAP) for net revenue. The baseline is set and externally verified, and the scope and method of calculation is disclosed under the framework, which we see as strengths. However, the KPI is a relative ratio, and could mask an absolute rise in net revenue from cigarettes. That said, we believe this risk is unlikely, since PMI also discloses additional KPIs in its framework, which show a consistent downward trend of sales of combustible tobacco units (includes cigarettes) in the past five years.

We note that this revenue-based KPI is a financial proxy and has only an indirect link to measuring positive health impacts. A strong KPI would track a more direct health outcome. That said, the KPI PMI has selected does lend itself to being simple enough to compare against other industry players and is referenced in some international standards (SASB), and hence in our view is material for the industry. In addition, we acknowledge that the actual health impact of the product portfolio is challenging to measure in a KPI and that no industry-wide methodology exists at present.

KPI 2 Number of markets where its smoke-free products are available for sale

Satisfactory

Strong

Advanced

The KPI is aligned with the SLLP and SLBP. The KPI is clearly defined, and we believe it is relevant to PMI's sustainability objective of helping adult smokers access alternative smoke-free products by making them available in more markets, although the link to health outcomes is somewhat indirect.

The KPI is objective and measurable, and the definition is a simple count of the number of markets. That said, we see some limitations, in particular because the definition relies on PMI's internal definition of a “market,” which makes the KPI more challenging for investors to benchmark, in our view. In most cases, a market is a country; however, there are exceptions listed in the framework, such as international duty-free, and other specific territories. A new market

Second Party Opinion

entry is achieved when PMI's smoke-free products are available for sale via traditional or digital channels, and is measured in the company's sales figures.

However, we believe the KPI has only an indirect link to measuring positive health impacts. A strong KPI would track a more direct health outcome. The KPI measures the number of markets where smoke-free products are available for sale, but does not directly measure the number of people that stop smoking or switch to smoke-free products. Additionally, not all markets are of a similar size in terms of number of smokers and affordability of products. As such, there is not a perfect correlation between the social benefit of broadening access to smoke-free products and this KPI.

Still, we believe the KPI addresses a material social issue for the tobacco industry. Some markets require that new tobacco products undergo significant regulatory processes, such as authorization or notification, prior to being made available for sale. While approval processes varies from market to market, they often include providing scientific evidence of the product's risks, and also a degree of confidence that the new product will not entice new, young users. Hence, once access is obtained, we believe it indirectly supports PMI's primary objective of improving health outcomes for smokers by broadening access to smoke-free products.

Calibration of sustainability performance targets (SPTs)

The Principles make optional recommendations for stronger structuring practices, which informs our ambition opinion as 'satisfactory', 'strong', or 'advanced'. We consider the level of ambition for each target by assessing its clarity and characteristics, how the issuer defines the target with reference either to its past performance, or to external or competitor benchmarks, and how it explains what factors could influence future performance.

 PMI's Business Transformation-Linked Financing Framework is aligned with this component of the SLLP and SLBP.

SPT 1 Increase full-year 2025 net revenue from smoke-free products to more than 50% of total from 23.8% in 2020

Satisfactory

Strong

Advanced

The SPT meets the expectations of the SLBP and SLLP. However, our assessment of the KPI calibration is constrained by limitations in benchmarking it with those of competitors and external benchmarks. PMI's target includes an expected timeline, and a benchmark is included for PMI's performance versus industry peers, but only a very limited number of peers disclose targets and there are no industry-wide agreed targets.

The SPT is in line with PMI's historical performance trajectory, and we believe PMI's significant investments will likely enable it to reach its goal. PMI's framework outlines the strategy for achieving the SPT, and external factors that could disrupt its achievement are discussed, which we view as a positive feature.

The benchmark versus peers, while a positive feature, is fairly restricted since there are very few players operating in the tobacco industry and even fewer with which to compare performance. However, we note that PMI currently outperforms its closest peer (23.8% versus 10%), which is the only peer in the framework's benchmark.

PMI's KPI disclosures are novel for the industry and there are no industry-wide agreed trajectories for transformation yet. Globally, the World Health Organization's Framework Convention on Tobacco Control aims "to reduce continuously and substantially the prevalence of tobacco use and exposure to tobacco smoke." However, there are no agreed numerical targets, beyond the Sustainable Development Goal 3's (Good Health and Well-Being) target to reduce by one-third by 2030 premature mortality from non-communicable disease, which would include tobacco-related illness.

SPT2	Increase number of markets where smoke-free products are for sale to at least 100 by 2025 from 64 in 2020	Satisfactory	Strong	Advanced

The SPT meets the expectations of the SLBP and SLLP. That said, our assessment of the KPI calibration is constrained by limitations in benchmarking it with those of competitors and external benchmarks. PMI's target includes an expected timeline, and a benchmark is included for PMI's performance versus industry peers, but no peers appear to have disclosed targets and there are no industry-wide agreed targets.

PMI's framework outlines its strategy for achieving the SPT, and discusses external factors and risks that could disrupt its achievement, which we view as a positive feature.

When comparing the target against own performance, we consider the SPT ambitious given that the pace of increasing new markets is slowing. This is because the initial set of markets included EU countries whose aligned fiscal and regulatory frameworks helped PMI unlock multiple markets. As such, the initial markets could be considered simpler to access, and we expect subsequent markets will be more challenging.

We also note that the benchmark versus peers faces a narrow peer group, which includes just two peers with comparable disclosure of current performance. In this KPI, PMI outperformed its closest peer as of the 2020 baseline date, with 64 markets versus over 50.

Finally, the benchmark is limited by the absence of industry-wide targets.

Instrument characteristics

The Principles require disclosure of the type of financial and/or structural impact involving trigger event(s), and the potential variation of the instrument's financial and/or structural characteristics.

 PMI's Business Transformation-Linked Financing Framework is aligned with this component of the SLLP and SLBP.

PMI discloses under its framework that instruments under the framework will be subject to a step-up margin amount, margin adjustment, or premium/discount amount, subject to the achievement of the applicable SPT(s).

The specifications of the mechanism will be described in the transaction documents of instruments issued under this framework and include language describing fallback mechanisms if performance cannot be calculated. The language will also consider extreme events that could impact the calculation of the KPIs or SPTs. PMI describes one such potential event to be a drastic change in the regulatory environment. Drastic regulatory changes include preemptive product bans and restricted market access for smoke-free products compared with combustible tobacco products.

Reporting

The Principles make optional recommendations for stronger disclosure practices, which informs our disclosure opinion as 'satisfactory', 'strong', or 'advanced'. We consider plans for updates on the sustainability performance of the issuer for general purpose funding, or the sustainability performance of the financed projects over the lifetime of any dedicated funding, including any commitments to post-issuance reporting.

-  PMI's Business Transformation-Linked Financing Framework is aligned with this component of the SLLP and SLBP.

Disclosure score

Satisfactory Strong Advanced

We consider PMI's overall reporting practices to be satisfactory.

PMI will include up to date information on performance at least annually and for the relevant period on its website for the life of the issuances. This information will be subject to limited assurance and supplemented by relevant information for investors to understand the company's progress. PMI also may disclose the main factors driving performance on an annual basis and illustrations of sustainability impacts, where possible. Finally, where feasible and possible, PMI also commits to disclose any relevant reassessments of KPIs and SPTs.

Post-issuance review

The Principle requires post-issuance review commitments including the type of post-issuance third-party verification, periodicity and how this will be made available to key stakeholders. Our opinion describes whether the documentation is 'aligned' or 'not aligned' with these requirements. Please note, our second party opinion is not itself a post-issuance review.

-  PMI's Business Transformation-Linked Financing Framework is aligned with this component of the SLLP and SLBP.

PMI commits to obtain independent and external post-issuance verification of its performance against each SPT for each KPI. The assurance will cover PMI's performance on KPIs against the relevant SPT.

Second Party Opinion

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