S&P Global
Ratings

Environmental, Social, And Governance Evaluation

Philip Morris International

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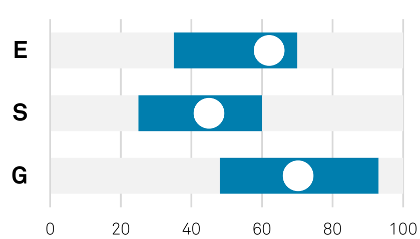
Summary

Philip Morris International (PMI) is an international cigarette, tobacco, and reduced-risk products (RRPs) manufacturer incorporated in the U.S. but operating outside of the U.S., mostly in the European Union (37% of net revenues in 2020) and Asia and Australia (34%). The company's products include a wide range of international and local brands across various price points (premium, mid, and low). Its top 10 cigarette brands include Marlboro, L&M, Chesterfield, Philip Morris, Parliament, Sampoerna A, Dij Sam Soe, Bond Street, Lark, and Next. In July 2020, its IQOS tobacco heating system received authorization to be marketed as a Modified Risk Tobacco Product (MRTP) from the U.S. Food and Drug Administration (FDA).

PMI operates in a sector that is highly exposed to sustainability risks, and in which very few companies participate. We see PMI's move into RRPs and efforts to mitigate risks in its supply chain as positively differentiating it from its tobacco peers. We recognize PMI's strong management relative to other tobacco companies on issues of child labor, which the company plans to eradicate by 2025, and greenhouse gas (GHG) emissions from tobacco curing. Its near-term focus is to remain in combustibles and maintain market share, but its long-term ambition is to switch smokers to its RRPs. PMI faces increased exposure to governance risks with most countries legally ratifying the World Health Organization's Framework Convention on Tobacco Control (WHO FCTC). We believe PMI is adequately prepared for future disruptions, reflecting its significant investments in RRPs, which smokers seem to accept as an alternative to cigarettes, and its solid track record of strategic execution despite headwinds. We therefore anticipate that net revenues from RRPs will likely increase and that PMI is on track to achieve its transition targets. That said, we believe that PMI's long-term strategy does not constitute a full strategic pivot given that it continues to rely on an addictive substance (nicotine) that constrains consumers' free choice, and to operate in a market where social disruptions will likely persist.

ESG Profile Score

57 /100



Company-specific attainable and actual scores

Preparedness Opinion (Scoring Impact)

Adequate (+ 3)

ESG Evaluation

60/100

A higher score indicates better sustainability

Component Scores

Environmental Profile

Sector/Region Score		20/50
	Greenhouse gas emissions	Leading
	Waste and pollution	Strong
	Water use	Good
	Land use and biodiversity	Strong
	General factors (optional)	None
Entity-Specific Score		**42/50**
E-Profile (30%)		**62/100**

Social Profile

Sector/Region Score		10/50
	Workforce and diversity	Strong
	Safety management	Good
	Customer engagement	Strong
	Communities	Good
	General factors (optional)	None
Entity-Specific Score		**35/50**
S-Profile (30%)		**45/100**

Governance Profile

Sector/Region Score		28/35
	Structure and oversight	Good
	Code and values	Good
	Transparency and reporting	Strong
	Financial and operational risks	Neutral
	General factors (optional)	None
Entity-Specific Score		**42/65**
G-Profile (40%)		**70/100**

ESG Profile (including any adjustments) **57/100**

Preparedness Summary

PMI faces significant challenges from its core business model of combustible tobacco products, which it aims to overcome by switching smokers to its range of so-called smokefree products, including IQOS. In our view, the company benefits from a board and senior management with strong capabilities to execute on its strategy. The company has made significant R&D investments, by sector standards, and is upskilling its management team to prepare for this transition. In our view, the company is well placed to meet its ambitions. Still, the business model remains focused on a relatively highly addictive substance with strong stakeholder opposition, and continues to face disruption. PMI acknowledges that its RRPs will use less tobacco and demand for tobacco leaf will continue to decline, which will ultimately affect farmers. The company aims to transition farmers onto other crops in the hope of countering this social risk, although so far this has been limited to pilot programs.

Capabilities	
Awareness	Good
Assessment	Good
Action plan	Good
Embeddedness	
Culture	Excellent
Decision-making	Excellent

Preparedness Opinion (Scoring Impact) **Adequate (+ 3)**

ESG Evaluation **60/100**

Environmental Profile

62/100

Sector/Region Score (20/50)

The most material environmental risks for the tobacco sector come from the cultivation and curing of tobacco, the production of cellulose acetate tow for cigarette filters, and the deforestation associated with flue curing (which often requires firewood) and land expansion. The tobacco sector also faces long-standing environmental risks from the end-of-life disposal of its products, including cigarette butts.

Entity-Specific Score (42/50)

Greenhouse gas emissions	Waste and pollution	Water use	Land use and biodiversity	General factors
Leading	**Strong**	**Good**	**Strong**	**None**

PMI leads its relatively small peer group of tobacco companies in the transition to carbon neutrality. Its recent adoption of a 1.5°C science-based target is unique among peers. Noting that the largest sources of GHG emission-related risk in the tobacco subsector stem from upstream suppliers, we regard PMI's actions to improve the energy efficiency of curing barns and the promotion of alternative, more sustainable, curing fuels as demonstrating leadership on this material risk. We also view favorably PMI's planned approach to mitigating its second biggest source of GHG emissions, cellulose acetate tow. Further, PMI differentiates itself from peers through its adoption of an internal carbon price, which it uses in tandem with advanced modelling tools, such as a marginal-abatement cost curve, to determine prudent climate-mitigating actions. PMI has taken concerted action regarding its direct GHG emissions, such as through the installation of heat pumps and onsite renewable energy generation technologies at some of its production facilities. The use of renewable energy certificates to tackle scope 2 emissions is common across the sector and form a fundamental part of PMI's net zero strategy; however, we expect PMI to continue focusing efforts on self-generation and power-purchase agreements.

PMI is actively and effectively incorporating circular economy principles into its waste management practices. As it transitions its business model from combustible products to integrated smoke-free units, we see cigarette butt littering diminishing over time. PMI clearly differentiates itself from peers through its use of recycling hubs for its IQOS products. However, we also note the 141,900 tons of plastic waste from PMI's cigarette and heated tobacco filters in 2019, and factor into our assessment its undistinguished approach to moving beyond cellulose acetate tow for cigarette filters.

We view PMI as having a robust approach to land use and biodiversity. Through its contractual arrangements with growers, it demonstrates higher visibility in its tobacco leaf supply chain compared to most peers. This level of oversight, in our view, garners a reduced risk of deforestation, agrochemical pollution, and soil degradation than we would expect from peers with less involvement in their supply chains. However, we view the company's afforestation and reforestation efforts as lagging more advanced peers.

Social Profile

45/100

Sector/Region Score (10/50)

The negative health effects associated with tobacco use, and the use of forced and child labor in the supply chain, heavily influence our assessment of the tobacco sector. The industry is moving to address these risks by introducing potentially reduced-harm alternatives to combustible cigarettes and by monitoring suppliers, as seen in the industry-wide Sustainable Tobacco Programme's focus on eliminating child labor. Marketing that targets young and non-smokers poses risks to the sector, as does the welfare of workers in the agricultural supply chain.

Entity-Specific Score (35/50)

Workforce and diversity	Safety management	Customer engagement	Communities	General factors
Strong	**Good**	**Strong**	**Good**	**None**

Safety management is driving PMI's ambition to switch 40 million smokers to smoke-free products by 2025 (16% of smokers in iQOS markets at year end of 2020, excluding China and the U.S.). Combustible products accounted for close to 76% of net revenue in 2020. Yet, we see the increasing proportion of net revenue from smoke-free products (to 24% in 2020 from 3% in 2016) as a differentiator for PMI, while one smaller company in the sector divested early from combustibles. We regard PMI's targeted oversight on supply-chain safety concerns, such as green tobacco sickness, as being among the best in the sector. Finally, PMI tends to outperform peers across a range of direct workforce safety metrics, which further cements our view that the company performs well on less material safety risks.

PMI performs strongly by workforce and diversity measures. We view its efforts to remove child and forced labor from its supply chain as among the most robust of tobacco peers. PMI's holistic child-labor targets (to zero by 2025) and its upholding of socio-economic standards (100% of contracted tobacco farmers to make a living income by 2025) stand out in the industry. Few companies report progress against these targets, whereas PMI monitors 92% of its farms and has detected child labor in 0.8% of cases in 2019. We do, however, view any degree of forced and/or child labor as a key issue for the sector to resolve. Within its direct workforce, we see PMI as broadly leading peers on workforce retention and is among the top companies in the sector in terms of gender diversity.

PMI's approach to customer engagement is unique among peers. Where we see peers marketing their RRPs primarily through conventional avenues, we see PMI adopting a novel direct-to-consumer approach through its IQOS stores. In our view, the model promotes myriad beneficial outcomes, not least the ability to educate consumers directly on the health consequences of sustained tobacco use, but also the ability to support low-income customers to make the initially expensive transition from cigarettes to RRPs.

Finally, PMI's community risks stem from the impact of its products on public health systems, which continues to erode the company's social license to operate. However, we view the methods of engagement with communities in its agricultural supply chain as a key difference between PMI and peers. Notwithstanding its financial contributions, we view PMI's efforts to tackle persistent issues arising in its tobacco leaf supply chain as an active and effective method of maintaining acceptance in these communities.

Governance Profile

70/100

Sector/Region Score (28/35)

PMI's corporate headquarters are in New York where the company is listed. Its Operations Center is in Switzerland, a country with high governance standards. PMI's global exposure includes the European Union (37% of net revenue in 2020), the Middle East and Africa (11%), Asia and Australia (34%), Eastern Europe (12%), and Latin America and Canada (6%). We note PMI's presence in Indonesia, Turkey, and Russia, for their higher exposure to governance risks.

Entity-Specific Score (42/65)

Structure and oversight	Code and values	Transparency and reporting	Financial and operational risks	General factors
Good	**Good**	**Strong**	**Neutral**	**None**

We view PMI's board structure and level of oversight as in line with regional peers. PMI has a diverse board, composed of 10 directors, all of whom are independent, excluding the chairman who has ties to the group spanning 35 years and was formerly the CEO. We view positively the large percentage of independent members, but we note that in 2021 three out of the 10 independent directors had served for nine years or more. These long tenures, in our view, can weaken a board's independence. We view the level of engagement as average, with directors in 2019 attending at least 75% of board meetings and committees to which they were allocated. The board has maintained a diverse background of skills, with the recent addition of members with experience in telecommunications and pharmaceuticals being aligned with PMI's transition to becoming a "smoke-free" company. Further, PMI seems open to capturing new challenges and strategic opportunities for future development. The board's gender diversity is, however, more limited as only 30% of its members are women. In geographical terms, 50% of the directors are European and the rest are internationally diverse.

In our view, the remuneration structure is clear. The split between fixed and variable and the allocation of shares depends on seniority. The variable part tends to be significantly higher than the fixed, for executives, and the vesting period for share remuneration is three years. We see this as aligned with peers but still not fully reflecting the time needed to achieve strategic objectives that are usually remunerated with an equity component. In 2019, the CEO's remuneration was 396x the median employee compensation in the group, which compares with few other large U.S. multinationals, and is also generally higher than many global non-U.S. peers. PMI has a code of ethics and business conduct that enshrines high standards. We note that there are no reported cases of breaches to the code in the past five years and that a third party has audited the company's compliance system, which we view favorably.

PMI discloses detailed, comprehensive, and audited nonfinancial information, which we view as being demonstrably ahead of sector peers. As evidenced in the company's first integrated report (2019), there is a clear description of the methodology used to calculate its nonfinancial quantitative metrics, and, moreover, the level of transparency and detail outweighs peers.

Finally, our assessment includes the sector-specific governance risks faced by tobacco companies, such as litigation and the WHO FCTC, which outlines that public policy on tobacco should be protected "from commercial and other vested interests of the tobacco industry" and has been legally ratified by 181 countries.

Preparedness Opinion

Adequate
(+ 3)

Preparedness	Low	Emerging	Adequate	Strong	Best in class

PMI's preparedness balances strong strategic execution capabilities against clear headwinds from overall disruptive risks. Its focus is on non-combustibles, which it hopes will cannibalize its historical business of cigarettes and other combustibles known for causing premature death. Its ambition is to maintain its market share in the cash generative combustible segment, in the near term, to fund the conversion of smokers to non-combustible nicotine products. We view favorably the strategy to convert smokers to less harmful substitutes rather than simply divest the combustibles business. We acknowledge PMI's track record of successful strategic execution; however, our preparedness opinion encompasses the company's strategic direction to remain focused on nicotine consumption.

Nicotine remains a highly regulated addictive substance with negative societal effects, including limiting consumers' free choice. Reducing the content of nicotine in its combustible range would ultimately lead to a loss in market share and PMI's strategy relies on maintaining addiction to nicotine in its consumer base, albeit increasingly via a mechanism that reduces the risk of premature death as determined by the U.S. FDA. Nicotine also exposes companies in the sector to disruptive regulatory changes, as we have seen with non-combustibles. Tobacco companies are inherently at a disadvantage when it comes to engaging with policymakers, some investors, and other stakeholders who remain wary of supporting the sector. For example, the U.S. and Switzerland are among the few countries that have not ratified the WHO FCTC. Despite these headwinds, PMI shows its strong strategic execution; as of February 2021, IQOS is approved for distribution in 63 of PMI's 175 markets, albeit mostly in cities and not nationwide. Notably, Australia has rejected IQOS' distribution. The country is known for leading on tobacco control, being the first country to use plain packaging.

The board's awareness and acceptance of the negative effects of cigarettes on public health (noting that cigarettes brought in more than 70% of PMI's 2020 revenues) is the foundation of the current strategy to eradicate the use of cigarettes in the long term, and shift to smoke-free alternatives. That said, we believe the shift will be gradual and, in the short to medium term, PMI will still be exposed to combustible products in its portfolio, a segment in which it enjoys an estimated global market share just below 30% of retail value. This shift could address the major near-term disruption risk in the industry -- the secular decline in cigarette volumes--, but as nicotine remains restricted by age limits and taxation, we may still see declines. That said, we acknowledge that the absence of nicotine alternatives in the near term will likely result in continued use of combustible products and see the associated health problems persist, given nicotine's addictive properties.

The board demonstrates a concrete and well-thought-out action plan to move to non-combustible, smoke-free products in the long term. It is making robust R&D investments in RRPs (about 99% R&D spend in 2020) and plans to further innovate several new products and manufacturing capacities, while discontinuing or consolidating cigarette manufacturing facilities. Tobacco companies in general have little need for R&D and the company's US$8 billion capital investment in RRPs since 2008 stands out in the sector. The company is in the middle of introducing new price points for its RRPs that it hopes will accelerate the transition. We view favorably its ambition to leverage the new technologies it developed for IQOS for use in other non-nicotine products, yet we still see this as an emerging ambition with no current revenues.

Preparedness

Management strongly believes in embedding a new culture across the board and in PMI's leadership team, with the same mindset and behaviors trickling down the organization. It has made significant organizational changes in the past three years with 45% of senior management being new. The senior team has been upskilled on topics such as sustainability, technology, and pharmacology. The company targets at least 40 million adult consumers to quit smoking and switch to PMI's smoke-free products by 2025 (equivalent to around 16% of smokers in markets where PMI was commercializing IQOS at Dec. 31, 2020, excluding China and the U.S.). The target is backed by a remuneration structure that links executives' performances to the progression of the RRPs. PMI acknowledges the transition needs to factor in tobacco farmers and it has pilot programs to help diversify cultivation to include other crops, a step we recognise as taking a stakeholder approach.

Sector And Region Risk

Primary sector(s)	Consumer Goods
Primary operating region(s)	Switzerland Germany Japan Indonesia Turkey

Sector Risk Summary

We consider PMI to operate exclusively in the tobacco sector. The tobacco sector sits within our Consumer Goods sector; however, we differentiate it from its parent sector across several factors, and therefore limit the peer group to companies operating primarily in tobacco.

Environmental exposure

The most material environmental risks for the tobacco subsector come from its agricultural supply chain. The cultivation and curing of tobacco, the production of cellulose acetate tow for cigarette filters, and the deforestation associated with flue curing (which often requires firewood) and land expansion, are fundamental sources of risk for the sector. The tobacco subsector also faces long-standing environmental risks from the end-of-life disposal of its products, including cigarette butts. We view water use as less of a material risk for tobacco due to its relatively limited irrigation requirements compared to other commodity crops..

Social exposure

The most material social risks for the tobacco subsector relate to the negative health effects associated with tobacco use, and the use of forced and child labor in the supply chain. The industry is largely moving to address these risks by introducing reduced-harm alternatives to combustible cigarettes and by monitoring suppliers, as typified by the industry-wide Sustainable Tobacco Programme' s focus on eliminating child labor. Marketing practices towards youth and non-smokers, and the welfare of workers in the agricultural supply chain also pose a risk to the subsector.

Regional Risk Summary

PMI's Operating Center is located in Switzerland, and the company operates in 175 markets globally. PMI's global exposure includes the European Union (37% of net revenue in 2020), Asia and Australia (34%), the Middle East and Africa (11%), Eastern Europe (12%), and Latin America and Canada (6%). Alongside Switzerland, we provide the rationale of several countries based on PMI's shipments within regions.

Switzerland

Switzerland has a strong track record of managing economic crises, and has extremely stable political institutions. It has extensive checks and balances, particularly with obligatory or facultative referenda. There is great respect for the rule of law, free flows of information, and timely and reliable data dissemination. Corporate governance requirements for publicly listed companies are based primarily on the 1911 Swiss Code of Obligations. In June 2020, the Federal

Council approved amendments to the Code, which will likely enter into effect in 2022. These include the introduction of a diversity target of 30% for boards of directors and 20% for executive committees, as well as a mandatory binding vote on executive remuneration. The latter reflects the incorporation of the 2014 Swiss Ordinance against Excessive Compensation in Listed Companies. Swiss companies have a single board of directors. Separate audit and nomination committees are recommended, while compensation committees are mandatory. Nevertheless, there is much flexibility for companies to establish their governance structure of choice. The Swiss Code of Best Practice for Corporate Governance, which was first adopted in 2002, offers some high-level, non-binding guidelines. It was revised in 2014 to include a comply-or-explain principle and recommends, among others, that boards comprise a majority of independent directors. In 2016, the Swiss Coalition for Corporate Justice submitted a proposal to increase corporations' human rights and environmental protection efforts, which a referendum rejected in 2020. However, parliament approved a counterproposal by the Federal Council, which will likely lead to a mandatory vote on ESG reporting. In 2020, the Federal Council also approved guidelines for sustainable finance practices and transparency. In terms of corruption, Switzerland ranks fourth out of 189 in Transparency International's 2019 Corruption Perceptions Index.

Germany

Germany has strong institutional and governance effectiveness, with much transparency and accountability. Rule of law is strong, the judiciary is independent, and corruption is viewed as a minor issue. Germany has a moderate amount of ESG regulation. While Deutsche Börse AG does not require ESG reporting as a listing rule, companies of over 500 employees are implementing the EU Non-Financial Reporting Directive's recommendations, which mandate the disclosure of ESG data like diversity and pay ratios. The German Corporate Governance Code (Kodex) is the reference document for Germany's best practices and works on a comply-or-explain basis. A new version of the Kodex came into effect on Jan. 1, 2020 when the EU Shareholder Rights Directive II was transposed into German law. Notable improvements include recommendations on board independence, as well as board oversight of related party transactions and executive pay. While the recommendations are less specific than most European codes, companies exhibit strong governance practices. Companies are typically governed by a two-tier board system: a management board of executives, which is overseen by a supervisory board comprising non-executives including shareholder and employee or labor union representatives. While not world-leading, there are corporate disclosure requirements for selected ESG aspects and both occupational pension funds and insurers must state whether and how they account for ESG considerations when managing pension fund assets under their control.

Japan

Corporate governance practices and policies are good but somewhat below the standards of other major advanced economies. Board diversity and transparency are areas where businesses lag their counterparts in other advanced markets. Improving Japanese corporate governance, backed by the recent government's strong initiative, has been a key thrust of the current government's economic revival strategy. The Japanese regulator's revision of the Stewardship Code in 2020 and the Corporate Governance Code in 2018 were important advances but implementation has been somewhat slow. Despite improvements some traditional habits are proving quite entrenched. These include cross-shareholdings among companies, limited outside director oversight, and limited diversification in management. Gender diversity in senior positions remains low--under 4% of executives in listed companies are women--although the government aims to reach 10% female executives and 30% female senior managers by 2020. Japanese boards are typically male-dominated and often by former executives with long tenures. Although it has been improving, the lack of diversity on boards in terms of age, background, gender, and experience might impede progress to transparent governance and decision making that is nimble enough to adapt to a rapidly changing business environment.

Indonesia

Social standards are in line with most other major developing economies, but there is significant disparity among Indonesian society. Rules for worker protection are strong but enforcement is patchy. Corporate governance standards are generally weak, particularly for smaller or unlisted companies. Indonesia's financial services regulator, Otoritas Jasa Keuangan, released a roadmap to improve corporate governance in 2014 but the implementation of best practices is still lacking. We note that many listed companies often fail to comply with mandatory regulations. Boards often lack independence and diversity, while compensation disclosures are scant. Transparency is limited and ESG disclosure is below other developing countries. Corruption remains an issue as it does in many other countries in the region. The judicial system is inefficient and outcomes can be unpredictable.

Turkey

Since 2013, pressures on Turkey's regulatory institutions and judiciary have coincided with weakening checks and balances and less predictable legal enforcement. One of the consequences of this deterioration is a notable decline in foreign direct investment over the past half-decade. Nevertheless, governance standards still benefit from a relatively advanced institutional framework. Since the publication of the landmark Capital Markets Law in 2012 the Capital Markets Board of Turkey has been working on further improving governance standards. Its Corporate Governance Principles (revised in 2014) introduced new and important clauses in areas such as board diversity and related-party transactions, among others, and made some provisions mandatory. Pyramidal ownership structures are prevalent in Turkey where controlled conglomerates own controlling shares at most companies. This affects minority shareholders rights. This is reflected on boards--often made up of several executives from the controlling group--while adherence to international best practices is more common among the key large-cap listed companies.

Related Research

- “The ESG Risk Atlas: Sector And Regional Rationales And Scores,” published July 22, 2020
- “Our Updated ESG Risk Atlas And Key Sustainability Factors: A Companion Guide,” published July 22, 2020
- “Environmental, Social, And Governance Evaluation: Analytical Approach,” published December 15, 2020
- “How We Apply Our ESG Evaluation Analytical Approach: Part 2,” published June 17, 2020

This report does not constitute a rating action.