

High Current Income from the Tobacco Industry

Lorillard, Inc. – Dividend Yield 6.05%

(Ticker Symbol: LO)

Greetings from LFS

Dear Clients and Friends:



Invest is a quarterly newsletter created and distributed by LFS. The purposes are to offer:

- An investment idea that will perform regardless of market conditions.
- Insight into an industry including trends, opportunity and challenges.

I welcome any questions, comments or suggestions.

Sincerely,

Douglas Ruth

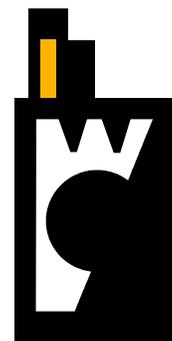
Invest

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Lorillard, Inc. (LO) is the third-largest producer of cigarettes in the United States.

- Founded in 1760, Lorillard is the oldest continuously operating tobacco company in the U.S.
- The company became an independent publicly held entity when it was spun off from its parent company, Loew's Corporation, on June 10, 2008. Loew's spun off Lorillard in order to pursue growth in other areas.
- The company's primary brand, Newport, represents more than 90% of its sales.
- Newport is the top-selling menthol cigarette and second-largest cigarette brand in the U.S.



The U.S. tobacco industry consists of three major companies:

Company	Percent of U.S. Market
1. Altria (MO)	49.9%
2. Reynolds American (RIA)	28.0%
3. Lorillard, Inc. (LO)	11.3%
All Others	10.8%

Lorillard has had the highest profit margins, but is currently trading at its lowest valuation.

Net Profit Margins

	2008	2009
MO	16.0%	13.6%
RIA	15.1%	11.4%
LO	21.1%	18.1%

Price-to-Earnings Ratio

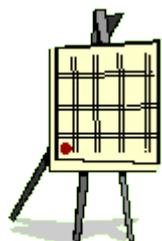
October 1, 2009 through September 30, 2010

	Stock Price 01/19/11	Earnings per Share	Price-to- Earnings Ratio
MO	\$24.02	\$1.78	13.5 to 1
RIA ¹	\$32.20	\$2.12	15.2 to 1
LO	\$76.64	\$6.56	11.7 to 1

1. Adjusted for discontinued operations.

Characteristics of the Industry:

Declining market:



The domestic cigarette market has been declining and the expectation is that this trend will continue for several reasons:

- Restrictions on advertising and promotions
- Increases in regulation and excise taxes
- Health concerns
 - A decline in the social acceptability of smoking
 - Increased pressure from anti-tobacco groups and other factors
- Industry-wide domestic cigarette sales decreased at a compound annual rate of approximately 3 percent from 1999 through 2009.

Decline of Cigarette Sales From Previous Year

2006	2007	2008	2009
1.5%	5.0%	3.3%	8.6%

Two Trends:

1. **Discounted cigarettes:** Increased consumption of deep discount cigarettes. Deep discount brands have grown from an estimated share in 1998 of less than 2.0 percent to an estimated 14.3 percent for the twelve months ending December 31, 2009.
2. **Increasing menthol sales:** The sale of menthol cigarettes is increasing.

Menthol and Nonmenthol Cigarette Sales

Market Share	2007	2008	2009
Menthol	27.9%	28.4%	28.8%
Nonmenthol	72.1%	71.6%	71.2%
Total	100.0%	100.0%	100.0%

Newport is the market leader in the menthol category and the brand is growing.

Newport's Market Share Of the Menthol Market

2007	2008	2009
32.9%	34.0%	34.1%

The U.S. Food and Drug Administration:

The U.S. Food and Drug Administration (FDA) is considering whether to ban the sale of menthol cigarettes.

Studies funded by the National Cancer Institute found that African-Americans and young adults disproportionately smoked menthol cigarettes and were less successful when they tried to quit.

These are the facts and figures:

Percentage of Smokers Who Prefer Menthol Cigarettes

Smoker	Percentage of Menthol Smokers
African-Americans	80%
Whites	22%
Hispanics	30%

According to a recent study, younger smokers chose menthol cigarettes more frequently than older smokers.

2006 Menthol Smokers

Age	Percentage
12-17	43.8%
18-24	35.6%
Over 35	30.6%

Smoking in School

African-American smokers who chose menthol:

Middle school	64%
High school	79%

Source: LegacyForHealth.org

The NAACP's Legal Defense and Education Fund has joined forces with the American Legacy Foundation, an anti-smoking group, to support an FDA ban in an effort to keep another generation of young people from being drawn in.



Community activists charge that cigarette companies continue to target young smokers with advertising designed to make smoking seem cool.

Why do People Smoke?

One of the mysteries of life is why people smoke. According to wisegeek.com, these are the reasons:

- Most people who smoke do so because they can't stop.
 - Nicotine is a highly addictive substance that makes people feel energized and alert.
 - Smokers get a rush after a cigarette, and giving up produces withdrawal symptoms that include difficulty sleeping and cravings.
 - Seventy percent of people who quit smoking eventually start again!
- Tobacco advertising also has a big influence on why people smoke. For years, the industry has focused on making smoking glamorous through advertising in movies, television and billboards.
- Smoking also produces psychological dependency.
 - Many people smoke because it helps them relax and cope with difficult situations or because it gives them confidence.
 - Others smoke when they feel bored.
 - Smoking produces a feeling of satisfaction that's difficult to give up.
 - Finally, people who smoke are usually in denial – they know that smoking is bad, but they convince themselves it's simply "not as terrible as they make it sound."
- Smoking is a social activity as well.
 - Many people who smoke do so as a way to start conversations and interact at parties or in crowded places.
 - This is known as "social smoking" and usually involves alcohol as a complement.



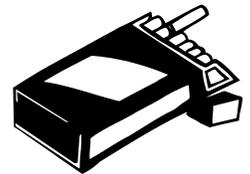
- Many teenagers start smoking because of peer pressure.
 - They may also feel more mature or consider smoking an act of rebellion against parental authority.
 - It has been proven that children are more likely to smoke if their parents do.

Cigarettes are a Legal Product:

According to *Wikipedia*:

- The earliest forms of cigarettes can be traced back to the ninth century in Central America.
- The French gave the cigarette its name around 1830.
- Widespread smoking in the western world occurred in the 20th century.
- Smoking peaked in 1965. At that time, about 50 percent of men and 35 percent of women smoked (42 percent of the population).
- In 2006, 20.8 percent of adults smoked.

An interesting question is why is smoking legal? According to yahoo.com, the answer is simple and straight-forward. Cigarettes do not alter behavior. Banned, addictive drugs can cause people to modify their normal/acceptable behavior, which may cause harm to others or themselves.



Heavily Regulated Industry:

- The cigarette industry is heavily regulated:
 - It is illegal to sell cigarettes to minors.
 - Retailers must verify that they are selling cigarettes only to adults.
 - The industry supports efforts to deter young people from smoking.
 - From time-to-time, there are articles in newspapers, which list the names of vendors who have been assessed fines for not following the rules.
- The industry is heavily taxed:
 - About \$130 billion is generated for the state and federal governments each year.

- A portion of the industry profits is used to help people quit smoking.

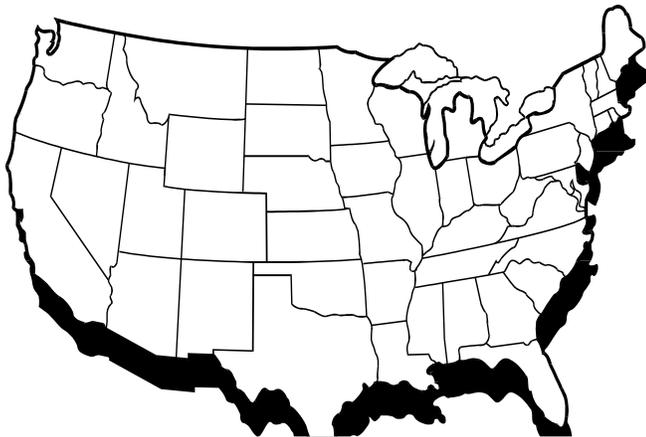
Oprah:

Oprah Winfrey is one of the most watched and highly regarded women in America. She has been quote in her magazine, *O*, as saying.

"We are each responsible for our own lives – no other person is or can be."

Additionally, Lorillard has stated there is no scientific evidence of increased harm using menthol cigarettes over other tobacco cigarettes.

LFS's position is that the NAACP Legal Defense and Education Fund is attempting to somehow make the tobacco companies responsible for the actions of smokers. Ultimately, each adult has freedom of choice and no one is being forced to buy cigarettes. While we disagree with the NAACP, we respect their right to express their



opinion.

LFS believes that America is the best place in the world to live. America's openness to new ideas and the ability for people to challenge or ultimately change a rule or regulation they are unhappy about is unique. These ideals explain why America continues to be a destination for many people who live outside of this country.

No One Can Stop It:

The information from *Wikipedia* shows that people have been smoking for more than 1,100 years.

Louis Camilleri was the CEO of Philip Morris International. In a May 4, 2009, *Business Week* article, he stated:

"If I shut down all the factories tomorrow, people aren't going to stop smoking."



In a November 24, 2010, article written by *Chicago Tribune* reporter Dahleen Glanton, Lorillard, Inc., stated some interesting facts and figures gathered from Lorillard spokesman, Gregg Perry:

Banning menthol cigarettes would:

- Force 30 percent of the cigarette market to go underground.
- Deal a blow to state and federal governments, which would lose \$40 billion in excise taxes and settlement fees collected each year from cigarette sales.
- Not have the consequences of improving public health.
- Fuel an underground criminal enterprise and lead to the illegal sale of more dangerous cigarettes than those now being sold by regulated companies.

For the most part, this is the same argument offered by the Congress of Racial Equality, the Black Law Enforcement Executives and the Black Chamber of Commerce, which have all urged the FDA not to impose a ban.

News Expected in March 2011:

The Food and Drug Administration is due to deliver a non-binding recommendation in 2011. LFS believes that menthol cigarettes will not be banned and LO stock will increase in value later in the year.

LO Operations:

The Tobacco Business is Uncomplicated:

Distributors: The company works through wholesale distributors, who, in turn, service:

- Retail outlets;
- Chain store organizations; and
- Government agencies, including the U.S. Armed Forces.

Number of	2009
Distributors	500
Retail customers served	More than 400,000



The biggest customer is the McLane Company. McLane is one of the largest wholesale suppliers of food products in the U.S., serving more than 50,000 retail stores and foodservice operators from about 40 distribution centers. Its grocery and retail distribution division serves convenience stores, drugstores, and mass merchants, including Wal-Mart.

Sales to McLane Company

2007	2008	2009
24%	26%	26%

Raw Materials and Manufacturing:

The company buys most of the tobacco it uses to make cigarettes from one supplier and operates a manufacturing facility. Additionally, LO maintains some warehouse, offices and a research facility. The details follow:

- In the production of cigarettes, LO uses domestic and foreign grown burley and flue-cured leaf tobaccos, as well as aromatic tobaccos grown primarily in Turkey and other Near Eastern countries.
- More than 80% of the domestic leaf tobacco is purchased from one dealer, Alliance One International, Inc. ("Alliance One").

Facilities:

- **Warehouses:** The tobacco is stored in 29 storage warehouses on the company's 130-acre Danville, Virginia, facility.

These tobacco receiving and storage facilities total approximately 1,400,000 square feet.

To protect against loss, amounts of all types and grades of tobacco are stored in separate warehouses.

- **Manufacturing facility:** The facility is located on approximately 80 acres in Greensboro, North Carolina.



This 854,300-square-foot plant contains modern high-speed cigarette manufacturing machinery.

The manufacturing plant has a production capacity of approximately 185 million cigarettes per day and approximately 43 billion cigarettes per year.

The Greensboro facility also includes a warehouse with shipping and receiving areas totaling 187,300 square feet.

- **Aging tobacco:** Certain types of tobacco used in the company blends must be allowed to mature over time to allow natural chemical changes that enhance certain characteristics affecting taste.

Because of these aging requirements, large quantities of leaf tobacco are maintained at all times.

- **Executive offices:** The executive offices are located in a 130,000-square-foot, four-story office building in Greensboro.
- **Research facility:** The company's 93,800 square-foot research facility is also located in Greensboro.

Working in the Tobacco Industry:

A job in the tobacco industry is considered desirable. The company provides:

For hourly union workers:

- A retirement plan;
- A profit sharing plan; and
- Other benefits.



For salaried employees:

- A retirement plan;
- Group life;
- Disability insurance;
- Health insurance;
- A savings plan; and
- An incentive compensation plan for certain salaried employees.

Some LO employees are union members; others are not.



Employees (Numbers are Approximate)

	2008	2009
Union members	1,050	1,000
Salaried employees	<u>1,750</u>	<u>1,700</u>
Total employees	2,800	2,700

Litigation:

Large sums of money are spent litigating tobacco suits. The general consensus is that, while the amount spent is large, it remains manageable.

Advertising and Marketing/Research and Development:

LO spends money on advertising and marketing, and research and development.

Advertising and Marketing Costs (In \$Millions)

2007	2008	2009
\$50	\$47	\$40

Research and Development (In \$Millions)

	2007	2008	2009
Cost	\$88	\$20	\$19
Scientists involved in R&D			60

The Cigarette Industry Today:

Four cigarette brands represent the majority of the industry sales today:

Brand	Market Share
Marlboro	42.6%
Newport	10.6%
Camel	8.0%
Pall Mall	7.8%
All others	<u>31.0%</u>
Total	100.00%



Sales and marketing people like to talk about the power of a successful brand. They will explain that the brand is so good that people will often pay more for the product than they would to purchase a competitor's product. Also, they will mention that, as other consumers notice the brand, they also will become loyal customers. In this case, the sales and marketing

people are exactly right! LO's premium brand of cigarettes, Newport, is consistently gaining market share. This is an impressive statistic!

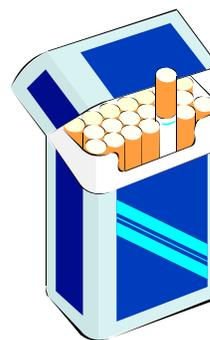
Newport's Share of the Cigarette Market

	Q1	Q2	Q3	Q4
2007	N/A	9.5%	9.6%	9.5%
2008	9.9%	10.0%	10.0%	9.9%
2009	10.2%	10.4%	10.3%	10.3%
2010	10.9%	10.9%	10.8%	-

LO Strategy:

The company's strategy is to:

1. Increase sales of the Newport brand.
2. Increase sales of the price/value brand, Maverick.
3. Focus on the shareholders.



1. Increase Sales of the Newport Brand:

- On August 3, 2010, Lorillard, Inc. (NYSE: LO) announced its plan to launch a non-menthol variety of its flagship Newport brand in November 2010.

- Lorillard believes it will further strengthen its competitive position and its Newport brand family with the national introduction of Newport Non-Menthol.

Martin Orlowsky, Chairman, President and Chief Executive Officer stated:

- *"We are excited to leverage Newport, one of the most recognized names in the cigarette industry."*
- *"With the introduction of Newport Non-Menthol, Lorillard will be afforded greater opportunity to compete in the largest segment of the U.S. cigarette market, as the non-menthol category represents approximately 70 percent of total industry volume."*

2. Increase Sales of Maverick:

In 2004, LO repackaged and rebranded the Maverick cigarette brand. Since that time, sales of Maverick have increased.

Units Sold (In Billions)

2007	2008	2009
1.4	2.3	3.5

Units Sold in Nine Months (In Billions)

2009	2010
2.5	3.4

3. Focus on the Shareholders

Tobacco companies are known for having an intense focus on rewarding their shareholders. Two strategies that have high priorities are stock buybacks and dividend payout ratios.

Stock Buybacks:

LO's earnings per share has increased partially because there are fewer shares outstanding.



Shares Outstanding (In Millions of Shares)

2007	2008	2009	09/30/10
173.9	172.2	164.6	151.5

Murray Kessler, who assumed his position as LO's President and CEO on September 13, 2010, explained during the company's third quarter 2010 earnings release:

"The 26-percent increase in earnings per diluted share for the third quarter includes the benefit of the company's share repurchase program which resulted in lower outstanding shares, and contributed \$0.14, or 9.7 percentage points to the increase in earnings per share."

Dividend Payout Ratio:

LO's goal is to payout 70 to 75 percent of its earnings to shareholders in the form of dividends. The company has raised its dividend two times in a short period of time.

Dividends per Share

Year	Quarter			
	1	2	3	4
2008	-	-	0.92	\$0.92
2009	\$0.92	\$0.92	▶\$1.00	\$1.00
2010	\$1.00	\$1.00	▶\$1.125	\$1.125

The "Munch Strategy:"

LFS believes that investors who buy tobacco stocks should consider them lifetime holdings. Over a period of time, the companies have a history of increasing value, and paying cash dividends as well as increasing them. While nothing is guaranteed, this industry has been very good to long-term investors.

Litigation, the fear of litigation, taxation and the possibility of increased taxation are characteristics of the industry. Understanding these fears can be helpful to the investor who is willing to own a tobacco stock.

Generally, when litigation or taxation changes are discussed, stocks like LO will drop in value. Investors can use the drop to buy additional shares or "munch" on the opportunity.

Tobacco stocks increase in value over a period of time because the companies have a history of earnings growth. LO's report for the first nine months of 2010 is impressive.

LO is an attractive stock to consider at this time because of the fear of a menthol ban.

Consolidated Condensed Statement of Income (In \$Millions except Share Data)

	Nine Months Ending 09/20	
	2009	2010
Net sales	\$3,855	\$4,446
Cost of Sales	<u>2,430</u>	<u>2,861</u>
Gross profit	\$1,425	\$1,585
SG&A Expense	<u>282</u>	<u>293</u>
Operating income	\$1,143	\$1,292
Investment income	4	3
Interest expense	<u>(18)</u>	<u>(66)</u>
Income before income taxes	\$1,129	\$1,229
Income taxes	<u>423</u>	<u>459</u>
Net income	\$706	\$770
Earnings per share		
Basic	\$4.24	\$5.04
Diluted	\$4.24	\$5.04

During challenging economic times, LO's net income has increased 9 percent for the first nine months of 2010.

Nice Dividends and Appreciation:

While no one knows what will happen with 100-percent certainty, LFS does not believe that a ban of menthol cigarettes will occur. The stock provides a nice dividend and the potential for it to appreciate in value over a period of time is realistic.

On a short-term basis, LFS believes that LO could trade at a similar price-to-earnings ratio of Altria (MO). This suggests that the stock could trade at a price of \$88 per share.

Calculation: Possible LO Stock Price

Company	Stock Price	Earnings-per-Share (EPS)	Price-To-Earnings Ratio (PE)
MO	\$24.02	\$1.78	13.5 to 1
LO	\$88.56 ¹	\$6.50	13.5 to 1

1. $\text{EPS} \times \text{PE} = \text{Possible share price}$
 $\$6.50 \times 13.5 = \88.56

We recommend that investors consider purchasing LO stock at this time.

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I would like information on the following:

- Bassett Industries, Inc. (BSET)
- CCA Industries, Inc. (CAW)
- Chromcraft Revington, Inc. (CRC)
- Delphax Technologies, Inc. (DLPX)
- Deswell Industries Incorporated (DSWL)
- Lakeland Industries, Inc. (LAKE)
- Lorillard, Inc. (LO)
- Parlux Fragrances, Inc. (PARL)
- RELM Wireless Corp. (RWC)
- Reynolds American, Inc. (RAI)
- 21st Century Holding Company (TCHC)

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