Half-Year Results 2018

Transcript of Q&A

Wednesday, 9th May 2018

Alison Cooper: We'll now take any questions. This presentation is being webcast, so please make sure you use the microphone beside the seat and give your name and organisation before asking your question.

Owen Bennett: Hi. A couple of questions, please. I mean, at year-end, you said you were hoping to do price/mix between 4% to 5% for the full year, taking your model. That, therefore, requires 8% in the second half. I'm just wondering what the key drivers of that pickup are. And particularly, how much is vapour contribution accelerating going to contribute in the second half?

And then secondly, more NGP-related, in terms of products, just any commentary on the *my*blu roll-out in the US and how that's getting on against JUUL, from any kind of feedback you've seen already? Thanks very much.

Alison Cooper: Okay. Do you want to pickup with the US and *my*blu?

Matthew Phillips: First? Yeah.

Alison Cooper: Yeah, and then price/mix.

Matthew Phillips: We're a couple of months in and it's going well. The feedback from retailers, the vape channel and from consumers, both directly and through the retailers, is very positive. A lot of people focus on Nielsen data, which we don't. Maybe an obvious reason is given the challenges that we see with the way that they cover the market. So, it's anecdotal at the moment. I mean, the guys are really excited about the good response that they're getting to the product. So yes, it's very positive.

Alison Cooper: And we have the nicotine salt edition coming up as well, so that will further drive momentum into H2.

Oliver Tant: And on price/mix, you're right around the 8% and you're right to assume that there is a tick-up in the revenues from blu, which obviously contribute to that. And I think Matt referred to that during the course of his presentation.

If you look at what we're expecting from Tobacco, it's much more in line with our historic norms. In fact, the exit numbers of the second quarter and actually the step-up is not, therefore, that dramatic from where we exited Q2. And we've got quite a lot of confidence in the ability to deliver that, given where pricing currently sits across the market.

Owen Bennett: Thank you.

Adam Spielman (Citigroup): Will you be launching nicotine salts in the US, given the FDA's 'deeming' regulation? And could you split out the mix in H1 between price and mix? *[QUESTIONS PARAPHRASED HERE DUE TO POOR AUDIO]*

Matthew Phillips: Yes, nicotine salts will be going into the US. They're going in liquid form in the next month or so and they're also going in pod form in July.

Alison Cooper: And on mix, Oliver?

Oliver Tant: On price/mix, pricing has been, broadly speaking, in line with our expectations.

Adam Spielman: Which was?

Oliver Tant: They're second half weighted. From memory, I think they were around the sort of 2% to 3%. I'm going to come back to you on that, Adam. But where we have been more materially impacted is around mix, where we've seen some element of product mix changes, to some large degree driven by excise duty and other events that have occurred across the markets in Saudi, for example, where we've seen excise duty absorbed across the market and markets like France.

And there's also been an element of geographic mix which is, I guess, a feature of the industry. The rates of size decline will change the portfolio and its contribution period-on-period. And they're broadly equally weighted, in terms of their impact in the first half.

Adam Spielman: And if you think about how mix is going to go forwards, do you think it will – as I say, I understand the point that price is going better. That's very clear. And the IP factor drops out. That's very clear. But I'm wondering if you can talk about how you think whether mix will be as negative in the second half as it was in the first half?

Oliver Tant: No, it ameliorates.

Adam Spielman: Okay.

Alison Cooper: On your point about the portfolio, Adam, there's some specifics on portfolio, in terms of product mix that come through. So, Saudi is the standout example because of the doubling of the excise. Clearly, the premium segment is under a lot of pressure. Consumers are downtrading to the value segment. We're well-positioned there, so it's a very good share performance for us.

Though as everybody is in that market, there's a mixed hit from that because of the shift in terms of the consumer. But in most markets, we're very value-biased anyway. So, it's not going to be a significant mix hit, in that sense. It's got to be one-off examples like the one I called out in Saudi that's going to be more significant. Other than that, as Oliver calls out, it's a lot to do with some of the market mix impacts in the first half which will ameliorate into the second half.

Jon Leinster (Berenberg) A couple of quick ones. On the currency minus 4% to 5%, is that just translation or was that translation and transaction what you'd given for the full-year?

Oliver Tant: That's translation.

Alison Cooper: It's on translation.

Jon Leinster: Okay.

Jon Leinster: And then secondly, in terms of on the gain on NGP, just to be clear, you obviously got second phase trials for the heated tobacco. I think previously, you'd said you wanted a product launch sort of by the end of calendar 2018 or early 2019. Is that still remain the sort of broad timetable?

Alison Cooper: Matt?

Matthew Phillips: Yes. If we choose to launch, that would be the timetable.

Jon Leinster: Right. Okay. And so, on the sort of non-tobacco oral pouches, is that something developed for the European market? And if so, is that going to go into Scandinavia or are you going to try and launch elsewhere in Europe as well or perhaps even America, with FDA approval?

Matthew Phillips: Absolutely. I mean, it's broader than Scandinavia. But you're right. If it was to be the US, it would need FDA approval. So, we're mainly focussed on non-US markets – maybe put it that way.

Jon Leinster: Interesting. Non-Scandinavian markets?

Matthew Phillips: Yes. We think it's an interesting opportunity.

Jon Leinster: Thanks.

Alison Cooper: Chas, yes.

Chas Manso (Société Générale): Hi. Question on your dividend policy. It's still 10% growth in the interim and the Chairman statement supported this saying, "Always under review". Can you just sort of give us a bit more colour on what that means? Does that mean that given that it's so high and growing, you may consider changing it at any time soon or whether, actually, the Board is giving its 100% support to the continuance of the 10% policy?

Alison Cooper: It was really a statement that's says what it says on the tin, which is any Board's responsibilities are to keep the dividend policy under review. But as you've seen at the half-year, we continue to have very strong cash generation, strong margins. We believe we're putting investment we need behind the business. And therefore, there's nothing further to comment about the policy. But "under review" is really just the good discipline of the Board to keep it under review – nothing more than that.

Oliver Tant: And it's worthwhile noting, Chas, we've a 67.6% payout ratio. It's not high against the peer group. We are producing £1.2 billion of debt pay-down. Doesn't exactly look like a group that's challenged for cash, at the moment.

Alicia Forry (Investec): Good morning. Just a few questions. I think in the statement, you mention in H2 that you expect further share gains. Can I just confirm that you're referring to volume share here? And in light of the significant outperformance versus your markets that you've seen on volumes in H1, I was just wondering if you could talk about a little bit more about what's driving that?

Are you taking, perhaps, less price than some of your peers? Is it just simply a factor of downtrading in your markets benefiting your brands? Just trying to understand what gives you confidence on the volume share gains to continue in H2 and possibly even beyond. That was question one.

Then, secondly, on the US. In the recent FDA letter to JUUL, just wondering if you've seen any fallout from that or had any change in dialogue with the FDA regarding your *my*blu products in that market and what the implications are of that development there? And on NGPs, are you planning, at some point, to break out the financials as some of your peers do?

And then, finally – sorry for the long list of questions.

Alison Cooper: Just go on.

Alicia Forry: With regards to earmarked assets for disposals, appreciate that there's a limit to what you can say, but if you could help us with regards to how you view possible dilution, what we should kind of prepare ourselves for? Thank you.

Alison Cooper: Okay. So, let's kill off the first one very quickly. It's volume share we're talking about. But clearly, with the improving price/mix dynamics we've got coming through Q2 at 4% as we see that improving through the second half as well, that clearly moves into a good value performance as well. I'm going to ask Dominic and Joerg briefly to comment on two markets. I'm thinking Russia and UK, but you pick.

In terms of what's driving that volume performance, we talk about the Market Repeatable Model and, really, it's the disciplined implementation of that. I can give you some examples where we've really driven the share. And I highlighted earlier, it's around the brands, the portfolio focus, but also around the whole customer relationship dynamic.

I want to be absolutely clear that the bit around always-on price strategy on the MRM is about price parity to competitor brands in the market. There's been no investment behind that part of the wheel in 2018. So, this isn't a price-driven – I call it borrowing share when you use price to drive share because it's not sustainable and we're driving a sustainable focus on share growth. So, I'll come back on that shortly.

FDA, if you pick up on that, Matt, and either you or me can pick up on this point on dilution. Do you want to go and briefly pick a market? I'm thinking Russia, UK, where it's worth giving a concrete example, yes?

Dominic Brisby: I'll speak quickly about Russia. And really, Russia as an example, but it's pretty consistent with the way we're handling all the markets, which is very clear, very strong execution of the MRM in every aspect.

So in the case of Russia, we've massively strengthened our position in key accounts. We were always strong in independents. Now, we're very strong and key accounts. And actually, a lot of the growth that we've delivered has come from our strong presence in these. And of course, key accounts are growing very much across Russia, at the moment.

So, we're growing share within a trade channel that's growing significantly. We've simplified the portfolio very much. We used to have a big tail of quite small brands and we've put big focus behind the brands which we see the biggest potential to grow, particularly value-for-money international brands like P&S.

And as Alison has said, we've made sure that price is a point of parity. But it's been nothing more than a point of parity. What's delivered the growth has been our work behind brand equity and our strength of these trade relations that we've got in Russia and that's a pretty consistent story across most of the markets where we're growing share.

Alison Cooper: And we're using that to leverage blu now as well.

Dominic Brisby: Yes exactly.

Joerg Biebernick: I'm almost afraid I can't offer a very substantially strategically different answer to what I just heard Dominic had already said – because it also applies to the UK. Pricing is not the key driver for the share growth. Our strategy is clearly about parity pricing. We're in a positive position there that a lot of the pricing is now embedded as well.

The share growth really has come from our investments and our growth plans, namely John Player Special. And we are very well-positioned at the market-end where consumers are trading into and in our FCT . These are really the key two drivers.

And then the sales execution. We've extended our sales coverage extensively and that's paying back. We're also very excited about the recent *my*blu launch. The consumer and customer reaction has been very strong, distribution is in line with expectations and the initial consumer off-take is also strong. Thank you.

Alison Cooper: Thanks. Matt, the FDA?

Matthew Phillips: On the FDA, I mean, the more interesting thing I thought about the tonality of the enforcement notice – about the enforcement wording that was used by the FDA. But actually, it was very positive towards vapour as a category and that's great.

From an enforcement perspective I don't know any more than you guys do in terms of actually what steps the FDA will take. We have always had very, very strong youth access prevention mechanisms and policies, so it's something that we completely endorse. And we're looking forward to working with the FDA to lift the standards, basically, of those that don't meet them currently. But in terms of our dialogue with them, there has not been a change.

Oliver Tant: And on the disposal programme, I think one has to look at the disposals in the context of the strategic framework which is driving them. I mean, our whole strategy, since Alison's appointment, has been around simplification.

Focus, focus, focus. Focus on key problems. Focus on key markets. Focus on Next Generation Product opportunities. And the real opportunity for some profit turns is that that focus, that simplification will draft both topline and bottomline performance.

What we're doing, therefore, with the operations that we will be disposing of is, really, simplifying to ensure we deliver the stronger earnings profile in the longer term. So, there may be some short-term dilution as we actually sell bits, but the longer term expectation is that that strategy will deliver a much better both topline and bottomline, performance. There'll be no dilution.

Alison Cooper: Yes.

Fulvio Cazzol (Goldman Sachs): Just as a follow-up on that comment. I appreciate that in 12 to 24 months, things can change significantly. But if you had £1 billion to £2 billion coming in today, what would you be using that cash for?

Alison Cooper: It's an answer which, unfortunately, is not going to be very satisfactory because there are clearly – the uses for cash are around that the debt position of the business, which we're still in the balance sheet rebuild mode, following the US deal. So, that would definitely play a part.

There's also clearly investment in the business. But at the moment, as we look at the current year, as we look at what we want to do next year, we're confident with the investment opportunities that we have in the funding of those investments. So, there'd be nothing incremental.

I don't think, at this stage, that we would highlight that we would want to put more money into. And clearly, there's the aspect, in terms of shareholder returns. So right here, right now, there's nothing, obviously, I'd do different, immediately. Because we are adopting a very disciplined investment approach to what we're doing in Next Generation Products. And we do see the way we are looking to unlock this opportunity is something that will be smart and capital-light, overall.

So, it's not a question of looking for more funds for investment in the business, currently. So, I think initially, probably we'd just take a little bit of debt down to make sure we rebuild the balance sheet right here, right now, if it was today.

Adam Spielman: Hi, again. Can you just talk, in general terms, a little bit more about tobacco heating both in terms of how you see the threat developing in Europe to the extent you do, where, what sort of customers or clients or consumers and also in terms of the opportunity for you? So, I guess if you can talk about it, first of all, from a tobacco point of view – the threat, but then also the opportunity?

And I'm very intrigued by your comment, Matthew, that you said you may not launch a heating tobacco product. You implied you still haven't made that decision. Thank you.

Alison Cooper: Do you want to speak about JUUL?

Matthew Phillips: Yeah. So, I mean, our focus is vapour. I've been consistent on that for a while because in our markets vapour is by far and away the biggest consumer category.

And you're looking at the same number of vapers, for example, in the UK or France, very similar number to the numbers of heated tobacco consumers. And so, we see the opportunity as being a very real one on the vaping side, but we recognise that there may well be opportunities from a heated tobacco perspective.

Now in terms of the types of consumer, I suppose it's difficult to be stereotypical. I mean, there's a suggestion that the heated tobacco consumers in Asia are particularly drawn to a menthol experience, for example. On the vaping side, it's broader than that. Flavours play a far broader role. In our view, you've got vaping sitting as an opportunity that sits almost beyond heated tobacco – maybe I'll put it that way.

So, I think there's room for both. I genuinely do think there's room for both. But I still think the bigger opportunity for us is on the vaping side. But we want to have the optionality to launch heated tobacco if there's a more effective or realistic opportunity to go after.

Alison Cooper: And I think there's a consumer lens here which I think doesn't get discussed enough. Matt talked about a standout consumer experience. We're beginning to see really good vaping experiences with a product like *my*blu, with blu ACE. And really, that's not really been in the market today.

We've been focussed with the assets we've accumulated to really perfect the consumer experience. We'll keep perfecting that consumer experience, but we do see a very real opportunity getting that consumer experiences right.

We've not seen that happen in a market yet to see how that plays out with consumers and the choices that they make. But as Matt says, I'm sure that there'll be room for heated tobacco, but we very much see the biggest opportunity for us in e-vapour.

Adam Spielman: And can you talk about the threat from tobacco? I mean, let's be absolutely crystal clear about this. Philip Morris is saying that it's going to grow European market share by at least two percentage points coming from IQOS.

Now if that's right, that implies the European market will fall two percentage points faster, worse than it used to. Now, that's a forecast. It may be wrong. It may be you think it's just complete nonsense. It may be you're quaking in your boots. Can you comment on it, please?

Alison Cooper: Well, we look at the risk, clearly. And we're monitoring what's going on with IQOS in Europe. We're looking to understand the consumer behaviours where IQOS does get some traction which, interestingly is the slightly more premium markets in Europe. But we're very much are on top of it, looking at the triggers where we might do something.

In terms of our portfolio currently, EVP is our focus, in terms of providing that alternative NGP experience for consumers. But yes, we're working on our heated tobacco offerings – in fact, quite a broad portfolio of NGP offerings which we believe we've got to use, should we need to, if some of these risks really come into play. But at the moment, we've got *my*blu going into markets.

We're very focussed on the investment behind that. In the UK market, for example, IQOS has been in for a while. Heated tobacco has been in for a while. And vaping is very much the category that's growing with consumers. And *my*blu, I think, has got a very important role to play there and it's got very significant opportunity, similarly, in other markets in Europe.

Adam Spielman: So, a long way of showing you don't think Philip Morris will grow IQOS as much as they say they will in Europe?

Alison Cooper: I don't really want to comment on their predictions. I don't have access to how they're thinking and forecasting things. All I do know is what we keep seeing in markets, the reviews that we are doing in markets and where we see the opportunities for us with our portfolio. And you have to keep remembering as well for us in many markets, this is additive business.

In some markets, we have very small shares. And therefore, we see, from a consumer conversion perspective from smoking into NGP, a big incremental opportunity for Imperial, which has a different starting point in a number of markets to other players.

Jon Leinster: Right. A couple more questions. With the collapse of P&H, do you actually see any disruption of costs in the UK market or is there any consolidation against you, in terms of wholesalers?

And secondly, going back to NGP and the way in which it's organised, some of the companies that have originally set up very separate organisations now seem to be merging it in. Just for a general knowledge point of view, how exactly are you doing the sort of selling and marketing process? Do you keep it in separate teams or have you just got it all in with the rest of the tobacco products?

Oliver Tant: No on P&H, there's not much to say. We were working with P&H for some while before they got themselves into the same position that they eventually ended up in. We had contingency plans in place that had been worked through by the markets. And the disruption was insignificant in the context of our business. They were well-executed, an outstanding performance from our UK team.

Alison Cooper: Okay. On NGP, the restructuring change is really driven by looking to leverage the strengths of the Tobacco. So when we first started looking at developing adjacencies to tobacco a number of years ago now, we initially set that up as quite a separate entity to make sure it had the space to really evolve and think about how we were going to really win in this space. As we've been stepping up through 2018, what we really want to do is now start leveraging the strengths within our Tobacco business.

So, we look at it from a perspective of the innovation, of the realisation of that innovation, commercialisation strategies and execution. Innovation, we keep separate still and we incubate that, in terms of a business that needs to be away from the distractions of actually how you actually get this thing to market and how do you make it. The realisation aspect is now we've now got a dedicated piece that sits within our manufacturing operations.

Clearly, tobacco manufacturing is not identical to e-vapour manufacturing. There's a lot of skills and principles, quality management – all those aspects that are pertinent to what we're doing in the NGP space. The commercial strategy side, in relation to blu, in relation to how we bring innovations to market – again, that's a separate piece that looks at that commercial strategy away from the tobacco side of the business. And then in execution, we actually have some different models, at the moment. It's one of the areas we're testing out to some degree.

The US is standalone, leveraging the sales force within ITGB whereas in the UK, it's fully integrated, for example. So, we've got some different models that we're playing out and also potentially some models that wouldn't involve our own infrastructure – maybe a distribution-type model as well.

We’re looking to leverage where we have it, the retail reach and key accounts we have in markets. That's broadly the principles around it. It's working well, it's really helping leverage the strengths that we have.

Fulvio Cazzol: Thank you for the follow-up. Just a quick one. Are you able to give us your market share within e-vapour across the key geographies that you track?

Alison Cooper: No. It's because at the moment, it's very early days, in terms of the launches. But second, it's difficult data to get at. All you ever see is a tiny, very inaccurate Nielsen view of the world, particularly when it comes to the US where retail is less than a third of the market.

Visibility, in terms of online sales. Visibility, in terms of the vape channel, in particular, which is your other two-thirds of the market in those markets. Very hard to get a decent read. So, something we're working on. But actually, to get anything that's very accurate is actually quite hard to do.

Matthew Phillips: Actually, it's better now. I mean, we don't really look at it in terms of market share. I know that's a way of measuring things, but we look at it in terms of consumer numbers. So, we'll be able to talk more as we go through the year and the full-year about the number of blu consumers that we've brought into the blu franchise.

Alison Cooper: Yes, in the UK you've actually got a fairly substantial pre-existing market. But in a lot of other markets, it's about creating the category. It's about converting smokers. It's not just grabbing a share of an existing category, if you see what I mean.

Jon Leinster: Okay. So, I've come up with a little list. So, coming back to the price/mix point, you say 4% in Q2.

Alison Cooper: Yes.

Jon Leinster: Can we assume that the exit rate was higher than that? And do you need any more pricing to come through in the markets or with what's already been announced, you have enough to meet guidance?

Then, on downtrading. So, downtrading environments in combustibles, given your portfolio skew, that ought to benefit you. But until now anyway, historically, that hasn't come through for various reasons. Competition got more aggressive down there. Could you perhaps comment on how you're feeling about downtrading starting to benefit you, whether competitive intensity at the value-for-money segment has levelled off?

And a general question on NGP. I mean, I think Matt started alluding to it, but fragmented market at the moment. How does the industry rebuild entry barriers, particularly in vapour, in your case?

Alison Cooper: Okay. Quickly on the first two. Yes, it was building through the second quarter, in terms of price/mix and exit rate. In terms of pricing, vast majority is done. So, there's not a lot we need to get additionally in H2. On the downtrading point, I don't think you can ever be complacent around the value-for-money category. Everyone has strong brands there.

My point I made earlier to Adam's question was more around that's been the bias of where we offer for a long time. So, it's not an additional mix push, in terms of our portfolio, apart from some specifics like Saudi. But everyone has got strong positions in the value-for-money category.

And therefore, I'm never complacent around the bottom-end of markets and some of the competitor activity which can go on, which is why we do have our always-on price strategy in the MRM. We will make sure, in priority markets, that we do get the parity that we need, unless there's a really good reason why we want to back-off there for some reason, which we have done historically, for example, in a market like Ukraine where we refused to play.

And then, on NGP. I think, Matt, in terms of the barriers to entry?

Matthew Phillips: Sure. Brand is one of them. The innovation capabilities and pipeline are a second. They have to keep moving the experience forward. Everyone is aware of what JUUL achieved with you know with a relatively simple innovation, which actually moved the market significantly. So, that's another area.

I think access to the consumer is a third barrier, if you want to call it that, particularly retail. And you think that the retail channel which we're finding through our experiences now is a very important switching channel for consumers from combustible products to vaping. But there's not that many players that actually have access to retail.

And then, the fourth would be the science and the know-how that's needed to actually back all of that up. And I alluded to it in presentation, there are very few people that have got those capabilities to be able to actually meet the requirements of regulators to be bringing new products to market. So, I've been saying for a while, the barriers, if you want to call them that – the right to play is getting more stringent and that's good.

Alison Cooper: Okay. Well, thank you, everybody, for joining us this morning and for the questions. And have a good day.