STRENGTHENING THE BALANCE SHEET

OLIVER TANT
Chief Financial Officer

When managing the performance of our business we focus on non-GAAP measures, which we refer to as adjusted measures. We believe they provide a better comparison of underlying performance from one period to the next as GAAP measures can include one-off, non-recurring items and recurring items that relate to earlier acquisitions. These adjusted measures are supplementary to, and should not be regarded as a substitute for, GAAP measures, which we refer to as reported measures. The basis of our adjusted measures is explained in our accounting policies accompanying our financial statements.

"We will further optimise our cost base and capital discipline to prioritise investment more effectively and deliver growing returns."

Reconciliations between reported and adjusted measures are included in the appropriate notes to our financial statements. Percentage growth figures for adjusted results are given on a constant currency basis, where the effects of exchange rate movements on the translation of the results of our overseas operations are removed.

During 2019 we reviewed the basis for our adjusted measures and committed to making a number of changes around the treatment of certain one-off items in 2020. In the 2020 accounts this impacted the treatment of fair value gains and losses on our investment in Auxly and this is detailed later in the review.

We also committed to reviewing our use of restructuring as an adjusted measure by the end of 2020 in line with the completion of the cost optimisation programmes which were due to conclude this year. However, the COVID-19 pandemic has meant some of these programme's projects have been delayed into 2021 and so we are deferring the review of the use of restructuring as an adjusted measure until the end of that year. In 2020 therefore we have continued to treat restructuring costs as an adjusting item.

PERFORMANCE OVERVIEW

2020 proved to be a challenging year with some disruption from the COVID-19 pandemic and a poor NGP performance.

Our overall financial delivery was disappointing, with adjusted earnings per share down 5.6 per cent at constant currency, with both NGP and tobacco profits down on last year. However, the tobacco performance needs to be seen in context of COVID-19, which has had a small net benefit to the top-line but has impacted profitability as a result of additional costs. For example, we have taken a cautious position in relation to a number of the exposures in our balance sheet at a point of time when the future is uncertain, for example through the increase in inventory and bad debt provisions. These include additional provisioning in respect of our debtor book, reflecting increased credit risks and in respect of finished goods stock where we have seen changing patterns of demand, which have altered stock durations.

Our tobacco business remained resilient with volumes down 2.1 per cent, declining at a slower rate than expected given recent history, and revenue up 1.8 per cent at constant currency against last year. The revenue performance was driven by stronger market size and share albeit this was delivered in some of our lower value markets which led to a weaker than usual price/mix up 3.9 per cent versus last year (2019: up 5.5 per cent). Consequently, the revenue performance was not as high as may have been expected given the headline market size and share positions.

Tobacco operating profit was down 3.1 per cent at constant currency having been impacted by the additional costs relating to COVID-19, regulatory compliance and overheads.

The NGP performance was impacted by new regulation and weaker than expected trading which has led to lower revenue as well as provisions for slow moving stock and asset impairments in the year.

ACTIVE CAPITAL DISCIPLINE

We continue to focus on capital discipline and this year's strong cash performance will be supplemented by the disposal of our Premium Cigar Division, which completed in October 2020, and the decision at the interim results to rebase the dividend.

Our headline adjusted operating cash conversion of 127 per cent benefited from VAT and duty payment date changes in Western Europe as a result of COVID-19, which amounted to c.£0.7 billion or 20 per cent cash conversion, which we expect to reverse next year. Whilst we completed the disposal of our Premium Cigar business after our year end, with the receipt of the majority of the proceeds, we did receive a £83 million non-refundable cash payment in 2020 and have deferred €407 million into 2021. These proceeds will predominantly be used to pay down debt.

At the interim results in May 2020 we announced a rebasing of our 2020 dividend policy by one third. We have adopted a progressive dividend policy, growing annually from the revised level, taking into account underlying business performance.

Effective capital allocation remains at the core of our decision making and we aim to use continued strong cash generation, the shareholder dividend savings and proceeds from the disposal of Premium Cigars to reduce our gearing to the lower end of our 2-2.5 times target range by the end of 2022. As of 30 September 2020, our adjusted net debt to EBITDA was 2.7 times (2019: 2.9 times).

CASH FLOW AND NET DEBT

Our 2020 cash delivery of £1.3 billion was supported by a £1.0 billion working capital inflow driven by c.£0.7 billion of COVID-19 related timing benefits. Excluding these COVID-19 related timing benefits our 2020 underlying cash conversion was c.107 per cent with an underlying net cash inflow of £0.6 billion. The COVID-19 working capital benefits were materially in our Logistics business due to changes in duty payments dates in Italy offsetting accelerated payments in France. In the UK we have also seen a £220 million deferment of VAT due to COVID-19. We expect these to unwind next year, providing a c.£0.7 billion or 20 per cent cash conversion headwind in 2021.

Excluding COVID-19, this year's underlying working capital inflow was strong at c.£300 million, which included a c.£200 million higher working capital position in Australia as the benefit seen last year reversed in line with guidance in last year's results. This cash outflow was offset by improvements in a number of markets, including the US.

Capital expenditure saw a year on year reduction of c.£80 million as we saw a reduction in NGP-related spend and continued tight control of tobacco investments. Restructuring cash costs were in line with last year.

After including £0.3 billion of lease liabilities on the adoption of IFRS 16, reported net debt decreased by £0.8 billion to £11.1 billion and adjusted net debt decreased by £1.1 billion to £10.3 billion at actual rates.

During the year we repaid two bonds totalling £1.6 billion equivalent. The denomination of our closing adjusted net debt was split approximately 68 per cent euro and 32 per cent US dollar.

As at 30 September 2020, the Group had committed financing in place of around £16.2 billion, which comprised 29 per cent bank facilities and 71 per cent raised from capital markets. During the year a new revolving credit facility of €3.5 billion replaced the existing revolving facilities of £3 billion equivalent and bilateral facilities totalling €1.7 billion were arranged whilst one bilateral facility of €300 million was cancelled.

GROUP RESULTS – CONSTANT CURRENCY ANALYSIS

£ million (unless otherwise indicated)	Year ended 30 September 2019	Foreign exchange	Constant currency movement	Year ended 30 September 2020	Change	Constant currency change
Tobacco & NGP Net Revenue						
Europe	3,633	(35)	**(29)**	**3,569**	**-1.8%**	**-0.8%**
Americas	2,469	2	**9**	**2,480**	**+0.4%**	**+0.4%**
Africa, Asia and Australasia	1,889	(35)	**82**	**1,936**	**+2.5%**	**+4.3%**
Total Group	7,991	(68)	**62**	**7,985**	**-0.1%**	**+0.8%**
Tobacco & NGP Adjusted Operating Profit						
Europe	1,694	(12)	**(100)**	**1,582**	**-6.6%**	**-5.9%**
Americas	1,064	4	**(36)**	**1,032**	**-3.0%**	**-3.4%**
Africa, Asia and Australasia	763	(23)	**(66)**	**674**	**-11.7%**	**-8.7%**
Total Group	3,521	(31)	**(202)**	**3,288**	**-6.6%**	**-5.7%**
Distribution						
Distribution fees	1,015	(7)	**7**	**1,015**	**+0.0%**	**+0.7%**
Adjusted operating profit	232	(2)	**(4)**	**226**	**-2.6%**	**-1.9%**
Group Adjusted Results						
Adjusted operating profit	3,739	(33)	**(179)**	**3,527**	**-5.7%**	**-4.8%**
Adjusted net finance costs	(450)	2	**19**	**(429)**	**+4.7%**	**+4.2%**
Adjusted EPS (pence)	272.3	(2.6)	**(15.3)**	**254.4**	**-6.6%**	**-5.6%**

GROUP EARNINGS PERFORMANCE

£ million unless otherwise indicated	Adjusted 2020	Adjusted 2019	Reported 2020	Reported 2019
Operating profit				
Tobacco & NGP	**3,288**	3,521	**2,587**	2,074
Distribution	**226**	232	**135**	137
Eliminations	**13**	(14)	**9**	(14)
Group operating profit	**3,527**	3,739	**2,731**	2,197
Net finance costs	**(429)**	(450)	**(610)**	(562)
Share of profit of investments accounted for using the equity method	**45**	55	**45**	55
Profit before tax	**3,143**	3,344	**2,166**	1,690
Tax	**(642)**	(642)	**(608)**	(609)
Minority interest	**(98)**	(107)	**(63)**	(71)
Earnings	**2,403**	2,595	**1,495**	1,010
Earnings per ordinary share (pence)	**254.4**	272.3	**158.3**	106.0

RECONCILIATION OF ADJUSTED PERFORMANCE MEASURES

£ million unless otherwise indicated	Operating profit 2020	Operating profit 2019 restated	Net finance costs 2020	Net finance costs 2019	Earnings per share (pence) 2020	Earnings per share (pence) 2019 restated
Reported	**2,731**	2,197	**(610)**	(562)	**158.3**	106.0
Acquisition and disposal costs	**26**	22	**–**	–	**2.8**	2.3
Amortisation & impairment of acquired intangibles	**523**	1,118	**–**	–	**49.2**	116.4
Excise tax provision	**(20)**	139	**–**	–	**(1.7)**	13.0
Fair value of loan receivable	**62**	(3)	**–**	–	**6.6**	(0.3)
Sale of intellectual property	**–**	(7)	**–**	–	**–**	(0.7)
Fair value adjustment of acquisition consideration	**–**	129	**–**	–	**–**	13.5
Fair value and exchange movements on derivative financial instruments	**–**	–	**176**	107	**25.3**	8.0
Post-employment benefits net financing costs	**–**	–	**5**	5	**0.4**	0.1
Restructuring costs	**205**	144	**–**	–	**18.4**	11.4
Tax on disposal of Premium Cigar business	**–**	–	**–**	–	**2.0**	–
Previously unrecognised tax credits	**–**	–	**–**	–	**(7.1)**	–
Uncertain tax positions	**–**	–	**–**	–	**8.2**	–
Tax on unrecognised losses	**–**	–	**–**	–	**(4.3)**	6.4
Items above attributable to non-controlling interests	**–**	–	**–**	–	**(3.7)**	(3.8)
Adjusted	**3,527**	3,739	**(429)**	(450)	**254.4**	272.3

2019 restated to include the fair value of loan receivable gain and sale of intellectual property relating to Auxly and the impact of the change to adjusted performance measures.

TOBACCO REVENUES IMPROVE, NGP DISAPPOINTS

Tobacco volumes fell 2.1 per cent, a significant improvement on last year (2019: 4.4 per cent reduction) as we saw better than expected market size across a number of our larger markets as consumers appeared to change behaviours and reprioritise disposable income during the COVID-19 pandemic, combined with a decrease in illicit trade. Whilst we delivered share growth in seven of our 10 priority markets, two of our more valuable markets showed share declines. We experienced a drag on our overall price/mix as a result of the fact that much of our growth was experienced in lower value markets with downtrading also evident. Consequently, the full benefit of good size and share performance did not flow through to the bottom line.

As a result of the impact of market and product mix tobacco price/mix was 3.9 per cent, slightly below the 5.5 per cent delivered in 2019. Overall tobacco net revenue grew by 1.8 per cent at constant currency.

The impacts of a sub optimal market and product mix dynamic led to a lower tobacco gross profit when compared with 2019. In addition, there were a number of other factors this year which have depressed tobacco performance with operating profit down 3.1 per cent in constant currency.

As a result of COVID-19 and its disruption to our ability to operate as planned in certain locations, we experienced some manufacturing inefficiencies. In addition, we have seen a number of changes in the risks to working capital balances, particularly in stock and debtors, reflecting changes in customer and consumer behaviours and we have made some additional provisions to protect against these increased risks.

The impact of these COVID-19 related additional costs amounts to £90 million. We have also seen an increase in costs associated with the implementation of EUTPD Track & Trace, payment of fines (which are being appealed) imposed by the competition authorities on the tobacco industry in the Netherlands and Ukraine, and a tax liability in Spain, which together contributed an additional £50 million of cost this year. We do not expect the majority of these costs to reoccur.

NGP revenues were down by 27 per cent at constant currency, which offset the growth in tobacco revenues reducing Group net revenue growth to 0.8 per cent at constant currency.

NGP operating loss was down 34 per cent at constant currency. The impact of the flavour ban in the US not only disrupted NGP sales in that market but also had a contagion effect into European and Asian markets. Consequently, the vapour category did not develop as we had forecast and sell out was below expectations. This resulted in us making an additional £97 million NGP slow moving stock provision in the year and a £27 million impairment of certain NGP intangible assets.

On a reported basis, Group operating profit increased by 24.3 per cent, materially driven by the lapping of the impairment charge taken last year relating to the disposal of the Premium Cigar business.

Last year's impairment charge was partially reversed by £35 million in the year due to the finalisation of the agreed sales price for the business and the revaluation of assets for foreign exchange differences. It is expected that on completion of the divestment, cumulative foreign exchange gains of approximately £250 million to £350 million, that have historically been recognised in reserves, will be recycled to the income statement.

The restructuring charge for the year of £205 million (2019: £144 million) relates mainly to our second cost optimisation programme announced in 2016. The total restructuring cash flow in the year ended 30 September 2020 was £145 million (2019: £146 million).

Adjusted net finance costs were lower at £429 million (2019: £450 million). This is primarily due to our active management of the debt portfolio to align with our strategic disposal initiatives. Reported net finance costs were £610 million (2019: £562 million), incorporating the impact of the net fair value and exchange losses on financial instruments of £176 million (2019: losses of £107 million) and post-employment benefits net financing costs of £5 million (2019: £5 million).

Our all-in cost of debt decreased to 3.4 per cent (2019: 3.6 per cent) as we continue to optimise our debt portfolio and our interest cover increased to 8.9 times (2019: 8.8 times). We remain fully compliant with all our banking covenants and remain committed to retaining our investment grade ratings.

Our effective adjusted tax rate was 20.7 per cent (2019: 19.1 per cent) and the effective reported tax rate is 28.1 per cent (2019: 36.0 per cent). The increase in the effective adjusted tax rate was due to a less favourable profit mix. The adjusted tax rate is lower than the reported rate due to limited tax relief on adjusting items.

We expect our effective adjusted tax rate for the year ended 30 September 2021 to be around 23 per cent. The increase in rate is due to legislative changes in several jurisdictions and the expiry of certain tax agreements.

The effective tax rate is sensitive to the geographic mix of profits, reflecting a combination of higher rates in certain markets such as the USA and lower rates in other markets such as the UK.

The rate is also sensitive to future legislative changes affecting international businesses such as changes arising from the OECD's (Organisation for Economic Co-operation and Development) Base Erosion Profit Shifting (BEPS) work. Whilst we seek to mitigate the impact of these changes, we anticipate there will be further upward pressure on the adjusted and reported tax rate in the medium term.

Our UK Tax Strategy is publicly available and can be found in the governance section of our corporate website.

Adjusted earnings per share were 254.4 pence (2019: 272.3 pence), down 5.6 per cent at constant currency and down 6.6 per cent at actual rates, reflecting operating profit weakness as well as a higher effective tax rate.

Reported earnings per share were up 49.4 per cent at 158.3 pence (2019: 106.0 pence), mainly impacted by the one-off accounting adjustments made last year relating to the disposal of Premium Cigars. The strengthening of sterling against the euro, Australian dollar, which delivers lower revenue/profit, and Polish zloty which increases manufacturing costs, has led to lower sterling equivalent profits by around 1 per cent.

COST OPTIMISATION

We optimise our cost base to realise operational efficiencies. Our first optimisation programme announced in January 2013 delivered savings of £305 million per annum from September 2018 at a cash restructuring cost of around £600 million. This first programme has now concluded although there remain some cash costs.

The second cost programme, announced in November 2016, is now expected to deliver c.£320 million of annual savings with £303 million of annual savings still expected from September 2020 and a further c.£16 million of savings from September 2021 as some of the original programme will now be initiated in 2021 due to the impact of the COVID-19 pandemic. The programme is expected to be completed at a cash restructuring cost of c.£650 million, a £100 million reduction against our original estimates.

The second programme continued to focus on reducing product cost and overheads and realised cost savings of £63 million in 2020 which brings the cumulative cost savings from both programmes to £608 million, with £305 million coming from the first and £303 million from the second.

Cash restructuring costs in the year from the first programme were £16 million (2019: £24 million) and £109 million (2019: £108 million) for the second, bringing the cumulative net cash cost of the two programmes to £1,066 million, with a cash cost of £559 million for the first and £507 million for the second.

CAPITAL ALLOCATION

Capital discipline is a key objective, with commercial analysis and hurdle rates underpinning returns. It is again clear that our investments in NGP have not returned at the levels expected.

Consequently, in the year we significantly reduced investment in NGP with underlying operating profit performance in the second half improved. Despite reduced investments, we have maintained a range of options across different markets and NGP categories to allow future strategic choices.

We typically seek an overall internal rate of return in excess of 13 per cent across the investments we make in order to support our investment choices and underpin returns for shareholders.

Despite the drag from NGP, our in year ROIC measure is slightly ahead of this internal rate of return at 13.2 per cent but lower than last year (2019: 14.4 per cent) due to the profit reduction.

DIVIDEND PAYMENTS

The Group has paid two interim dividends totalling 41.70 pence per share in June 2020 and September 2020, in line with our quarterly dividend payment policy to give shareholders a more regular cash return.

The Board approved a further interim dividend of 48.00 pence per share and will propose a final dividend of 48.01 pence per share, bringing the total dividend for the year to 137.71 pence per share. The third interim dividend will be paid on 31 December 2020 with an ex-dividend date of 26 November 2020. Subject to AGM approval, the proposed final dividend will be paid on 31 March 2021, with an ex-dividend date of 18 February 2021.

BREXIT

The Group has assessed the potential impacts of the UK not concluding a trade deal with the EU prior to 1 January 2021.

The key risks identified include: the potential increase in import duties and impact on UK customers; additional risk of tobacco smuggling; inventory requirements to ensure supply; impact on consumer confidence; and implications on existing international tax arrangements.

In the event of a no trade deal, we estimate there could be additional costs of around £75 million relating principally to import duties and the impact on existing tax arrangements.

NEW ACCOUNTING STANDARD

We adopted the new accounting standard IFRS 16 "Leases" on 1 October 2019.

Implementation of IFRS 16 has resulted in the recognition of 'right of use assets' which are depreciated over the period that they are leased and a corresponding interest bearing lease liabilities creditor, which are paid down over the life of each lease.

The impact associated with the adoption of this standard is disclosed in note 1 of the accounting policies.

ADJUSTED PERFORMANCE MEASURES

In managing the business, we focus on adjusted performance measures as we believe they provide a better comparison of performance from one period to the next.

As announced last year, we refined our approach to the use of adjusted performance measures by focusing more on the performance drivers of our core activities of the manufacture, sales and marketing of tobacco and NGP products.

The changes we have made to our adjusted performance measures include the exclusion of one-off gains and losses from asset disposals and other non-recurring activities that do not relate directly to the core activities.

In 2020 valuation losses related to our investment in Auxly of £62 million were excluded from adjusted profit as a result of this change. Income from the sale of intellectual property and a valuation gain of £10 million on Auxly were included in adjusted profit in 2019 and as a consequence of this the 2019 results have been restated to provide more understandable like-for-like comparisons.

The write-down of the convertible debt owed by Auxly reflects the challenges faced by the business due to the slower than anticipated evolution of the Canadian cannabis sector, in part the result of the economic impact of COVID-19, putting into doubt Auxly's ability to repay the debt in full on its due date.

Last year we said that we would undertake a review of the treatment of restructuring costs as an adjusting item, considering whether or not the exclusion of these costs from adjusted profit was appropriate.

In light of certain COVID-19 related delays to the conclusion of the second cost optimisation programme that was previously due to end in 2020, this review has been deferred into the next year.

OLIVER TANT
Chief Financial Officer