OPERATING REVIEW

A CHALLENGING YEAR

COVID-19 has had a significant impact on all our lives with the temporary restrictions and lockdowns across many countries leading to changes in consumer behaviour and in our operating environments.

However, the business has been relatively well positioned to navigate these challenges. Throughout, we have prioritised the health and safety of our people and have always strictly adhered to guidance from governments and public health authorities. It is a credit to our manufacturing and supply chain colleagues that they managed to keep the vast majority of our factories operating throughout the crisis, ensuring that our customers and consumers around the world were able to continue to enjoy their favourite brands.

Lockdowns, the restrictions on travel and the benefit of fiscal stimulus measures in several markets have resulted in some changes in consumer behaviour. These have resulted in slightly better market size trends for the Group overall as a result of several factors.

- It would appear smokers have chosen to allocate more of their discretionary spend towards tobacco. More time spent at home has resulted in consumers reducing expenditure in certain areas, such as holidays or going out;
- Fiscal stimulus measures in several markets have increased consumer discretionary spend;
- Border and other restrictions have reduced the level of illicit trade in certain markets such as the UK, resulting in better volumes in the duty paid market;
- Markets in areas such as Northern Europe have benefited from consumers having to stay at home, leading to a temporary switch in volumes from traditional holiday destinations in Southern Europe; and
- It would also appear COVID-19 has resulted in consumers going to stores less often with increases in bulk buying and greater demand for big box formats.

These positive drivers have offset the negative consumption impacts from COVID-19, which include:

- The temporary closure of certain retail channels, such as duty free and hospitality outlets; and
- Travel restrictions which have led to significantly lower demand in traditional holiday destinations, such as Spain and the Canary Islands.

COVID-19-related restrictions in some of our manufacturing facilities have disrupted production capacity and affected operating efficiencies. We expect that changes in consumer behaviour and our manufacturing operations will be temporary and will reverse once COVID-19 restrictions are relaxed. However, given the rising number of COVID-19 cases in many markets and the greater uncertainty, we have increased provisions, mainly in respect of stock and debtor positions, which has impacted profit delivery.

PERFORMANCE REVIEW

Imperial Brands comprises two distinct businesses: Tobacco & NGP and Distribution. The Tobacco & NGP business is responsible for the manufacture, marketing and sale of tobacco and NGP products, which are managed primarily through three geographic sales and marketing divisions: Europe, Americas and Africa, Asia and Australasia. It is through these three divisions, we manage performance and prioritise the allocation of resources and investment.

OUR BRANDS

TOBACCO & NGP

Tobacco

We delivered +50bps of tobacco share growth but this was largely in markets representing lower value to the Group both in terms of net revenue and profit. As a result, the gross profit contribution from the tobacco category did not grow in line with the growth in net revenue. The top five priority markets by net revenue account for 70% of the operating profit. Whilst we grew tobacco market share in three of these top five markets the growth was principally in brand families with lower net revenue per stick and accordingly less profitable. We achieve optimum growth in profitability where we are able to grow in the higher value markets and in those brands with the higher price points.

JPS

JPS tobacco sales volumes declined as price segments have compressed in many of its markets, squeezing its position as a value brand. However, net brand contribution benefited from increased pricing on fine cut tobacco variants in the UK and Australia. Product innovation remains focused on creating new formats to appeal to adult smokers.

West

We have grown share of West this year, with strong performances across all its ranges. The king size core range performed particularly well in the Middle East following the introduction of plain packaging, aided by low tar and fresh seal variants. West's make your own range has met consumer demand in Central Europe for value, with volumes strengthened by the migration of Fairwind by Players to West in Germany.

Winston

Winston's performance has benefited from a new marketing campaign, centred on the product and lifestyles of its adult consumers. The campaign's message focused around Winston's key ingredients of "tobacco, water and attitude", supported by specialised print media and brand events. This enabled Winston to maintain share within the declining US premium segment.

Davidoff

The brand continues to expand its geographic presence with the more progressive Davidoff Evolve and Reach ranges. The king size variant, Evolve, has now been launched in a total of 22 markets, doubling its volume. The new range has been particularly well received by consumers in the Middle East. Davidoff Reach, the queen size range, has been successful in Eastern Europe, with innovative crushball flavour extensions helping to maintain growth. The premium range has been affected by border closures in the duty free channel as a result of COVID-19.

Parker & Simpson

Parker & Simpson has benefited from sales growth in Australia and Poland, and improving margins in Russia. The brand continues to focus on meeting consumer demand for a more modern range of tobacco product, including sales of a crushball variant, a new flavour launch in Russia and a super-slim product for central Europe.

Next Generation Products (NGP)

During 2020, we pulled back significantly on our investment in the NGP category as we sought to improve returns and reflect on how to prioritise future investments in this segment. Towards the end of 2019, it became clear our investments were significantly underperforming against our plans and that severe corrective measures were necessary. A combination of factors, including US regulatory intervention in the vapour market, competitor behaviour, uncertainty on the part of retailers and a lower than expected take-up of our products by consumers, all contributed to our lack of success.

As a consequence, we have taken disciplined action to stabilise performance by curtailing investment, which significantly reduced the run-rate of operating losses in the second half. We have also assessed the balance sheet implications and have taken write-offs for slow-moving stock and against some intellectual property assets. These, and the reduction in sales, have significantly impacted this year's results.

Our focus has been on improving the performance, returns and capabilities of our NGP activities, while maintaining a range of options across the vapour, heated tobacco and modern oral categories. There are a number of areas where we can improve future performance. For example, by seeking to develop products that are sufficiently differentiated and that are thoroughly tested and qualified with consumers in our launch markets. We can also be more disciplined in how we invest to scale the business over time. These will be a key focus for the future.

Vapour

While the vapour category has been disrupted by regulation and adverse news-flow, our performance has been below expectations. As a result, we have reset investment levels and reduced costs, taking a more disciplined approach in order to improve returns. Despite our reduced investment in several markets, share of blu has held up relatively well and we have renegotiated trade terms to benefit margins.

Regulation and public perception of vaping in the US market has continued to evolve, with the FDA having banned flavoured pods in January and emerging health concerns with vaping products. This reinforces our view that the industry needs a clear regulatory framework that enforces high product standards and responsible sales and marketing. To support this, we submitted our Premarket Tobacco Product Application (PMTA) in the US, seeking authority to continue marketing a range of blu vapour products with various nicotine strengths and flavours.

Heated Tobacco

At the beginning of the year, we expanded distribution of our Pulze heated tobacco product and iD heat sticks in Japan, through two national key accounts. However, the roll-out has fallen short of our expectations so we limited investment and paused further expansion within Japan and to other geographies pending the outcome of the strategic review. Our roll-out in Japan has provided useful consumer feedback on the functionality of the Pulze device, the robustness of the iD stick and preferences for levels of nicotine and menthol in the products. We have also improved our understanding of the category, enhancing our in-house production and product development capabilities.

Modern Oral Nicotine

Modern oral nicotine has a relatively small presence within Europe and we have continued to explore opportunities for its development in a prudent manner while developing our capabilities. We have achieved good initial growth from our new product offerings in the first half in several European markets including Austria, Germany, Norway and Sweden. Although the business is still small, our experience in these markets has enabled us to gain valuable consumer insight and refine our approach to meet consumer needs. We have recently delayed our plans to launch new product variants in Germany, pending clarity around the regulatory landscape for modern oral nicotine following the Bavarian court ruling classifying chew bags as snus.

DISTRIBUTION

Despite the challenges of COVID-19, Logista has continued to distribute products to clients across its footprint with almost all the points of sale, products and services classified as essential by governments adopting lockdown measures.

Distribution fee income increased 0.7 per cent reflecting positive performances in Italy and Spain, offsetting some declines in France. Italy benefited from growth in NGP and a relatively resilient tobacco performance. Good performances in the convenience, pharmaceutical and courier transport segments, helped to offset tobacco declines in Spain. The trading environment in France was more challenging, with weaker tobacco volumes and a poor performance in the convenience channel.

Adjusted operating profit was down 1.9 per cent at constant currency, with ongoing cost management offset by additional cost pressures caused by COVID-19 and the impact from an asset disposal. The adjusted operating profit contribution to the Group increased 10.6 per cent at constant currency, reflecting the reduction in eliminations compared to the 2019 NGP inventory build in support of market launch activity.

In line with other Imperial owned entities, we continue to benefit from an intercompany cash pooling arrangement with Logista. In 2020, the daily average cash balance loaned to the Group by Logista was £1.9 billion, with movements in the cash position during the year varying from a high of £3.9 billion to a low of £0.5 billion. At the year end the loan position was £2.4 billion. The cash benefit was higher than normal due to favourable changes in the timing of excise duty payments.

		Full Year Result		Change	
		2020	**2019**	**Actual**	**Constant Currency**
Distribution fees	£m	**1,015**	1,015	0.0%	+0.7%
Adjusted operating profit	£m	**226**	232	-2.6%	-1.9%
Adjusted operating margin	%	**22.7**	22.9	-20 bps	-20 bps
Eliminations	£m	**13**	(14)	>100%	>100%
Adjusted operating profit contribution	£m	**239**	218	+9.6%	+10.6%

EUROPE DIVISION

POSITIVES

- Strong financial performance in the UK and Germany with better than expected market size
- Share gains in Spain and France for the first time in several years
- blu share holding relatively well, despite lower investment

NEGATIVES

- Despite strong financial performance, we lost market share in the UK and Germany
- Price/mix has been affected by adverse product mix with increased demand for value formats
- Travel bans reduced sales in global duty free and traditional summer holiday destinations

		Full Year Result		Change	
		2020	2019	Actual	Constant Currency
Tobacco volume	bn SE	**130.1**	134.9	-3.5%	
Total net revenue	£m	**3,569**	3,633	-1.8%	-0.8%
Tobacco net revenue	£m	**3,471**	3,505	-1.0%	-0.0%
NGP net revenue	£m	**98**	128	-23.4%	-21.9%
Adjusted operating profit	£m	**1,582**	1,694	-6.6%	-5.9%
Asset Brand % of net revenue	%	**75.2**	74.4	+80 bps	+80 bps

2019 restated to reflect volume movements of Canada and Latin America volumes to Americas (-0.3bn SE) and the inclusion of France cigar sales from the AAA division (+0.1bn SE); Auxly adjustments of £(3)m net revenue and £(5)m operating profit; and Asset Brand net revenue restated for reclassification of brands.

While our performance in Europe was disappointing with lower NGP net revenues and the associated write-downs and our overall tobacco performance was also lower, there were a number of achievements. Most notably we grew tobacco market share in France and Spain for the first time in several years and the share of *my*blu held up relatively well despite reduced investment.

Overall divisional market share declined 10 basis points with share declines in Germany and the UK, although we achieved improvements in the second half in both markets.

Our tobacco volumes declined by 3.5 per cent. This reflects several different factors with better than expected market size trends, particularly in Northern Europe such as the UK, Germany, Scandinavia and France, as consumers stayed at home and appeared to allocate more spend towards tobacco. In addition, border closures helped to reduce the flow of illicit tobacco, also benefiting the duty paid market size in markets such as the UK. Travel restrictions caused weaker volumes in global duty free and traditional summer holiday destinations, such as Spain.

Tobacco net revenue was flat on last year at constant currency, with favourable price/mix of 3.5 per cent. Price/mix was driven by relatively strong pricing in the UK and Germany and partially offset by negative product mix in those markets with increased demand for value brands and formats. Some of this increased demand has been driven by switches from illicit trade to the duty paid market. However, mix was adversely affected by the growth in private label product to customers in Germany.

The European ban on characterising flavours, introduced in May, has so far had a limited impact with the majority of consumers remaining within the cigarette category, but switching to traditional tobacco flavoured variants, and with a limited number moving to next generation products.

PRIORITY MARKETS

Priority Markets Tobacco Share	Performance
GERMANY **-90bps** (20.4%)	**12 per cent of Group net revenue** Duty paid market size benefited from border closures and the repatriation of volumes from neighbouring markets such as the Czech Republic and Poland. The premium cigarette segment held up well and there was increased demand for larger formats. Our market share declined although the sequential trend improved in the second half with Gauloises, the launch of a JPS 50s box and new larger fine cut formats. Industry revenues benefited from temporary VAT changes as part of fiscal stimulus measures. Sales of *my*blu declined as we destocked trade inventories. Our performance in modern oral nicotine was limited by the recent chewing tobacco ban, with the need for clearer category regulation.
UK **-10bps** (40.5%)	**8 per cent of Group net revenue** Financial delivery was strong as industry volumes grew as a result of lower illicit volumes and consumers staying at home. It also benefited from a temporary change in UK anti-forestalling arrangements, allowing for greater stock profits ahead of the excise increase in March. While overall share was down, we achieved improving share trends in the second half driven by Lambert & Butler and Golden Virginia. The share momentum was partly limited by some share loss following the characterising flavours ban. In vapour, consumer demand for blu PLUS and liquids remains stable and we successfully re-negotiated trade terms to the benefit of margins.
SPAIN **+10bps** (29.0%)	**4 per cent of Group net revenue** Market size deteriorated with COVID-related border closures affecting our travel retail business with reduced tourist numbers. The domestic market was also negatively affected by lockdown restrictions and reduced occasions for social smoking. We grew our total tobacco market share in both cigarettes and fine cut tobacco, supported by continued investment behind larger value formats in West, Ducados and Fortuna. In NGP *my*blu retained its market leading share position, despite lower sales as we reduced investment.
FRANCE **+10bps** (18.2%)	**3 per cent of Group net revenue** The domestic duty paid market grew in the second half of the year due to border closures, reducing the inflow from neighbouring markets and the level of illicit product. We grew our overall share of market for the first time driven by News fine cut tobacco formats which offset a decline in Royale following the removal of menthol variants in May. Our blu market share remains resilient despite lower investment levels and a successful renegotiation of trade terms.
ITALY **-10bps** (5.4%)	**1 per cent of Group net revenue** Our tobacco market share declined as we increased on-shelf prices earlier than competitors and our brand activation activities were limited by COVID. Market size was impacted by lockdown restrictions impacting travel retail and the domestic market. To capitalise on consumer demand shifts to economy cigarettes and fine cut, we implemented a range of price repositioning and portfolio initiatives for JPS and West. We remain the market leader in vapour although the category has been impacted by adverse news-flow from the US market and reduced activation activities limited consumer trial.

Our NGP performance for the year was below our original expectations. Following a write-down of inventory and destocking of the supply chain during the first half we have focused on improving trade margins and moderating investment in order to improve category returns. Despite lower activation spend the share performance of blu has remained relatively stable, with operating losses significantly reduced in the second half of the year.

Profitability was also affected by lower duty free and travel retail sales and by increased costs relating to the implementation of EUTPD II regulations for track and trace and some write-offs following the introduction of the characterising flavours ban in May. In addition, we increased provisions in respect of stock and debtor positions, given the ongoing COVID-19 uncertainties, and incurred some additional manufacturing costs arising from COVID-19 restrictions on our supply chain operations.

Adjusted operating profit was down 5.9 per cent at constant currency.

AMERICAS DIVISION

POSITIVES

- Cigarette share growth for second year running
- Tobacco net revenue driven by strong cigarette pricing
- Mass market cigars driven by Backwoods with improved supply and extended distribution

NEGATIVES

- Cigarette share growth driven primarily by discount segment
- Tobacco profitability reduced with increased provisions for COVID-19-related risks and higher manufacturing costs reflecting COVID-19 restrictions
- Disappointing NGP performance with lower vapour sales and inventory write-downs affecting profitability

		Full Year Result		Change	
		2020	2019	Actual	Constant Currency
Tobacco volume	bn SE	**21.3**	22.0	-3.3%	
Total net revenue	£m	**2,480**	2,469	+0.4%	+0.4%
Tobacco net revenue	£m	**2,409**	2,361	+2.0%	+1.9%
NGP net revenue	£m	**71**	108	-34.3%	-34.3%
Adjusted operating profit	£m	**1,032**	1,064	-3.0%	-3.4%
Asset Brand % of net revenue	%	**53.7**	54.2	-50 bps	-60 bps

2019 restated to include Canada & Latin America volumes from Europe (+0.3bn SE); Auxly adjustments of £(3)m net revenue and £(4)m operating profit; and Asset Brand net revenue restated for reclassification of brands.

The USA is our largest single market representing 31 per cent of Group net revenue. Despite tobacco net revenue growth, our overall performance was affected by lower NGP sales and stock write-downs, while our tobacco profitability was reduced by weaker price mix and various COVID-19 related costs.

Our tobacco volume performance declined 3.3 per cent, with US volumes down 2.5 per cent against market size declines of 1.0 per cent. However, this was impacted by year-on-year trade inventory movements of 700 million sticks, which if adjusted for meant our volumes were slightly up, outperforming the market volume decline through share gains. The relatively slower rate of market size decline was driven by increased home working presenting smokers with more occasions to consume, reduced switching to NGP and fiscal support packages supporting consumer expenditure.

We delivered cigarette share growth for the second consecutive year, up 10 basis points to 8.9 per cent. This was driven by good performances from Sonoma and Montclair in the growing deep discount segment and investment in Winston and Kool to maintain their shares in the declining premium segment.

We have benefited from continued strong demand in the mass market cigar segment during the year with market volumes up by around 9 per cent. We grew share by 70 basis points having regained momentum in Backwoods during the second half with improved leaf sourcing and expanded on-shelf availability through a wider network of outlets.

At constant currency, tobacco net revenue was up 1.9 per cent with price/mix of 5.2 per cent driven by continued strong cigarette pricing, partially offset by some adverse product mix from growth in deep discount brands.

Our NGP results were disappointing, with net revenues 34.3 per cent lower at constant currency driven by a destock of trade inventories and reduced promotional activities. We submitted our Premarket Tobacco Product Applications (PMTA) to the Food and Drug Administration, seeking authority to continue the marketing of a range of blu vapour products including *my*blu, blu PLUS and blu Disposable, with various nicotine strengths and flavours.

Adjusted operating profit was 3.4 per cent lower at constant currency, reflecting NGP losses and lower tobacco profit. The NGP losses were driven by a £48 million write-down of flavoured inventory following the FDA ban and lower NGP sales. Tobacco profitability was impacted by increased provisions for COVID-related risks, mainly in respect of stock and debtor positions as we took a more cautious view in light of ongoing uncertainties, and higher overheads as we invested in the tobacco sales force to drive share growth.

AFRICA, ASIA, AUSTRALASIA DIVISION

POSITIVES

- Continued share gains across all priority markets
- Price gains driven by Australia and further supported by Australia stock profits

NEGATIVES

- Adverse mix caused by negative market and product mix
- Lower NGP revenues
- Profit reduced with higher NGP losses and increased tobacco provisions for COVID-related risks and higher manufacturing costs

		Full Year Result		Change	
		2020	2019	Actual	Constant Currency
Tobacco volume	bn SE	**87.7**	87.3	+0.4%	
Total net revenue	£m	**1,936**	1,889	+2.5%	+4.3%
Tobacco net revenue	£m	**1,904**	1,847	+3.1%	+5.0%
NGP net revenue	£m	**32**	42	-23.8%	-23.8%
Adjusted operating profit	£m	**674**	763	-11.7%	-8.7%
Asset Brand % of net revenue	%	**59.9**	58.9	+100 bps	+90 bps

2019 volumes restated for transfer of France cigar sales to Europe from AAA division (-0.1bn SE); Auxly adjustments of £(1)m net revenue and £(1)m operating profit; and Asset Brand net revenue restated for reclassification of brands.

Although revenues benefited from volume growth and price/mix gains, overall profit delivery was impacted by further NGP losses as a result of increased investment to support the launch of our heated tobacco product and higher provisions following a cautious assessment of balance sheet exposure for COVID-19 related risks.

Tobacco volumes were 0.4 per cent up, reflecting a strong performance in lower margin markets in the Middle East, Turkey and Ivory Coast, which more than offset the impact of ongoing market size declines in the higher value market, Australia. These dynamics adversely affected market mix for the Group.

Tobacco net revenue was up 5.0 per cent at constant currency reflecting the volume gains and price mix benefit from the sell-through of inventory in Australia accumulated ahead of the September 2019 excise increase, of which around £50 million will not repeat next year. Otherwise, product and market mix was negative.

NGP performance was disappointing with net revenue down 23.8 per cent at constant currency reflecting lower vapour sales in Japan. In Russia *my*blu has achieved good retail sell out, supported by a launch of coloured devices.

Adjusted operating profit was down 8.7 per cent at constant currency driven primarily by NGP losses. Tobacco profits also declined as we took a cautious approach to the COVID-19 related risks associated with the longer supply chains and the relatively higher customer credit risk in the region. We increased our provisions for stock and debtor positions accordingly.

PRIORITY MARKETS

Priority Markets Tobacco Share	Performance
AUSTRALIA **+20bps** (32.7%)	**5 per cent of Group net revenue** Industry volumes declined by 8.6 per cent with increased illicit trade. Parker & Simpson continues to gain share in the growing 'fifth price tier'. Price increases and the sell-through of duty paid inventory accumulated last year benefited revenue and profit, more than offsetting the negative product mix impact from the growth in the discount segment.
RUSSIA **+50bps** (8.4%)	**2 per cent of Group net revenue** Financial performance benefited from improved market pricing and a reduction in discounting in the key account channel. Market share gains benefited from the launch of new crushball variants of Davidoff and Parker & Simpson meeting consumer demand for modern formats.
JAPAN **+10bps** (1.3%)	**1 per cent of Group net revenue** Following excise related price increases, West continues to benefit from demand for the value segment. Net revenue from vapour was impacted by a reduction in trade inventories, although *my*blu continues to retain market leadership of the relatively small vapour category. Distribution of Pulze was extended through national key accounts, although any further roll-out was paused.
SAUDI ARABIA **+450bps** (18.8%)	**1 per cent of Group net revenue** Sales of Davidoff and West supported market share growth, driven by better field coverage and on-shelf availability following the introduction of plain packaging in November 2019. COVID-19 related border closures led to an increase in domestic duty paid market size, which improved our financial delivery.