Imperial Tobacco

Investor Day Presentation

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Unlocking Our Potential – Sustainable high cash returns

Good morning.

Today you will hear a lot about sales growth which is central to our strategy.

But before we hear more about that I want to remind you of what has to be the end result of that growth, sustainable high cash returns for our shareholders.

Sustainable High Cash Returns

Through the course of my presentation I want to leave you with three key messages.

First, we already have high operating margins, but they have the potential to go higher given our focus on cost optimisation, our high gross margins and our top line growth potential. I will give you an insight to our gross margins and you will hear more of our growth potential later today from Roberto and Arthur.

Second, because of our high margins and our focus on capex, working capital and tax, we generate very strong cash flows – cash flows that can grow on the back of our growth strategy.

High cash conversion is a hallmark of Imperial, that means managing our working capital and justifying our capital spend, spend that generates a strong IRR will be approved every time, even if it means falling outside our 90-100 per cent target cash conversion range for a period.

And third, our balance sheet provides a potential store of value for our shareholders. We are committed to investment grade and I don't see that changing, but within the parameters of that commitment we will run an efficient balance sheet and look to enhance returns by effectively managing the capital in our business – there is no value in leaving excess cash idle on the balance sheet, and we will not allow that to happen.

So, the key messages;

Our margins have the potential to increase as we grow the business and we continue to focus on cost optimisation;

Our growth agenda will support further growth in our already strong cash flows; and

We will manage the capital we deploy and utilise our cash to maximise shareholder returns.

Total Tobacco Growth Opportunities

You will hear a lot about Total Tobacco over the course of today, ahead of that let me give you some context.

Of our tobacco business, non-factory made cigarette represents just over 25 per cent of our profits.

There is great potential in our factory made cigarette, or FMC, business driven by our Global Strategic Brands and our array of regional and local brands.

However, there is also great potential in fine cut tobacco, cigars, snus, papers and tubes.

Let me give you just a couple of insights to our Total Tobacco business in terms of gross margins and the potential this offers us.

Total Tobacco Gross Margins (1)

I think this will surprise most of you.

Across our portfolio we generate a higher absolute gross margin per thousand stick equivalents from our fine cut business than we do from our FMC business. The numbers on the chart are indexed.

Our absolute gross profit margin for Global Strategic Brands and JPS is, as you would expect, higher than the Group's and that is despite the Group margin benefiting from a high exposure to Western Europe than the GSBs.

Our absolute profit gross margin for 1000 fine cut stick equivalents is currently seven per cent higher than it is in FMC.

And if you add 1,000 papers to 1,000 fine cut stick equivalents, the absolute profit gross margin of 1,000 fine cut stick equivalents plus the paper is 22 per cent above FMC.

Our fine cut tobacco volumes have grown consistently, over five per cent in the first half of 2011 and nine per cent in our 2010 year.

FCT volume growth is a good thing, a very good thing. We put significant resource behind our fine cut business. We have the brands, the consumer insights and the technology to leverage our world leading position and continue to drive higher gross margins from this business.

Total Tobacco Gross Margins (2)

Let's extend our analysis wider into Total Tobacco and look at our gross margins on a percentage margin basis as opposed to an absolute profit basis. Once again, the numbers have been indexed.

You have already seen that FCT margins on an absolute profit basis are higher than in FMC, confirmed here on a percentage basis, but look also at cigar and our other tobacco products.

Cigarette and fine cut tobacco gross margins are exceptionally high. Though not as high as cigarette and FCT, our cigar and other category margins are very high by FMCG standards.

Gross margins across our entire business are very high and incremental volume growth is clearly a strong driver of profit growth, even if it comes from some of our lower gross margin businesses.

Industry Leading Operating Margins

Turning to our operating margins;

we have the leading tobacco margins of the global players.

Following the acquisition of Altadis margins were re-based to just over 40 per cent but from there, helped by the Altadis synergies, we have grown margins to reach 42.8 per cent at the half year – an improvement of 70bps on the same period last year.

Focussing on margins is part of our DNA, we do not have to change our culture or our focus to drive higher margins, it has and will always be there, and as we drive growth at the gross margin levels I have shared with you, there is scope for our operating margins to go higher over the medium to long term.

High Margins to Superior Cash

Ultimately the driver of shareholder value is cash.

So what does our growth potential and high gross margins mean for cash.

In any one year there may be a temporary cash drain on the business as we grow, whether it is capex, working capital or something else.

However, over the medium term we would expect to see a cash flow gearing of about 1.6 times to revenue growth, that is for every 100 units in revenue we would expect to see a 160 units in equity free cash flow.

That is an average figure across our business. Clearly, if growth is skewed to our higher gross margin brands and products, equity free cash flow growth could be stronger.

Using Cash to Maximise Returns

Having looked at margins and managing our cost base, let's turn to cash utilisation.

Cash utilisation tends to be seen in terms of the end result for shareholders, repatriation of cash, whether it be dividends or buy-backs, but we have to manage a number of variables to get to that point.

Not only do we have to manage the operational side of the business in terms of supporting the sales growth agenda, we also have to manage:

- The resultant working capital demands on the business as we grow;
- The investment decisions that can be a drain on cash though are clearly the right thing for the business; and
- Our tax liability.

All whilst ensuring our debt profile, maturity and headroom are managed to ensure we can reward our shareholders.

Let's look at some of these in more detail.

Excellent Cash Conversion

Starting with cash conversion;

where over the last five years our average cash conversion has been in excess of our 90-100 per cent target range, at 101 per cent.

As you know we were able take significant working capital out of the business in 2009 and maintained that position in 2010 with a cash conversion rate of 97 per cent.

Managing our working capital is key to maximising shareholder returns in terms of the capital we deploy. While we continue to invest in our business we have relatively low capex requirements, and as you know, we generate around two billion pounds of equity free cash flow each year and around one billion pounds of that is paid as a dividend leaving around a billion pounds for debt pay down and share buybacks.

And looking at our average cash conversion of 101 per cent over the last five years in a different way: cash flow from operating activities after capex has been 11.2 billion pounds against total adjusted operating profits of 11.1 billion pounds.

Effectively Managing Tax

Moving on to tax; not an area that receives a great deal of attention from investors but the value of managing our tax affairs to drive an optimal long term sustainable rate of tax should not be lost.

Tax drains around 25 per cent of cash out of our business.

We manage our tax affairs responsibly but at the same time ensure our shareholders retain as much value as possible.

In 2007, before the acquisition of Altadis our tax rate was 25 per cent and following the acquisition our tax charge rose to 26.5 per cent.

Since then we have been able to steadily reduce our tax charge and in our Q1 IMS said that our tax charge for the year would be 24.5 per cent.

Tax is sometimes viewed as lower quality EPS growth, but when the charge is sustainable, as ours is, that is hard to see.

Actively Managing Debt Profile

Moving on to managing our debt position;

We have been working hard on our debt profile and as you know we have had various refinancings over the last few months, including our bank debt and a recent bond issue.

We have grown this business by acquisition and have financed the bulk of acquisition costs through the debt markets.

With large deals like Altadis, that has resulted in a somewhat lumpy maturity profile as we primarily financed the deal in the debt markets, and initially with bank financing.

As time has progressed, we have paid down debt and re-financed and as you can see the maturity profile of our book is improving all the time.

We will continue to manage the maturity profile and reduce the financing peaks we faced immediately after Altadis.

As I said earlier, we generate around a billion pounds of cash flow post dividend.

The ideal maturity profile may be to have a billion pounds of financing maturing each year so that we are not a price-taker but with a billion pounds of free cash post dividends and a billion pounds of financing maturing each year, we have the option to refinance or pay down debt with our cash flow.

We are making steady progress in that direction.

Financing is a balance of many things, not only the maturity profile but the average debt maturity as well, both of which have to be considered against the cost of debt.

Mindful of the cost, there is clear value in extending the average maturity of our debt funding.

After we refinanced the Altadis acquisition in 2008, the average maturity of our debt was 3.7 years; over the last two and a half years we have extended that to 5.2 years, and subject to cost, we will look to extend it further.

We are currently financed 23 per cent through the bank market and 77 per cent through the bond market.

Over time we have reduced our reliance on the bank market as we have extended the maturity of our book, and that may continue.

At March 2011 we had headroom of around 1.4 billon pounds and today we have headroom in the region of 2 billion pounds.

Maximising Shareholder Returns (1)

Our strategy is about delivering sustainable shareholder returns with efficient cash utilisation a key component of value creation. But, as I have explained, our ability to utilise our cash is predicated on managing a number of inputs across growth, working capital, capex and our debt financing.

As you know from the half year, following successful debt pay down and announcing the 50 per cent dividend payout for 2011, we have reviewed our options as to how best to deploy our ongoing strong cash flows.

A higher dividend payout and share buybacks are not mutually exclusive, and noting where our shares trade, we recognise the value in both.

Accordingly we envisage growing dividends per share ahead of earnings per share over the long term thereby steadily increasing the payout ratio.

By steadily increasing the payout ratio we are able to offer strong dividend growth from an already attractive yield while also employing a share buyback programme starting immediately at an annualised rate of 500 million pounds.

Absent M&A, for which, as always, returns have to exceed both a risk adjusted weighted average cost of capital and the returns from a share buyback, utilising a combination of a steadily increasing payout ratio and an appropriate level of share buybacks allows us to maximise our cash returns and maintain an appropriate capital structure.

Maximising Shareholder Return (2)

Maximising shareholder returns is about growing the business, maximising our cash flow, and successfully redeploying that cash.

Roberto and Arthur will take you through how we will generate sustainable revenue growth.

From that revenue growth, our high gross margins and efficient operations will drive our operating margins higher, which, coupled with underlying growth, will drive cash flow growth, which we will reinvest in the business while also managing the capital we deploy to further maximise returns and reward our shareholders.

Thank you, I will now take any questions you may have.