Investor Day Presentations

26 February 2013

Sustainable Growth; Growing Cash Returns – Alison Cooper, Chief Executive

Good morning and welcome to our investor day.

It's great to have the opportunity to take some time with you today away from the usual quarterly round of announcements and to take some time to update you on the success of the strategic progress of Imperial, our continuing delivery against our earnings model and also to get you to understand the next phase of our strategic journey all driving sustainable growth and growing cash returns.

Sustainable Growth; Growing Cash Returns

I've got three key messages for you to take out of today. The first one is around the strategic choices we're making and how those are delivering quality sales growth. You've seen that over the last few years with the growth in our key strategic brands and our total tobacco portfolio, and you'll see further evidence of this through the course of today reinforcing the success of those strategic choices. We've got more to do on that and you'll see the next phase of those choices today as well.

Then on costs; cost focus is a key strength of Imperial and as part of the strategic journey we're on, the strategic focus is enabling us to further optimise our cost base. You'll see in the announcement we made this morning that we see opportunities to realise cost savings of £300 million per annum by 2018 not only to reinvest in the business but clearly to reinforce the earnings model delivery as well. Our quality sales growth combined with the cost optimisation and cash utilisation opportunities for Imperial gives us confidence in the sustainable delivery of our earnings and means that we will grow dividends by at least 10% per annum for the medium term.

So these are the three key messages for you to take away today. We'll build meat on the bones of them over the course of the day but the focus is around: the quality of the sales growth we're delivering; how we're going to strengthen that yet further; and the cost optimisation opportunity in the business, very much enabled by the strategic focus, translating into growing cash returns with at least a 10% dividend growth for the medium-term.

Our strategy

I'm going to kick off with two horribly familiar slides. The first one is our strategy our consistent focus in Imperial over the last few years. I've lived and breathed this slide. It's all about returns and I think Imperial have been very clear about this since its demerger from Hanson in '96. We have deep share ownership in the business and we're about generating sustainable shareholder returns.

And that leads me into the sales growth agenda and how we focus on sustainable, quality sales growth. As you're familiar with this slide, you're familiar with the key assets that we focus on. Our total tobacco portfolio, brand equity, footprint and people. And we've made some key choices around how we drive sales growth through those assets with our sales growth drivers. They won't be a prime focus for today but they're integral to the way we grow this business through our portfolio management, innovation, pricing and customer engagement. They are as relevant in a lighter market like Germany, as they are in a market like Australia, as you'll see later and of huge importance in this environment in order to grow our sales.

And then there are our three key enablers at the bottom. Consumer insights: this is at the heart of our decisions around our portfolio, around our footprint and where we see opportunities for growth. It drives our investments and our investment thinking in the organisation. We'll spend a bit more time on that later. But also important are the alignment of operations, supply chain, and also making sure we're keeping an eye on the framework for the future by investing behind our regulatory and responsibility agenda.

So, I hope most of you in the room are pretty familiar with this sales growth strategy but it's always flanked by two other focus areas: cost optimisation and cash utilisation. And together these three provide the levers by which we deliver sustainable returns.

The Earnings Model; Consistent Delivery

So from strategy into another familiar slide: the earnings model. With a slight tweak, which I'll come on to, this has been our earnings model for a number of years. And I'll also demonstrate to you how we've consistently delivered against this earnings model.

It's about sales growth of 2-4%, both its quality and sustainability, that's important for the continuation and delivery against the earnings model.

It's about cost optimisation, which probably hasn't come through at a top level that clearly in the numbers over the last couple of years because of the increased investment in the business, but it's still there being about how we allocate resources and how we invest behind the key assets in the organisation.

And then for those of you who know this model very well, there's the slight tweak of the 1-2% on cash utilisation, this used to be 2-3%. This is about tax, tax management and about interest management. Now, on the tax side, again, we've done a lot of work over the last few years and we've gone from an effective tax rate of 26½% down to 23%. I'll push Bob a bit harder. There may be a little bit more to go, but there's not going to be a huge amount more to go on that tax rate. On the interest side though, we have opportunities and we'll see that coming through more over the coming years in terms of that cash utilisation. But clearly, as we increase the dividend payout, that gives us slightly less opportunities there. Hence the slight tweak to 1-2% on cash utilisation from the 2-3 that it used to be.

Delivering Against the Model

And here is the delivery against that model over the last three years. Given Spain, given a tough EU environment already over the last couple of years, given a significant transition of this business, which I'll come on to, we've consistently delivered against the model. The range on revenue has been 2 to 4 and a bit per cent and on EPS from just over 5 to over 12% and that's with the buybacks only really kicking in, in 2012.

A Significant Transition

Let me talk a little bit more about the transition that I mentioned. I think we make it probably look a little bit easy externally but this business has been through a significant transition over the last few years, and continues to transition. Let me take you through a few points around this. They may be a little bit black and white in places but you'll understand what I'm trying to communicate to you. Let me discuss the key points for my 'From' and 'To' statements on the slide. Let's kick off with an obvious one. You're all familiar with the history of Imperial, the fact that we used to be about M&A growth, buying businesses, kicking the costs out of them, very little on top line delivery promised off the back of those acquisitions, which was good for the delivery of those deals, but now we're shifting. And we have shifted to a focus on sustainable sales growth requiring a very different mind-set and a very different approach in the business.

And that has implications. With M&A, we bought an awful lot of brands, including some great ones which we're focused on maximising, but also gave us our total tobacco portfolio. A very strong and powerful portfolio across those consumer occasions, consumer needs. But we've got to move now and we've been moving, as you've seen with the KSBs, to maximising these key assets. Maximising the key brand equity that we have in this business is a shift for the organisation.

We also moved from cost cutting. We've shifted from buying businesses and taking the costs out to much more of a resource allocation focus. How do we create the value? How do we best allocate our investments, our funds behind the initiatives that will drive growth? Now you probably immediately think of sales and marketing in that regard but one of the key areas where this has been felt most has been in manufacturing and in our supply chain where there has been a key shift in mind-set in those parts of the organisation. They've done a fantastic job at managing costs in manufacturing and supply chain historically but with a sales growth agenda, that's not enough. They've got to balance flexibility, quality and costs.

This is probably a little bit black and white but it leads me on from the manufacturing point. A few years ago, if you looked at our website, we described ourselves as a tobacco manufacturer and the shift in the business to go from a business that was broadly and led from a manufacturing mind-set to a consumer-led business has again been very significant. The word consumer was hardly heard in Imperial three years ago. And now it's at the centre of every conversation we have. Everything we talk about around our investments, how we drive the growth in the business, whether you're in manufacturing, whether you're in sales, or whether you're in group marketing.

This is also quite key, and key for you to bear in mind when I talk about cost optimisation later. It's very strong, local autonomy in Imperial. We bought businesses and we integrated them but actually with still quite a strong holding company, Hanson-type model, in the business: very strong local autonomy with local portfolios. We've now shifted to much more central direction. I prefer the term "centre-led" to "centralised" and I'm sure most of the guys in the team do as well but that's because it has to been co-created with the market. You've got to get that local insight, that local understanding to do the central direction piece. This is not just a centralised approach, ivory towers in Bristol, it's centre-led but co-created with the local insights, and local markets.

And finally, from short-term delivery to sustainable delivery: one of my team said to me some years ago that we've got to shift from being sprinters to mid-distance runners. We used to sprint, we used to buy a business, take the costs out, rebuild the balance sheet and run for the next deal. Now, we've got a focus on the mid-distance capabilities. Profit is still really important but so are other indicators and metrics around the quality and the sustainability of our delivery. We've got to invest in the future as well as deliver today.

I'm sure the guys in the room could tell you a lot more "froms" and 'tos" than the ones I've highlighted here, but these are some of the significant mind-set shifts in the business. And the one that I haven't talked about is the focus as well on the "how". How we behave in the organisation. How we collaborate to make the results happen is hugely important. We've gone from quite a siloed mentality within the organisation to a collaborative, joined-up approach to delivering the agenda.

The Strategic Journey

So a bit of reflection on where we've been going. Here I've articulated it as a journey. Where are we? Where are we going next?

The strategic journey started with the consumer and we'll spend a little bit of time on this later today. Some of you are familiar with it. But we've got a very differentiated approach to understanding consumers and how we apply that to our portfolio. It's been applied in key markets and it's been applied strongly to our key strategic brands and you've seen the delivery against those. That's really, in terms of the strategic journey, how far we've got. So what's next?

The next stage is to take that approach with the key strategic brands and translate that expertise into the broader portfolio. I'll talk you through a bit of that and Arthur will talk you through a bit more later. But also in terms of our resource allocation, further refining that within our footprint. And it's that focus on that resource allocation within markets that enables us to further optimise. That enables us to take the cost agenda further forward, all driving the sustainable delivery of our earnings model.

And that's really the map of what I'm going to take you through today. I'll briefly take you through each of those areas now. Arthur will put more meat on the bones in terms of the sales growth agenda and how we're strengthening that. Then also you'll see some live examples in the break-out sessions after lunch with JPS, with Davidoff and with our premium cigar business.

A Differentiated Consumer Understanding

So let's just have a little look at each of these now. Just briefly, this is our approach to understanding consumers. It's differentiated because it's based on consumer motivations, underlying consumer needs and not on observed behaviours, not on consumer trends. This is the generic model. Arthur will give you more detail later around some of these areas, around the tobacco translated bespoke model that we have in Imperial.

This is very intuitive and has gone very rapidly into the organisation. People get it. It's played with in the organisation and it drives our choices around our total tobacco portfolio, around our brand equity investments, and how we position our brands in the business. It's a very, very powerful tool.

We're taking it one step further as well by applying that consumer understanding and evolving consumer needs into a business we're calling Fontem Ventures. This is currently at the set-up stage. We've got a number of initiatives already that we're looking at within this business. This is around non-tobacco but it's not just about nicotine delivery. It's not a nicotine venture but this is where we'll be putting some of our progress within areas like e-vapour as we go forward.

Driving Quality Sustainable Sales Growth

So, a differentiated consumer understanding that we've applied to the portfolio. This slide shows the growth we've been delivering against our total tobacco portfolio. These are compound three-year numbers. Our Key Strategic Brands have delivered volumes growth of 4% and revenues up 9% over the last three years. These are fantastic brand equity. They're growing nicely for us.

In fine cut tobacco we're world leaders with make your own being a significant growth segment here. FCT volumes have grown 6% compound over the last three years and with revenues up by 10%. And added to that, clearly there's the papers and tubes opportunity with 3% compound volume growth over the last three years. In premium cigars, I think that consumer thinking has been embedded there longer than it's been in the rest of the business. This luxury segment has been growing volumes at 4% and revenues by 3% on a compound basis. And in Skruf, our small but perfectly formed smokeless business, has delivered some fantastic compound growth over the last three years.

So to meddle with some words of a famous Meat Loaf song," five out of six ain't bad". But the problem or the opportunity lies in that missing box.

Unlocking Further Sustainable Quality Growth

This box represents 58% of our white stick equivalent volumes roughly 150 brands brands with different degrees of equity and varied performance. There's some good equity there but also some less good equity and these brands have been declining at 6% compound over the last three years. So we need to address this issue, or in Imperial we prefer to see it as an opportunity. How do we take this piece of the portfolio forward, apply the learnings from the things we've done with the other five out of the six boxes, and make this box work for us too, to deliver quality sales growth?

Clear Portfolio Priorities

Let me just outline to you how we're going to take this forward. Arthur will tell you a bit more later. This requires clear portfolio priorities. You can see the work we've done on our Key Strategic Brands, and the growth we've delivered from them. We are now going to apply that expertise to the focus brands. For now we've identified four. I think this number will be increased over time with similar opportunities to the Key Strategic Brands but clearly much more limited geographic potential. Together, the Key Strategic Brands and the focus brands will be our focus for value growth, for volume growth and for revenue growth with high returns from these brands. And then you've got the portfolio brands with the question being "What you do with those?" As I said, there are some key brands in there around cash and around scale in markets. There are brands we need to nurture but there are also brands that we'll be looking to migrate into the focus and Key Strategic Brands to further strengthen our portfolio and our sales growth opportunities.

This is our direction of travel. I'm not putting any specific time scale on this at the moment but over time we want the KSBs to be 50% (of our total stick equivalent volumes) and the focus brands to be 30% giving 80% with good growth prospects in terms of revenues and returns. Our portfolio brands will be a mere 20% of the portfolio. This is the direction of travel.

Clear Footprint Priorities

And those portfolio priorities also help refine our footprint priorities. Again, Arthur will talk a little bit more about this. But we're very clear on the priorities for each of our markets. Some are around profit, some around share and some around building scale. Together, they give a balance of opportunities for both volume and profit going forward, reinforcing our sales growth potential.

Strategic Focus Enables Cost Optimisation

So if you're going through the journey with me, we've gone through the consumer-centred piece. We've talked about how we've applied that to KSBs and the growth that we've delivered across our KSBs and total tobacco portfolio. We're now applying that in terms of our portfolio and our footprint to drive the focus more behind that quality sales growth. And now we're on the cost box.

We kicked off the programme looking at costs last year. Some of it's been running for over a year already and we wanted to align that with the strategic priorities of the business. The strategic focus I've just talked about is the key enabler to this cost optimisation programme when you focus on the portfolio and footprint, that provides optimisation opportunities: optimisation of investment, optimisation of product cost and optimisation of overheads.

Together, we see an opportunity for savings of £300 million per annum by the end of 2018 and this will provide us with funds to put behind our investments in the business but also to reinforce our earnings model. I think most of you are aware this is the last year of our significant step-up in investment in the business. I'm going to put a bit more meat on the bones for you now but more detail will be available around this programme at our half-year results at the end of April. So you can ask me more questions if you want but there's not a huge amount more detail I'm going to be able to give you at this stage due to some of the internal sensitivities of finalising the details of this programme.

Strategic Focus Enables Cost Optimisation

But here's a bit more meat on the bones. On the investment side, I think it's a fairly easy, logical conclusion that if you're focusing down on a smaller number of brands within your portfolio, that gives you resource allocation opportunities, but also means you need to rollout your initiatives over a smaller brand volume. There are opportunities therefore within the investments to further optimise how we take that forward.

But the bigger opportunities are from complexity reduction within the product cost. As we rationalise the portfolio, that provides the opportunities to take costs out of the product because we've got less SKUs. It's less complex for the manufacturing organisation to deal with. We can therefore standardise more around our blends and around our non-tobacco materials. There are opportunities there, clearly, for cost optimisation and also in the footprint. We continue to keep our manufacturing footprint under review to see if the opportunities are there as well.

The next point, "operational excellence", is an initiative that's already been going on for about a year; we've just completed the test pilot in our Radom factory. This is around effectiveness and it's around efficiencies within our manufacturing footprint. That will also, clearly, be helped by the complexity reduction as well but that adds to the opportunity cost.

And then on overheads where we have two key areas: one is in relation to the operating model and the other to procurement. I've talked to you around the move from a more local autonomy to a more central-led organisation and as we do that, there are clearly opportunities around the operating model to realise further costs in the business. On procurement, we do very well already at non-tobacco materials and leaf, but as we take the operating model forward, there's more we can do from a procurement perspective across the globe on our other cost base. So there you have a little bit more meat on the bones around where we see those cost opportunities. As I say, there's only so much detail I can give you today. You'll have to hold off until our half year results for a little bit more detail.

The Strategic Journey

So I've talked to you through where we already are in terms of the strategic journey and where we see the next opportunities for us, all driving the sustainable growth of the business.

Sustainable Growth; Growing Cash Returns

That strategy translates into the earnings model with sales growth of 2-4%.

As you can see, by extending the approach across the brand portfolio, adding into that the footprint opportunities as well, further refinements and refocus behind those footprint opportunities, that really strengthens that lever of our earnings model.

The cost optimisation programme gives us more opportunities on cost, again for investment, but also to reinforce the earnings model. And then on cash utilisation, we also have opportunities there on interest going forward and maybe a smidge on tax. All of these support our confidence in our ongoing delivery of dividend growth of at least 10% for the medium term.

Sustainable Growth; Growing Cash Returns

Now I've given you an overview of the approach here. I've told you what I can tell you about the cost piece at the moment and I think you're aware as well some of that's being accelerated into the current year which Bob will touch on shortly. Bob will also now talk around the cash piece in a little bit more detail. And Arthur will put a chunk more meat on the bones around the sales growth agenda and how we're taking that forward.

But for now, just the three key messages to leave you with before I hand on to Bob: around the strategic choices and the quality of the sales growth focus, how that's coming through and how we'll further strengthen that going forward; the cost opportunity and how we're approaching that and realising that; all enabled by the strategic focus and double-digit dividend growth and our confidence in delivering that dividend growth for the medium term.

Thank you. At this point, I'll hand over to Bob to talk through how we're growing cash returns.

Sustainable Growth; Growing Cash Returns – Bob Dyrbus, Finance Director

Thanks Alison. Good morning, ladies and gentlemen.

Sustainable growth and growing cash returns: I will be talking about the model and what it means going forward but before that I'd just like to take a couple of seconds, being a finance person looking at the here and now, post-the IMS that we put out in January, as there seems to be a little bit of confusion in terms of what we actually meant.

HY13: Performance Drivers

In terms of the current financial year, I'll talk about the first half and then the second half. Basically, in the first half of 2013, what we are seeing impacting the operating profit is softness in the EU markets. If you take a look at where the EU was in the year to December, EU markets had actually deteriorated compared to the year to September. Therefore by deduction, the EU markets were significantly weaker in the fourth calendar quarter. We've also had softness in Russia and movement in trade stocks but that's business as usual, it happens, these things come and go depending on what you're talking about and in which month.

At our preliminary results last year, we talked about a £200 million additional investment in FY12, which was actually back-loaded into the second half. That run rate carried into our first half of this year and was committed by the time the dramatic increase in EU weakness became apparent in late December. Given the weak comparator from the year before, the impact on our first half results is significant. We have said that we are stepping up investment this financial year but in terms of the year-on-year comparison, the H2 level this year will be considerably lower than the second half of last year.

The US is still in a state of turnaround. We started with the new model in the second half of last year, initially applying it in four States and then extended to a further 15 States. So this initiative was also back half loaded meaning that this year we've got the comparison of the investment we are putting behind the US coming through. As we go into the second half, we obviously lap that positioning.

H213: Levers to Deliver

What can we do? Well, we're not assuming any change in the markets. So we're assuming the markets do what the markets do. I've already mentioned the significant investment uplift in the first half of this year and the consequential reduction in investment in the second half but still up overall on FY12 levels.

In terms of business delivery, we are actually delivering. I know it's tough to see it from the outside but if you actually go back and take a look at what's actually happening in market, what's happening with the portfolio, the business is delivering and will continue to deliver in the second half.

There are two impacts of pricing which will benefit our second half: firstly, in terms of general pricing we're taking in the market place, these are coming through as expected; and secondly, part of the investment that we have made in the US is effectively in the price positioning of some of our brands, so we'll have a more favourable price mix in the US against the same period last year.

And finally, there will be some early cost optimisation benefits coming though in our second half but the vast, vast majority of the programme Alison was talking about, relates to beyond 2013. I have heard seen some suggestions that our cost savings in the current year need to be almost as big as our total costs optimisation programme. That's, frankly, not true.

Sustainable Growth; Growing Cash Returns

So, that's 2013. But, let's talk about what we're here to talk about, which is growing cash returns, sustainable growth. This, effectively, well-designed model, it is about sales growth, it's about quality sales growth driving margins, driving cash, using that cash to reinvest in further sales growth and maximise returns to our shareholders. Nothing much changes. You go round faster and you throw off more money.

Growing Cash Returns: RoIC

It's not only just about the quality of cash. It's about making investment decisions, about making resource allocation decisions sensibly because investing capital effectively in this business and generating a strong return on that invested capital is an important internal metric that we keep an eye on. You can argue about what is our average cost of capital but I'd say that a 15% return on invested capital is well above that level. As we effectively invest, de-lever and do what we're doing, we will see improving return on invested capital over time. It's going in one direction.

Growing Cash Returns: Cash Conversion

We're immensely cash generative. Historically, we converted virtually all of our adjusted operating profit into cash flow after capex, you can see the rates on the slide. Last year it was slightly lower than normal because of the working capital outflow. Going forward, with the expected increase in the dividend payout and with capital investment slightly ahead of depreciation, we see the cash conversion rate being in the range of 80-100%

and it will continue to be in this range year after year.

Growing Cash Returns: Increasing Pay-Out

And what can we do with those growing cash returns? Alison's alluded to the increasing payout. You can see from 2009 to 2012, the payout ratio increasing from 45% to a little over 52%. You've seen the earnings model and that combined with a 10% per annum dividend growth, says that payout will steadily increase. You can run the spreadsheets yourselves in terms of how many years that can continue for and once you've plugged in the earnings number, it continues for a significant time.

Growing Cash Returns

And what have we done? Well, in terms of cash returns to our shareholders, since 2010 it has almost doubled from just over £770 million to around £1.5 billion with a mixture of dividends and buy-backs. And because of where we are in terms of running an efficient balance sheet, you will see returns being a mixture of dividends, and you've heard what the dividend growth will be, and, if there is excess cash, then on increasing the buy-back programme. So what does that mean in terms of the model.

Sustainable Growth; Growing Cash Returns

If you look at it as a financial model, effectively the sustainable returns are driven by the top line aided by cost optimisation and cash utilisation, as Alison pointed out. What those three things combined do is deliver around about £2 billion of free cash flow per annum and growing. And it's that cash flow that enables us to have confidence in the commitment to the 10% dividend growth. There will be an element of de-leveraging, and it will also fund buy-backs in terms of returns to shareholders, a simple model.

Sustainable Growth; Growing Cash Returns

Alison highlighted the strategic choices, she's highlighted the cost optimisation, and I'll leave you with one thought on cash which is our commitment to sustainable 10% dividend growth for the medium term.

Thank you very much indeed.