

## Transcript – Cost Leadership at Competitive Quality

### Walter Prinz, Manufacturing, Supply and R&D Director

Certain statements in this presentation constitute or may constitute forward-looking statements. Any statement in this presentation that is not a statement of historical fact including, without limitation, those regarding the Company's future expectations, operations, financial performance, financial condition and business is or may be a forward-looking statement. Such forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from those projected or implied in any forward-looking statement. These risks and uncertainties include, among other factors, changing economic, financial, business or other market conditions. These and other factors could adversely affect the outcome and financial effects of the plans and events described in this presentation. As a result, you are cautioned not to place any reliance on such forward-looking statements. The forward-looking statements reflect knowledge and information available at the date of this presentation and the Company undertakes no obligation to update its view of such risks and uncertainties or to update the forward-looking statements contained herein. Nothing in this presentation should be construed as a profit forecast or profit estimate and no statement in this presentation should be interpreted to mean that the future earnings per share of the Company for current or future financial years will necessarily match or exceed the historical or published earnings per share of the Company. This presentation has been prepared for, and only for the members of the Company, as a body, and no other persons. The Company, its directors, employees, agents or advisers do not accept or assume responsibility to any other person to whom this presentation is shown or into whose hands it may come and any such responsibility or liability is expressly disclaimed. The material in this presentation is not provided for tobacco product advertising or promotional purposes. This material does not constitute and should not be construed as constituting an offer to sell, or a solicitation of an offer to buy, any tobacco products. The Company's products are sold only in compliance with the laws of the particular jurisdictions in which they are sold.

**Walter Prinz:** Thank you Alison, good morning everybody. The theme of my presentation will be how our core capability of execution excellence creates value, and enables the business to deliver sustainable shareholder returns.

As you can see here, and we heard that in John's presentation, our team was reorganised last year, so we combined the functions manufacturing, R&D and supply chain. This change in operating model has reduced interfaces, increased our agility and effectiveness and finally strengthened the new function significantly. Execution excellence is our core capability, and the key enabler to successfully implement the wider group strategy of sustainable shareholder returns.

Our clear purpose; cost leadership at competitive quality is already implemented and delivered through my committed team.

We also gave the new enlarged function you see here on the right hand the identity 'Woman and Man of Action' and I will come back to this reference at the end of my presentation, and what it stands for.

So these are the three key focus areas through which we deliver execution excellence; firstly quality, we have to ensure that all our products meet the consumer needs, and are compliant to all the regulations. Secondly agility and responsiveness, we have to be able to respond flexibly and quickly to demand shifts, changes in regulations and of course innovation opportunities. Last but not least, cost discipline and efficiency, we keep our focus on value creation and cost leadership by managing our cost base in the most effective way without compromising on quality and speed of response.

So the core of this successful strategy is our engaged people, focusing on customer and product. Let me start with the focus area quality; as I said we have to ensure that our products meet the consumer needs

and are compliant, so we ask our consumers what they perceive as quality. This consumer insight has been translated into our product specifications. We also implemented a new fault catalogue in our factory to assess the production quality now with consumer eyes.

So here we can see the results of having the right focus and the right investment. Our quality index improved, so the quality indexes measuring our production quality improved by 17% the last three years. Our consumer complaints have been reduced by 11%. A complaint number of below 5 per 100 million stick equivalents is considered best in class, and we are actually sitting at 3.4 complaints per 100 million stick equivalents.

Moving on to the second strategic focus area, agility; in order to get the product faster to the consumer our priorities are in the following areas: The implementation of lean management manufacturing tools, this has improved our factory flexibility and change over times. You will see in the next presentation Titus, our operations director will go in more details around this programme. The success of our simplification agenda, this has enabled us to put our standard format production on the newest generation of ultra-high speed machines. The optimisation of supply chain processes and systems capabilities improved the availability in market and supplier reliability. Finally, we improved our scalability potential and fast decision making process.

These are just a few examples of our capability to scale up production capacities, for example we increased the capacities of big box by 113%, queen size by 226%, and snus by 77% the last few years. Our fast decision making process and the high levels of format flexibility of our make pack combinations enabled this success. As I said, complexity reduction is important for our efficiency improvements, the agility and the flexibility in manufacturing supply and R&D.

We heard a lot from Marcus about the success on SKU reduction programme, but we in manufacturing, we have really put the emphasis on our component reduction. As you can see here we have reduced significantly our components by an average 28%, and you see here cigarette papers, plug wraps and filter tows. This programme is very, very important also for our NTM purchasing programme, because the bigger the lot size the better our prices.

These are two KPIs from supply chain which underline our agility. As you can see on the left hand side, our availability of product at the first point of sale is above 99.9%. Everything beyond 99% is considered as world class. Another KPI is supplier reliability, so delivering the right quantity on time and here you can see on the right hand side we improved over the years and in P6 we entered the world class territory which is above 95%.

We have further strengthened our research and development capability through a reorganisation also in that area, and the creation of a new innovation department. This department holds all the required capabilities from engineering, packaging, print, tobacco plants and non-tobacco materials. We also have revised our innovation stage gate process, and are leveraging our suppliers' innovation capabilities now much more. As a result, the ideas and patterns have increased significantly and as an example of our agile innovation; you see here the JPS, John Player Special Origines launch took us from the go decision to the launch in Italy, 10 weeks.

Let's have a look at our cost base, our costs are one third non-tobacco materials, one third leaf and one third conversion cost. To keep our unit cost flat is our overarching target, to achieve this we do need to compensate all the price inflation in all the areas, and also the impact of our volume reduction. We have

done this in the past and we are very confident that we will realise further cost savings in all three areas, to fuel growth and stay ahead of our competition.

Due to our history, we inherited a variety of sites. Reviewing our manufacturing footprint and capacity requirements through our product supply strategy is an ongoing task, to continually reduce our conversion costs. Key drivers for our footprint rationalisation and complexity reduction also the improved machine efficiencies, the changes in regulation- we heard today, plain packaging from a manufacturing point is reducing formats, it's reducing complexity. Purely from our perspective that's good, and also the footprint is very much driven by our volume declines.

Additionally to our cost reduction efforts in manufacturing we also have a very strong focus on cash. We do have an internal cash conversion KPI for manufacturing which includes the majority of the group's raw materials and finished goods stocks, as well as significant cash spending from our factory closure activities. Our target is to deliver in manufacturing a cash conversion of above 95%, and as you can see here, which has been overachieved last year by 2%.

Here you see also two examples, one is the leaf stocks, and the other one is our CAPEX which helped us to deliver this strong cash performance. We were able to reduce CAPEX by \$90 million in the last 3 years due to footprint and complexity reduction and the change in our innovation approach. We also raised the bar for our internal return on investment requirement, so we've made it harder to spend the company's money. Our leaf stocks have reduced by \$160 billion since fiscal year '13 due to much stronger stock control, and we also changed the duration policy, we implemented a shorter duration for our commodity leaf. Also the reduction on the leaf supplier base and the lower volumes were drivers for this inventory reduction.

This is one of my favourite charts, so for us pride in every leaf means sustainability, supply, security at all times and compliant and competitive quality. Our agile leaf strategy delivers a huge cost advantage as you can see on this chart. Our average purchase price in 2015 was \$3.99 which is 23% below the average sales price of Alliance 1, which is the second biggest international leaf supplier to all the tobacco companies worldwide. Because the vast majority of the Alliance 1 sales are generated through their vertical integration the Alliance 1 sales price mirrors more or less the cost if you grow your own tobacco.

So our cost advantage is because we are not vertically integrated, and therefore have much more flexibility in the selection of which part of the plant to purchase compared to our competitors. We do have a breakout session this afternoon, and Jürgen and Dan which are responsible for these areas will give you much more details around our leaf strategy in this session later.

So in summary, these are the key initiatives which drive our cost leadership at competitive quality by realising further cost savings and providing a strong emphasis on cash. With the focus on these activities we will keep our unit cost flat and offset the raw material inflation.

So execution excellence, delivering the right product in the right quality and the right quantity on time at the lowest cost, that's our core capability and key strength.

To conclude; we are cost leaders at competitive quality, we do have an outstanding supply chain and we are a world class enabler and the business knows that they can rely on us.

So finally I come back to Woman and Man in Action, I'd like to show you a video to give you a bit more insight into our manufacturing, supply, R&D culture.



***Video played***

**Walter Prinz:** People are our key assets, so we delivered in the past and we are committed to deliver in the future. Thank you very much for your attention. I'll hand over now to Titus, our operations director.