

## Transcript – Quality Growth – New Consumer Experiences

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**Matthew Phillips:** Thank you, Alison, and good morning, ladies and gentlemen. The last set of presentations before lunch is about new consumer experiences and how we in Imperial think about those new consumer experiences.

As Alison said in her opening remarks, back in 2010 we put the consumer at the heart of our thinking. Although it seems fairly obvious now with the benefit of hindsight, a few of the realisations that we came to were that tobacco is a pretty unique product. It has historically been able to satisfy and meet all of the consumer needs and all of the consumer occasions.

However, for a variety of reasons, over the past 30/40 years social and regulatory pressures around tobacco consumption have started to encroach onto those consumer needs and those consumer occasions.

These social pressures combined with the emergence of new opportunities, means for us that some of these tobacco rituals are going to end up being reinvented. When they are reinvented, they will be reinvented in a way that is both socially acceptable and remains mood enhancing or pleasurable. Otherwise, you don't have a mass-market consumer proposition, you have a niche product.

So, for us the distinction between tobacco and non-tobacco is a very important one.

So, how have we gone about it? In 2012 we set up Fontem Ventures, as you've heard already. It's a standalone subsidiary based in Holland. We started from a relatively low base compared to where we

are now, to build our know-how, and our capabilities, and our expertise. That's been done in a variety of ways.

Some of you will be aware we have an R&D facility out in Beijing, which is run by Mr Hon Lik, who is the original inventor of e-vapour products. We also have R&D capabilities in Hamburg, and more importantly now also in Silicon Valley, so we've been very carefully establishing our know-how and our capabilities. With that know-how and capabilities, we've been defining the intellectual property requirements in this playing field.

As you know, one of our technologies, the first generation of technology, is in the process of being licensed out to the myriad of e-vapour suppliers globally, both big and small. Meanwhile, we're focused on the rollout of the second generation of technology. As you'll hear from Arthur in a minute and you'll get the chance to experience for yourselves, the third generation and beyond is already in hand.

We've acquired the best brand in this space, I think, by far. In terms of potential and in terms of consumer unprompted awareness, all of those sorts of things, 'blu' stands on its own. Finally, what we've been working quietly behind the scenes is trying to put together the technology, either by development or by acquisition that ultimately is going to lead to us cracking that consumer experience.

We're very excited about the long-term opportunities of this, of Fontem and of the e-vapour category, but it's important for you to understand that we have approached this in a very deliberate and a very measured way. I'll now hand over to Arthur, who is the CEO of Fontem Ventures, to give you a detailed overview of the strategy of Fontem and of blu.

**Arthur Van Benthem:** Thank you, thank you, Matt. Thank you and good morning.

Why is it that we don't see continued growth beyond the explosive growth we actually saw in 2011 and '12, when the world met with e-vapour products, and smokers – many, many smokers – actually tried this product? You can see this on this chart; you can see the numbers from the US in that 57% of US smokers have tried e-vapour products, and yet only 6.5% of those smokers have remained a loyal consumer – a dual or a completely converted consumer.

Why is that? Many of you will know the answer already, is that these e-vapour products – and this is 'Generation 2' – do not yet satisfy the consumer. Actually, these e-vapour products currently on the market require to learn a slightly different behaviour than what a smoker is used to. It doesn't work like a cigarette and it doesn't satisfy yet as a cigarette.

What we're about to do and about to show you is how we see the opportunity. We're not discarding the opportunity for e-vapour at all; it is this 'Generation 2'. Most of the world is still trying 'Generation 1', which we license to others. We are working and you'll experience this afternoon generation three, and we have line of sight of 'Generation 4, and 5', and beyond.

What we've seen over the last number of years, as we've seen this explosive growth and the world meeting with e-vapour products for the first time, is a lot of scepticism – scepticism from regulators not knowing what to do with this, scepticism with public health authorities not knowing what to do with this, scientists actually disputing one another's research on this, and therefore a growing concern among consumers. "Are these things good for you, or bad for you, or are they as bad as cigarettes, or are they better than cigarettes?"

I pose to you that this is clearing up; this controversy is very clearly clearing up, right here, right now, and particularly in Europe, I would say. It started in the UK with the Public Health England report in 2015 that came out to say that e-vapour products are at least 95% safer than cigarettes. Then more recently what we've seen is the Royal College of Physicians actually endorsing that and taking a step further to actually say, "We should be promoting this. We should provide this and make this widely available for smokers to convert."

That widespread endorsement from these UK authorities is spreading out in Europe.

Meanwhile, obviously we've all seen deeming regs come out in the US by the FDA, which effectively consider EVP to be tobacco, and, therefore, taking it under its control. Clearly we've been preparing for that; clearly we're ready for that. What it will mean in the short term is that players in the market will be moved out. They simply can't afford the cost and the compliance that is associated with complying to deeming regs.

In the longer term, it clearly provides a very significant opportunity for ourselves, because the market consolidation provides opportunity for margin and shared growth in this segment, as well as for consumers; it provides better-quality products to these consumers.

However, of concern is that the US will lag in innovation. Where Europe will go further more quickly with Generations 4, and 5, and beyond, in the US, due to the deeming regs protocol authorisation process, innovation will come slower to the US consumer. That is not necessarily in the best interest of the consumer, nor in public health.

So, how big is this market going to be? That's anybody's question, I guess. It's also ours. If you believe Wells Fargo, they believe that EVPs and next-generation products were probably fivefold over the current 6.5bn retail sales value. Some others are more modest, and we are all aligned with everyone to say that this will be very significant. For that very reason, that this is the only product that provides the opportunity to replicate the benefits and the rituals.

But clearly it requires technology. Remember your phones. We were talking about this over dinner last night; there wasn't anyone around the table, the two tables I sat at, that actually had purchased a generation-one Apple phone. There wasn't anyone at the table that purchased a generation two. There was one that had a generation three and there were several that adopted iPhones with generation 4S, and most of us around the table had a 6 around the table, even 6Ss. Consumers adopt a new technology at different stages of its development. We're at 'Generation 2'.

More on the science, and the controversy clearing up, and the technology that sits behind this, now from Joe, who will provide us with some answers.

**Joe Thompson:** Thank you, Arthur. Good morning, I'm Joe Thompson. I'm Director of Product Science. I'm going to look at the science of e-vapour. You've already heard a lot about quality this morning, and blu is a quality product. We undertake scientific testing to ensure that quality.

Chemical, biological, and toxicology testing all takes place as part of the design process, before any product goes to market. We look at device quality and stability testing, guided by standards from the pharmaceutical industry. Post-market we continue to monitor safety in use and conduct clinical studies, which I'll come onto in a few moments, but I'm going to focus on four big questions.

In the last five years, 40 clinical studies have been published looking at aspects of safety and tolerability of e-vapour use amongst smokers. Those studies show that e-vapour, relative to the medicinal product it's compared to, has a good safety profile. Yet these four questions remain: what impact does e-vapour have on consumers? What impact does it have on bystanders? Do they re-normalise or act as a gateway to tobacco? And what's the addictiveness or long-term health impacts of nicotine? I'm going to briefly take you through our views on these questions and some of the science that addresses them.

Question one: what's the impact of e-vapour on consumers? With blu products there's greater than 98% reduction in harmful and potentially harmful constituents in the aerosol, relative to the cigarette.

The chart shows average reductions in the formation and presence, by chemical class, of those HPHCs when blu is vaped on a per-puff basis compared to the cigarette. There's a substantial reduction. In fact, many of the constituents we couldn't even detect, couldn't measure.

So, we took the limit of science; we took the limit of quantification to give us a baseline measurement to calculate a percentage reduction. HPHCs are either significantly reduced or are just not present. It shouldn't be a surprise, therefore, that in their absence there's a marked reduction in toxicity in standard in vitro tests, again comparing the aerosol versus the conventional cigarette.

In tests for cellular toxicity, the bar on the left-hand side, greater than 99% reduction. In tests for DNA damage that could be indicative towards cancer, greater than 98% reduction. Again we took the worst case in terms of the limits of the assay to look at the percentage reduction, because under standard conditions there was no statistically significant response in any of these assays with our products.

The absence of HPHCs is confirmed with some of our clinical work. Clinical studies is where you take human volunteers, and we're looking at not what they vape but what chemicals subsequently enter the body. You do this by measuring them directly or measuring the chemical breakdown products in urine or in blood. These measures are known as biological markers, or biomarkers, of exposure.

The chart on the left shows measures from urine of what chemicals have been broken down and excreted by chemical class. They're shown as percentage changes compared to an individual's own smoking. So, they're all smokers and we're comparing the blue bars with the pink bars – blue bars when they switch to blu, versus the pink bars when they stop, i.e. smoking cessation. Grey bars are dual use, smoking and vaping together.

What you can see is that the blue bars are similar to the pink bars, i.e. the reduction in selected HPHCs over five days is comparable when you switch to blu as if you stop smoking. On the right-hand side, you see the changes in blood, which shows the same thing except, of course, for the two on the far right, which is nicotine. You'd expect that to be different.

We'd expect the reduction to be greater than this over time, reflecting that these chemicals often take longer than five days to be eliminated from the body. That will be confirmed in our two-year clinical study, which completes in November of this year and we believe is the longest study to date of this type.

Turning to the second question: what impact does e-vapour have on bystanders? There's no negative impact on indoor air quality when you vape our products. Vaped in an enclosed area, we couldn't detect any HPHCs. You can measure nicotine, but again at a very reduced level, a low level. We believe there's no negative impact on indoor air quality.

Turning to question three: does e-vapour act as a gateway to tobacco? No. That's actually fairly well understood in Europe and by the World Health Organisation. The debate is really in the United States. The concern is does e-vapour lead to tobacco; does it lead to smoking? That concern is not evidence based, but that underlines the need for good science, good, robust studies from which regulators can assess and draw their own conclusions.

We're funding two studies, two studies through the UK Centre for Substance Use Research. The study in the US has over 30,000 vapours enrolled. That's twice the size of the US Centre of Disease Control's own study, and it's looking at whether e-vapour products lead to an appeal to smoke. It's also investigating smoking initiation, cessation, and nicotine dependency, and that study will complete in November.

The UK study, which has just completed this month and detailed results will be available later this month, but the headlines are that e-vapour products actually act as a deterrent or a roadblock to smoking, rather than a gateway. E-vapour de-normalises smoking rather than normalising it, through increased awareness, understanding, visibility, and social acceptance.

Turning to the fourth question: what about the addictiveness and health impacts of nicotine? Nicotine is regarded as addictive, but it's because e-vapour devices provide the consumer with nicotine, as well as the sensorimotor or the smoking ritual aspects of smoking such as the hand-to-mouth action, watching the exhaled vape, the catch in the back of the throat, it's because e-vapour products provide all of those aspects that those devices are beginning to be indicated for smoking cessation.

There is no toxicity concern with nicotine at the low levels present in e-vapour products, but it is important that young children are prevented from accessing nicotine or being exposed. Therefore, we do that through child-safe packaging.

In terms of the long-term health risks of nicotine and vaping, in 2014 the US Surgeon General concluded that the science base was inadequate to decide either way whether nicotine had a role in cancer. Our own evaluation agrees with that conclusion.

Nicotine has been associated with long-term cardiovascular risks, and again we're continuing to evaluate that science and that research. In all of these areas, it's very clear that more work is needed, more research is needed. We're continuing to investigate that, to assess the science base, and to conduct our own studies.

To summarise: clinical studies show that e-vapour products have a good safety profile and that HPHCs are greatly reduced. There's no negative impact on indoor air quality with our products. Evidence is growing to suggest that e-vapours do not act as a gateway to tobacco, and whilst nicotine is addictive, the long-term risks of vaping are largely unknown.

We're playing our part in that to try and understand through research. We're conducting consumer perception and behavioural assessment to look at potential public health impact, as well as carrying out post-market surveillance and clinical studies. We take our responsibilities in this area very seriously, and we're well underway to submitting to the UK MHRA for a medicinal licence for an e-vapour cessation device. Thank you for your time. With that, I'll hand back to Arthur.

**Arthur Van Benthem:** Thank you, Joe. By all means, check out 'Fontemscience.com' to read all about the science behind e-vapour and the clear answers that we're creating that is creating the consensus in Europe, as well as elsewhere.



Our strategy is very simple: our strategy is to pursue a global consumer with a global proposition and blu, the brand blu. We're investing very clearly in the brand, as you will have seen also here in the UK with a new brand campaign; more on that later on in the Pavilion.

We're investing very clearly in innovation, because we're moving from 'Generation 1 to 3' and beyond to clearly provide what will be a 'better than a cigarette' experience for the consumer. And we're investing in digital, online. We believe that consumers shop online and we believe consumers shop omni-channel. Irrespective of where they are, at an arm's reach of desire we are providing the opportunity to interact with our brand.

We've built a very lean and, in future, scalable operating model. Operating out of the Netherlands, with also a head office in Charlotte, we're able to cover the European markets and the US, but for the moment we're focused on four markets – in fact, the four largest EVP markets. The US, the UK, France, and Italy is where we're currently operating, and we'll stay operating in those markets to crack the consumer experience before we'll scale and after which we'll scale. Clearly, we're focused on licensing the intellectual property which we own, which is called 'Generation 1' products. That's our strategy.

As Matt already said, we have the best brand. blu is the best brand in the category, we believe. It is a simple brand name, three letters. It is very memorable, therefore. It's timeless and has tremendous iconography. It works much like the golden arches for McDonald's; the contour bottle for Coke is the blue light for blu. blu is all about, and we're all about, creating a preferred vapour brand. It's all about, blu is all about, staying true to yourself; it's about enjoying your moment, your truth, and actually making that better as a consumer. More on that again later on this afternoon.

We're experiencing quality growth. In fact, I'm very pleased to see also the US market to return to volume but also value growth, after having had several months, if not a year, of competitors actually pricing down, discounting. In the absence of greater technology and better technology, we're now seeing consistent, albeit small, value growth returning also in the US.

We're seeing very good growth momentum for our brand, though. In the US we've stabilised the brand; post the acquisition, we're now seeing the ability to actually grow the brand. In fact, we are outgrowing the refill category, which is a segment within – the largest segment within – vaping, three times over the market average.

In the UK in the last 12 months, we've grown from the number 4/5 in the market to a 16% number 2 in the market. Also, in Italy we have launched blu more recently, as in earlier in this year, and we see very good growth momentum in that market. In France, for the moment, we're available online until the new generation comes, which we'll make available not just in tobacconists but across more channels to consumers.

We're very focused on this best brand, the best vaping experience among a very loyal consumer base, and that's actually working for us. In the States, what we already see is that consumers of blu vape twice as much as the nearest competitor. In the UK, what we're seeing is very similar numbers.

blu creates value to Imperial, and yesterday we also had a number of conversations on that. Here you see some numbers on the gross margin. We've yet to actually get bottom-line profitability, clearly, but here you see numbers on the gross margin, which compares the average gross margin we earn on an average cigarette consumer in the US versus the gross margin we earn with blu on an average blu user. That improves with time; that improves, that gross margin generation, with further generations.

Moreover, we see very clear levers for bottom-line profitability over time, first of all through pricing. The average consumer in the UK spends about £2 on his habit on a daily basis, versus £5 on cigarettes. The opportunity for pricing, even with excise coming in, is quite significant.

Trade margins: in the absence of real brands in this category, the trade has had a bonanza. They've been able to extract trade margins, which are exorbitant and are being reduced down, even in the last 12 months, in the UK.

Economies of scale: with growing volumes, you can see how automation will significantly reduce cost of goods and thereby increase margins. Online I've already spoken about; we see a significant opportunity for online sales to become a very significant portion of our overall business, from an average of 15% already today. That comes with greater margin.

I've spoken a few times about not satisfying smokers yet. I've spoken also about our absolute ambition – and, in fact, our line of sight – of being able to provide to consumers an experience that is as good as a cigarette, if not better. We do have clear line of sight on that.

We're chasing the smoking experience and looking to create something that is better than a cigarette.

That comes from a number of different things; it comes from a variety of different things, but importantly it comes from actually replicating the smoke. It comes from the draw of a cigarette, the hit in the back of your throat, the kick that you get from the nicotine and the vape that you exhale.

You can convince yourself that a line of sight of us being able to create an as good, if not better than a cigarette, performance, we've already taken the next step on that with our 'Generation 3', which works like a cigarette, therefore it would not be difficult to understand and to believe that if it does, then you would have smokers not just to try but actually repeat their purchase. That's what we'll be trying to demonstrate this afternoon.

In summary: quality, agility, discipline also applies to Fontem. We're very much focused on the best brand and the best vaping experience ever for consumers at any point in time. We're very much focused on providing consumers with a gradual generation by generation, a roadmap towards a 'better than a cigarette' experience.

We're very agile in having built a lean and, in time, scalable operating model focused on having signs to underpin not just our innovation but also public endorsement for these products. We're very focused on those four markets, the four largest EVP markets today, which comprise of around 70% of the total business, the total e-vapour market globally, and cracking the consumer experience in those markets before we scale the experience beyond that. Thank you for your attention.