Transcript – ITG Brands

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David Taylor: Thank you, Alison, and good afternoon, everybody. Let me first start by saying how delighted I am to be here with you this afternoon and also how excited I am to be leading Imperial's new business, ITG Brands. The US market remains a highly attractive one for Imperial and really all tobacco companies. It represents the world's largest profit pool after China and accounts for about one quarter of the global tobacco profit annually. It's the number two market in volume terms also, excluding China. Although volumes have been in decline, long-term decline for decades, the decline rate is generally steady and generally predictable.

For the last year, however, we've seen much more benign volume trends, with the US cigarette volumes essentially flat and cigar volumes increasing. We'd attribute that to a generally better US economy, lower gasoline prices, all combined, which leaves more money in our consumers' pockets. We do expect, however, these volume trends to return to their long-term historical trend over time. Now, this steady volume trend, along with robust industry pricing, has led to net revenue and operating profit for all US tobacco participants. In addition, you saw from Dominic's chart earlier, cigarettes are generally affordable in comparison to other developed countries, which bodes well for price leverage to continue for many years to come.

The regulatory environment, though not constructive, is also reasonably predictable, with the predictable pressures from states and municipalities for more age restrictions on tobacco purchases and local and state excise tax pressures. So far, the industry had been able to avoid the more draconian measures, like plain packaging or graphic health warnings. The federal regulatory scheme under the Food and Drug Administration presents many challenges for all tobacco participants, challenges to comply with all the reporting requirements, the filings and other restrictions and difficulties going forward. The industry will hold the FDA to its mandate to regulate the tobacco industry based on scientific evidence.

Just a quick snapshot of what ITG brands looks like today. Roughly 85% of our revenue comes from the sale of cigarettes and roughly 15% comes from the sale of machine-made cigars. Our focused brands comprise about 70% of our cigarette revenue and about 80% of our cigar revenue. ITG employs about 2,700 employees, and those people are in manufacturing, they're in supply chain, in sales and marketing and essentially all other corporate activities. We have a national sales force of roughly 950 people and we manufacture our cigarette products in two plants in North Carolina.

The integration of our US businesses is largely complete. As you know, we've been deeply involved in combining the Commonwealth-Altadis business, previously owned by Imperial, and the newly formed ITG Brands and the acquired assets. Now, one of the benefits of the very long review by the Federal Trade Commission prior to closing the acquisition in June was that it allowed us time to plan for the rather complicated integration. That planning has really paid off.

The new business was up and running instantly on day one and we've had almost no issues with production, billing or otherwise since the close. All corporate activities have migrated to our new headquarters in Greensboro, North Carolina, and the wind-down of the Commonwealth-Altadis activities in Fort Lauderdale, Florida, is almost done. We have one combined sales force representing our cigarettes, our cigars and Fontem's e-vapour business all across the country. The manufacturing transition is also going smoothly.

As you know, ITG brands continued to manufacture certain of Reynolds products for Reynolds, and Reynolds continued to manufacture certain of ITG Brands' products for us during a transition phase while we worked out where the machines would end up and we moved those machines to our respective factories. That migration is now virtually complete and all of our products are now made in our factory in Greensboro, North Carolina.

Now, because of that significant volume of product that's moved to Reynolds in this transition, we'll experience a significant production decline in our Greensboro factory. We've recently announced a significant workforce reduction to, or, more correctly, right-size our capacity and our costs in that plant. Now, more work needs to be done here and we will continue to evaluate footprint consolidation options and match those with our new business requirements going forward.

The ITG Brands' team was built on the strong backbone of the former Lorillard team and it was supplemented by talent from Commonwealth-Altadis. That strategy provided significant scale, experience and talent to the US Imperial team. The culture of winning in the face of still competition from larger competitors still resonates with that team. We're also a highly experienced team with a history of building strong brands, and that is what we're all about. Our cigarette and cigar brands are iconic and they have long histories upon which to build improved awareness and loyalty.

We expect to build share and profitability on behalf of Imperial in the US. We have a vision to restore the glory of our brands. They are not dead, despite the premature declaration by some analysts. They need attention, they need support and they need to be nurtured, but they will grow to be a significant market force again and we will succeed in that mission. Now, it'll be a long process and it will take years and a lot of patience. We do not expect to upset the very profitable US cigarette algorithm, nor do we expect to achieve this goal overnight.

The vast majority of cigarette volume in the US is done through convenience stores, over 70% in fact. Now, this channel is comprised of large chains, like 7-Eleven and Couche-Tard's US operation Circle K, but there's also many, many more smaller chains and individually owned convenience stores. Cigarette volumes sold through grocery chains and cigarette stores has steadily declined over the years. Now, in the convenience channel, display space for cigarettes is generally governed by contracts between retailers and cigarette manufacturers.

All of the cigarette manufacturers have retail merchandising programmes that are included in these retail contracts, and they're similar in very many ways. They support four key strategies. In a retail outlet under a merchandising contract a retailer agrees to carry certain of our focused brands. The retailer agrees to provide space in the cigarette display rack to provide visibility of our product to the consumer and he also agrees to place certain of our point-of-sale advertising materials, which enhances awareness of the product and its price points.

In addition, for those stores under contract, we manage the price points of our product through additional promotional values through what we call a buy-down payment. In a buy-down arrangement, essentially we ask a retailer to reduce the retail price of one or more of our products by a certain amount and then we reimburse that retailer for the amount of that price reduction based on the volume sold during that promotional period. That protects the retailer's margin on the product, but allows us to actively manage the consumer price point in order to be competitive market by market. Retailers not under contract do not receive this same sort of retail price support. Now, this arrangement obviously provides retailer incentive to participate in our programmes by enhancing consumer demand and store traffic, but still protecting that retail margin.

Now, our retail sales force has done an outstanding job selling these retail merchandising programmes to the US retail community. We currently have about 164,000 stores under contract. We estimate now there's roughly 320 retail locations in the US that sell cigarettes, but the vast majority of that volume is sold in substantially fewer than that. The 164,000 stores under and ITG Brands' contract sell about 88% of all the cigarettes sold in the United States. Those stores sell about 92% of Winston's current volume and about an 89% of the competitors' volume, so we are well represented in all the right places.

Now, there's been some recent commentary about ITG Brands losing the most shelf space over the prior year compared to Altria and Reynolds. Now, that's really very confusing to us because ITG Brands didn't exist a year ago and our shelf space is generally governed by the retail contract that I just described, which requires our display space to be equal to our market share in those markets. Now, to put the number of stores into context, Lorillard had about 150,000 stores under contract right before it was acquired by Reynolds, and Reynolds had about the same number, 150,000 under contract at that same point in time.

Our strategy is to focus on four primary brands. Winston and Kool will represent our premium offering in the non-menthol and menthol space respectively, and Maverick and USA Gold will comprise our discount offering. Winston and Kool will be carried and promoted on a national basis, and our focus is on volume and share growth. We believe that the long-term value of this company will rest on our ability to build share in the premium category and we believe it's important to have strong brands in both menthol and non-menthol in the premium category. Our brand-building efforts will be focused primarily on those two brands, Winston and Kool.

In the discount segment, Maverick and USA Gold have different roles in different markets. Historically, Maverick had the most brand strength in urban and suburban markets, following on to where Newport was strong, and as you might expect since Maverick was a Lorillard brand. USA Gold had more brand equity in rural markets, so our discount offering will be one of either Maverick or USA Gold, depending on the territory. As you can see, ITG Brands sells three of the top ten cigarette brands in America.

For Winston, our brand support is geared toward long-term sustainable market growth. It will be price supported on a national basis and we'll also support it with all the other brand-building tools available to us. We've conducted product tests and I'm pleased to tell you that the product performs very well against its primary competitive set. In other words, we don't have a product taste or performance issue, which would have proven tricky to fix given the regulatory environment we're operating in.

In addition, from the outset we thought it was important to redesign this pack. We conducted many consumer tests and focus groups to find out the appropriate pack design that would resonate with adult consumers, our intended audience, and still maintain some of the legacy design elements that made Winston famous over the years. Now, after a couple of tries we think that we have that in this design. This pack design will be in the market sometime later this summer.

In addition, we've been working on an advertising campaign that will also speak to our intended audience while recalling some of the historical cues that are both authentic and reinforce that brand's positioning. That work is still in progress, but will be completed pretty soon. We'll support the brand in other ways, such as relationship marketing, using tools like direct mail, website content and social media where appropriate. We're developing a mobile couponing application for smartphones.

We expect to do many of the same things for Kool. This will also be a key national brand for us and will be concentrated really on those markets where menthol is strong. Menthol is about one-third of the US market and its share of the total has been growing, so it's important that we have a strong offering here. Many of our current team members, as you know, were involved with Newport, the number one menthol cigarette brand when it was owned by Lorillard. We viewed Kool as the closest competitor in terms of the taste and demographic profile, so we know the product tests well with consumers. We'll also engage in the same sorts of brand-building activities in support of Kool as we do Winston. However, we don't think that this pack needs a redesign at this point, so we'll stick with this pack.

How are we doing so far? You can see from this chart that our focused brands had roughly a 6.75 share for the 13-week period just prior to the closing of the acquisition in June 2015. Volumes were declining at roughly a 3% rate compared to the year-ago period. Now, for the 13-week period ended April 2nd 2016, those brands now have a 6.9% share and we've stemmed the volume decline. That increase is attributable to gains for Winston and Kool and are really just the result of the price promotions we've put in place and the better visibility for product and point-of-sale advertising. Remember that the very good response to the retail merchandising contracts set the stage for that sort of improvement.

We have other brands in our portfolio other than focused brands, as you know, but we're not investing significant resources behind them. We expect those brands probably to continue their recent trends and offset some of the market share gains that we see in focused brands. We believe that concentrating our resources on a core range of products with the best growth opportunities is the best way to build long-term value going forward.

As I may have mentioned in the past, both Winston and Kool have been in share decline for many, many years. Many of you may know that Winston was the number one brand in America at one point, and that was back in the 1960s. This chart starts in late 2012 and shows the share trend that Winston demonstrated for the couple of years leading up to the acquisition in June 2015. Now, there was a fivemonth standstill period in the acquisition agreement with Reynolds that governed the route to market. It really limited what ITG Brands could do and what Reynolds could do in terms of shelf space resets or in terms of new retail merchandising contracts with the retail community.

Now, on expiration of that standstill period in mid-November the share gains have been demonstrable, moving from an approximately 2.0 share to 2.17 share points. Now, we hope to continue this upward trend and accelerate it in the future. I said before that this a long-term plan and this is still early days, but we're happy with this sort of progress.

We see similar share trends for Kool. With the introduction of the new merchandising and pricing strategy, we see marked changes in the share trends, moving up from 1.71 share points to 1.88 share points. Again, we're pleased with this responsiveness, but we're currently examining ways that we might accelerate these trends with changes to the promotional schemes and other equity-building initiatives.

We've also made significant progress against our plan to turn around our cigar business, which comprises roughly 15% of our net revenues, as I said. Now, this is our machine-made cigar business with brand names such as Dutch Masters, Dutch, Backwoods and Phillies. This is not the premium cigar business that some of you got to enjoy last night. No. Prior to this year, the machine-made cigar business was characterised by what I've called a push model, wherein various deals were made to certain wholesalers in an effort to move high volumes, and relationships with retailers were largely left to the wholesaler. Special incentives to certain wholesalers, such as discounted or free product, often resulted in uneven product demand, significant returns, price disparities for retailers and consumers.

We made a decision to change all that. We wanted our cigar business focused on fewer brands and fewer SKUs and focused on those with the greatest brand equity. We wanted to operate this cigar business in a manner that's much more similar to the manner in which we operate our cigarette business, one in which the wholesale distributor is utilised to warehouse product and deliver that product to the retail outlet and earns a margin for that service, one in which our wholesale customers are all treated fairly. Also, they're treated the same, large or small. One in which our 1,000-person salesforce can represent our cigar portfolio in a similar fashion to our cigarette portfolio, with retail merchandising contracts, governing display space, with structured merchandising payment schemes and logical display requirements. That way we can ensure maximum distribution and visibility, arrangements which can provide all those benefits that I described earlier when I was talking about cigarettes.

We also wanted our marketing and promotional dollars to go towards real brand building and price promotions where we were certain that they made their way into consumers' pockets. That way we can enhance the opportunity to create trial and actually enhance demand moving forward. That new model touches many aspects of the business and creates many positives, from improved manufacturing planning and efficiencies to portfolio optimisation opportunities, to better consumer economics and better brand-building insights.

In the end, we believe that we'll have a stronger, more profitable portfolio based on a simpler range of products with better distribution, more appropriately priced for consumers. We're seeing results here today. I caution once more that this is a long-term proposition, but we're optimistic that we can regain momentum in our cigar business and drive a much more vibrant business behind our focused brands, Dutch Masters, Dutch and Backwoods.

We'll also work to maintain and enhance those brands' relevance. We'll engage in appropriate advertising and brand-building activities for those brands and we want to make them highly visible to our consumers. We'll actively manage price promotions to incentivise trial and maintain consumer loyalty. We believe that by focusing on the consumer we can capture a growing share in what is currently a growing category in the US.

The most recent deeming rules issued by the FDA with respect to cigars are worrisome and they will present challenges for all industry participants. However, our team is very experienced in dealing with the FDA regulations on cigarettes and we are prepared to comply on cigars. Although FDA rules on characterising flavours, such as cherry, grape, banana and the like, have not been proposed, our current portfolio is not as highly dependent on those sorts of flavours as many of our competitors are. In addition, we think that we're probably in better shape on specifications for predicate products than many competitors.

To summarise, we're seeing positive results from the actions we've taken to date. We're encouraged by that, but brand building takes time and those efforts are underway. You'll see much more visible in-market activity on those sorts of activities later this summer. We have a team that is motivated, that is disciplined and experienced in building winning brands and creating value for all stakeholders. We think the future is bright for us here at ITG Brands.

With that, I'm going to hand it back to Alison.