

Transcript – Discipline

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Oliver Tant: Good afternoon, everybody. I'm delighted to be on stage and have the opportunity to talk to you all this afternoon.

When Alison started us off this morning she talked very clearly about three themes. Consistent themes that I'm sure you will have reflected upon and witnessed during the course of the presentations that you've heard today.

You heard a great deal from my colleagues earlier on in the morning, talking about how through what we're doing with our brands, what we're doing in markets, and what we're doing with new consumer experiences, we're really reinforcing the quality behind our business propositions.

You heard my colleagues in manufacturing, supply chain, research and development, talk about agility, together with John Jackson, when he was talking about the operating model. And how we're building in flexibility in our business, through the ways of working, to ensure that we're able to respond in an uncertain world.

What I'm going to do now is have a look at how we're approaching discipline very clearly through a financial lens.

I'm going to talk about this in the context of our approach towards resource allocation, cost management, and cash optimisation, and how all three, but more particularly that last issue, are contributing to driving revenue, margins, cash, dividend, and general growth.

Before I do that, I suspect it won't have been lost on you that actually all of these themes are interconnected. They reinforce one another.

So as I talk through discipline through a financial lens, around capital allocation, cash conversion, working capital management, and cost management, the things that we're doing also enable and create agility within the business.

By ensuring that we're focusing on applying the resources that we have in the most effective way, to generate the best returns, and that we're building flexibility in our cost base, thereby building agility.

Also, by looking at the way in which we are managing performance to ensure greater levels of predictability, reduced risk within the portfolio, higher levels of cash generation, and a much more focused spend, we're building behind the quality within our business.

I know this is a slide that many of you will be familiar with, because we've used it often externally. I think this is at the heart of our capital allocation strategy, and it's really about how we manage cash.

Capital allocation inevitably is achieved through the medium of cash, and we have a very, very clear strategy around our uses of cash, that we've reinforced on many occasions.

Our first priority is to invest in our strongest brands and our key markets. Then we will use that cash to support our dividend growth promise of 10% each year of growth over the medium term, and then reduce our debt.

We also need to manage the sources of cash. We need to manage cash flow from operations. And we've a very disciplined and managed approach towards the management of cash from our operations.

You will have seen and borne witness to this as we've been through the presentations today, where you can see each and every part of the business has a focus on improving cash generation from operations.

You might imagine a mature business like Imperial Brands with actually a very short-term investment horizon in many cases. We're a mature business. We shouldn't have to put large sums of money out for very long periods of time. It means that we should be able to translate earned profits into a high level of cash from operations.

We also have a strong focus on working capital efficiency, which I will talk about in a bit more detail later, but we've also been very clearly focused on ensuring those assets that we've invested in, in the past, are appropriately generating returns.

Where that's not been the case we've been focused on realising cash from those businesses. The sale of elements of our pipe brand portfolio, or the realisation of part of our Logista holding, would be clear examples of where we've applied that strategy in the context of focused use of cash.

So, disciplined capital allocation, and disciplined cash management, are much the same thing, and in our context we're focused on both the sources of cash and the uses of cash.

Internally and externally we've put a great deal of focus on cash conversion as our key KPI, and you can see from this chart we really have done rather well.

Over the past few years we've seen consistent improvements in cash conversion within the business. Based upon the principles that we use for managing and calculating our cash conversion numbers, we've seen over an £850m improvement in operating cash flow generation over the past three years, as compared to the previous period.

Now, we've achieved this in part by many of the activities that you've heard us talk about today. There have been continuous references throughout the day to the impact that these activities are having on our cash flow and our cost management activity.

We've also instituted revised hurdle rates for investment proposals. We've looked at our financial policies around stockholding duration, payment terms, and debt collection.

We're benefiting consistently from business simplification, and this is going to drive through not just in terms of the results that you've seen to date, but as we've moved forward to improve our cash generation over time.

We have implemented a much stronger cash culture internally within Imperial.

Let me start by looking at our approach to the uses of cash. What I've got here is a very simple diagrammatic representation of the philosophy that we're adopting.

As an investment proposition for all of you in the room we're a low-risk income yielding asset and investment proposition. It's not our role to invest in a highly risky panoply of alternative investment options. That discipline has been applied to the way in which we look at investment opportunities within Imperial brands.

Now, this isn't about compromising on returns. It's about limiting the deviation of out-turn and therefore reducing the risk within our business.

You will have heard from Amal and Dominic, who were talking about our approach to in-market investment, that we have some very clear metrics that we use when we identify priority markets for investment, around economic stability, exchange, volatility, regulation, size of the profit pool.

We make choices in environments where we believe we have greater certainty of outcome and the best chance of winning.

This has also been evidenced in our choice of additional markets to invest in, our investment strategy from an M&A perspective. We clearly chose the US environment, which we saw as a relatively much lower risk alternative.

That's not because it was the only opportunity that was available to us at the time. Many of you may be aware that we were in many gossip columns within the M&A industry. Seen to be interested in acquiring assets in Russia, in other parts of North Africa that we don't currently trade in and parts of Asia.

We chose to put our money behind the US market, consistent with this philosophy, because we believe the deviation of risk on return was much, much more restricted.

So we are investing with risk in mind, with a very clear focus on seeking to optimise our returns, but do that in a fashion which reinforces the investment proposition that we offer to yourselves.

Now, clearly, in terms of uses of cash, our dividend promise is another key commitment, but I want to turn very briefly to the third of those commitments, which is around our approach to our net debt and deleverage.

You will see from this slide that over the last two years we've done remarkably well in this area too. Over £2.1bn like for like reduction in our underlying net debt, before the acquisition of the US businesses.

From a discipline perspective we're managing very clearly our debt book, and we're doing this very carefully, because debt is a very important instrument to us. It provides us with opportunity.

Therefore, actually it's not just about the net level of debt. It's also about the management of our overall facilities. That are critical to us in providing both that agility and the opportunity for us to invest behind quality investment propositions.

From a financing perspective, therefore, we have some very clear principles that apply.

We look to have sufficient finance in place to support the business. We look at a variety of different instruments that match the term profile of our needs. We have a balanced range of debt maturities, but also sources of that debt from bond market, bank, and ECP facilities.

Also, we have significant commitments that ensure that we don't need to raise any form of financing over the next 18 months, and have headroom in excess of £1bn as we look forward today.

That's not to say that we won't capitalise on opportunities to improve the quality of our debt book, and our committed facilities, if those opportunities arise over the short-term.

Looking at our financing structures, this gives you a bit of insight in terms of where we are. We're very disciplined in terms of trying to ensure that we're managing increasingly the book, to end up with a series of maturities over the longer term that meet our cash flow expectations, and we've been using both DCM and bank facilities in order to ensure we create that profile.

We've also capitalised on what we believe is an opportunity to take advantage of currently favourable interest rates to fix a greater proportion of our commitment, and improve therefore the risk profile of future interest obligations as we move into subsequent trading periods.

I think it's also vital to see how, from a quality perspective and a discipline perspective, we've managed this position, and managed our position with the rating agencies over the last two years or so.

You've seen with the acquisition of the US business that we saw a number of the rating agencies move our position to negative outlook. We've seen that return to stable outlook with two revised outlook statements over the past three months.

We are clearly very committed to maintaining our investment grade status, and our management of our debt book, and access to the debt markets remains a vital opportunity for us to access finance.

Moving on to how we are generating cash, I want to talk a little about our approach to managing working capital.

Now, once again this has been fundamentally dependent on a lot of the activity you've heard my colleagues talking about today, and much activity that's still ongoing, and initiatives that we have in hand, but you can see we've made major improvements in working capital management.

From a stock perspective we're reduced leaf stock by 22% versus a 10% underlying volume decline. So we've made significant savings.

The lead period on aspects of our stockholding, particularly leaf stock, is relatively long, but we've also been working on finished goods stock and work in progress. Which has been enabled by some of the broader changes that we've been making, through the operating model, to the structure of our business.

Reduced SKUs, reduced factory footprint, reduced complexity within our business, are all aiding the reduction of overall stock levels.

From a debtor perspective, we've reduced debtor days by 10% over the last two years, reducing the number of days from 36 to 32. That's principally been addressed by an increased cash consciousness within the business, and a reduction in levels of overdue debt from our customer base.

From a creditor perspective, we've been much, much more disciplined around the application of our credit policies.

Remarkably, we were very generous with many of our suppliers, who implicit within prices negotiated had offered credit terms which we weren't taking in full.

We've increasingly moved our position to optimising the credit that we take under those arrangements, and hence have received net inbound funding from that source.

Let me talk a little about our disciplined approach to the management of cost.

You will all be familiar with our Right Moves programme, and our cost optimisation programme that Alison referred to earlier on in the day.

On the left-hand side of this slide you can see a very simple representation of where we are with that today, in terms of progress, and also how we have been generating those cost savings across different cost categories within our business.

You will have heard a great deal today about a whole series of initiatives, aimed at improving our operating model and the cost effectiveness within the business.

This programme was started back in 2012. As you might imagine, the impetus continues very strongly, and the opportunities in this area for us to make further cost savings are increasingly growing, as the results of that work come to fruition.

I want to talk about a number of themes that impact our approach to cost management, and two specific areas, with you just quickly.

The first of these is to talk a little about our approach to shared services. John mentioned, in a presentation on the operating model this morning, how we were using shared services increasingly from an efficiency perspective.

Also through standardising process, and through centralisation of much of the transactional processing activity, we were able to upgrade the quality of resources we had executing those processes, and we've created centres in parts of our business, around HR and IS, in various jurisdictions around the world.

This has a number of advantages to us. Not only does it improve efficiency and effectiveness, but it is, through relocation of those costs, giving us an arbitrage opportunity, yet further enhancing the benefits that we're obtaining through this theme.

It's fair to say we've only really just started this journey, so the impact it's had on our underlying cost base is only relatively limited as we stand here today.

Another theme I want to talk about is the increased flexibility that we're introducing into our cost base. Many of the things that we've talked about have a very clear impact on the balance between fixed and variable cost within our cost base.

So the type of activity that we were talking about around our brands, with the simplification of the portfolio, removing SKU complexity. And actually increasingly reducing the number of initiatives, but

having bigger and better initiatives behind our brands, mean that we end up with smaller fixed costs associated with those initiatives, and a broader impact across more of our portfolio.

We reduce the fixed cost base in marketing supporting our overall brand activity, and thereby end up with much greater flexibility in our cost base.

The same applies across our manufacturing. As we simplify the portfolio actually we're able to operate on fewer machines that are more consistent in size, and increase levels of utilisation of those machines. The fixed cost absorption associated with that therefore becomes a lower proportion of our overall product cost.

That enables us to respond to changes in volumes much, much more effectively, in the context of protecting our profitability and our cash flow generation as a business.

Looking at two specific areas, global procurement has been oft mentioned as an area on which we have put focus. Tomorrow our team meets for a global conference, to look at ways in which they can continue to enhance the contribution that they're going to make to the business as we move forward.

It's worthwhile saying the simplification process that we've talked about is really the driver for many of the opportunities within global procurement, and we've only just started this journey. Therefore, the opportunities for them to continue to contribute to effective cost management are still great.

So what does all this mean for shareholders? What does it mean for investors in the business?

Well, I've got a number of slides I want to put up quickly, which will give a sense of what all the things that we've talked about today, and the disciplined approach we've been adopting, are doing for shareholders.

We've clearly seen significant improvement in our profitability, and this is evidenced by improving gross margin. You can see over the past four reported financial years we've improved our gross margin by 500 basis points.

This has substantially been driven by a simplification process, but it also reflects the fact that we've been very clear in our investment decisions.

We've been very clear in building agility into our business, and ensuring that we are able to respond to the VUCA world in which we form a part of today.

Our ability to use agility to ensure that we maintain a focus on strong profitability has been critical to us being able to drive margins.

Now, many of you may know that my previous career was at KPMG. I spent 32 years at KPMG.

For many of those years I was in the audit practice. In fact, towards the end of my career I was responsible for managing the European audit practices, and one of the things that I had to do was oversee the audits of a substantial portion of the larger corporates in Europe.

One measure which was always very, very important to us, in terms of judging the quality of earnings, was the degree to which those earnings turned up in cash. At the end of the day, you can manufacture accounting profits, but you can't manufacture cash. So cash is a very, very important measure.

I've always looked at our cash performance, and looked to compare it with our peers, because for me determining the quality of our profits is importantly assessed by exactly how we are performing against the peer group in similar markets.

I've done some analysis, and unfortunately one of the things that complicates, and accountants are very good at this, is finding little ways of tweaking the measures so that there is apparent clear comparability, but there's a lack of actual real comparability.

So we've actually looked at cash conversion in the context of normalising everybody's cash conversion numbers, to end up with a similar measure.

As you can see, in our financial year 2015 our cash conversion is now leading in the context of market practice. So at 95% we are doing very well.

Now, the number here is 107%, because we've made a number of adjustments to this to reflect items other people don't include in their cash conversion metrics, and where we can't, through looking at their accounts, get visibility of those items.

So actually the number becomes inflated across most of the peer group through doing that, but it is a comparative measure. As you can see, our cash conversion performance is extremely strong.

Now, that's very, very important in the context of the agility that it gives us as a business, because cash gives us options. In particular, it gives us options around our ability to use cash to reinvest behind the business, to support our 10% dividend proposition, and to repay debt.

You're all aware that one of the key investment attributes of our stock is our commitment to 10% dividend growth. Our dividend performance over the last eight years has been very strong indeed. With a 10% dividend promise we've declared over £8bn of dividends over the past years and consistently grown by 10%.

How does that compare with our peer group? Well, I had a look at those statistics as well, and actually, from a dividend perspective, we have a market leading proposition.

This particular statistic aims at looking at dividend growth over a four-year period, because just looking at one year in isolation picks up a number of unusual facets in people's dividend declarations, which maybe isn't a longer term reflection of what they've managed to achieve.

Now, I know for many of you, and I've had this during the course of the day, there have been questions about how sustainable that 10% dividend promise is.

I've looked at some analysis, which I present here, which is our dividend growth proposition as compared to pay-out ratios across the piste.

You can see for dividend friendly stock actually we sit in a remarkably good position, in that our pay-out ratios are relatively low by comparison to our competitors within the space.

We are generating the cash to support our ability to continue to invest behind the business, and grow our profitability, and maintain our commitment to our 10% dividend.

So our financial approach is strongly governed by tight and disciplined management of cash flow, to support growing the business, support our 10% dividend promise, and repay debt.

Capital discipline supports consistent cash generation. Effective cost management drives cash generation.

Focused investment, improving the quality of growth across our business, growing our overall commercial activities, and generating further cash to feed-in to investment opportunities, is improving agility for us.



Effective cost and cash management is vital to creating options for Imperial Brands, and any other business, and disciplined cost management and cash management within this business is creating a platform for future growth.

Thank you very much.