Acquisition transforms US business

15 July 2014

Alison Cooper, Chief Executive

Good afternoon and welcome. This is an exciting day for Imperial Tobacco. With me to share our excitement with you is Oliver Tant, Chief Financial Officer, and Matt Phillips, Corporate Affairs Director.

Disclaimer

I will take it as read that you have read our disclaimer.

Transaction Highlights

You will all be aware of the other piece of M&A announced in the sector today and clearly this is a linked transaction.

Although opportunistic, this has been well planned for and the deal we have announced today represents a positive step in progressing our overall strategy.

To remind you we have been focussed over the past couple of years on strengthening our portfolio and our footprint to build a stronger platform for growth, thereby generating consistent earnings and cash flow momentum to support growing shareholder returns.

Once complete, this deal will expand our presence in the US market. The US will account for around a quarter of group net revenue.

It diversifies our geography further, giving us a significant new stream of returns from a large, stable market.

It transforms our US business, making us a stronger competitor in the world's largest profit pool, outside China, with a 10% market share.

It gives us an enhanced product portfolio in the US market. We're buying a brand portfolio which includes **Winston**, with strong and untapped brand equity, and it will be the focus of our portfolio going forward alongside blu.

It transforms the scale and presence of our business in the US, moving us from focused distribution in 19 states, to national distribution with a significantly larger sales force and corresponding effectiveness and influence.

I'm also pleased to announce that Marty Orlowsky has joined Imperial to work with us in overseeing the transition, the integration and the roll-out of the new brand portfolio strategy.

Some of you will no doubt recognise Marty as the previous CEO of Lorillard. He is starting immediately as Executive Chairman Designate of the enlarged US business and has been working with us through the deal process. Marty is with us here today.

I have already mentioned **blu**. This gives us immediate leadership in e-cigarettes with the number one brand in the US and it has great international growth potential, complementing our existing Fontem business.

Given the construct of the deal we have focused on having a clear plan for integrating the acquired assets with Commonwealth-Altadis, to create a new, more competitive business.

And this will generate savings to fuel further investment behind the brand portfolio to drive growth.

And all of this comes with some compelling financials – a year one return on invested capital of more than 10% will exceed our weighted average cost of capital, whilst the deal will also be significantly earnings accretive.

Transaction Overview

So let me run through the main points of the deal for you.

The first point to make is that we are acquiring assets from Reynolds; we are not buying any companies.

The legal entities will remain with Reynolds. Clearly this is a significant positive as regards the responsibility for historic product liabilities.

Transaction Overview (pictorial)

As you can see from the chart, we are acquiring **Winston, Kool and Salem**, all Reynolds brands, along with Maverick and blu, which currently sit with Lorillard.

We will also acquire Lorillard's infrastructure consisting of its factory and offices at Greensboro, plus its sales force and commercial infrastructure.

The new business will also include our Commonwealth-Altadis brands including **USA Gold**, our mass-market cigar business plus manufacturing at Reidsville, our sales force, offices and supply chain.

Returning to slide four…

Transaction Overview

Oliver will go into a little more depth on financial metrics and financing for the deal shortly, though I would just like to say a word about the multiple.

At a headline level, consideration of $7.1bn equates to a multiple of 8.8 times 2013 EBITDA.

However we will also get tax benefits from the step up in amortisation of intangibles which arise from the deal, meaning that the true multiple is only 6.9 times.

Transaction Rationale

This acquisition will transform our US business.

- From a distant number five in the market with a 3% share to number three with a 10% share
- From a business delivering just over half a billion of net revenues to one representing nearly a quarter of the group with around two billion in net revenue
- From a limited brand portfolio based around **USA Gold** to an enhanced portfolio with increased appeal for consumers and more relevance for retailers
- From no presence in e-cigarettes in the US to market leadership with the clear number one brand
- From a business that has focussed on 19 states, to national distribution supported by an experienced sales force with deeper coverage of key accounts

- From a low level of presence at retail, to having stronger retailer relevance with an increased share of voice and enhanced customer engagement.
- From a newish management team with a growing track record to the opportunity to combine the best of both companies to create a strong management team under the leadership of Marty.

Transaction Rationale – Diversity of Income

From an Imperial perspective, the deal is an important step forward in the context of our strategy.

With this acquisition, we will increase the proportion of revenue we derive from Growth Markets by around 40%, with Growth Markets representing over two fifths of combined tobacco net revenue and almost a quarter of this generated in the US.

The USA Market: Opportunity to grow in large & profitable market

We define the US as a growth market because of is the size and profit potential for us. So what do we see as the attractions?

Outside China, the USA is by far the largest tobacco profit pool and at around $14bn it is equal to around a quarter of all the profits the industry makes and the US is the second largest market by volume at around 272bn stick equivalents.

Although the market has been declining in volume, by around 3% to 4% a year in the past few years, progressive pricing has meant that the profit pool is growing steadily.

In fact the profit pool has grown by around 6% every year over the past decade, roughly doubling in that time period – partly due to cost savings and partly due to pricing – the pricing opportunity continues to be good because cigarettes are still very affordable.

As regards regulation, the US has a relatively stable environment for tobacco and the last federal excise tax increase was in 2009.

Changes in regulation tend to be more predictable and measured with the FDA adopting a largely scientific approach and looking at evidence before making decisions.

And finally, the US has the largest and fastest developing e-cigarette market with a current size at retail of $1.7bn.

Acquisition transforms US business

15 July 2014

The USA Market: US cigarettes affordable

Just to reinforce the affordability point, currently cigarette prices are amongst the most affordable in the world measured against local purchasing power.

As you can see from the chart, not only are US cigarettes comparatively cheap when compared to many European countries, they also compare very favourably to emerging markets such as Brazil and Indonesia.

The point of this is that it leaves plenty of opportunity for price-led profit growth going forward.

Execution Strategy

We have a clear plan to succeed and turn the combined company into a strong competitor in the US market.

In the past few months we have focused on the following key areas:

- Clearly defining the strategy for our brand portfolio
- Evaluating areas to leverage the strength of **blu** both in the US and internationally
- Mapping out our opportunities as a national player with an enlarged sales force, transforming our relevance in the market
- Making the most of the additional experienced resource that will be coming on board and building a company representing the best of both existing teams and setting ourselves up for a rapid integration that should ensure that we are up and running effectively as soon as possible post completion – clearly something we have done a few times before!

Let me now talk about each of these in turn.

Brand Strategy

We already have clear plans for the enlarged brand portfolio which will now include three of the top 10 cigarette brands in the US.

The primary assets for us will be **Winston** and **blu**. In line with the approach we are taking within the existing portfolio, the primary brands will be the focus for the lion's share of time and money invested.

They will be supported by **Maverick, Kool** and **USA Gold** depending upon which of these is the most relevant on a state by state basis.

We already have a clear state by state plan determining which secondary brand will support **Winston**.

Salem and others will be largely run for cash in line with our existing portfolio strategy.

Acquisition transforms US business

15 July 2014

Brand Plan – Primary Winston

So why the confidence in **Winston**?

Well, it is the second most popular brand in the world so clearly has brand equity; equity which we know exists in the US, but has been untapped in recent years.

It currently has around 2.1% market share in the US, and is number seven in the market, despite not having been one of Reynolds's Key Focus Brands, and having had little or no investment for a number of years.

The states in which **Winston** is strongest are largely those which are the most material to the US tobacco market – the majority of the states in which **Winston**'s share exceeds its national average are the top 20 states by volume.

To validate our confidence in the brand's potential we have carried out market research on **Winston**, the results of which are encouraging.

It has strong residual brand equity with consumers, a great quality perception and is widely recognised.

What has been lacking is focus, investment and clear and consistent positioning and that is what we can put right.

Brand Plan – Winston 2012

And this has been done before. In 2012, **Winston** did have some investment and managed to stabilise and then increase market share in the USA.

However this was not maintained but the results in 2012 add to our confidence that focus and investment are what's needed.

Brand Plan – Winston ex USA

Also I am sure you know the brand has been very successful outside of the USA where it is owned by a Company that prioritises it.

Under JTI's ownership, **Winston** has grown volume by 10% compound in the past 10 plus years supported by investment, clear and consistent price positioning and focus.

Volume has increased by more than 100 billion sticks, making it the world's number two brand.

Furthermore, its growth has been from a low base in a number of markets including Russia, Turkey and Spain where it's now the number one or two brand.

So the potential is there, provided it's supported by the right plan.

Brand Plan – Secondary

And we have a clear plan for the secondary brands within the portfolio.

Maverick is a value brand, which has about 2% of the national market and is much stronger than this in selected states.

Acquisition transforms US business

15 July 2014

Consumer research shows that **Maverick** complements **USA Gold** strengthening our position in the value segment of the market.

Our plan is to focus on whichever of **Maverick** or **USA Gold** has the greater regional or state-by-state strength.

Kool is a menthol brand with a generally loyal consumer base. It also has around 2% national share and will also support **Winston** as a secondary focus in certain states.

So we have a plan ready for execution on day one that has the portfolio clearly segmented into primary and secondary focus for each individual state, with appropriate investment allocations.

As I alluded to earlier **Salem**, which is also a menthol brand, will largely be run for cash, along with our remaining portfolio brands.

Brand Strategy

The execution of that strategy will of course be based around our four sales growth drivers.

A clear portfolio strategy – a primary focus on **Winston** and **blu** (of which more in a moment), and a secondary focus on **Maverick**, **USA Gold** and **Kool**.

This will be supported by an innovation drumbeat – opportunities are more limited due to the FDA processes but there are activities that will support the portfolio. Currently we are evaluating the early results on Glide Tec of **USA Gold** which are encouraging.

And there is a clear state by state pricing strategy.

Finally and critically we now have a larger experienced salesforce to engage with customers on a national scale with more relevance and influence with the trade.

e-Cigarette Opportunity

We are obviously delighted to be acquiring the leading e-cigarette business in the market blu is the market leader in the USA with a 45% retail share.

It's a strong brand franchise and it's recognised that Lorillard has done a great job at building the brand in what remains a highly fragmented market.

As you know, we have always been measured in our approach to e-cigarettes and have been clear that it's the right combination of brand and technology that's required to win.

In blu we have a fabulous brand – the leading brand in the US and this purchase is complementary to our Fontem Ventures business.

The US market for e-cigarettes has grown exponentially, doubling every year since 2008 to a current retail size of around $1.7bn.

It is a rapidly evolving market where consumer interest and trial has possibly run ahead of the ability of the technology to deliver consistent consumer satisfaction but that is what provides us the opportunity in future.

Imperial Tobacco

Acquisition transforms US business

15 July 2014

We will combine the strong brand recognition of **blu** and their technology platform with the technology and know-how from Fontem in order to build on our position in the US and take advantage of international opportunities.

Broad Distribution Coverage

One of the key attractions of the deal is that it moves us to a truly national platform in the US market, with a transformed presence and scale.

Today we have chosen to focus on 19 states where we have a stronger presence with our portfolio.

Post the deal, we will be completely national, with at least 10% share in half of all States, many of them the most populated states in the north east, south east and mid-west.

Experienced Resource

And the combination of the assets being acquired, together with Commonwealth-Altadis will give us strength in management, in sales force capability, in manufacturing and in infrastructure.

In management Marty together with senior resource from Imperial will lead the integration, preparing for the combined business to get going immediately once the transaction completes.

Beneath him, we will have access to management formerly at Lorillard and from the time I have spent with their team already there is a strong cultural fit with Imperial.

We will ensure that we have the best from both teams working in the enlarged business.

Within sales, we will significantly add to our capabilities as we assimilate an experienced and proven team.

And we will also acquire Lorillard's factory at Greensboro, with a capacity of 50 billion sticks as well as taking on the supply and commercial infrastructure.

We expect some synergies from this integration – in supply chain, in manufacturing, in back office overlap for example.

And every dollar in costs we can save, we intend to reinvest further in driving the new brand portfolio strategy.

Rapid Integration

This acquisition, as I am sure you are all no doubt aware, will now be reviewed by the FTC as part of the anti-trust process in the US and therefore, we aren't able to take control of the acquired assets until that review is completed.

Within that context however, we will have defined our approach and determined the way in which we will integrate the businesses.

Our integration team will be led by Marty who is clearly very familiar with the assets and infrastructure we have bought and by a senior member of the Imperial management team.

And as you'd expect given Imperial's history we are able to build upon a strong foundation of learnings from past M&A activity and we will obviously be employing this experience as we strive to build an organisation comprising the best of both businesses to start competing from day one.

The combined business

I said earlier that the combination of stronger brands, a more extensive infrastructure and enhanced operational capabilities would transform our US business.

A more complete portfolio, with untapped equity, especially in our primary tobacco brand, and market leadership in the developing e-cigarette category, has more appeal to consumers and critically far more relevance for category buyers.

We will now be more important to retailers nationally, and to more key accounts. More sales visits and better account coverage will help us achieve a more significant share of voice, meaning greater shelf space, merchandising and point of sale presence. Overall, we will have greater retail influence.

Behind all of this we will create a team which will be made up of the best of both organistions, a team with strong relationships with both the brands and the customers. A well planned and well executed integration process will mean that we hit the ground running.

And a final point about the culture, something many in the city overlook with such deals – the strength of the winning culture both in Lorillard and Commonwealth-Altadis will also be a critical execution success factor.

Before we move on, I'm delighted that Marty has been able to join us here this afternoon and Marty, perhaps you'd like to say a few words before Oliver touches on the financing in a little more detail. Marty, over to you…

Thanks Marty, I'd like now to hand over to Oliver who will run you through a few of the key financials.

Oliver Tant, Chief Financial Officer

Financials: Key Metrics

Thank you Alison and good afternoon everyone.

As you will have seen in our earlier announcement, this deal is the acquisition of assets, a combination of brands and infrastructure which includes some property plant and equipment, for a total consideration of $7.1bn.

Acquisition transforms US business

15 July 2014

Alison has already gone into some depth on the brands we are acquiring and indeed the majority of the asset value relates to the value of these brands and their associated goodwill.

As Alison mentioned earlier, for tax purposes the goodwill arising in the US will be amortised over a period of 15 years in line with appropriate US tax guidelines, which creates an expected tax asset of c. $1.5bn.

Adjusting for this, the net consideration for assets acquired is roughly $5.6bn which equates to a net EBITDA multiple of only 6.9 times.

The combined stick equivalent volume for 2013 from **Winston**, **Blu**, **Maverick**, **Kool** and **Salem** was 20bn, which generated associated net revenue of $2.4bn. Combined with the infrastructure assets and resource we are acquiring, the associated operating profit from these brands was $0.6bn.

Finally I wanted to re-iterate the financial strength of this acquisition, which we expect to generate a return on investment well in excess of our weighted average cost of capital in the first full year of our ownership.

We believe that the deal will yield a first year ROIC of more than 10% in 2016.

Structure of Financing

It is proposed that the consideration of $7.1bn will be met in cash and financed through new borrowing facilities which we have now put in place.

In addition to acquisition funding we have also taken the opportunity to refinance our core bank borrowings, with all financing for the next two years fully underwritten and maturities spread up to five years from the estimated transaction completion date.

With our last bank financing put in place back in 2010, you'll be unsurprised to know that we have managed to secure our new facilities at relatively attractive terms.

All three ratings agencies, Standard & Poor's, Moody's and Fitch have been consulted on the financial parameters arising from the transaction and based upon that we expect that the Company's existing investment grade rating will be maintained post completion of the transaction.

I should add that covenant levels under the terms of our new facilities remain unchanged. We have included a little more detail on funding in the appendices. There will of course be extensive detail in our circular to shareholders.

In order to help accelerate the pace of debt repayment, we have taken the decision to suspend our share buy-back programme. The shares purchased to date in the current financial year are a little over 14m at a cost of £339m.

Finally we are not proposing any change to our previous dividend guidance, with the intention to increase dividends by at least 10% for financial year 2014 unchanged.

Acquisition transforms US business

15 July 2014

Timeline

From the timeline you can see that we are not expecting the deal to complete for six to nine months, with shareholder approval and the blessing of the FTC required.

We expect the circular to shareholders to be published in around three months' time. We will of course update you further as timings and details become firmer.

Alison Cooper, Chief Executive

Summary/Closing

Thank you Oliver. Let me summarise;

This is a compelling deal for Imperial both strategically and financially.

As you are aware our focus in the last few years has been on building a platform for sustained organic growth but we have always kept a healthy eye out for M&A that makes sense in the context of our strategy.

I joined Imperial during the M&A heydays in the industry and this reminds me of the first deal I was involved in from the inside which was when we acquired an underinvested and underperforming portfolio of brands as a result of BAT's deal with Rothmans.

We inherited a market share of around 17%, generating net revenue of a little under £120m – with some very particular challenges as the excise structure of the market was changing to the detriment of the acquired portfolio.

Those same brands are now worth three times as much in terms of net revenue and we now have a share closer to 30% than 20%.

Back to this deal, 15 years later…

These assets materially enhance our portfolio, our scale and our capability in the US and with a 10% share we will be a stronger competitor in the world's largest accessible profit pool.

We intend to unlock the untapped brand equity that **Winston** demonstrates and build upon the international growth opportunities offered by blu.

And, as Oliver said, we have acquired these assets at a financially attractive price for shareholders, ensuring returns well ahead of our Group cost of capital as soon as 2016.

We continue to be focused on generating growing returns for our shareholders and this deal further strengthens our ability to do that.

Thank you. I would now like to hand over to you for any questions you may have…