Half Year Results 2014

07 May 2014

Alison Cooper, Chief Executive

Good morning.

I'm Alison Cooper, Chief Executive. I'm here with Oliver Tant, Chief Financial Officer, and a number of other members of the senior management team.

Disclaimer

Our Priorities for 2014

I'm going to start with a quick reminder of our strategic priorities for 2014 as we set them out in November. These are about delivering sustainable, high quality growth.

The first priority is strengthening our portfolio, focusing on our Growth and Specialist Brands. There are 10 Growth Brands but in fact they fit into four brand platforms. And we have our Specialist Brands, which reflect our unique total tobacco portfolio.

Then we are focused on backing growth by increasing investment in the right brands in the right markets. By the right brands, I mean our Growth Brands and Specialist Brands.

The right markets mean those markets where Imperial can grow either because we are under-represented in large profit pools, such as Italy, Russia or USA. Or because the markets themselves offer growth potential, such as many of those in Asia or the Middle East. These are our Growth Markets.

Right markets also includes those markets where we already have significant presence, mainly in Western Europe, where our strategy is to at least maintain share and maximise returns. These are our Returns Markets.

And we have our growth business in new consumer experiences, Fontem Ventures, which has had an important half year.

To support our growth strategy, we focus on cost and stock optimisation. Cost optimisation exploits our new portfolio driven business model to take out cost, which we can reinvest in our growth agenda. Stock optimisation takes inventory out of the trade to improve efficiency and flexibility in our route to market.

All of this activity positions the business with a stronger portfolio, a stronger footprint and a stronger platform for growth.

So how are we doing?

So how are we doing? I am just going to pick out some highlights at this point. Our Growth Brands are outperforming the market, growing volume and gaining share. On an underlying basis, our 10 Growth Brands have increased volume by 4% globally. In Growth Markets, the underlying growth was 11%. Six of the 10 Growth Brands are growing volume, the same number as at Q1, but with stronger momentum – the underlying growth of the Growth Brands picked up in Q2.

In Growth Markets we are also improving. Remember that the major focus of our stock optimisation programme so far is in Growth Markets, so the reported numbers are particularly misleading. Tobacco net revenue in Growth Markets increased by 7% on an underlying basis, with strong growth across many markets in Asia and the

Middle East. Profits from Growth Markets reflect the scale of the stock optimisation we have done and the level of investment we are making in many of the markets in this division.

Returns Markets have maintained profits in challenging conditions. I am seeing greater resilience from our performance in the UK and Germany while our performance in Australia has been excellent. There are some signs of improvement in Return Markets South. I'm confident our continued focus on our four sales growth drivers will support our strategic priorities in these markets.

So overall we are making good progress against our strategic objectives. I'm pleased that the quality of our business, particularly the share of Growth Brands as a proportion of total volume and net revenue, continues to grow.

We have some market share work to do as you might infer from the reported results metrics. I think the overall picture is better than the numbers show and I believe we are holding our own – as our underlying total volume of -4% is close to the market development in our geographical footprint.

On stock optimisation, we made significant progress in the half year. We have now taken out trade inventory of over 6 billion sticks. In Q1 we told you about major stock optimisation in Iraq and Middle East. In Q2 we reduced in-market inventory in Russia and other markets.

On cost optimisation, we are fully on track for this year, with savings of £60m; and we are on track with the overall programme to save £300m a year by 2018.

On cash, our conversion has improved to 78% in the year to March.

So, in summary, we are working hard on the strategic priorities we set out in November, and the delivery is continuing to come through.

I'll now pass over to Oliver to take you through some of the financial reporting. I will come back at the end to share with you some examples of how we are putting our strategy to work.

Oliver Tant, Chief Financial Officer

Good morning.

Stock Optimisation

I am going to start with our stock optimisation programme because I think it's critical that you understand what it is, why we are doing it, and why it is right to look at our volume and revenue on an underlying basis – i.e. looking through the impact of stock optimisation to the in-market performance of the business.

So what is stock optimisation? In simple terms, it is about working with some of our wholesalers and distributors to reduce their inventory in a number of markets to bring about a more efficient and flexible route to market for our brands.

So why is this so important? Because it improves the quality of our underlying business. We get much better visibility of market dynamics and therefore faster reaction times to changes in the consumer, competitive or regulatory landscape. Our route to market becomes much more orderly because there is not a weight of inventory sitting between us and our end consumer. Our new initiatives can get onto the shelf much more quickly than if they have to work their way through a three month inventory turn. Our product is much fresher in the market, and in places like the Middle East that is important to consumers.

And as a finance man, you would expect me to add that the working capital consequences should be positive both for our customers and for us. So while it is a constraint on our results this year, the benefits of pushing ahead with our stock optimisation programme are obvious.

Stock Optimisation

Take the example of Iraq which I know we mentioned last time. Our supply to Iraq, for historical reasons, used to be from our factories in France. Supplies used to take two months to ship from the factory to the warehouse and our distributor held three months inventory to guarantee security of supply. With our global supply chain, we can supply Iraq from neighbouring Turkey, with a lead time of two weeks. Now our distributor only needs to hold a month of inventory for security. So we have been able to take out three months' worth of stock.

Or take Russia. There we have a slightly different situation with the market declining steeply. And trade channels are changing due to regulation – kiosks will no longer be allowed to sell tobacco from June this year while the modern trade channel is developing fast. And our distributor is in the middle of a major efficiency and modernisation drive which means that they are as keen to reduce inventory as we are. As a result, we are able to take out two months of stock.

The same logic applies to other markets.

Underlying Trends

It's only by stripping out the impact of our stock optimisation programme that you get a true picture of how our business is performing – that is why we give you the percentage change numbers on an **underlying** basis for volume and net revenue throughout the release and in this presentation. These numbers adjust out the impact of stock optimisation.

What you then see is an encouraging picture. The half year is stronger than Q1, with a modest improvement in our overall volume and revenue, and a pickup in the rate of growth of our Growth Brands, Specialist Brands and Growth Markets.

Without going through every line of our results which are extensively described in our press release, I am just going to focus on a few key points which show how we are increasing the quality of our growth, improving our financial performance, and delivering returns to shareholders.

Growth Brands

As Alison said, our Growth Brands are doing increasingly well with better underlying momentum in Q2. In the half year, underlying volume grew 4% and net revenue grew 6%, both better than in Q1. The Growth Brands are clearly increasing share.

Importantly, the 10 Growth Brands represent an increasing proportion of the business from a volume and net revenue point of view. Six of the 10 Growth Brands are showing good underlying growth in volume, particularly JPS which increased volume by double digits, and Parker & Simpson which was launched in a number of new markets.

Specialist Brands

Our Specialist Brands have also increased their share of our business. Underlying net revenue grew 6%, with strong performance from specialist cigarettes, mass market cigars, our premium cigar division and our Snus business.

Growth Markets

In Growth Markets, our underlying net revenue grew 7%. Growth Markets were most affected by stock optimisation, since Iraq, Russia and the Middle East are all in this division. That is why the delta between constant and **underlying** growth is so great. Stock optimisation is also the main reason why the profits in Growth Markets were down in the half year, although another factor is that we are investing in these markets. We saw strong underlying growth in Asia and the Middle East offset by Russia. Market share was ahead excluding Russia.

The Russian market has been challenging this year. The market is declining at high single digit rates and will probably decline faster in the second half following large excise tax increases and regulatory changes. Although our volume and revenue have been affected by the market decline, Maxim performed well against this backdrop due to Maxim Premium Line, and value packs including Maxim 25s and Queen Size. Performance was supported by Davidoff and Style although we have lost volume in the local portfolio brands.

In the US, we continue to focus on USA Gold in targeted states. Where we are pursuing our strategy, based on pricing and customer engagement, our share in those states shows progress. And our profit in the US is substantially ahead of last year.

What is more important is that the quality of our business in these markets is improving. Growth Brands in Growth Markets were disproportionately impacted by stock optimisation. On an underlying basis, Growth Brands increased as a proportion of the total business in Growth Markets by both volume and net revenue.

Total Returns Markets

Meanwhile we are demonstrating greater resilience in Returns Markets with maintained profits and a consistently higher quality of business as Growth Brands increase as a proportion of the total business.

Our performance in Germany and Australia has been particularly pleasing. In Germany, good pricing and our strong portfolio have seen our profits ahead of last year. In Australia, our volume, revenue, profit and market share are all strongly ahead. In the UK, helped by a number of new launches, our Q2 share was up on last year and on the previous quarter.

We have greater challenges in France, Spain and Morocco with total market decline and some pressure on our shares (from a high base), mainly due to our large position in dark tobacco.

Logistics

In logistics, distribution fees increased by 3%. This is a pleasing result in a tough environment and reflects improvements in the logistics and transport activities in Spain. Reported operating profit decreased by 1%. We announced in February that we are reviewing our options in relation to a potential IPO of Logista. The review is continuing and I do not propose to comment on it further today.

Cost Optimisation Programme

We have made good progress with our cost optimisation programme this year towards our target of saving £300m a year from September 2018.

Restructuring projects announced in April to strengthen our competitive position in the UK and France, including the potential closure of cigarette factories in Nottingham and Nantes and the consolidation of French R&D facilities, support the cost optimisation programme.

We also now have our global procurement function fully up and running, covering all our procurement other than tobacco and non-tobacco materials (which we always purchased centrally) and we are already seeing some good savings from this.

We started more than a year ago on the long process of standardising and simplifying our business, rationalising the long tail of brands to simplify the portfolio. This will have consequent cost savings in procurement, manufacturing and marketing. So as you hear about brand migrations or de-listings for commercial reasons, remember that fewer, bigger brand platforms are also good for effectiveness, efficiency and cost.

We are fully on track for the £60m cost saving target this year, and for the £300m a year target by 2018.

HY 2014 Adjusted Net Debt

Our net debt traditionally rises in the first half. Our cash flow profile has followed the normal pattern of a significant working capital outflow in the first half of just over a billion pounds, due to a number of factors including pre-production ahead of January and February duty **increases** that we expect to unwind in the second half of the Year. After cash costs of restructuring and the dividend and share buyback, the net debt position has increased to just over £11bn, a similar level to the half year last year.

Cash Conversion

One area I have focussed on in my first six months has been on realising cash from the business. Profit is all very well, but it is cash that pays the dividend. There are two areas where I believe we can improve our financial performance.

Cash conversion is better over the last 12 months – 78% up from the depressed level of 63% a year ago. But the best in class in consumer goods are closer to 100% cash conversion. I'm not promising that we will get to 100%, but each percentage point we improve is worth £30m of extra cash a year to our shareholders. So I have put a project team to work to improve our cash conversion and I hope to see improvement by year end.

One source of improvement will be working capital – there is room for us to improve relative to the best. I have put in place a programme to improve our working capital management, through permanent improvement in the parameters (day's payable and receivable, inventory). I expect to see that beginning to contribute next year.

These are ways in which we can improve the business without having to sell a single pack more. I believe there is some real potential to improve our financial performance.

Foreign Exchange

Let me finish by giving some guidance on two important issues, foreign exchange and dividends.

Exchange rates on translation have reduced adjusted operating profit by 3% and adjusted earnings per share by 4% in the half year. This is all translation with no cash impact. You will notice also that the adverse impact in Returns Markets is relatively minor (about 200 basis points) whereas in Growth Markets, the effect is larger (400 basis points).

You can see from the spot rates that sterling is continuing to strengthen and therefore the impact of translation is likely to be greater in the second half of the year.

Quarterly Dividend

On dividends, we are moving to quarterly dividend payments with effect from financial year 2015. The logic is that we believe a more regular cash return is attractive for shareholders. Our proposals will give them the same cash dividends as they would have received, just with some of it paid earlier.

For us internally, this is a business with a relatively consistent cash inflow during the year and payment of more regular dividends is therefore a better match between incoming cash and outgoing.

In 2014 there will be no change in the way we pay dividends. Today's announced interim will be paid in August. The final dividend, subject to approval at the AGM, will be paid in February.

However from next financial year, we intend to pay our dividends quarterly. The first two quarters will be announced with our half year results in May and will be paid in June and September. The third and fourth dividends will be announced with the full year results in November and paid in December and, subject to AGM approval, in March. The eagle eyed amongst you will immediately realise that this means half of the dividends will be paid two months **earlier** than now, and half of them one month **later**. Net, shareholders get the same money, but on balance earlier.

Let me now hand back to Alison.

Alison Cooper, Chief Executive

What I am now going to do is share with you some of the work we are doing putting our strategy to work.

Brand Portfolio?

Let's start with the brand portfolio. This was the situation a few years ago when we had over 250 brands; many of them single country brands, supported by a network of over 25 marketing agencies. Since then we have done the groundwork to get to…

Clear Brand Portfolio Strategy

…a very clearly defined brand portfolio strategy with 10 Growth Brands, which are the main focus of our efforts globally. But in fact it's even simpler than that because these 10 Growth Brands are grouped into four platforms (or chassis is the term we use internally) as the overall brand propositions for the consumer are similar.

Each brand chassis is moving towards having a standard offering – sharing innovations, range, marketing plans where appropriate. This clearly makes for significant synergies in cost and in focus, but also allows for some differentiation where needed – due to consumer preferences or regulation.

Then we have our Specialist Brands – completing our total tobacco offering – with our brands in specialist cigarettes, fine cut tobacco, premium cigars, mass market cigars, Snus and papers.

All our other brands fall under Portfolio Brands – but with very specific plans. A number of brands will be migrated into one of the Growth Brand chassis – and we have started that process. Some brands will be delisted to clarify and focus local portfolios. And the remainder can be run primarily for cash.

An important development earlier this year was the appointment of our first global marketing agency to support our brand portfolio development. We will start to see the benefits of that focus in terms of globally consistent execution in the next few years.

So let's look at some of the things we are doing in each brand chassis.

JPF Chassis

On the JPF chassis (which stands for JPS, Parker & Simpson, Fine – hence JPF) we are rolling out a number of innovations with success. Glide Tec is very much alive and growing in 10 markets and growing. We launched Additive Free, in three markets and are due to roll out to more. Duo, our crushball variant, is in seven markets and volume doubled in the first half. JPS Fine cut is in 17 markets, and increased volume and share in the first half.

Also under the same chassis, Fine is a leading brand in Asia and Africa, growing volume and share in the year to date. And we are rolling out Parker & Simpson – it's now in 20 markets globally, increasing substantially in the first half.

West Chassis

West is a major brand in our Growth Markets in Asia, Middle East and Africa. Also under the West platform is News, an important brand in France and Belux, Lambert & Butler, a major brand in the UK and Bastos, which is strong in Vietnam.

We have introduced new slimmer formats on West, which grew volume in double digits in Central Asia, and we have been rolling out crushball which more than doubled volume. On News, we have grown fine cut tobacco significantly. Meanwhile Bastos has grown volume and share significantly in Vietnam.

Gauloises Blondes

On Gauloises, the major development this year has been the launch of Gauloises Generation, a Queen Size variant which has doubled our segment share where launched and fine cut tobacco in France and now in Morocco. In France we launched the Connecting range, building on the heritage and equity of Gauloises. And, we are extending the range of Gauloises in Morocco with Elements, which includes mint leaf.

Davidoff

Davidoff trends improved in the second quarter as we have been working on further developing the Davidoff range. We are rolling out a global design change with early benefits being growth in market share in Taiwan and Saudi. We have also successfully extended our activities in Queen Size and Recessed Filter products. Davidoff market share is improving with good performance across many markets in Asia and the Middle East.

Brand Migrations

I talked about brand migrations before. As I said last November at the full year, we are doing 12 brand migrations this year to further test out the methodology. We've had a lot of questions about brand migrations, so I thought I would share an example with you.

In Iraq, we are migrating a local brand, Royale Club, to Parker & Simpson. What you see on the slide is the various stages the packaging is going through in the transition. What it allows you to see is the way in which the consumer is led on a developing journey from Royale Club, through Royale Club by P&S to pure P&S at the end. So far, we have actually seen volume of the brand growing through the process – which is probably due to the greater focus and investment it receives as it migrates. As I said, we are doing 12 migrations this year, and more will follow.

So that gives you a flavour of the work we are doing to develop our Growth Brands under the four chassis – although the eagle eyed among you will notice that I haven't talked about USA Gold. That's because there isn't much new to report at the half year – most of our activity is going to happen in the second half. Meanwhile, we are doing, with USA Gold, exactly what we set out to do more than a year ago – get the price positioning right, drive presence and share in our targeted states, and build on the solid base we have now established.

Now I'm going to talk through some examples of how we are improving our business from a markets perspective.

So how are we delivering in market?

You will remember that we have four sales growth drivers, the activities that we have chosen to excel at for sustainable growth.

These are

- Portfolio
- Innovation
- Pricing & Excise
- Customer engagement

So let's look at how we are applying these in some of our Growth and Returns Markets.

Growth Markets

Two of our targeted Growth Markets are Italy and Turkey. Not that these are growing markets for tobacco, but they offer significant growth potential for us.

In Italy, we have grown share consistently over the last year Prior to last year, Italy was part of Western Europe and had been struggling to make headway as it was run primarily for profit. Now it is part of our Growth Markets, and the focus is on growing the business with a focus on pricing and customer engagement. We launched JPS at an attractive **price** point and we built the **customer engagement** proposition around the fact that this price point helps to counter illicit trade, and therefore helps increase footfall through the tobacconists.

In Turkey our progress has also been impressive and is due to a combination of all the sales growth drivers. On **pricing**, we ensured the right positioning of our brands with a **portfolio** focus behind West and Davidoff. On **customer engagement,** we developed a new route to market contracting out the physical distribution, and focusing our efforts on better direct engagement with retailers. On **innovation**, we have launched West Red, West Duo and Davidoff Slims this year to enlarge the portfolio. The result is a record share in Turkey this year at 5.5%.

I could go through many Growth Markets illustrating success, but I will just show you a few more examples: -

Taiwan where getting Davidoff on the right **price** point, building the **portfolio** with Davidoff at the top end and West at the value end, rolling out new **innovations** such as Davidoff Queen Size, and an outstanding **customer engagement** programme across over 3,000 outlets, have all helped our share grow consistently in the past year.

Or Kazakhstan. We **innovated** by introducing new formats of Davidoff and West KS and QS. We rolled out another excellent **customer engagement** programme which involved improved trade terms and more regular deliveries. The result has been an increase in share from 5% to nearly 8% in a year.

Or Cambodia, where with absolute focus on Fine and strong **customer engagement**, we have increased our share by over a third from 27% to 36%.

I could add more case studies such as our Snus business in Sweden and Norway – I know some believe that our success in Snus has all been about price, but in fact it's been down to some excellent work on portfolio development and particularly on customer engagement.

So the common characteristic in all cases is that focus on the right brand portfolio, the right pricing, the right innovations in the market and excellent customer engagement can drive consistent market share growth for us.

Australia

We apply exactly the same operational principles in our Returns Markets.

A great example being Australia where we are showing we can win despite the significant restrictions placed on marketing.

The right portfolio of brands focused on the value segment, relevant innovations to deliver value, such as big boxes helped build on the outstanding work on equity that was done in preparation for the plain packaging regulations, enhancing excellent work on customer engagement with key accounts.

The result of this joined up planning and the execution of a cohesive sales strategy has enabled us to grow market share, net revenues and profitability since the introduction of plain packaging over a year ago.

UK

And our share in the UK is in better shape – Q2 was better than Q1– we have been picking up share in cigarettes and stabilising our share in fine cut tobacco.

This is due to some excellent work on developing our brands. We are focusing behind the two Growth Brands, JPS and Lambert & Butler. This year we have launched Lambert & Butler Blue, a new sub-range and it's the first brand ever to have 10s Glide Tec packs and we have launched Player's from JPS in cigarettes in 19s to offer more value to consumers. In fine cut tobacco, Players Gold Leaf is doing well and gaining share. On customer engagement, the UK team have rolled out a service model to independent trade that has been very well received, winning them 'Tobacco Supplier of the Year' from The Grocer whilst improving on-shelf availability of Growth Brands by 3%.

Returns Markets South

Turning to Returns Markets South – a few further examples.

In Spain, we have been running an excellent programme which brings the trade to us to experience our portfolio, our factories and our people – so that they develop a better understanding and engagement with us. The results, in the estancos that have participated so far, has been a noticeable market share gain.

In Morocco we have been developing our portfolio around our major local hero brand, Marquise. We have launched a number of new products including MQS (a modern execution building on the heritage of Marquise), and Marquise 100s, Gauloises Elements and Gauloises 24s. We have also just initiated the Fine Cut category in Morocco with the launch of Gauloises and Marquise fine cut tobacco.

Fontem Ventures

Fontem Ventures is our standalone business focusing on adjacent consumer experiences. As you probably know, Fontem launched its first product, Puritane, in February this year, in 2,400 Boots stores across the UK. Puritane is designed as a healthcare channel brand. Marketing in print and online started in April. So far the launch has attracted positive consumer feedback, and we believe momentum will build now that activation has started. We expect to have one more product launch later this year.

Our approach to the e-vapour market continues to be a measured one – we are not rushing in with shareholders money! Given the uncertainties around the whole category in terms of developing regulation, although we do now have some decisions from the FDA in the US - this has to be the right approach.

In the meantime we are strengthening our business by developing patented technology. That was the reason behind the Dragonite acquisition – the chance to get our hands on the expertise and the new generation technology. The low rate of adoption of existing e-cigs shows that this is a category which needs further technological development and branding.

Full Year Outlook

Last November I said that this would be an important year in our transition. I said that this year we would work on

- Strengthening our portfolio – with our Growth and Specialist Brands growing as a proportion of our business.
- Backing growth with increased investment in our Growth Brands, Growth Markets, Returns Markets and Fontem Ventures.
- Building resilience through cost optimisation and importantly implementing our stock optimisation programme.

And that we would exit this year with a stronger portfolio, a stronger footprint and therefore a stronger platform for quality growth.

I hope we have demonstrated to you that we are indeed making progress on all these fronts.

The interim results show that we are on track to deliver our targets for 2014. Our second half priority is to build on our growth momentum with a particular focus on strengthening our market shares. Conditions are still tough in some markets, but we continue to demonstrate our resilience.

I said in November that a sensible working assumption for this year would be for modest growth in adjusted earnings per share at constant exchange, given the scale of investment we are making in our Growth Brands, Growth Markets and stock optimisation programme. We are on track to deliver that in a year of significant transition.

We can now take questions. As this is being recorded, can you please wait for the microphone and state your name and the institution you represent.

Thank you