Preliminary Results 2014

04 November 2014

Alison Cooper

Good morning everybody and welcome.

I'm Alison Cooper, Chief Executive. I'm joined on stage by Oliver Tant, Chief Financial Officer, and we have with us here today several members of our senior management team.

Disclaimer

I will take it that you have read our disclaimer.

A Reminder of our Strategy

I'm going to start with a reminder of our strategy, which is focused on building the quality and sustainability of our earnings to maximise returns to shareholders.

There are four key priorities that we focus on.

The first is about strengthening our portfolio – focussing investment and resource on our brands with the strongest equity: our Growth and Specialist Brands. Within our overall portfolio also sits our non-tobacco subsidiary Fontem Ventures, through which we're developing new consumer experiences.

The second priority is the development of our footprint.

In Growth Markets, we target long-term share and profit growth. These are markets with typically large volume and/or profit pools; markets where we're under-represented and where we see great potential for growth.

Returns Markets are typically more mature. We tend to have a significant presence in these markets and focus on sustainable profit performance, whilst actively managing our share position.

To support the development of our brands and markets, we continually focus on driving efficiency across the business and we're now two years into our cost optimisation programme, which is on track to deliver savings of £300 million a year from 2018.

And the fourth priority is the use of cash. We're improving the efficiency of our balance sheet, focusing on working capital and cash conversion as we further embed stronger capital discipline throughout the business.

FY14: Driving Strategy Forward

So, how have we performed against each of these priorities this year? I'd like to pick out a few key highlights.

We generated strong underlying growth in our Growth Brands, improving volume and market share, supported by good early results from our brand migration programme which began during the year.

We also increased the net revenue contribution from our Specialist Brands.

At the start of the year we announced a stock optimisation programme to improve the effectiveness of our route to market. This was a joint initiative with trade customers to reduce the level of stock they hold. The programme was successfully completed and resulted in more than nine billion sticks being taken out of the supply chain.

And Fontem launched its first E-Vapour product, Puritane. Initially sales were exclusively through the national retailer Boots but Fontem's now widening the brand's availability in the UK by partnering with additional retailers.

We have continued to grow profits in our Returns Markets, in spite of particularly tough trading conditions in Returns South.

Net revenue in Growth Markets was up 7% on an underlying basis and we're pleased to be expanding our footprint by establishing positions in Egypt and Japan.

We're also excited about the US deal we announced in July and the opportunities it gives us to significantly strengthen our position in another key Growth Market.

Our cost optimisation programme delivered more than £60 million savings, which has been re-invested to support our growth agenda.

And over the course of the year, we reduced our level of net debt by £1 billion. Some of that came from our partial divestment of Logista and foreign exchange benefits, but what I'm particularly pleased about is the great work across the business to improve our working capital position and drive greater cash conversion.

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

Oliver Tant

Thank you Alison and good morning everyone.

Group Results

We've delivered a great deal this year and have laid a solid foundation for sustainable growth in profits going forward.

The progress we've made is I think only partly reflected in the reported numbers you see here. As you know we engaged with our distributors to help reduce their level of trade inventories, which is why we've focussed more on underlying movements in the P&L.

What the results show is that although we effectively only sold just under 51 weeks' worth of product in FY14, we've managed to maintain the same level of operating profit on a constant currency basis. Volumes were down 7% on a reported basis, though just over 3% of this was driven by the stock optimisation programme.

Exchange rates on translation reduced both operating profit and EPS by 5% with our adjusted EPS showing growth in constant currency terms of around 2%.

In true CFO fashion I will come on to talk in more depth about cash and debt shortly. Suffice to say I'm particularly pleased with the solid progress we've made towards embedding a higher level of cash conversion which has contributed to a £1 billion reduction in our closing net debt.

Increased discipline around cash and the allocation of capital are key to our overall objective of maximising sustainable returns to investors. In line with our guidance the dividend announced today of 128.1p is up 10%.

Preliminary Results 2014

04 November 2014

Stock Optimisation

Our programme of stock optimisation is now complete. Going forward we will of course continue to optimise inventory levels as part of business as usual.

We worked with our distributors to remove over nine billion sticks from their trade inventories, reducing the level of stock they hold in specific countries such as Russia, Taiwan, Iraq and several other Middle East markets.

The stock programme leaves us with a more efficient route to market and enables us to respond quicker to changing market dynamics.

So, whilst a constraint on our results this year, we are confident of the longer term benefits going forward.

Underlying Performance

Adjusting for the impact of our stock programme you get a better picture of how we performed.

From a volume perspective we remain in line with the overall movement across the markets in our footprint, which also declined at around 4%.

Net revenue in the second half continued to grow at a rate of 2%, with the rate of growth in Growth Brand volumes and net revenue increasing, driven in part by the step up in our brand migration programme.

Net revenue was up 7% in Growth Markets and down 1% in Returns Markets, driven by pressures in Returns South.

Overall an encouraging picture with further indications that we are continuing to build the overall quality of our revenue.

Growth Brands

Growth Brands have continued to improve market share, driven by JPS, West and Parker & Simpson, which has now been launched in 27 markets.

Brand migrations added to organic growth, delivering a step up in volumes and net revenue, particularly in the final quarter.

Growth Brand contribution to net revenue, which was up by almost 300 basis points, is another indicator of the enhanced quality of our sales.

Specialist Brands

Supply constraints in Cuba meant that growth in Cuban cigars during the second half was lower than expected. In spite of this, Specialist Brands maintained their overall share of our business, growing net revenue by 2%. We saw a strong performance in our snus business in Scandinavia which was up over 30% as well as continued growth in the US from *Backwoods* our mass market cigars brand.

Growth Markets

Our overall share position in Growth Markets was up slightly to 5.8 per cent and our financial performance was good, with underlying net revenue up 7 per cent.

We made good progress in a broad spread of these markets including Italy, Greece, Scandinavia, Taiwan and Cambodia.

Results in Russia were undermined by difficult trading conditions, as industry volumes continued to decline following excise increases and changes to regulation and the route to market. In the USA, we improved our share position in a number of key states.

Overall our Growth Brands in these markets now represent 38% of net revenue, an increase of 150 basis points.

Returns Markets

Our performance in Returns Markets has remained resilient against a generally challenging economic backdrop, with affordability concerns contributing to increased competition in the value segment in many markets.

These trends, together with the challenge we face from declining dark tobacco in Spain and France, have contributed to a decline in net revenue in Returns South. This has been partly offset by growth in Australia, Ukraine and Germany in Returns North, and overall we increased operating profits by 1%.

JPS, Parker & Simpson, West and *Fine* all performed well, as we continued to build the quality of our revenue. Growth Brands now account for 43% of net revenue, an increase of over 300 basis points.

Logistics

In logistics, distribution fees increased by 2%, which given the tough economic environment across Southern Europe, is a pleasing result. The continued growth of direct delivery pharma sales, growing sales of convenience products and continued cost control measures have helped to mitigate the impact of declining tobacco volumes.

A 3% decline in operating profit was largely due to one off items.

As you know, we regard Logista as non-core and in July we completed a partial IPO. We divested 30% of the business for a little under £400 million, which has gone towards the repayment of Group debt as part of our ongoing focus on capital allocation.

Cost Optimisation

We generated further cost savings to support investment in our portfolio and footprint. Savings have come from global procurement and various operational excellence initiatives in manufacturing.

Going forward the brand migration programme will continue to play a key part in simplifying our portfolio, enabling more targeted investment. To support this and the ongoing development of our key Growth Markets, our investment in FY15 is likely to exceed our cost optimisation target of £85m.

We remain on track to deliver our overall target of generating £300 million of savings a year from September 2018.

Preliminary Results 2014

04 November 2014

Clear Objectives for Cash

Alison spent a little time earlier re-visiting our overall strategy and talked about our quality of growth. That is partly to do with deriving more of our earnings from the strongest brands in our portfolio, as well as strengthening our footprint.

It is also, however, about realising cash from the business since its cash that funds returns to shareholders.

As well as focussing on working capital we are also looking closely at capital allocation to ensure we maximise value from our assets.

As regards uses of cash, our commitment to dividend growth of 10% or more remains the priority. Our share buyback programme was turned off during the year in conjunction with the announcement of the US acquisition. Going forward we will use excess cash to reduce net debt, which I'll come on to shortly.

Cash Conversion

I have talked a lot about improving cash conversion over the past six months. It is an area I feel particularly passionate about.

We now have a specific team in place which has a remit to embed new processes around the management of working capital. As you can see, it's starting to yield benefits.

We've started to reduce our holdings of leaf stock to a level better matched to market demand and improved credit balances through a more consistent application of existing supplier terms.

Increased focus and discipline around investment has also enabled us to reduce our net capex spend by a little over £50 million.

These are ways in which we can enhance the sustainability of shareholder returns without having to sell a single pack more. Cash conversion was 5% higher year on year and 9% higher than the average level achieved over the past three years.

The business has been here before however, so our priority is to embed the processes and ways of working that have helped drive the improvement.

Adjusted Net Debt

That improvement in cash conversion has contributed to a significant reduction in our net debt, which ended the year £1 billion lower at just over £8 billion.

In addition to the positive deltas in both working capital and capex which contributed to this reduction, we generated £0.4 billion through the Logista IPO as well as seeing a £0.3 billion positive movement driven by the strengthening of sterling.

The reduction of net debt remains a priority for the business going forward.

Logista, Financing, Tax & Forex

The 30% IPO of Logista created a minority interest charge in the P&L of £10 million. On a pro forma basis the full year impact of this would have been a little over £40 million, which at an adjusted EPS level is 4.4p.

Our average cost of debt for the year was 4.9%. The acquisition facilities we put in place back in July do not come into play until we complete and our new revolving credit facility is currently undrawn. As we stand today therefore we expect to see a similar average cost of debt in % terms in 2015.

After the year end we took the opportunity to move an additional £2 billion of our existing debt onto fixed terms, taking advantage of low interest rates in the market and reducing the financial exposure of the business to rate rises over the longer term. Despite this, we still expect our total cost of finance to be similar in FY15, given the reduction in net debt.

Our reported rate of Group tax for the year was particularly low at 4.5%. This is due to a large credit for deferred tax on intangibles. Our adjusted rate, which is a far more useful comparison of business performance year on year, was 21%, a level we expect to maintain going forward.

Exchange rates on translation reduced both adjusted operating profit and adjusted earnings this year by 5%. At current spot rates we expect the movement in exchange to have a circa 2% impact in FY15.

A Reminder of our Strategy

As I said in my opening slide, we have achieved a lot this year, building a strong foundation for growth going forward and we will continue to focus on driving material cost efficiencies and improving capital discipline.

Both of these are fundamental aspects of generating sustainable returns for shareholders.

Now back to Alison.

Alison Cooper

Thank you.

A Reminder of our Strategy

I'd now like to share a little more detail about the work we are doing to strengthen our portfolio and develop our market footprint.

Strengthening our Portfolio

Let me start with our brands.

Our portfolio strategy is about simplifying and strengthening our portfolio, investing more in our quality assets: our Growth and Specialist Brands.

In 2014, these brands grew 270 basis points to now account for 54% of total Group net revenue.

Our objective over the coming years is to drive revenues from these brands to around 80% of our Group net revenues.

Let me show you some of the progress we're making.

Strengthening our Portfolio *[building equity: Gauloises]*

This has been a significant year of equity building for *Gauloises*. With the launch of several portfolio initiatives including;

- a fine cut offering in Morocco and France,
- a queen size variant which has proven to be very successful, particularly in Iraq,
- our new 'retro' focussed Generation range in France
- as well as several variants as part of a natural solutions range, which include additive free and biodegradable filters

As well as these product innovations, we have recently revamped the pack and globally re-launched the brand with a new campaign to evoke the essence of joie de vivre and spontaneity which the brand represents.

This is the start of a process which will see us invest in new campaigns to support all our Growth Brands.

Strengthening our Portfolio *[building equity: JPF chassis]*

Moving on to the JPF chassis.

JPS has been a huge success story this year, and a major contributor to the 9% increase in underlying Growth Brand net revenue. *JPS* has grown by almost 15% in underlying volume, over 15% in net revenue, and increased market share in markets such as Spain, Italy and the UK.

The brand's biggest impact has been in Australia where it's grown around 600 basis points to achieve a spot share of around 17%, which makes *JPS* the leading brand in the market.

We have continued to roll out our fine cut variants, which are now in 16 markets and have grown volume by 12% for the year.

Fine, a key brand for us in Asia and Africa, has grown net revenue by over 30% on an underlying basis. *Fine's* strong performance in Cambodia has been particularly pleasing, securing a 38% share of market; up 300 basis points.

Finally, we have now rolled out *Parker & Simpson* into 27 countries. *Parker & Simpson* has been the destination brand for several of our early migrations – more on that later.

Strengthening our Portfolio *[building equity: West chassis]*

Within the *West* chassis, we launched a new variant of our leading UK brand, *Lambert & Butler*.

L&B Blue has been a great success, achieving over 1.5% share of the market in a little under five months.

News continues to forge ahead with make your own volume growing strongly, whilst for *West*, slimmer formats in Central Asia, share growth in Taiwan and a growing presence in Japan all contributed to the brand's overall growth.

Strengthening our Portfolio *[building equity: Davidoff]*

Our new global design for *Davidoff* is now in nearly 60 of markets, covering close to 90% of global volume. We've seen share move up across our top 10 markets for *Davidoff* and pleasing progress in the Middle East. Our new flagship *Davidoff* store in Dubai aims to build on the success we're achieving in this geography.

In Russia we launched *Davidoff GlideTec* and won an innovation award for *Boudoir Superfine*, a slims variant we launched last year.

Migration Process *[improving growth trajectories]*

Brand migrations support our ongoing objective to enhance the quality of our earnings. But let's be clear, it's not the brand we are migrating, it's the consumer.

Through a combination of visual prompts via the evolution of the pack, which you can see here in this example from Taiwan, we have successfully begun the process of migrating consumers away from Portfolio Brands and into our Growth Brands.

Migration Process *[good early results – more to come 2015]*

We have now started 22 migrations and completed five.

The average retention rate we've seen to date is encouraging and here you can see more examples of migrations that are ongoing, with *Brooklyn* moving into the *West* family in Spain and *Moon* moving to *Parker & Simpson* in the Czech Republic.

Migrations play a key part in helping to simplify and strengthen the portfolio and we'll keep you updated on how the programme develops over the coming year. It is also important to remember that retaining the consumers from the migrated brand is just the first part of the story.

Over the longer term, success will be measured by our ability to enhance the quality and sustainability of revenues which is also about attracting new consumers to our strongest brands, focusing our investment and resource to grow their equity, consumer awareness, and appeal.

Developing our Footprint

Before moving on to talk through footprint developments, a brief look at what we're seeing from a market volume perspective.

Market Decline has Eased Slightly

We've seen the rate of volume decline ease across our footprint as a whole during the second half of the year, driven by improvements in many of our key Returns Markets. Over FY14 the market declined at a rate of just under 4%, an improvement versus the position at the first half.

We're encouraged by this but caution is needed, as increased activity in the value segment in many of our markets is driving a proportion of this improvement and there is the possibility of deeper declines in Russia to come.

Our plans for FY15 do not factor in any further market size improvements at this stage.

Growth Markets

Let's now take a look at some of our Growth Markets.

Developing our Footprint *[investing in Growth Markets]*

We made progress this year expanding our Growth Market footprint, with Egypt and Japan both good examples of how we are investing to build the sustainability and diversity of our earnings.

Egypt is a significant market of around 80bn sticks, in which we established a partnership with one of the country's leading distributors earlier this year. After launching in the summer, we've worked hard on consumer activation and distribution, with *Gauloises* and *Davidoff* now available in around 80% of retailers and achieving a market share of 0.6%.

Japan is also a material market with a large and stable profit pool. We've been building a strong position in the convenience channel, which is around 60% of the market. Q4 data shows that *West* has a share of around 0.7% and we're focused on adding to this as we continue developing our capabilities and scale going forward.

Developing our Footprint *[strengthening our position in Growth Markets]*

We continue to achieve great success in Scandinavia.

We have made further share gains in Sweden, where *Knox* is now the second largest snus brand in the grocery channel, whilst in Norway, *Skruf* has grown to become the country's number one brand. Delivering share growth of around 400 basis points and growing *Skruf Slim Fresh* to become the number one variant are fitting ways to mark the 10th anniversary of the Skruf business.

Italy is a great example of a market in which we have built share steadily and consistently through investment in our Growth Brands. During the first half, we grew the share of *JPS* through a focus on increased distribution, whilst the second half has been all about awareness and equity building activity, particularly around the iconic black and gold imagery.

JPS has responded well and is now at around 2% of the market.

Russia & Iraq

In Iraq we've seen positive momentum in *Parker and Simpson*, supported by the *Royale Club* migration. However, the political and security situation has clearly had a negative impact on our business during the second half. With sales activity focused on main cities only, volumes were around 3 billion sticks short of where we would expect, using the implied volume trend in the first half. We're continuing to monitor the situation and are working with our distributor to minimise any impact, whilst ensuring the safety of our employees.

The tobacco market in Russia has undergone significant change over the past year, brought about by rapid excise increases and tightening of regulation, which has yet to be fully reflected in volumes. Consequently, we expect the rate of market decline in Russia to increase over the coming months.

Our market share was broadly flat, with an improved performance in the second half reflecting a strengthening of our position in East Russia and Siberia, where *Maxim* is particularly strong and growing, driven by queen size and large formats.

USA

In the US we have continued to make progress with *USA Gold*, with our share across our Focus 19 states growing sequentially through FY14 and year on year in the final quarter.

The new GlideTec pack is now widely distributed across more than twenty thousand retailers and we've been focused on building consumer equity in the second half with a new direct marketing campaign.

The US is a significant Growth Market for us and one in which we again grew profits this year.

Acquisition of USA Assets

Before moving on to discuss some of our key Returns Markets, let me briefly recap on our proposed acquisition of assets in the US.

As you know we require the approval of both our shareholders and the FTC, and are expecting the deal to conclude in the spring of 2015.

As far as is allowable, we have been laying the foundations to hit the ground running in the US. Our integration team is looking at how the combined business will be structured and how we'll operate from day one.

As we said back in July, this is a transformational deal for Imperial in the US. It will strengthen our portfolio, enhance our scale and capabilities and make us a far more visible and material player in a significant profit pool.

Returns Markets

Let me now turn to our Returns Markets, starting with Returns South.

Spain, Morocco and France

Spain continues to be a difficult market with a high degree of price sensitivity in the sub value segment and a contraction in fine cut tobacco, with excise increases narrowing the price gap to cigarettes.

However, recent economic improvement and a stabilisation in illicit trade have contributed to a lower level of market decline than we saw during the first half. We've seen a stabilisation of our performance in blonde cigarettes and a good performance from our Growth Brands.

The Moroccan market continues to decline at a high single digit rate, driven by increases in excise and a rising level of illicit trade. During the year, we launched *MQS*, a more modern incarnation of Marquise, as well as Gauloises fine cut in order to enhance our portfolio in the value segment. As a result, our market share decline slowed during the second half.

Our high share in the traditional brunes market in France continues to impact on our overall position. With competition in the lower price bracket still a key feature, we have continued to focus on modern fine cut variants of our Growth Brands and both *Gauloises* and *News* make your own variants are doing well.

UK

The trading environment in the UK has been challenging, particularly within the value segment, where we've seen an increase in price discounting from competitors. We've continued to adopt a pragmatic and patient approach to this, competing strongly through the flexibility that our broad portfolio offers.

We've achieved success with *L&B Blue* in cigarette, as well as in fine cut with *Gold Leaf* and *GV Smooth*, a modern version of *Golden Virginia*.

We've driven significant increases in product availability over the past year, having evolved our route to market and sales force structure. The introduction of availability representatives, a new programme of trade investment and more scientific approach to distribution has been welcomed by customers and is helping build engagement.

Germany

The German market remains consistently steady, with a small decline in cigarette volumes and broadly flat volumes of fine cut.

Growth Brands continue to perform strongly, particularly *JPS, Davidoff* and *Gauloises*.

This month sees us launch two new variants of *JPS* in Germany – *Black Line* and *Silver Line*. These will extend our *JPS* portfolio, strengthening our cigarette offering in the value segment.

All in all, another good year for Germany and one in which we continued to grow profits.

Australia

Further success in Australia, where we've significantly grown both market share and profit, has been down to the consistently solid execution of a simple but focused approach to portfolio, pricing and customer engagement.

The growth of *JPS* in both cigarettes and fine cut has been key. A number of excise increases, the latest of which came in at the start of September, have driven the growth of the sub value segment; this is now over a third of the market and *JPS* accounts for half of it.

Contrary to what some might have you believe however, this is not all about price. Others are priced lower in the market but three quarters of total consumer purchases are still above the price floor. Our success in building the equity and share of *JPS* in a dark market is more down to customer engagement than low price.

As in the UK we're competing through expansion of the portfolio, recently launching both *JPS* 'tubing tobacco' as it's known in Australia, and a lower priced cigarette offering through Players.

The notable rise in non-duty paid consumption in Australia highlights the adverse impact of plain packaging and the ongoing increase in excise. This will no doubt continue with the most recent tax increase having landed just a couple of months ago.

Our strategy will remain the same going forward as we continue to focus on leveraging the equity we've created in the *JPS* brand to grow share and profitability.

Fontem Ventures

Fontem Ventures, continues to develop its portfolio of innovative products in lifestyle consumer goods categories. At present, the key commercial focus is on e-vapour.

The e-vapour category has shown strong growth over the last three years, and we believe that the market is primed to grow still further if the consumer experience is right.

Fontem's *Puritane*, is largely focused on the healthcare channel. We believe these products offer a superior consumer experience, as well as offering guarantees of quality and reliability. Our application for a licence from MHRA in the UK is currently progressing.

Beyond *Puritane*, Fontem is currently focused on extending its presence in Europe with a second e-vapour product, which we expect to see during the first half of the year.

We'll continue to take a measured approach in this space and believe we are well positioned through Fontem and the acquisition of blu, to capitalise on growth opportunities.

Preliminary Results 2014

04 November 2014

FY15 Outlook

Last year we further strengthened our business and we will build on that in FY15 as we continue to focus on our key four priorities.

The portfolio focus is on further driving the performance of our Growth and Specialist Brands – that's where the quality of our portfolio lies. Migrations and further investment will support their on-going development.

From a footprint perspective, the focus is on building momentum across our Growth Markets, whilst maximising performance in Returns Markets.

And of course, we have the completion of the US deal to look forward to. We expect this in the spring of 2015 and intend to hit the ground running with integration and the implementation of our plans to turn those brands around.

Effective cost and cash management support our growth strategy. You've seen further evidence of the progress we're making with cost optimisation and we'll be adding to that over the coming year.

Embedding stronger capital discipline in the business really paid off for us in 2014 – cash conversion back in the 90s and a significant chunk of our debt reduced. There's more to come here.

We're a stronger business going into 2015. The external environment is still challenging but the actions we've taken have strengthened our ability to grow the business against this backdrop.

We look forward to adding to our track record of shareholder value creation in 2015 and that includes delivering on our existing target of dividend growth of at least 10 per cent.

Preliminary Results 2014

Thank you. That concludes today's presentation and we'll now take any questions you may have.

The presentation is being recorded so please wait for a microphone and give your name and organisation before asking your question.