Half Year Results presentation

06 May 2015

Alison Cooper

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

I'll take it you've read our disclaimer.

Our Priorities for 2015 – *a reminder of what we said in November*

I'm going to start with a quick reminder of the 2015 priorities we set out in November.

We're strengthening our portfolio by building the contribution of Growth and Specialist Brands, supported by new launches from Fontem Ventures and a focus on share and profit performance is central to our footprint development.

Our cost optimisation programme is improving efficiencies and by embedding stronger capital discipline, we're more effectively managing working capital and driving higher cash conversion.

So, what progress have we made in these four areas in the first half?

Good First Half Performance – *on track for full year*

We generated excellent results from our Growth Brands, which supported by our successful brand migration programme, outperformed the market, growing volumes and share.

Our Specialist Brands have a track record of delivering sustainable revenue growth, and this continued with an increase in underlying net revenue in the first half. Together with our Growth Brands, these now account for 59 per cent of Group revenues.

In addition, Fontem widened the availability of Puritane in the UK and launched the JAI e-vapour brand in Italy and France.

From a footprint perspective, we've seen a positive performance from our Returns Markets and continued momentum in most of our Growth Markets.

In January our shareholders approved the acquisition of assets in the USA from Reynolds American. The acquisition remains subject to regulatory approval, which we still expect to receive in spring 2015.

And our cost optimisation programme is on track to save a further £85 million this year, which will be reinvested to support our growth agenda.

The focus on capital discipline is improving our working capital position, we improved our cash conversion to 102 per cent for the half year, and for the full year we expect cash conversion to be around 90 per cent. We've also made good progress with debt reduction, with adjusted net debt £2 billion lower than it was 12 months ago.

Our performance reflects our continued focus on delivering sustainable returns to shareholders and we have announced a further 10 per cent increase in the dividend.

I'll now hand over to Oliver to take you through the financials.

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Oliver Tant

Thank you Alison and good morning everyone.

Underlying Performance – *improving market share*

Our last results focused on underlying numbers, which excluded the impact of the stock optimisation programme.

For transparency, we've taken the same approach this year, removing the effect of the stock programme from comparative numbers to give you a clearer view of our performance.

We've also highlighted the impact of Iraq on our underlying performance, where the deteriorating political and security situation has significantly impacted volumes.

On an underlying basis, tobacco volumes were down 5 per cent. Excluding Iraq, our underlying volumes were down 3 per cent, better than the industry decline in our market footprint. Whilst you don't see it in the twelve-month aggregate market share number that we present, this outperformance reflects improvements in a number of key markets. When I look at recent share data, the last quarter has seen an improvement in the aggregate share overall and there are a significant number of markets with either a stable or improving share.

Underlying tobacco net revenue was flat with a positive price/mix of 5 per cent, which has continued to improve since the first quarter.

The impact of Iraq is a particularly noticeable delta to the performance of our Growth Markets, and our Growth Brand volumes, with over 80 per cent of our sales in Iraq coming from Growth Brands, and the remainder from Specialist Brands.

HY15 Adjusted EPS Growth

Looking at adjusted earnings per share, we delivered a good performance, with adjusted EPS up 4 per cent. This is largely due to increased profit performance which was boosted by the impact of last year's stock optimisation, but, as you can see on the slide, were it not for foreign exchange our EPS would have been up by 7 per cent.

Let me now talk you through some of the detail.

Growth and Specialist Brands – *strengthening our portfolio*

Our Growth Brands continue to outperform the market, with underlying volumes up 12 per cent and market share up to 6.1 per cent. In line with our strategy, this growth is mainly driven by brand migrations.

Specialist Brands also contributed positively, with underlying net revenue growth of 2 per cent driven by strong performances from snus and premium cigar.

As Alison mentioned earlier, Growth and Specialist Brands now account for 59 per cent of tobacco net revenue, an increase of 7% in the last year.

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Growth Markets – *developing our footprint*

Our financial performance was good in Growth Markets, with price mix of 12 per cent offsetting the underlying volume decline. We continued to build positive momentum across a number of territories including Italy, Saudi Arabia, Taiwan and Russia. Underlying net revenue was up by 1 per cent and excluding Iraq, the growth was 4 per cent.

Growth Brand volumes in our Growth Markets were down 7 per cent, but nearly 6 per cent of this was down to lower volumes in Iraq and it was also impacted by Vietnam where rising illicit trade has reduced market volumes by 20 per cent.

Growth Brands now represent 43 per cent of net revenue in Growth Markets and the market share of our Growth Brands in Growth Markets was up 20 basis points to 2.7 per cent. Our overall Growth Market share was broadly flat.

Adjusted operating profit increased by 26 per cent, reflecting the impact of last year's stock optimisation programme.

Returns Markets – *developing our footprint*

Good results in a number of Returns Markets North, including Australia and Germany, offset the negative impact of trading conditions in the Returns South markets of Spain, France and Morocco such that net revenue per thousand stick equivalents and adjusted operating profit were up by 1 per cent.

Our share performance was stable, in line with our strategy for managing these markets. Gains in markets such as Australia and the Ukraine, were offset by smaller declines year on year in markets including the UK and Germany.

We continue to focus on driving the performance of our Growth Brands and they now account for nearly half the net revenue in Returns Markets, and their market share has increased to 13 per cent.

Logistics – *encouraging performance*

We continue to be encouraged by the performance of our logistics business which delivered a 10 per cent increase in operating profit. This reflected growing sales of non-tobacco products, price increases and cost control measures, which helped mitigate the impact of declining tobacco volumes.

Adjusted Net Debt & Cash – *driving further improvements*

A focus on effective working capital management is embedding stronger capital discipline in the business such that we increased cash conversion to 102 per cent.

This reflects improvements in the management of our leaf stock and the timing benefit of finished goods inventory versus last year. For the full year, we expect to maintain cash conversion at around 90 per cent, in line with last year.

We're continuing our review of inventory holdings to better align ourselves to market demand, more effectively managing debtor balances and simplifying our existing supplier terms and combined with a benefit from foreign exchange, these improvements have contributed to a substantial reduction in adjusted net debt which has come down by £2 billion in the last year.

Reducing debt remains a priority and we're embedding new processes and ways of working to drive further improvements across the business and as a consequence of the strong inflow of funds generated from our existing business, we have cancelled £500 million of facilities raised in relation to the proposed acquisition of assets from Reynolds American.

Foreign Exchange – *3% impact on half year profit*

Turning to foreign exchange when we started the year, we anticipated a 2 per cent impact on earnings, but the movements so far, particularly in the Euro and Russian Rouble, impacted adjusted earnings per share by 3 per cent.

Based on current exchange rates, we now expect the impact on full year earnings to be close to 5 per cent.

Good First Half Performance – *on track for full year*

Overall a pleasing start to the year. We delivered a good first half performance and have many opportunities to build on that in the months ahead. We remain on track to deliver full year results in line with expectations, and expect stronger pricing in the second half to offset volume pressures.

Effective cost management supports our sales strategy, and we continued to make excellent progress. We expect to generate £85 million of savings this year; delivered through a range of initiatives that are reducing business complexity, driving operational efficiencies and enhancing global procurement benefits.

As Alison said, the consistency of our delivery is reflected in the dividend – another strong 10 per cent increase. And as a reminder, we're providing more regular cash returns to our shareholders as we move to paying dividends quarterly, starting with the interim dividend announced today.

Thank you. I'll now hand back to Alison.

Alison

Thank you. I'll start by looking at the portfolio.

Strengthening our Portfolio – *improving net revenue quality*

Our priority is to drive the performance of our Growth and Specialist Brands and to keep building the contribution they make to the business. They now account for nearly 60 per cent of Group revenues, compared to 50 per cent two years ago.

Strengthening our Portfolio – *successful brand migrations*

Our brand migration programme continues to play a key part in simplifying and strengthening our portfolio; it supports more targeted investment and is improving the quality and sustainability of our sales growth.

Migrations accounted for the majority of our Growth Brand volume gains in the first half, and they continue to deliver an average success rate of close to 100 per cent. We completed 5 migrations in the half including Gold Leaf to JPS in the UK and four local brands to Parker & Simpson in Poland. A further 19 migrations are in progress and several more are planned.

This has resulted in the market share of Growth Brands increasing in 12 of our top 15 markets, and the overall share of our Growth Brands increasing by 1 per cent in the last year.

Investment has supported this share growth: we've rejuvenated several Growth Brands and continue to rollout new pack and marketing campaigns for Gauloises Blondes, JPS and Parker & Simpson. A pleasing performance and one we'll be looking to build on in the second half.

Here's a quick look at the new JPS 'Born That Way' campaign which we've begun rolling out.

VIDEO

[JPS Video plays]

Improving in-market focus and delivery

And our change in agenda isn't limited to our brand portfolio. We're executing changes in our ways of working – our operating model – to further improve our in-market focus and delivery.

The consistent application of our sales growth drivers across all our markets is integral to our success, and it's supported by the work we're doing to improve our operating model. It may sound like dry stuff but its key to generating sustainable results and it's engaging our people in getting behind new ways of working, removing complexity across all areas of the business and improving efficiency and effectiveness in-market.

Customer engagement includes our 3FT and iServe programmes. 3FT provides greater clarity around roles and responsibilities in our field force, and is instilling a sharper focus on the priorities for growth. And iServe is about providing the Field Force with tools that will enhance the commercial conversations and provide our customers with vital brand and legislative information in engaging formats. So far, more than 30 markets have restructured their sales teams around the new model and the benefits are being reflected in both our performance and employee engagement levels.

Market Environment – *industry volumes down c.4% in HY15*

You may remember this chart from our results presentation in November when we highlighted that we'd seen the rate of volume decline ease across our footprint. With the exception of Russia, which we've previously highlighted, it's remained a relatively similar profile in the first half.

Whilst a number of our key Returns Markets are showing a slower rate of decline, in many cases this is due to the phasing and quantum of price and excise increases.

Looking forward, we don't expect the rate of aggregate decline to move materially, though we've yet to see the full impact of regulatory and excise changes in Russia. Increasing prices may also have an impact but as Oliver said earlier, we expect stronger second half pricing to offset volume pressures.

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Developing our Footprint – *USA*

Across our Growth Markets I see lots of positive progress with our Growth Brands, market shares and financial objectives. What we're reporting this first half obscures this progress due to the big deltas in Iraq. Let's look at some examples.

In the US, our focussed strategy is delivering good momentum in our cigarette performance with USA Gold performing well in our target states, gaining volume and share. Mass market cigars are performing less well due to competitive trends, but we are addressing this with initiatives such as the relaunch of Dutch Masters.

We await regulatory approval from the FTC for the acquisition of assets from Reynolds American. These are being sold as a condition of the acquisition of Lorillard by Reynolds and include US cigarette brands, the blu e-cigarette and Lorillard's cigarette factory and national sales force. Closing of the transaction still remains subject to conditions described in the circular to shareholders and we expect the deal to be completed in spring 2015.

Developing our Footprint – *Growth Markets*

Some examples of our progress in other Growth Markets, starting with Italy where we've maintained our growth momentum, increasing volumes and market share. JPS continued to grow, supported by Davidoff and in March, we launched the JAI e-vapour brand.

We also made a good start to the year in Taiwan, with strong growth from Davidoff, supported by West and Parker & Simpson.

As I mentioned, the turbulence in Iraq has severely impacted industry volumes and accounted for around 2 per cent of the decline in our first half volumes but with a lesser impact to revenues. We continue to monitor the situation and work with our distributor to do what we can to mitigate the impact.

In Russia, there's been significant excise and regulatory change. In November, we said this had yet to be fully reflected in volumes and we expected the rate of market decline to increase over the coming months; that's been the case, with the market down around 10 per cent. Our results have been encouraging: we've maintained our share, with an improved performance from Maxim, and we also increased revenue due to strong pricing.

We're enhancing the quality of our share across our Growth Markets, with the share of our Growth Brands increasing by 20 basis points to 2.7 per cent. Our overall cigarette share was up in a number of markets, and we delivered strong revenue and profit growth; a great base to build on in the second half.

Developing our Footprint – *Returns Markets*

We're also making positive progress in Returns Markets. Our overall share performance was stable, in line with our strategy for managing these markets, and again we're improving the quality with an increase of 210 basis points in the share of our Growth Brands to 13 per cent. In the UK we've delivered some good brand performances and we're seeing an improving trend in our market share, with L&B Blue continuing to strengthen the Lambert & Butler franchise, and gv making further gains in fine cut tobacco.

In Germany, market conditions were stable and our financial delivery was strong, driven by a good performance from JPS now supported by the new JPS campaign.

In Spain, industry volume declines have slowed in both cigarette and fine cut tobacco. A small price increase has improved our financial delivery and we maintained our blonde cigarette share and strengthened the portfolio with the migration of Brooklyn to West.

In Australia, we continue to grow revenue and profit, and our overall market share was up to over 30 per cent, with JPS the key driver of our performance.

Fontem Ventures – *building presence in Europe*

Fontem has continued to build its portfolio presence in Europe. The team has been widening the availability of the Puritane e-cigarette brand in the UK through partnerships with additional retailers, and launched the JAI brand in France and Italy.

This video gives you an insight into how we're positioning JAI.

VIDEO

[JAI Video plays]

On Track for 2015

Finishing where we began with my first slide. We've made good progress against our 2015 priorities. In the second half, we'll be continuing that focus with Growth and Specialist Brands, while making the most of opportunities for growth across our footprint.

The US will be a particular focus and we look forward to completing the deal that will transform our operations in this key Growth Market.

Effective cost and cash management will continue to support our growth ambitions. The strong cash flows we generate will be used to further reward shareholders, reinvest in the business and pay down debt.

I'm pleased with the progress we're making with our strategic agenda. It's a full agenda and it's the energy and commitment and 'bring it on' attitude of the people in the business that's making it happen. They are improving the consistency and the quality of our performance, and that's what gives me confidence in creating further value for shareholders in 2015 and beyond.

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