FULL YEAR RESULTS FOR THE TWELVE MONTHS ENDED 30 SEPTEMBER 2016

Q&A Transcript

Adam Spielman - Citi

Hi. It's Adam Spielman from Citi. So my first question, I guess it's a double-barrelled question. It's about the phasing of the cost savings and also the investment. So I understand the cost savings, I think. But the question there is, you've taken I think four years to get to £300 million savings in phase one, and it sounds like you're doing 2.5 years to get to £300 million savings in phase two, but you've done the low-hanging fruit first, one assumes. So, that's a little bit of a difficulty.

And then related to that, I'm slightly confused about the investment. Are you doing all £300 million - the press release implied you're doing £300 million in year one, but I think you said it's all not going to be a big bang. It's going to be slightly delayed, so if you can just clarify that, as well. Then I have a follow-up question if I may, after that.

Alison Cooper - *Chief Executive*

Okay, sure. Okay, so first of all, to clarify the phasing cost and investment. As I indicated during the presentation, through the work we've done over 2016, we're very clear around the investment step that we want to make behind the business, and we've identified £300 million of opportunities which will all be spent in 2017. But as Oliver indicated, the net impact we anticipate in 2017 of that spend is £200 million, because there will be some return against that investment in the year to the tune of £100 million. So, it's a net of £200 million before any funding from the cost-saving programs.

So, that will all come through in 2017. Just to be clear, I'm not saying it's the end of our investment in 2017, but anything from 2018 forwards in terms of our current plans would just be some smaller incremental step ups. As we achieve some of the payback on the investment, some of that will be reinvested to some degree, so that's the total £300 million in 2017.

Then the cost savings, you're right. There's if you like a mismatch on the phasing in that we are funding the £300 million through a cost optimisation program. In effect, what we're doing is spending our money behind the top line and finding opportunities to release that money from elsewhere in the business, but that's going to come through - it's actually over the next four years. 2020 is the deadline for the second phase of cost optimisation, so it's a very similar time period.

The part of the time period is due to the fact that the complexity we take out of the business as we execute a number of the portfolio actions I outlined, that takes a while to wind through in terms of realising the efficiencies we can from the complexity reduction in the organisation.

Adam Spielman - Citigroup

Okay, I think that partially answers it, but it still seems to me that on the cost savings, you've closed factories. You've done some easy stuff. Yet surely it's harder - each pound of savings gets harder and harder to achieve.

Alison Cooper – *Chief Executive*

Well, you can see it's slightly more expensive, this phase, because we did £300 million at a cost of £600 million the first time around. This is going to cost us £750 million, but we've got a very clear line of sight to the next £300 million, and it is still through further product cost initiatives. As I said, driving complexity out is a very key aspect of being able to realise those efficiencies, but also through overheads. As we align and we focus behind the priorities of the business, behind the brands, behind the markets, that releases opportunity for us to reduce overheads across the business as well.

Adam Spielman - Citigroup

And then just to make sure I really understood this, you are saying once the - this is now about the investment. Once you've done the £300 million investment this year, fiscal 2017, basically you've got your portfolio almost exactly where you want it and anything else will be small, incremental and minor? I think that's what you said.

Alison Cooper – *Chief Executive*

I think in a changing world environment, you keep having to optimise how you spend your money, so I think it would be quite an arrogant person who would say, oh yeah, it will be absolutely perfect come 2017, but this is the step up we think we need behind the brands and the priority markets in 2017.

In our plans moving forward from 2017, there is some incremental step up behind our key tobacco assets, but it's nothing - we have nothing significant planned.

Adam Spielman - Citigroup

Thank you.

Alison Cooper – *Chief Executive*

Where shall we go next? Let's go [right here].

James Bushnell - Exane

Hi, morning. James Bushnell here from Exane. Two questions, please. The first one is on your outlook for 2017. You've been quite specific on the EPS growth headwinds you're seeing. This is, as you've explained, down to costs and investment. I wonder how you'd see the development of the top line next year, particularly in terms of organic sales. You've done something like 1% in 2016. You've spoken of about 2% being in line with what you'd hoped for, for the model. Should we expect to see 2% next year?

Alison Cooper – *Chief Executive*

In terms of the overall revenue projections for the planned period, there's aspects of our investment as we look at the £300 million, some of which will go into A&P and overhead, some of which will also be impacted against the top line. So for example, within our investment plans for 2017, there's some additional step up in buy downs behind the US business. Clearly that will also pay back against the revenue line as well in 2017. But there will be some things that impact the revenue line as well. The investment also includes some investment in sub-economy price segments in markets such as the UK as well, which will also have a mix impact on the top line. So from a 2017 perspective, I don't expect any material uplift in the top line for 2017, but the investments we're putting in place will give us top-line uplifts from 2018 onwards, post the investments we're putting into the business.

James Bushnell - Exane

Okay, thanks. Sorry, when you talk about uplifts, is that uplift versus the 1% we saw this year, or is that uplift versus 0%?

Alison Cooper – *Chief Executive*

Well in 2018 and beyond, uplifts against the 1%. So our target range on revenue is up to 4%, so that's the sort of range we're looking at.

James Bushnell - Exane

Okay, I think I understand.

Alison Cooper – *Chief Executive*

From 1% to 4%.

James Bushnell - Exane

And my second question was about the UK market, which is the minimum excise tax, which we're hoping to hear about next week. There's been some stories in the papers. Conceptually, I would imagine this is hopefully a good thing. How much credibility do you give to the recent stories and do you expect this to be a positive development for the UK profit pool in limiting the ability of the consumer to downtrade to prices that are unprofitable or significantly less profitable for you?

Alison Cooper – *Chief Executive*

Do you want to comment on the minimum excise tax?

Oliver Tant – *Chief Financial Officer*

As you say, we'll have to wait to hear whether it's going to be brought forward or not. We understand the government have been looking at it quite seriously, and you can understand from a revenue protection perspective why they would do that. The devil will be in the detail clearly in terms of how they bring this in, but I think your assumptions would be broadly right. It would reduce the downtrading dynamic within the UK market and therefore protect the UK government revenues. But we will just have to wait and see what happens next week.

James Bushnell - Exane

Okay, thanks very much.

Fulvio Cazzol - Goldman Sachs

Good morning. Fulvio Cazzol from Goldman Sachs. Excuse me. You highlighted in your outlook that you expect to go back to the 4% to 8% EPS growth by 2018. Can I just clarify for 2017 the reason why you moved away from that target? Is it solidly because of the investment, i.e., the 4% headwind? So ex that, could you be within the 4% to 8%?

And then the second question is, in terms of the investments, you mentioned the UK market as being an area where you want to focus in the sub-economy segment. I believe that's been an area of focus for you already, and if you do have this development coming through with the minimum excise, is this likely to change your objective of investing in the sub-economy in the UK? Thank you.

Alison Cooper – *Chief Executive*

Do you want to pick up on the guidance point, first off?

Oliver Tant – *Chief Financial Officer*

Fulvio, I think in answer to your first question, yes, the answer is that were we not to make the 4% investment we would have been within our target range of 4% to 8% on a constant currency basis. It's also worthwhile noting that we guided to an expectation based on current exchange rates of a 14% delta on translation, which needs to be added to that number in terms of actuals.

Alison Cooper – *Chief Executive*

From a UK perspective, I've indicated previously with the UK, there's a lot of moving parts currently, so we've got a quite significant impact from regulation. It's now standardised packaging, but even with the EUTPD, I've talked here before about the consumer churn that's going on because of the changing of pack formats and the smaller pack formats going out of the market, therefore the consumers having to make a different choice around the product that they're purchasing.

There's also actually impacts from the euro-sterling rate at the moment, from a travel retail perspective, as well, impacting the UK market. There's absolutely competitive impacts as well around some of the price positioning of the brands, and we've got a market in flux between old packs, new packs, all sorts going on at the moment. So there are a number of factors which the -- we're looking to position our portfolio correctly in this market. We've got a clear focus behind our brands and what we've done so far with fine cut is yielding benefits, because we're growing share. Excuse me - with Gold Leaf growing significantly.

On the cigarette side - excuse me while I croak for a second. One second. On the cigarette side, our focus is behind Lambert & Butler and Players, and again, Players is performing very well in the sub-economy segment for us. We want to do more of that. But there is a lot to do in this market.

We're investing behind, yes, our share in sub-economy to defend our position in the market, but also behind sales execution, customer engagement, brand activation. There's a lot of activities going in in the UK which add to our investment profile for 2017.

The minimum excise tax would be helpful to our business, absolutely. We're supportive of it, but it's one of the things in the mix for the 2017 performance. Jon?

Jon Leinster - Berenberg

Sorry, Jon Leinster, Berenberg. Just going back to that £300 million and such again I'm afraid, what sort of targets or how are you going to judge the success of this £300 million investment in the market and over what timescale? Is it going to be market shares? Is it going to be the group of brands? Is it going to be organic sales growth? What's the judgment for keys to whether it's been successful or not?

Secondly, do you think it's going to elicit any response from competitors in terms of if you're up in the market, is everybody else just going to do the same? And thirdly, in terms of going back to I think you mentioned in the presentation that actually you've done this sort of radical SKU cut in a number of trial markets, so can you give us some idea as to how it impacted the sort of volumes and share on a timescale perspective?

Alison Cooper – *Chief Executive*

Yes, certainly. I'll briefly comment on how we've approached the investments, but I'll let Oliver add as well, because I'm sure he'll be itching to. The success metrics around the investments we're making are very clearly articulated, so we've been through an exercise of really looking at where the opportunities are, of almost having not quite a balloon debate but a discussion as to what we really think we ought to back in the first instance as a business, and we've incorporated those opportunities into our investment thinking. They are the more significant opportunities, as it turns out, and we've got very clear metrics around what we're expecting those investments to deliver.

Yes, they have to play back from a profit perspective, but their prime focus is to drive quality revenue. It's behind brands. It's behind top line. It's behind market share, because we've been talking for a number of years, as you know, about quality growth at

Imperial, but we need to generate more of it for growth brands. The specialist brands are growing, but the drag from the portfolio brands means we still generate low-single digit in terms of revenue growth, and that's what we're trying to invest with this investment program.

So therefore, the prime metrics that we're driving in the business are around the revenue and the market share in the right brands, clearly, through the investment that we're putting into the business. So that's really the very important point around how we're metricising the organisation and monitoring the delivery of these investments. I'm not saying there isn't a profit element, and at this point, I'll hand it over to Oliver who will make sure to cover that point off as well.

Oliver Tant – *Chief Financial Officer*

Yes, clearly, one of the hallmarks of Imperial over the last few years has been its disciplined approach to capital allocation. I'll just look at our cash conversion number that's been consistently at the head of the pack, our dividend pay-out ratio, which is now the lowest amongst its peer group, to demonstrate that. We're not entering into an investment phase without that discipline being in place.

What we are doing is looking at slightly longer-term horizons over which those investments can pay back in order to ensure that we look at a broader range of opportunities to enhance our top-line development. The purpose of this is very clearly to work at one area where I guess some observers have criticised us a little bit, which is around our top-line development and to ensure that we're making the right investments to ensure that development is operating in a way that sustains our ability to deliver the 4% to 8% in the longer term and sustain for a longer period of time that 10% growth in dividend promise.

Jon Leinster - Berenberg

Does that imply that the timescale (inaudible) as 2018? By which one (inaudible).

Alison Cooper – *Chief Executive*

Can you repeat the question?

Oliver Tant – *Chief Financial Officer*

Sorry. Can you repeat the question?

Jon Leinster - Berenberg

Just in terms of timescale, therefore, it seems to imply that given you're going to be back to 4% to 8%, so does that mean the timescale, in terms of judging the success, is just going to be as quick as 2018, or is it we're looking longer than that?

Oliver Tant – *Chief Financial Officer*

Well I think judging success will be around the momentum within our top line. Alison mentioned that we intend to continue with an investment program, but that we intend to fund this through improved performance in future years, so hence the guidance of 4% to 8% in 2018 and beyond. We intend to keep that top-line momentum growing by making sure that we continue to invest in opportunities, as I say, to ensure that the 4% to 8% is sustainable over a longer period of time, and hence our 10% dividend growth proposition is sustainable over a longer period of time.

Jon Leinster - Berenberg

And just going back to, sorry, you mentioned in the presentation there was actually some markets where you'd done this, and I'd asked if there's some sort of in terms of timescale or learnings as to what the impact was. Is there anything you can tell us about from the --

Alison Cooper – *Chief Executive*

Yes, that's your point on the radical SKU reduction point, yes. Yes, because you had two other bits to your question. One was on competitor response, and let me just pick up on that one briefly. When we put plans together, we absolutely do clearly consider the environment and the competitive environment we're operating in and look at varying scenarios within that. And yes, we're beginning to do a lot more around looking at, which I think some people refer to as pre-mortems, looking at what could go wrong in a situation before it happens, which is a good discipline to start building more of in the business. Most businesses do scenarios, but this is a little bit more rigorous to look at.

So we've got a very clear view of the environment we're looking to drive this in, so we're not operating in a vacuum clearly around some of our investment thinking and what we think we can deliver from it.

On your point on the radical SKU reduction, we did two pilots in 2017, which we also discussed with you at the investor day. Those two pilots were in part of the market where we had a control part of the market as well, so we could do some very clear comparatives around what was going on between the SKU cut part of the market and the normal part of the market.

The results have been really very encouraging, in that we've taken, as I said, 40% to 60% of SKUs, depending on which market you were looking at, and within those markets, we - from driving the focus behind the priority portfolio, the optimal portfolio in those markets, getting the distribution of those key brands, working with the retailers who have actually loved the initiative as it's really taken complexity and working capital out for them as well and really leveraging that as part of the process. We have therefore actually grown gross margin. We've grown share in those areas as well, and it's really been positive on all metrics.

We were happy to accept the fact that initially it might just be a neutral impact, but actually it's been better than that on all metrics. That was a pilot test over a four to six-month period effectively we're still monitoring as well, but that's what we're looking to roll out in a measured way over the coming years starting in 2017.

Back.

Owen Bennett - Jefferies

Hi. Owen Bennett at Jefferies. Three questions, please, and firstly, how is the investment likely to be split across returns growth in the US? Secondly, the 4% to 8% medium-term growth target, what's actually assumed for profit growth in the UK? And then thirdly, just wondering where you are with PMTA applications on vapour in the US. Thank you.

Alison Cooper –*Chief Executive*

Was that on vapour in the US? Yes, okay, that's fine. All right. The split, we're not giving a very significant split. If you include US as it is classified, as a growth division type business, even though we split it out separately, it's fairly even between the returns and growth markets of the £300 million. On the UK profit, it's not something we disclose, she says to be unhelpful. And on vaping, I hand it over to Matt.

Matthew Phillips – *Chief Development Officer*

Yes, as you know, we've got two years to submit the applications. We're well placed to do it, so yeah, we'll be submitting them in due course.

Alison Cooper – *Chief Executive*

Jon.

Jon Fell: Ash Park Capital

Hi. Also two things. First, a quick one, and sorry if I missed this. Can you let us know if there's any non-cash elements or the £750 million restructuring changes, or was that all cash?

Oliver Tant – *Chief Financial Officer*

The £750 million is all cash.

Jon Fell: Ash Park Capital

All cash. Thanks, okay. Then secondly, Iraq and Syria have been a regular feature of the presentations the last couple of years. Is this likely to be the last we hear about them as a negative for a while? And then the other markets, where you've taken footprint decisions and seen a volume hit, like Morocco, Russia, Azerbaijan, Turkey, are there going to be more of those in the future or an ongoing impact from those markets? Or have you done a lot of that footprint adjustment now?

Alison Cooper – *Chief Executive*

Okay, right, on the first one, do you want to pick that?

Oliver Tant – *Chief Financial Officer*

Well I think that - and I hope I've got the first one of your questions, but if we're talking about the footprint strategy, to be clear, it's only an element of those markets where we have taken choices which have been to do with the fact that they've been market behaviour or activity within those markets that have made segments of the market unattractive.

What we've chosen to do in many cases is where we don't think we'd be doing anything else other than renting share at a cost to us, we've chosen not to participate in that segment of the market's activity. A classic example will be the Ukraine, where there has been during the course of the last 12 months or so some quite heavy discounting going on. We chose not to participate in that. We lost some market share as a result.

We estimate that the profit pool lost about £220 million as a consequence of that, which the impact on our profitability was only about £25 million. Others were hit much, much more substantially. And since greater discipline has returned to the market, we've seen our market shares begin to improve substantially and have recovered the majority of the loss that we incurred as a result of that activity, really proving the point that actually we want quality market share, not just any old market share.

Alison Cooper – *Chief Executive*

Can I just pick up on a couple of the markets you cited, though? Morocco is - we have been investing in Morocco where we see opportunities. It's just been a really challenging market, so that hasn't been an investment choice to back of Morocco, and interestingly enough, with some of our portfolio moves this year, we're actually seeing some quite good traction behind our share again in Morocco currently, so that is an improving situation that I'm reluctant to call it out until we see more significant improvement there.

Russia again, it was more I think when we talked to the first half we were at a slight price disadvantage with some longer durations of stocks that we had in the market, and we've had some of impact from some of this big box ban that's come through recently. But we are active. We've had a very successful migration with P&S from Balkan Star during the year. We're seeing good traction actually with a portfolio much more sorted behind Davidoff West and Parker & Simpson in the market.

So we've actually done a lot of the portfolio sorting in Russia and are now in a really good place to move that agenda forward in Russia, which has been one of our sticker points with Russia, because of the fragmentation of the portfolio historically. You're right in terms of Ukraine and Turkey were choices, definitely, but not the other two we're looking to -- we're still looking to very much invest in those markets.

And your first point on Iraq and Syria, it should be gone. It's so small now it can't cause that much of a delta on the Group results, so that should be the end of it. I very much hope so.

Jon Fell: Ash Park Capital

Thank you.

Alison Cooper – *Chief Executive*

Yes. Any more questions? One more for Adam, then, in that case. Let's have a quick, come Chas first. Okay.

Chas Manso - Societe Generale

Sorry, Chas Manso from SocGen. Could you talk a little bit about your market share, which is a concern for many? Down again 60 basis points, including the US contribution.

Alison Cooper – *Chief Executive*

Up 30 including the US.

Chas Manso - Societe Generale

Up 30, including the US.

Alison Cooper – *Chief Executive*

Down 60 ex the US, then.

Chas Manso - Societe Generale

Okay, great, and a lot of this is clearly down to your footprint decisions. Is there any way you could separate out for us what you feel your market share dynamic is in the markets where you're not needing to make these footprint decisions to try and get a feel for what your underlying market share momentum is?

And the second question would be on next-generation products. We haven't had a question on that, so we might as well throw one in. Industry seems to be heating up, maybe not burning up, but heating up for next-generation products over the next, 12, 24 months, whatever, and some feel that maybe Imperial is a bit behind the curve on that and a bit behind the investment curve.

Could you give your perspective and why you're not behind the curve? Thank you.

Alison Cooper – *Chief Executive*

Okay, well first of all, on the market share point, I don't think it's really fair to try and pull out an underlying market share of any sort in reality. There are some markets where we're pleased with our progress, so in the growth division, we had seven key markets that we wanted to grow share in this year. We grew in five out of the seven. One was pretty flat and the one that we called out where we had some pressure was Russia, which we're looking to address. I just commented on that.

But really, the point on market share is really another indicator to the point that we were calling out earlier, which is we are generating quality growth. We're seeing progress with our growth in specialist brands, but there's a drag from our portfolio brands, and what we're looking to do with this additional investment is look to address that and look to get more quality growth coming through to offset some of the declines in the portfolio brands that are coming through, through the various initiatives I talked about, more migrations, more radical SKU reductions and more investment behind the key equities and the focus behind those and investment in their distribution and sales execution activities that support them.

So really your question is linked to the heart of what we're looking to do with this additional investment. And maybe hand over to Matt to talk about heated tobacco.

Matthew Phillips – *Chief Development Officer*

I recognise the perception that you're describing. I think if you look at it from a consumer perspective, you've heard me say this before. I think there are consumers who are looking for a tobacco experience. They're wedded to a tobacco experience, and that may be either because of a love of tobacco or because they've got no alternative in their market.

There has been a lot of noise that has been made about the progress that has been made in one market in particular that fits that sort of category, so I get why you'd be asking the question. However, from a broader consumer perspective, we've always seen it, that the bigger opportunity ultimately sits with people who are looking for a non-tobacco experience or are just looking for a different experience. There, the optionality that e-vapour provides is of a different order, so the ability to provide nicotine or non-nicotine, flavoured or non-flavoured, open systems, closed systems, et cetera, provides far greater opportunity and marketing, et cetera, freedoms that we think that's the right horse to be backing.

We're pleased with the progress that blu is making. We continue to invest in the equity of the brand, as you've heard. We continue to invest in the technology. We're still licencing out the first generation. We've got the second generation in the market, the third generation ready to go. But as you've also heard me say, we want to crack the experience before we scale it to reach its full potential, so that's my perspective on it.

Adam Spielman - Citi

Just a couple of minor follow-up questions. First of all, without talking about your profit in the UK, can you - I strongly believe, assume, the profit pool in the UK is in decline. Is that how you see it would be one question? And a follow-up question about really margins, historically, you've had very good margin growth. I think let's forget 2017, fiscal 2017, and think about 2018 and beyond.

It sounds like you want to be using a lot more of a top line to reinvest in building brand equity. Am I to take it that actually margin growth will be more modest than before and we're getting towards maxing out on the margins as you think about - maybe you can divide that between your growth markets and return markets.

Alison Cooper – *Chief Executive*

I'll ask Oliver to pick up on the margin question in a second. The UK, there's no doubt, you can see from the data, that the profit pool is under pressure in the UK, because of the various dynamics with both the - the excise increases, the volume declines and then also the mix impacts in the UK, as we see the growth in the sub-economy segment. So you're right, the profit pool is under pressure, yes. Do you want to pick up on the --

Oliver Tant – *Chief Financial Officer*

You see on margins - just to be clear, we've had a fantastic performance in FY 2016 with 60 basis point improvement in our margin to 46.9. I think this has been now four consecutive years of margin improvement, and the work and focus in particular of my colleagues in our manufacturing outfit who've had to deal with reducing volumes and yet have been sustaining and reducing conversion costs has been really outstanding and something that I know internally we're all very proud of.

I think as you look forward, we're making investments in attractive markets. Those generally tend to be markets that have relatively attractive margins with them. Therefore from a mix perspective, you might imagine that the mix will continue to favour markets with more attractive margins, and therefore we will get some level of incremental uptick in the longer term from the margin perspective, let alone the impact of some of the pricing and cost dynamics that we're playing to through improving and simplifying our business.

So I would expect it to continue. To be honest with you, I'm not sure I would expect it to continue at the rate of development that we've seen over the last four years, but I would expect it to tick up. We've been through a very thorough process of analysing the investment opportunities that we have. We've put in hurdle rates, which Alison referred to in her presentation to ensure that the impact of these investments very, very clearly play out our profitability and our margin.

I for one and the team have been through it in great detail. We remain of the view that this will enhance our longer-term profit trajectory based on a substantial and focused investment program.

Adam Spielman - Citi

Thank you, and if I can ask - if nobody else wants to ask a question, I might as well ask them. Can you talk a little bit in more detail about market share in Germany? I'd love to have the decline in bps. I imagine you will say we don't disclose that, but if you can indicate was it a small decline, big decline? Which sort of areas where it was and that was your thinking?

Alison Cooper – *Chief Executive*

Most of the pressure has been in the fine-cut portfolio. There has been some pressure in the cigarette, but actually the actions we took in the second half have stabilised that position and therefore the cigarette share is moving in the right direction. And fine cut, we are taking some actions currently to address the fine cut. Because we do a white stick equivalent share, it's largely the fine-cut portfolio that impacted the share.

Any more questions? Well I just want to say thank you for joining us today. We are very excited about this next phase of growth. We've put a lot of work in terms of the foundations we've put in place over the last five years to drive the quality of growth in Imperial.

We're getting the brands in the right place, and we're really focusing the investment now in 2017 behind those brands and behind the key markets within the business as well and very much looking forward to updating you on our progress over the coming year. Thank you.

[End]