Q&A Transcript

Alison Cooper – *Chief Executive*

Let's start with Martin.

Martin Deboo - Jefferies

Hi, everybody. Martin Deboo, Jefferies. Can I talk about medium-term cash flow outlook, because clearly you want to keep your operating cash conversion close to 100%? It looks as if capex was actually quite a lot lower this half than I expected. I'm just wondering, as you rationalise your footprint, whether you are able to give us some commentary and colour on the main lines of the operating cash flow and how much capex do you think the business needs in its rationalised state? How do you feel about controlling working capital?

Alison Cooper – *Chief Executive*

Okay. Thank you. Oliver?

Oliver Tant – *Chief Financial Officer*

Well, we've been very clear that we're targeting a low 90% cash conversion over the medium term. I think we feel exceptionally confident, given the state of our balance sheet and the opportunities that sit therein, as well as the adoption of a more disciplined approach to cash management on a year-on-year basis, that absent any one-off issues that we ought to be able to sustain that 90% cash conversion. And that's very much what we're working towards.

Clearly, the levers are working capital, capex and restructuring. And from a capex perspective we have simplified our business model which has significant impact in the context of the level of capex that we need to incur. And if I'm honest, Martin, the reality is a lot of the capex is related to product launches. If you simplify the portfolio, you reduce the number of differential SKU launches, you reduce the necessary capital cost associated with launching those products. So a lot of it comes from a much more disciplined approach to portfolio management and a much more disciplined approach to the factory footprint. And we recently announced the closure of one of our European factories which reinforces that point.

So from a Capex perspective I think we feel reasonably comfortable that we can operate at levels that are lower than they historically have been. I'd estimate at roughly two-thirds of where they have been if you were looking for a number. I hope that answers the question.

Martin Deboo - Jefferies

Yes.

Adam Spielman - Citi

Hi. It's Adam Spielman. Imperial has seen over many years various things that make comparability extremely hard. You've had destocks. You've had Iraq and Syria. You've now taken the decision to exit low-value brands in places like Ukraine and Turkey with really big volume impacts. And I'm wondering when this cycle will be through. Is this the last set of exiting strange low-value volumes or should we expect more in future years?

And I've got a very minor question also to follow up to.

Alison Cooper – *Chief Executive*

Okay. I think the best way of looking at this is, as I described at the beginning of the presentation. We look to focus the business and therefore we have to make some very clear choices in the business as to where we see the quality of growth and opportunity.

And Ukraine in particular, I refer back to Poland when I was talking about how we're seeing Ukraine at the moment. And I refer to the Polish yoyo, because ever since we bought Reemtsma, I remember Poland going up and down and all over the place. And people grab share with a brand and then somebody else would grab some share, and actually the profitability of that market was at rock bottom for years. It's finally now improving. Our business in Poland is actually improving with consolidation of our portfolio, largely into Parker & Simpson and West, and building profitability in that market. But it's taken a number of years of yoyo before that's settled down.

So with a market like Ukraine it's not that we're backing off Ukraine, what we're saying is right here, right now, looking at the dynamics of the market, looking at the prospects over the next few years, we see opportunities to rent share at the bottom of the market, but we don't see opportunities to build a sustainable quality position currently. We still have around a 20% share of the Ukrainian market to give you a feel for where we're sitting.

And it's those decisions and focussed choices around investment that are important for our growth going forward. So this isn't about cycles. This isn't about listing the markets that we want to deprioritise and take out of the mix. But it is agile decision-making around what makes sense for the portfolio and for quality growth going forward.

And Turkey we actually deprioritised a little bit earlier than Ukraine and as a result we are shaping our infrastructure in the market. We're refocusing our efforts in the market. But we're still positioned in the market if the economic environment and dynamics change. So it's quite an active strategy.

Oliver Tant – *Chief Financial Officer*

I think, Adam, this is a clear demonstration of capital allocation in practice.

Alison Cooper – *Chief Executive*

It is, yes.

Oliver Tant – *Chief Financial Officer*

We are doing exactly as we said on the tin. There are certain markets which in the short term don't offer the same attractive value proposition. We are growing in Algeria. We are growing in the U.S. We are growing a series of markets where we see much better opportunity. We are putting investors' money to work in the best way that we can in the current circumstances. And as Alison says, we are not withdrawing from markets. We are simply taking a more holistic view.

Adam Spielman - Citi

Okay. Thank you. And a minor question. I noticed on your brand migrations you say you've got 95% consumer retention. Is there anything in that other than volume retention or am I just getting my microscope out too much?

Alison Cooper – *Chief Executive*

No. The way we look at this is we talk for short hand brand migrations, but in reality we are migrating consumers. And therefore our key metrics around migrations are to look at the consumers that we have of the brand when we go into the migration and have we retained those consumers when we come out at the other end of the migration. So that's the measure that we take. Now if you're sitting in a market where volumes have declined, maybe something extreme, at 50% in the meantime, then clearly you won't have helped volumes in migrating those consumers. But what you're looking to do is use share as the proxy, keep your share, because you are keeping the consumers in the brand.

Adam Spielman

Thank you.

Stephanie D'Ath - Bank of America

Hi. Stephanie, Bank of America. My first question please in on the market share in the U.S. The charts you were showing us with the volume - I think its volume share gains.

Alison Cooper – *Chief Executive*

That's right.

Stephanie D'Ath - Bank of America

Could you please put it in context from the value perspective? Do you believe you have been gaining share from a value perspective or have you gained the volume share thanks to promotions?

And my second question relates to how you split price and mix. So if we look at the volume on an organic basis, I think they were down about 9%. Your revenues were up 2.5%, I think, on an organic basis again. So excluding FX and excluding the scope impacts, what is mix and what is price and how do you expect those going forward? Thank you.

Alison Cooper – *Chief Executive*

Okay. In terms of the overall movement in the half on the Group price mix, and it will just be price mix as we don't split out price and mix, I can pick that up shortly. On the trends on share in overall value terms there will be an impact in terms of value share for Winston and Kool towards the back end of the period, because clearly there are buy downs associated with these brands. But I don't think that's a metric that's particularly pertinent, given the fact that we are implementing a new strategy for these brands in the market. This was part of our deal model and our investment case going into the U.S. And we knew when we went into these brands that it would be part of the strategy that we would deploy to grow the brands.

So it's not just about price. Yes, there are buy downs against them to make them competitive in the market which is one of our key learnings going into the deal. But also there's distribution now, 160,000 retailers, as I mentioned, signed up. We've got programmes in each of those retailers to get the brands visible in the first place, to actually get them merchandised and then also to put the buy downs behind the brands as well.

So this is a part of the whole cocktail of initiatives behind the brands to build steady, sustainable share growth in the market. And clearly there's an initial repositioning in terms of the value of those brands given those strategies, but over time that will build, as we increase prices in the market and build value through those brands too.

Oliver Tant – *Chief Financial Officer*

I'm not sure whether the price mix question was specific to the business as a whole or the U.S., but I'll answer both. The whole? Okay. Well, you may recall that we talked at the full year and at the previous half year in last year's numbers around the fact that our first half year, FY15, price mix was relatively weak with a much stronger volume performance and that we saw much of the price uplift in FY15 occurring in the second half. So when we look at the comparator in FY16 we are obviously starting from a relatively low comparator in terms of the delta.

I think in addition to that we have the impact of greater volume from the US which has a much better mix impact and we've lost volume from Iraq/Syria where the revenue per stick is significantly lower. So you can see a mix factor which is having a significant influence on overall price mix as well.

I'd add to that two specifics, one of which is that we've made comments on the progress of blu and the IP revenue associated with the blu asset. We've seen good, strong revenue development. We have no denominator in terms of number of sticks in our price mix numbers, so that is price mix enhancing in terms of the overall number.

And also as far as the U.S. is concerned, we engaged in a destock in the first half of last year and therefore we've got some benefit as a consequence of the nature of the SKUs that we were destocking in advance of the acquisition completing and focusing on our ongoing focus brand portfolio which is having an impact as well.

So you have a combination of things which drive that significant and positive price mix equation.

Stephanie D'Ath - Bank of America

I have one more question. On plain packaging, if I understand well, you are expected to implement in the U.K. from 20 May this year. So when you do a launch, like the JPS one you mentioned, crushball, does that mean that this launch will move to plain packing very shortly? And in practicality how is that happening?

Alison Cooper – *Chief Executive*

The JPS crushball launch? Well, at the moment we're waiting to see what happens in mid-May in the U.K. because we're not quite clear what's going to happen either from an EUTPD or plain pack perspective in the U.K., given the various challenges that are sitting out there at the moment, although we are preparing for the implementation. Crushball is an opportunity just to get some more interest around the brand and to build some consumer equity around the brand in the short term. That's the focus of it.

Eddy Hargreaves - Canaccord

Hi. It's Eddy Hargreaves at Canaccord. A couple of questions.

One on the U.S. You were very clear when you made the acquisition that you would reinvest all cost savings in that business. Could you just confirm that has been the case in the period you have just reported and is the quantum of the savings that you are seeing as expected when you did the deal? How much more is there to generate?

And then the second question is on blu where you've said that you are the number two player in the market in both the U.S. and the U.K. Could you say what your shares actually are in both of those markets, please?

Alison Cooper *– Chief Executive*

Okay. On the U.S. overall it's very much in line with the deal model. As you might remember, we had quite a lot of time to refine the model through the waiting time that we had. And therefore, our view on the synergies, the reinvestment of those synergies is very much in line with what we planned and it's all been reinvested in the first half. We intend to do that in second half. And in fact there is a little bit more investment going into the second half, as we put some more equity initiatives behind Winston as well. But that's all built into and in line with our expectations for delivery this year.

Matthew Phillips - *Chief Development Officer*

In terms of value share it's roughly 20% of the U.S. market and roughly 16% of the U.K. market.

It's very confusing in terms of how this gets reported because some people report volume, some people report value. And what no one reports is actually the couponing that a lot of the manufacturers are actually putting through. We are not. But that doesn't sit in the value numbers. And so therefore, when you actually get down to the profitability of the different players, it's hugely different because the couponing is going on. To give you an example, one of the offers in the market at the moment is the $6.99 retail price which a coupon gets you $5.99 off that. So you only pay $1. But what gets reported in terms of the value share is $6.99.

Chris Wickham - Whitman Howard

Thank you. Chris Wickham from Whitman Howard. Just going on there while we're still with blu, obviously we get some quite good news sometimes coming out in terms of authoritative comments like the news we had from the RCP giving a big tick last week. But at the same time, the regulations seem to be looking to get tighter, TV advertising. And then just local observations about where and when you can vape and how that gets caught up into the whole cigarette regulation and rules at a local level. I'm just wondering where we are now within the whole debate? What constraint the potential for blu and the segment moving forward and whether or not there is a tipping point? When do we get to that tipping and what actually does the tipping point comprise?

And also when you talk about your own company, you talk in terms of total tobacco. I was wondering to what extent you actually think total nicotine rather than total tobacco?

Matthew Phillips - *Chief Development Officer*

We heard an interesting point in the regulatory debates. As you rightly say, the U.K. authorities in particular have come out with a lot of evidence finally, trying to pull together a lot of the different scientific studies that have been done. And they've looked at arguments like gateway as an example which you may be familiar with, which people have used as a fear reason not to look favourably on this as category. And they've dismissed that as being relevant. So finally we've got some evidence, scientific evidence, which is emerging in the category.

I would also, if you're interested, Fontem yesterday launched a website called FontemScience.com which you can go and have a look at a lot of the science that we've been working on. So you've got the emerging science on the one hand and you've still got fear and opinion sitting in other places, which is fear of the unknown. That's what led it to be regulated as a category in a tobacco mind-set a number of years ago as this category was emerging. I think both the FDA and the EU are saddled is perhaps the wrong word, but have a tobacco regulation framework, but actually are recognising that this is a different category and therefore should it be regulated differently to traditional tobacco. Mitch Zeller, the FDA head said a couple of weeks ago that this is a golden opportunity from a public health perspective and that actually both the industry and the FDA needed to find a way to regulate it. But actually, as he describes it, pulmonary delivery of nicotine in a non-combustible format is a really important health opportunity for the health community.

So we are at a bit of a crossroad. I think the science is improving massively around e-vapour and therefore we've got a regulatory opportunity primarily because it is a non-tobacco product. And I think that is a big difference in a regulator's mind.

Jon Leinster - Berenberg

Thanks. Jon Leinster, Berenberg. A few questions.

First of all, in terms of the U.K. market has there been any noticeable change in the behaviour of Philip Morris following them becoming independent?

Secondly, with regard to, and as you've mentioned, the turmoil in the market or churn in the market, is there going to be any significant changes particularly with the ban of packs under 20? Is that likely to cause any changes in the price points?

And the U.K. is it clear when the menthol ban is going to come into effect?

And lastly, at the Q1, I think you said the price mix for the year is going to be about plus 6, which I presume is against plus 10 in the first half. So is that likely to be stronger than that for the full year?

Alison Cooper – *Chief Executive*

If I look at the U.K. market, I mentioned the sub-economy segment which we have been investing in our position, and if you remember we came from quite a low share of that segment and we wanted to very much gain our fair share. And I mentioned that Player is now the key brand in that segment. So that part of the strategy is working for us but it continues to be a very, very active segment. Philip Morris in particular with Chesterfield are very active in that segment currently and with some new launches.

But the interesting thing about that segment is it also involves quite a lot of pack sizes that are below 20. So this is also part of the churn we're going to see going forward, as we have to move to 20s being the minimum pack size, because of EUTPD. Quite how that's going to play out in terms of price points and consumer choices in the market who have been used to paying the lower sum but for a 17s or 18s packet of cigarettes. And roughly 25% of the U.K. market is in pack sizes lower than 20. So it gives you a feel for whether you want to see it as a risk. We prefer to see it as an opportunity. But those consumers are going to have to make some different choices as we move to packs of 20 over the next 12 months in the market.

Jon Leinster - Berenberg

Sorry, does that ban come in straight away on 20 May?

Alison Cooper ***– Chief Executive***

Manufacturing has to cease on 20 May. So clearly there can be quite a significant amount of activity in the market still over the next 12 months. Market clearance for most markets in the EU will be within the 12 months after that manufacturing cessation.

On fine cut as well there's going to be quite significant churn, as the small pack sizes in the U.K., below 30 grams, are very prevalent around 70% of the market. So quite a lot of consumer choices to be made within that and opportunities.

Matt, can I just ask you on the menthol please? Have you got the timeline?

Matthew Phillips - ***Chief Development Officer***

I need to double check. I think its May 2020, but I'll need to double check. As far as I know.

Alison Cooper ***– Chief Executive***

And on price mix our guidance still stands of around the underlying 5% to 6% price mix for the full year.

Jon Leinster - Berenberg

But that's against 10 in the first half?

Alison Cooper ***– Chief Executive***

Yes.

Jon Leinster - Berenberg

So not in the second half?

Alison Cooper ***– Chief Executive***

No. We'll see weaker price mix in the second half.

Oliver Tant – ***Chief Financial Officer***

One needs to bear in mind the fact that we are obviously lapping the U.S. acquisition, so an element of it is mix. We are also lapping the impact of Iraq/Syria coming out. So you've got two items which have in part driven the period delta in the first half which don't apply in the second half.

Jon Leinster - Berenberg

But clearly BATs and PMI are certainly suggesting from a total market perspective, although there's differences in time and differences in terms of U.S., non-U.S., there's an accelerated price as we go through 2016, whereas you seem to suggest the exact opposite.

Alison Cooper – *Chief Executive*

Yes, but we've got the other factors in the mix around the U.S., around Iraq and Syria, also we've got the PMI contract coming out. There's a few other factors. It might be worth you going through the details with the IR team. It's not that we have a different view on the price aspect of the equation, those are weighed slightly differently given our year-end being 30 September, but there are other factors in the mix that we can take you through that Oliver has alluded to.

Chas Manso - Societe Generale

Yes. Chas Manso, SocGen. On the 50 basis points of market share decline ex U.S., could you give us some colour about how much of that is down to the markets where you're deliberately defocusing? And I think you've said grow, defend and let go, so if we put those in the let go, what's your organic market share in the grow and defend?

On plain packaging, has there been any trade loading by retailers ahead of the looming May manufacturing deadline and if so, by how much?

Thirdly, you mentioned some interesting things on brand names in France. Could you perhaps detail those?

And finally, on the cost saving programme, £70m to go over the next two years obviously implies a slowdown in the realisation of cost savings. Should we just put that in or should we expect further cost saving programmes? Thank you.

Alison Cooper – *Chief Executive*

Okay. Let's kick off with the market share. The biggest factor in terms of our market share shortfall is Russia and that's due to the fact that I outlined around the Maxim price differential disadvantage which with Russia, when you've got a price disadvantage, it's take quite a while to fix in the market, which is why it's taken a bit of a lag to come through. But that's now been fixed and is actually meaning we're stabilising share in the market. So Russia is very much an improving situation after that temporary disadvantage.

And then, to be honest, it's bits. So it includes the bits of the various markets that I mentioned that we're letting go. But it also includes some of the pressure on our U.K. market share currently that I mentioned as well within that. But the biggest bit, just because of its sheer volume size and therefore weighting in the calculation, is Russia.

On plain packs I don't think there's anything we've seen significantly or EUTPD in terms of trade loading currently. It's a manufacturing deadline, if you remember, in May, not a sell-to-market deadline, because you've got market clear-out a year later. So there's not a particular incentive for the trade to load necessarily.

Brand names in France, I knew I wish I hadn't mentioned that, but I'll let Matt comment on it.

Matthew Phillips - *Chief Development Officer*

Yes. I don't know how much has been said publicly, so I'll be slightly circumspect. But the French Ministry of Health has started interpreting what it sees as the EUTPD and coming to, I think, slightly more extreme views in terms of brand names and brand descriptors and lifestyle connotations of certain brand names than perhaps anyone had been anticipating. The legality of it, I think, is a completely different question. At the moment it's the thought process of the Department of Health.

Alison Cooper – *Chief Executive*

And on the cost saving programme, yes, another £70m to go. That doesn't mean we stop thinking and looking at opportunities from a cost perspective. I mentioned briefly as part of my comment on brand migrations how we are looking at the next stage of simplification for the business. It's something you may have seen in other FMCG businesses when you really do look to crunch down the number of SKUs and therefore look at not only benefits from a cost efficiency perspective but actually then look at opportunities to, as I called it, grow the head, which is then very much around that you put more focus behind the SKUs with retail and with your initiative programmes, then you'll look to therefore get accelerated growth within those particular SKUs. So that's the next phase of the programme and I suspect we'll spend a little bit more time on that in early June.

Simon Hales - Barclays

Yes. Thanks. It's Simon Hales from Barclays. Two questions, please.

Can we just go back to transactional FX when you've reiterated your 3% headwind for the full year? Is it too early to think about FY17 given the movements we've seen in the rouble recently? Should we be thinking about some benefit there or will it just be captured in normal margin moves next year? Is there any reason why I should not be more optimistic about FY17 outlook from a transactional FX standpoint?

And secondly, just in terms of the new retail agreements in the U.S., 160,000 retailers now signed up, I think that's a 10,000 increase on where you were at the Q1 stage. What rate should we expect going forward or are we largely done now and we should expect the level of sign-up to really slow from here?

Alison Cooper – *Chief Executive*

Okay. Thank you. Oliver, transaction FX.

Oliver Tant – *Chief Financial Officer*

I think clearly the prognosis for the rouble is an interesting one. We've seen some part recovery on that of late which has been beneficial. But actually the core of this particular issue relates to the U.S. dollar input costs into our Russian and Ukrainian factories and the fact that a lot of the stocks that we're buying into those environments have a relatively long lead time. So certainly, we should expect it to unwind but whether and how much impact it will have in the first half I think you can assume it will continue into the first half of next year.

Alison Cooper – ***Chief Executive***

And on the retail agreements, yes, we've been phenomenally successful in terms of getting retailers signed up. They've been very enthusiastic to support a third player in the market. But really the drive for that now is largely over. We're still working on MMC to build the agreements for that as well, the mass market cigar business. But I think roughly 160,000 is probably where we're going to level out, give or take a few.

Alison Cooper – ***Chief Executive***

Okay. If there aren't any more questions, thank you very much for joining us today and please pick up with our IR team if you've got any further questions that occur. And have a good rest of the day. Thank you. [End]