Credit Suisse Retail & Consumer Conference 2018

Imperial Brands fireside chat with Alan Erskine

Erskine: Well I'm delighted to welcome Alison Cooper CEO of Imperial Brands to our conference this morning and rather than give a presentation Alison has graciously agreed to submit to a gentle grilling by me.

Cooper: You didn't promise it would be gentle, it's good you say so now.

Erskine: Yes exactly, exactly. Hopefully we'll cover most of the ground I know investors have been asking about but if not, I think we'll have some time at the end to open it to the floor. So, Alison again welcome.

Cooper: It's great to be here.

Erskine: If I may I'm going to cut to the chase with my first question. Imperial shares have fallen actually nearly 40% in the last 12 months despite the company continuing to deliver solid earnings growth, I mean on the assumption that you don't think the market is being rational what are people missing, what message has not been communicated effectively do you think:

Cooper: There's a lot of emotion around this as you can imagine both externally and internally and words you know like puzzled and irrational, really just quite frustrated feelings I think both from investors clearly, but also internally and from the board as well in terms of how the business is being perceived, so this is one where we spent a lot of time thinking about.

It does seem that we are in quite a spooked environment I think at the moment if that's not too colloquial way of describing it. We've got a concern I think that from a tobacco perspective the future for tobacco in a market like Japan is being almost 'copy pasted' on the world. I think at the same time there's the whole NGP dynamic how's that going to shape up going forward. I think that's created a very uncertain environment with some investors but I think from our perspective we find it an increasing disconnect with how we're seeing things from an Imperial Brands perspective. From a tobacco side, with the investments we did last year, our confidence is growing and we put out some positive indications on that at our AGM statement.

We've got a very exciting year with NGP as well so I think from my perspective I do find it puzzling. What else can I do I think beyond delivering against what we said we're going to do in 18. I'll keep on communicating so any chance I get to talk to people about what's going on in the business, that's an opportunity I seize and really just trying to get the understanding out there.

In particular I think the cash point has been my most recent example of why I think people are really losing the plot around what's going on at Imperial, cash for us is absolutely not an issue. I suspect we may come onto talking a little bit more about that later but we're in a very strong cash position and the uncertainties that seem to be out there around our cash delivery and dividend support going forward are really completely unfounded.

This is something that sits in my head day in and day out in terms of how we fix for this but there is very much a disconnect between our confidence internally and the level of confidence externally, I've just got to keep working on fixing for that.

Erskine: I guess one of the big factors is NGP and reduce risk nicotine products, what do you think are going to be the critical success factors as this category develops because I guess it's still really in its infancy in many respects?

Cooper: We have a really big ambition at Imperial and we really do think we're in a great place to capitalise on that given our position from a combustible cigarette perspective where we only have roughly 13-14% share. It is a very important area for us go after and to be successful there is much around consumer conversion and getting the consumer experience right which means you can really move consumers, many of which aren't already ours from a tobacco perspective.

We're been focused on providing a superb consumer experience in EVP, it's something we've been working on over the last few years with the assets that we've pulled together. We're really looking to provide not only the delivery, the device and the technical aspects that everybody seems to focus on in this space but also the brand connection, the emotion and the route to consumer. If you get all of those experiences right then you can recruit the consumers and it's that recruitment that is really is where the credible success factor sits and then absolutely you will make money; I talk about really solving for the consumer experience but at the same time clearly solving for making money.

We've got some great innovations in that space, we already make money in the US, but can add to that and further improve our profitability going forward.

Erskine: Well yes at a very simplistic level one perception is that it's all about who's got the deepest pockets you know you're perceived to come up short against PMI and BAT I mean presumably you don't think it's just a question of throwing money at it?

Cooper: I think that's a very big corporate dominate logic if I can describe it like that i.e. that you've really got to have billions of dollars to really succeed in this space and I think we can all think of plenty of examples where the winners in new technologies have not been the big dominant incumbents and we very much approach this as an opportunity for us as a smaller player to really do this differently and we are doing it differently.

We're looking at smart ways that we can execute, smart ways that we can invest, looking at leveraging different ways of connecting to the consumer to convert them. The cost of conversion of consumers is a very important metric for us, we really want that as low so are looking at asset light investment; we're not putting loads of money into capital and you know all of those things, the agility, the test and learn and scale, things I think you would find you know in a normal more start up growth type business are the things that we're leveraging to grow in this space.

We're really excited about the opportunity. We are investing, we've invested 400 million to the end of 17. We're doing another 300 million in the current year. We're not constrained from an investment perspective, but we are looking to really crack this space with an eye to returns which I think most investors would like to hear.

Erskine: One of the recent examples that contradicts this big is best approach is the phenomenal success of JUUL. Again, I think that has also sort of educated investors that maybe this isn't going to be the hedge money of the large guys, so what do you make of JUUL and what does that tell you about the barriers to entry that exist particularly in the vaping area?

Cooper: Yes JUUL as you say is a great example of a company that’s making some significant inroads into NGP but from nowhere and they have got certain aspects of the consumer experience that’s attractive currently in the EVP space and clearly we’ve crawled all over that as a case study and have got some learnings from it as well as you can imagine. But for us looking at the barriers, the technical barriers, this is something we are in very confident territory on. We started building an asset portfolio in this space several years ago, we’ve got the original IP that sits behind most vapour products out there currently.

We’ve got the stand out ‘real’ brand in the E-vapour space in blu and as you’ve probably seen over the years we’ve been acquiring additional bits of technology to build a proprietary consumer experience that we can leverage and for me this is the most important aspect of the barrier that we can build, it’s that innovative capability.

You’ll have seen we’ve brought a business called Nerudia a few months ago. They bring additional innovative capability for us. We held a blu event which you’ll be able to see some details of on our website where we talked about the innovations that we’re bringing into this space in flavours, in connectivity, in what we can do from a nicotine delivery perspective. All of these things really crack the consumer experience and drive that conversion but they’re proprietary, we’re building them and for me that’s the biggest barrier that we can build and have.

Erskine: I think it’s fascinating your Myblu product is actually very comparable to the JUUL product, yet I bet if you asked a lot of investors out there what multiple would you put on JUUL it would be a lot more than the nine times you’re trading on at the moment.

Cooper: I think that’s a great angle to explore.

Erskine: Now heated tobacco you’ve been slightly maybe half-hearted at going into that category can you explain why and what you think are the advantages you can bring and what sort of device are you thinking of launching?

Cooper: Yes, deliberately. Our position on heated tobacco is reflective of our view of the opportunity in that currently we’ve got 30 million EVP consumers in the world, 5 million heated tobacco consumers and if you look at the growth going forward in relation to our footprint the opportunity is very much about growth in E-vapour and not in heated tobacco and that’s a view I think shared with other people in this space as well.

So, we took a choice around EVP being the prime focus for what we wanted to do and that’s what we back. I believe we are pioneers in the EVP space. JUUL is getting some success currently. Myblu is a better proposition for consumers and the pipeline of initiatives we have is significant in terms of improving that consumer experience so we’re going to continue to pioneer in that space. We’re following in heated tobacco space and think it’s sensible to have something there. We’ve got several products there, we’re in consumer testing with those and we’ll have something in the stable should we choose to move forward with that.

Erskine: So maybe in those markets where heated tobacco does get some attraction you would want to have a representation?

Cooper: Yes. It's also important to remember in Japan that heated tobacco doesn't have EVP competition and I do think people forget that. Nicotine EVP is not allowed it's illegal in the Japanese market. You do find people who just vape non-nicotine and that's quite an interesting area to explore as well but you know heated tobacco in that market has run without EVP competition. If you move across to Italy where IQOS was launched at a very similar time to Japan with a very similar amount of attention and effort put behind it, EVP has been significantly present in that market. blu has a 40% market share, iQOS has not made the same inroads as it has done in Japan.

Erskine: This conference is looking at how the digital age is throwing up opportunities and threats for brand owners and how they connect with consumers can you maybe give us some examples of things you're doing in the digital sphere?

Cooper: Yes, it's quite strange isn't it to have a tobacco company at a digital conference isn't it, and shows how the worlds moving. This is for me really one of the exciting aspects of what we're doing in EVP. In tobacco, as you might imagine, we don't really do much in the digital space although we do have some quite strong digital businesses from a premium cigar perspective in the US particularly, so we have got experience but this has been a big capability build for us over the last year or so.

It' about smart execution with EVP because only roughly a third of EVP sales go through normal retail channels, a third through VAPE shops and a third online so it is an important skill set for us. It's important for margin; what you can do here is really build a connective consumer journey through 'omni channel', connect them to the brand, in the US we call it the 'blu nation', we build the 'blu nation' and look to build consumer loyalty, really interact with them, keep improving the consumer experience and with the connected device I mentioned earlier that we're going to introduce in the next 12 months, we'll be getting a lot more data from those consumers. For me it's a critical of our Blu strategy not only for conversion loyalty but then also for increasing the lifetime value of those consumers and building more value.

Erskine: And that's part of the investment you're making?

Cooper: It is although actually it's light investment; it's about getting the right capabilities to build in the space. So for example the guy who heads up this area for us in Blu and drives the overall strategy globally is from Nespresso. It's those capabilities, if you can get those on board you can drive this quite fast and quite economically.

Erskine: I'll look for George Clooney to urm…

Cooper: I think he's taken.

Erskine: So looking at your recent remuneration policy suggests you're looking to grow NGP revenues by 150% per annum over the next three years which if I've done my maths right would mean NGP could be as much as 12-15% of group revenues. Do you think that is the sort of trajectory you're looking for and what are the key milestones that will get you there?

Cooper: We spent some time with the board looking at this; we wanted to go for a big ambition so yes, it does max out at 150% compound growth over the next three years and that's aligned with internal targets that we're driving people to achieve. We've addressed it initially internally via a consumer recruitment target. We're looking one and half million consumers by the end of this year, four million next year and eight million the following year. Back to what I was saying before it's about consumer experience driving consumer conversion, really getting people to go after getting consumers into our eco system, interacting with them and building that loyalty.

Erskine: When do you get to that tipping point where you start to amortise those investment costs across a big enough revenue base to start to make some decent money?

Cooper: We have a very strong eye on that. There's a couple of things that need fixing for. One is around the fact that the retail margins are too high and this space the way it's developed over the last few years. That's a key area of work for us. Traditional retails is only about a third of where the market sits so clearly if we can drive acquisition to other channels that helps too, but getting that margin down is important.

The biggest driver though for gross margin is this new innovation that we have that takes the number of components down in the E-vapour device it takes it down to three key components, in doing that it allows you therefore to automate quite cheaply and in doing that it provides a 70% reduction in cost of goods.

Scale is obviously also important; then of course through the P&L you get the benefits of the A&P and overheads normalising over time and we can see a 40-45% operating margin as being very achievable. I think one point worth making people don't realise we already make money in the US, so we already have a profit model that works in the US which we can add to as we put these further innovations in although that takes a little bit of time because of FDA in the US.

Erskine: And one of the things that PMI and BAT have both experienced is capacity constraints and probably even more than they expected, and I mean as you see out to your top line aspirations are you comfortable that the capacity can meet those aspirations?

Cooper: Yes it's a very hot topic this one, in fact we've got a further team session on it on Friday, but we are clear that we are planning for success and very significant capacity over the next couple of years. We do this via a partnership model so we work with third parties to deliver the capacity and that's very much something they're geared up to do. It's just a question of how to phase that and bring that on board but we have absolutely the capabilities and the partners to do it.

Erskine: And the lead time's reasonable?

Cooper: This is not tobacco lead times. Tobacco machines are around 25 million a throw and they take the best part of a year to come on line as you might imagine a tobacco machinery manufacturers at the moment have got fairly full books as well. It's a slow process in terms of lead times in tobacco, but this is a lot more agile.

Erskine: Well I think time to turn to the combustible business.

Cooper: Why not. As you were saying earlier 110% of our profit.

Erskine: Yes let's talk about it for a bit. It does feel like the in last 12 months or so we've seen a greater level of duty increases that we've seen historically particularly in some high volume markets and that seems to put some limits on the industry's ability to pricing. Now we've been here before there are good years and bad years is that how you would contextualise what's going on or do you think there's anything structural here?

Cooper: I think reading something macro or structural into this is not the right conclusion. 2017 was I think, as everybody in the industry highlighted, a particularly tough year for various reasons. Some of it was excise but it also reflected different competitor actions in markets as well. If you looked to the current markets like Saudi and France are specifics in terms of some quite significant excise increases.

I have to say I tend to focus on a more individual market basis. It's something that's very important to us, driving our priorities from a market perspective and where we invest for returns and therefore I think you know that focus is where you have to go in this environment so Saudi we're continuing to invest behind, there's been an excise increase it has had an impact but there is price increases coming through in Saudi as well and we still see that as a market with some good growth potential.

I'll be quite open France we've kind of backed off a bit really for the time being because there's a lot of nonsensical behaviour in that market currently and therefore we're prepared to let a little bit of share go to drive a bit more profitability. But in other we're taking price increases and growing share, our priority markets are performing well currently with the exception of France.

Erskine: And you mentioned earlier the investment you've put behind the combustible business in terms of marketplace investment particularly in your 10 priority markets, can you give us an idea of the specific things you've invested behind and also how should we measure success there, I mean you've seen some good market share performance should we now be ensuring that those are sustained is that going to be a key test?

Cooper: We did a lot of work on the brand portfolio over the last few years. We had a very fragmented portfolio but have progressed from about 50% of our asset brands in terms of net revenue to now 63-64%. That was a piece of work I very much wanted to see significantly progress before we stepped up investment. That investment last year was behind asset brands in what we refer to as the 'priority markets' i.e. the ones that are really important for our growth not only day to day but for the future.
That would include markets like the USA, like Germany and like Russia. We stepped up investment behind something we call our market repeatable model which is our go to market approach in combustible tobacco. That's about; getting the right portfolio in market and making sure we've got a strong parity price positioning with competition. But then also the bit which I think is more our point of difference in Imperial is how we engage with the trade and how we really leverage distribution in the market. Some of the investment was equity investment, some of it was in relation to getting our brands back on price parity with competition in a market.

That resulted last year in 7 of our priority markets being in market share growth in 2017. We're making sure we maintain that momentum. It doesn't have to be big investment to be clear because in some of these markets we've got very big shares and we don't want to be too aggressive from a share perspective.

It's now about the top line growth which is ultimately what we're fixing for with this investment. You saw that coming through, beginning to at the back end of last year. We highlighted H1 would be a tougher first half because of comparatives but as we come through to a half year results you will see some of the momentum coming through on that and very much being delivered in the second half.

Erskine: Now you mentioned the US I mean the acquisition of the Lorillard assets has been a fantastic deal and realising meaningful synergies and lots of cash but as we look out further how do you think you can deliver profitable growth against what seems to be a more competitive background if vaping is growing and there's concern that maybe you know Altria in particular might use some of its tax break to try and grab some market share how do you seen that dynamic playing out in the US?

Cooper: I've got to at least pause for two seconds and you know remind myself what a great deal that was. I have to say you know without being you too self-congratulatory, it was a phenomenal deal when you look at some of other acquisitions being done in the tobacco space at fairly significant multiples.

We're over 10% post-tax ROIC in the first year with the US asset deal. We've continued to grow, we grew profits by 10% last year constant currency, 22% actual currency, it has been a phenomenal deal for us. Kool & Winston are the key assets that we've continued to focus and invest behind. We're in a strong position in the US from a tobacco perspective with a 9% cigarette share. Competitively to be honest it's been a very competitive market for years, significant investment is put behind the cigarette market and Altria and Reynolds continue to do that.

So yes we'll keep an eye on it but they're clearly also both bothered about delivering profit as well so I think it's a competitive market we're used to. I think the bigger opportunity for us with 9% of this market is what we're doing in the EVP space and I'm really excited myblu is in the market. We've got a fantastic opportunity here and as I said earlier we already make money from it - it's additive to the business and you know mass market cigars, premium cigars are also a nice bit of the portfolio but the prime focus is that EVP opportunity.

Erskine: And that was a particular synergy wasn't it that with the mass market cigars and the Lorillard sales force?

Cooper: It was absolutely stunning because our mass market cigars business you might remember was not in great shape at the time we brought this business and the Lorillard guys I have to say initially were "well do we really have to deal with this one as well" and we said it kind of makes sense you know. They just got on the case and turned the business around and last year was absolutely fantastic in terms of both share growth, revenue growth and profit growth.

Erskine: And staying the US the FDA is back in the headlines again with the latest development I mean it would be interesting to hear your perspective and you know I guess some people are getting a bit nervous about the FDA unilaterally banning menthol or unilaterally announcing some big reduction in nicotine, how do you see… what do you think is the FDA's end game and how do you see that playing out?

Cooper: First of all the FDA as a regulator is one of the more refreshing regulators globally as it actually looks at evidence, whereas in other countries it's clearly a much more of a political play than evidence based. We are being very positive about these moves by the FDA to move the world on from 2007.

Ever since they were announced last summer for some reason the market thought it was a bad idea but we're actually incredibly positive about it. I think whatever they do on tobacco they've already kicked off the consultation. That's something we feel we can work with and participate in. Whatever the outcomes are, in the rest of the world nicotine levels are already significantly lower. I think the opportunity that they recognise is risk continuum and how they're now placing and talking about EVP I really see as very exciting in terms of how we can therefore position and grow our EVP business going forward.

Overall we feel very positive about the moves and keen to see how this is going to develop but it will take time. You mentioned menthol, menthol was kicked off I don't know how many years ago now the best part of decade and we're still not there.

Erskine: I'd like to ask you about timeline because obviously we're still at a discussion document stage and there's plenty of consultation and perhaps even legal challenges along the way I mean what sort of time frame would you be looking at and also within that risk continuum I mean the FDA I don't think is the body that will decide how vaping for example what duty levels might apply to vaping I mean how do you think that process will evolve as well?

Cooper: The timings are not clear but we know it does take time. I saw estimates from someone yesterday of 8 to 10 years for example. I think we can all speculate on exactly how long but it is going to take time and as you say there's going to be various responses and debates through that consultation as well.

Erskine: Again you mentioned earlier cashflow I mean this year the cashflow is depressed a little bit by some NGP investment and restructuring but at what point I mean unless you disagree I don't think your cashflow is going to be growing at 10% per annum so at what point would you start to look again at the commitment to the 10% dividend growth and how do you see that playing out?

Cooper: The board clearly does keep that under review. I think it's important to put the relative amounts we're talking about into context here with the amount of free cashflow we generate which has been on average around 800 million for each of the last three years versus the increment of the dividends - 10% dividend growth is about 150 million. You don't have to have your free cashflow growing at 10% to support the dividend growth of 10%.

If I look at where we are now from a balance sheet perspective leverage is now at three times and that's very much getting within the tram rails we talked about i.e. two to three times post the US deal. We've deleveraged quite rapidly post that. We're at 64% dividend pay-out ratio and have got head room. The board will keep it under review and make sure we're looking at how we're really allocating those returns to investors but for the time being there's no concern about delivering the dividend.

Erskine: Like you say you've got a decent maturity on your debt at well so you're not sort of hostage to short term.

Cooper: No we do, we do absolutely.

Erskine: Given where the valuation is I mean are there other ways that you look maybe to unlock value for shareholders, you know we talked about the dividend but I don't share buy-backs, trying to sell something that just illustrates the value within the portfolio, I mean I saw what JT paid for a Russian business I'm sure you've business that would fit in terms of that sort of group, how widely are you thinking about you know just to demonstrate the value that's hidden in the business?

Cooper: Capital allocation is something that's very much on my and the board's agenda.

We talked very much about our focus on the important markets for Imperial, the important products for Imperial, the importance of EVP for Imperial. As you keep sharpening that focus I clearly there are things that fit more and things that fit less within our overall asset portfolio. You may have seen this morning something quite small but it's the US Other Tobacco (OTP) assets that we've sold.

That's part of our ongoing review. It is a small example but we're absolutely looking at opportunities as we sharpen our focus behind things we think are really important for our future success. Clearly there are things we can; whether that's invest further behind new growth opportunities with NGP or there's clearly returns to shareholders to look at as well. I see us with various options in this space but an absolute focus on capital allocation.

Erskine: At this point I'm just going to throw out if there's any questions in the audience at this stage?

Q: With interest rates going up your share price having gone down the relative merits of dividends versus buy-back have shifted materially, are you flexible enough that you don't see it as a climb down if you had to say okay forget the 10% dividend growth we're going to buy-back shares because that's the you know when the facts change I change sort of thing?

Cooper: We are absolutely flexible in our thinking. I think what we've got to appreciate though that we've got investors who are invested in Imperial for income. Only six months ago we were talking about when we got below the three times net debt to EBITDA and the discussion was about being in a cash rich position i.e. what are you going to be doing with that cash; quite ironic considering how some of the debates are working out at the moment.

There's very differing views with investors around the buy-back piece and therefore it is something as we move forward we keep as an open conversation item, we do keep it under review but currently I think there's an awful lot of people who are invested in us for that dividend and therefore it would take some consultation I think before we shifted off that but we always try and be flexible in our thinking.

Q: Alison how do you see the UK market potentially playing out from a regulatory perspective and thinking particularly about the NGP category sort of post Brexit there being I would say very limiting regulations particularly on nicotine content placed on the industry, how do you see that developing you know are you potentially one of the sectors that actually do benefit in a post Brexit world?

Cooper: I'd probably have to think a little bit more around Brexit type implications for NGP and EVP in the UK I can't see any particularly significant things that are going to change it dramatically currently.

UK consumers are used to lower nicotine levels anyway because of the regulation around. What we're bringing to market in the next few months is a nicotine formulation and a nicotine salt that we've tuned for the throat hit for consumers as well which I think will be significant in terms of the consumer experience in this market. I feel we've got plenty we can do. I think what is incredibly positive in the UK though is the government attitude to E-vapour and you've got Public Health England out there talking about it being 95% safer than cigarettes, you've got them putting adverts out during Stoptober telling consumers to stop smoking and to take up vaping; advocating it. I think the environment for us therefore from a vapour perspective in the UK is a positive. Myblu has just been launched, it's getting some good traction, I think it's going to be a very exciting market for us for E-vapour.

Erskine: Where are we in the UK combustible market because we've seen quite a bit of dislocation around the EUTPD and quite a lot of downtrading, are we sort of coming out the other side of that?

Cooper: We are coming out the other side now. You may remember there was a lot of disruption in the UK market not only from the disruption from EUTPD where tens were banned but also there was a lot of competitor activity prior to EUTPD with low prices in the market. I think we are coming out post the EUTPD, we're used now to the 20 pack sizes and the 30 grams plus in terms of RYO. The overall environment in terms of excise is still quite a considerable but we successfully saw the introduction of an MET (minimum excise tax) in the market so that's really helped as well in terms of just making sure that we see profit opportunities. We're growing share and is now pulling out from that EUTPD implementation.

Erskine: So share momentum has continued?

Cooper: Share momentum has continued in the UK.

Erskine: Okay we have time for one last question.

Q: On M&A - combustible M&A has been very successful for you and for other players in the industry, as we are you know moving towards more of an NGP world do you think combustible M&AE is therefore less likely because people are really trying to solve NGP problems?

Cooper: I think there's clearly interest in tobacco assets, as we've only seen this week in terms of the Donskoy acquisition. From our perspective we are much more focussed on opportunities in the NGP space. We've brought a number of small things. You can get some real little gems particularly from an IP perspective that really do take the agenda forward, they don't have to be particularly costly and we did a deal this week with Cosmic Fog which is one of the major vape liquid players in the US and in a number of markets around the world. That again just adds something to our flavour capability, our vape capability more generally, so it's those sorts of things we tend to be looking at. They add to our asset base and our experience. I think for us it is more of a focus than tobacco deals. We have some quite strong financial disciplines around our tobacco deals which would maybe put us in a slightly different arena in terms of price we're willing to pay.

Erskine: Super. Okay with that I hope you'll join me in thanking Alison for her time and her insight, thank you very much.

Cooper: Thank you everyone.