Half Year results

30 April 2013

Alison Cooper, Chief Executive

Good morning. I'm Alison Cooper, Chief Executive. I'm here with Finance Director Bob Dyrbus and other members of the senior management team.

Disclaimer

HY13 Results: Context

Early in the year we said this wouldn't be a pretty set of results and as you'll have seen from the RNS these numbers are well below our usual standard.

We flagged that profits would be second half weighted. We expect to grow full year earnings per share in line with our earnings model, albeit at the lower end given the difficult operating environment.

We're going to talk you through the main factors that have affected our results and give you some colour around how we're managing them to deliver the full year and position ourselves for growth in 2014.

In the first half we delivered on our strategy with some good performances across our total tobacco portfolio, achieving further growth from our key strategic brands, fine cut tobaccos, cigars and smokeless products.

And from a footprint perspective we delivered some good EU results in the UK and Germany and made further progress in a number of emerging markets in our Rest of World region, particularly across Asia-Pacific, and Africa and the Middle East.

This has been offset by the following factors.

HY13 Results: Context

First, weakness in the EU is materially impacting market sizes and there are no signs that this is ameliorating.

Outside the EU, Russia and the USA have clouded good results in Asia-Pacific, and Africa and the Middle East, compounded by reduced trade stocks in some markets.

Following recent excise changes in Russia, the market is declining and the value segment is shrinking, which is impacting our share and in the US we continue to transition to our new cigarette pricing strategy.

Investment was higher than in the first half of last year across the Group and a large chunk of this was in Russia and the US.

These were the main headwinds in the first half; we're taking a number of actions in line with our strategy to address them and strengthen the sustainability of the business.

In the EU, that's about building on a robust performance. Our total tobacco focus meant that EU profits were down just 2 per cent, an encouraging result given the deteriorating conditions. Portfolio initiatives, pricing and cost optimisation will support profit delivery in the second half and into 2014.

In Russia the focus continues to be on driving quality growth from our key strategic brands, supported by investments and portfolio initiatives to address current trends.

In the US we're focused on strengthening our position with our sales growth drivers, embedding the new pricing strategy and progressing portfolio and customer engagement initiatives.

The actions we're taking in Russia and the US should deliver improved performance in the second half.

We see many opportunities for growth outside the EU, including in Asia-Pacific and Africa and the Middle East, where we'll be building on good first half performances.

The second half will also benefit from lapping the higher investment levels that began in the second half of 2012 as well as an initial £30 million saving from our cost optimisation programme.

So, some context for today's presentation; I'll now handover to Bob to go through the financials.

Bob Dyrbus, Finance Director

HY13 Results: Overview

Thanks Alison and good morning everyone. As usual, my comments relate to constant currency performance.

Our overall revenue and volume results have been impacted by the factors Alison highlighted but we're still driving momentum behind our total tobacco offerings.

Our key strategic brands aren't immune from the tough environment but their equity strength and international reach resulted in net revenue growth of 5 per cent and volume growth of 1 per cent.

Our fine cut tobacco performance was excellent, with revenues up 10 per cent and volumes up 9 per cent.

Adjusted operating profit declined 5 per cent, reflecting reduced revenues and increased investment behind our sales growth strategy.

Our tobacco adjusted operating margin was around 41 per cent.

EPS declined 2 per cent, also reflecting a lower interest cost and the benefit of our share buyback programme.

Including the impact of FX, EPS declined 3 per cent in part due to around 10 million pounds of negative FX on leaf purchases. If current FX rates prevail we estimate the negative impact of this at the year-end to be in the region of 40 million pounds.

We've increased the interim dividend by 11 per cent and bought back 295 million pounds worth of shares as part of our annualised 500 million pound buy-back programme.

I'll now give you more detail around the factors affecting our results from a market perspective.

Footprint: EU

EU markets have been impacted by market size declines due to austerity measures, which have affected disposable incomes.

Unemployment is rising – now at almost 11 per cent across the EU – and over 27 per cent in Spain.

We've also seen some marked increases in illicit trade. In the 2012 calendar year, non-duty paid volumes increased in many EU markets and a significant proportion of this was illicit tobacco.

Markets affected included the UK, Spain and France and there was a material increase in non-duty paid volumes in these markets in the first quarter of our 2013 financial year.

We've seen nothing to suggest this rise in illicit trade is easing and continue to work with authorities across the EU to tackle the supply of illegal tobacco.

In the EU we've continued to focus on balancing profit delivery and share performance.

We achieved good results in Germany, increasing our volumes, revenues, profits and market share. This was driven by growth in Gauloises Blondes, JPS and a number of fine cut tobacco brands.

Profits were up in the UK, driven by strong price/mix, and our cigarette share was stable.

In Spain and the Rest of EU, the impact of the macro factors was more pronounced and this significantly affected our performance.

In the EU consumers are still searching for value and we continued to capitalise on growth in fine cut tobacco across the region; volumes were up 9 per cent and we grew share in a number of markets.

Footprint: Non-EU

We delivered some good performances in emerging markets, although overall Non-EU net revenues and profits were impacted by Russia and the USA. We also continued to invest across the region to support growth.

Higher investment impacted our financial performance in the USA. Investment is supporting the new pricing strategy, as well as portfolio and customer engagement activities and in mass market cigar we're further focusing on portfolio initiatives to drive growth.

We delivered a good performance with our strategic brands in some Eastern European markets, particularly in the high growth queen size segment.

In Russia we've invested ahead of regulatory changes to support the development of our key strategic brands. The market's been impacted by recent excise changes – market volumes are declining and the value segment, where 75 per cent of our volumes sit, is declining faster, which is impacting our share.

In Africa and the Middle East we increased net revenues and grew volumes of our key strategic brands by 10 per cent.

Gauloises Blondes continues to perform well, increasing regional volumes by 7 per cent and we're driving good growth from Fine in our core African markets.

Profit growth in Turkey and Saudi Arabia was strong and we delivered very good results in Asia-Pacific, growing revenues and increasing volumes of our key strategic brands by 8 per cent.

West grew share in Taiwan and JPS continues to perform well in Australia; these brand performances supported profit and share growth in both markets.

It's now five months since plain packaging's been in place in Australia; so far we've seen no material impact on consumption and we've continued to grow share in both cigarette and fine cut tobacco.

Cash Conversion

Our cash conversion rate over the 12 month period to March was 63 per cent impacted by a negative working capital swing in logistics of 400 million pounds as excise flows were reduced following tobacco volume weakness in Spain, France and Italy.

Standalone tobacco cash conversion was in line with the previous 12 months, at around 75 per cent. We expect 80 to 100 per cent cash conversion for the full year, with our usual caveat around the potential impact of any material excise or price increases.

Financing and Logistics

Our closing adjusted net debt for this half was 11 billion pounds, up from 9.9 billion pounds at the end of March last year.

This was due to the negative working capital swing in logistics and tax paid, which was 300 million pounds higher as we settled some outstanding tax matters which last year allowed us to right back some provisions we had previously made. Foreign exchange and other was 200 million pounds higher than last year.

The net interest charge was 263 million pounds; our average all-in cost of net debt was 5 per cent and our tax rate was in line with our expectations at 23 per cent.

In logistics, adjusted operating profit declined 1 per cent – a good result given the current environment. Costs saving initiatives and price increases have offset market volume declines in tobacco logistics and in non-tobacco we made further efficiency gains in our transport business.

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

Alison Cooper, Chief Executive.

Total tobacco is a key strength in the current environment; our consumer insights continue to drive investment priorities and the sustainable development of our brands and products.

I'll now give you an overview of our portfolio results and highlight the initiatives we're implementing to build on our growth record.

I'll start with the key strategic brands.

Building Brands – Key Strategic Brands

Maximising the potential of our key strategic brands remains a priority. Despite the difficult environment, we've again added to the track record of growth these brands have achieved in recent years, increasing revenues by 5 per cent and volumes by 1 per cent.

These four brands account for 32 per cent of our total volumes – that's more than 100 billion sticks on an annual basis and we're focused on growing this further.

Davidoff continues to perform well in a number of EU markets, including Germany, Italy and Greece.

Davidoff was impacted by reduced trade stocks in Eastern Europe but grew share in the core markets of Russia and Ukraine and is generating very good results in

Turkey, where volumes were up by almost 30 per cent.

We increased volumes of Gauloises Blondes, with good growth in Africa and the Middle East where regional volumes were up 7 per cent. Gauloises was also a key driver of our overall cigarette share growth in Germany.

West made good share gains in Africa & Middle East and Asia-Pacific, although the brand performed less well in Eastern Europe, largely as a result of increased competition in Azerbaijan.

JPS volumes grew as we strengthened the brand's share in markets such as Australia, Germany and the UK.

JPS is doing a great job at hitting the right consumer needs and trends in the current environment.

JPS: The Total Tobacco Brand

JPS is the total tobacco brand, meeting a range of consumer needs through an extensive line of products and formats across cigarette and fine cut tobacco.

Our focus on generating sustainable growth has increased volumes to over 25 billion stick equivalents on an annual basis and JPS is now the fifth largest tobacco brand within its EU footprint.

Innovation in key growth segments has underpinned the brand's performance and we're building on this with the launch of the first expanded natural tobacco make-your-own product in Germany and Austria.

We see plenty of opportunities for further growth in Western Europe and Australasia, where consumers are seeking a high quality, value for money smoking experience.

Building Brands – Fine Cut Tobacco

JPS was integral to our excellent performance in fine cut tobacco; revenues were up 10 per cent, volumes were up 9 per cent and we outperformed in the EU, where our volumes increased 9 per cent against the market being up by 7 per cent.

This was driven by gains in make-your-own, particularly in Spain with Ducados and Germany with JPS, Route 66 and Fairwind.

Our fine cut success was complemented by further good growth in papers and tubes, with volumes of both up by 3 per cent.

Building Brands – Premium Cigar

Our premium cigar division increased overall volumes by 3 per cent and emerging market volumes by an excellent 18 per cent.

Growth was particularly strong in Africa and the Middle East and the success of Montecristo Minis continues to support our growth across markets in Eastern Europe and Asia-Pacific.

Our US premium cigar portfolio is also performing well following a number of successful launches.

Building Brands – Smokeless

In Scandinavia we're driving further growth in our snus brands, increasing revenues by 31 per cent, volumes by 30 per cent and profits by 28 per cent.

Our share performance was also strong, particularly in Sweden where we're edging towards 9 per cent of the market, and with the strength of our snus portfolio we see further opportunities for growth.

Maximising Growth Opportunities

We continue to develop our portfolio strategy, focused on building total tobacco brands that truly resonate with consumers; brands that will deliver quality, sustainable growth across our footprint.

This slide will be familiar to those of you at our Investor Day; it breaks down the core components of our portfolio and shows the quality of growth we've been delivering on a compound three-year basis.

The volume and revenue growth we've achieved spans the total tobacco spectrum.

Maximising Growth Opportunities

And we've added to this track record of growth in the first half.

As we highlighted at the investor day, we're taking steps to address the box at the top right; this is not sustainable – it's undermining our quality of growth and we've undertaken a strategic portfolio review to drive clear portfolio priorities.

Clear Portfolio Priorities

I won't dwell on the key strategic brands – they've been performing well versus market trends, and we continue to focus on generating growth across our footprint.

We highlighted four additional brands for focus at our investor day, these focus brands have strong equity with consumers and will deliver volume and revenue growth on an aggregate basis.

And then there are the portfolio brands, these are brands with variable equity. Some are performing well, others aren't. The good performers generate consistent returns, others need nurturing to boost performance and a number will be migrated into key strategic or focus brands to reduce complexity.

Focus Brands

We've assigned 'focus brand status' to a number of other brands since the investor day, including USA Gold and a new international value brand Parker and Simpson, or P&S.

We've also confirmed three specialist fine cut tobacco focus brands: Golden Virginia, Drum and Route 66.

Key Strategic and Focus Brands

Our key strategic and focus brands generate high returns and represent nearly 50 per cent of our total stick equivalent volumes.

Collectively, these brands will drive sustainable volume and revenue growth. The contribution of each brand will vary but on an aggregate basis, volumes and revenues will increase and we're investing in initiatives to support this growth.

You can see some of them on the next few slides.

Key Brand Initiatives

We've been active with all four key strategic brands.

In May we'll start rolling out a global rejuvenation of Davidoff to reinforce the brand's premium credentials and we've also rejuvenated West. Again, this is a global brand initiative. The new-look West was recently launched in Russia and Poland, and more markets will follow in the second half.

And we're continuing to support our queen size formats in Eastern Europe; this is a high growth segment in which we have strong representation with Davidoff, Gauloises Blondes and West.

Key Brand Initiatives

Natural tobacco is another high growth segment where we're performing well. Gauloises and JPS natural tobacco have added to our growth momentum in Germany and we're building on this by making these products available in more markets, including France and Austria.

And we've also been investing in the development of our focus brands here you can see some examples – a GlideTec variant for News, a new design for Lambert & Butler, a rejuvenation of Golden Virginia Green and gv 'born in Britain', a new addition to the Golden Virginia franchise.

Lambert & Butler has just gone into the UK market and gv will follow next week.

All these initiatives will strengthen our ability to drive growth in the second half and into the new financial year.

Cost Optimisation

As we outlined at the Investor Day, our top line focus is supported by the work we're doing to optimise our cost base.

Our cost programme is aligned with our strategic portfolio and footprint priorities, and provides optimisation opportunities in two core areas: product cost and overheads.

The programme will deliver savings of £300 million a year by September 2018.

Cost Optimisation

Cost optimisation starts with the right portfolio.

Our portfolio priorities drive many opportunities for increased efficiency. There are opportunities to reduce complexity and product cost, to optimise overheads and to focus our initiatives and investments.

Product cost opportunities include reviewing manufacturing capacity and implementing enhanced best practice across our operations.

In overheads, there are significant opportunities through procurement and refining our operating model.

There are also opportunities to proactively reduce inefficient trade stocks. This will increase our supply agility around portfolio, innovation and pricing initiatives as well as enhance trade relationships, which supports our customer engagement strategies.

In terms of the breakdown, we expect around 45 per cent to come from simplifying product complexity and around 55 per cent from reducing overheads.

We've charged over 20 million pounds within restructuring costs in the first half and expect to charge an additional 100 million pounds in the second half.

We currently expect the cash cost of the programme to be in the region of 600 million pounds and expect a cash outflow of around 50 million pounds this year.

We'll keep you up to speed on our progress and will provide another update in our Q3 IMS.

2013 H2 Drivers

The initial £30 million savings from the cost programme will support our earnings delivery in the second half this, combined with the initiatives we're driving and investment step-up slowing, will enable us to navigate the current headwinds.

In the EU, our total tobacco strength, pricing and cost benefits should result in an improved performance in the second half.

Outside the EU, we've had Russia and the US masking good performances in Africa and the Middle East and Asia-Pacific.

As I've said – in Russia it's about leveraging the key strategic brands and wider portfolio initiatives to address volume pressures and in the US, the focus is on the sales growth drivers to strengthen our position in core states, embedding the new pricing strategy, supported by portfolio and customer engagement initiatives.

Creating Sustainable Shareholder Value

Looking beyond 2013, the environment reinforces the strategic choices we're making to maximise the potential of our key assets and drive long-term growth.

Top line growth maybe tougher in the short term but total tobacco offers us more opportunities to build momentum behind our brands and products, supported by our focus on cost and cash.

Effective cash management supports our ability to grow; we have opportunities on interest and we keep tax under review.

Some benefits of the cost programme will be realised in the short term; the bulk will come through over the coming years and the focus is very much on simplifying and strengthening the business – reducing complexity and overheads, and targeting investments to support growth.

We've had great success with our total tobacco approach in recent years; we're now applying our expertise to a wider group of focus brands and optimising the broader portfolio.

The footprint is what it is; we've talked you through the issues and we can't control the environment but we can control, shape and adapt the portfolio to succeed in this environment.

Our focus on maximising sales, cost and cash opportunities gives us confidence in our ability to create sustainable value and grow dividends by at least 10 per cent over the medium term.

Thank you; we'll now take any questions you may have.

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