



BAT full-year 2016 results

Ben Stevens, FD

Q: What for you are the key financial highlights of these results?

A: I think these are an excellent set of results. Our net turnover organically is up by over 5% and our operating profit is up over 10%, if you strip out the adverse effect of transactional foreign exchange. Our operating margin is up 160 basis points on an underlying basis. Our earnings per share is up 19% and as a result of that we can reward our shareholders with a 10% growth in the dividend. Our operating cash flow conversion is up to 93% - 2 percentage points higher than it was last year. So altogether I think these are an outstanding set of results.

Q: You mentioned the foreign exchange markets, how much of an impact has the volatility in those markets had over the last year?

A: Well certainly Brexit had a major effect on sterling. So we were looking at an FX headwind for the first half of the year. This turned into a tailwind for the second half of the year. So overall, during the year we've got a 6% translational FX tailwind.

But of course on transactional FX it's more currencies against the dollar that count and we had a 6% headwind on transactional FX for the first half of the year and it was the same in the second half of the year so it came out at 6% headwind for the full year.

Margins

Q: How much of an impact is transactional FX having on margins, and what do you see is the outlook here for 2017?

A: Our underlying operating margin grew by 160 basis points which is a very, very good result. But of course we had to face the effect of transactional FX and that pulled operating margin down by 210 basis points. So the overall effect on operating margin, if you account for the transactional effects and the effect of our acquisition activity, there was a reported drop of 90 basis points. But underlying the growth was 160 basis points.

It's very early to talk about currency effects for the year 2017, but it looks at the moment as though, if currencies stay where they are, we'll be facing a transactional FX hit of around 2%.

Reynolds acquisition

Q: Can you outline the financial rationale and benefits of the Reynolds American deal?

A: Yes, I think the Reynolds American deal, if it's voted for by shareholders will prove to be an excellent deal for BAT. It covers its cost of capital in year five, it gives us mid-single digit earnings growth by year three. So financially it's a very strong deal. But it also gives us control of the Reynolds cashflow which we can put to use in terms of further growing and developing the BAT business.

So, all in all, I think this will be a very, very strong acquisition for BAT.

Q: With the Reynolds acquisition you will be taking on considerable debt. How will this be financed and how do you view the de-leveraging process that follows?

A: We're taking on a combination of bridging loans and debt. There will be £20 billion of bridging loans that we will re-finance in the debt capital markets over a period of time. We've got flexibility to do that when we think it's most appropriate. That means our net debt to EBITDA will be approaching four by the end of this year, but it comes down pretty quickly with the cash that we generate so we think we can take about half a turn off that each and every year.

Outlook

Q: You're increasing your dividend by 10% which means that your pay-out ratio will drop from 74% to 68%. What are your plans regarding future dividend policy and growth?

A: Our constant currency earnings growth is over 10% this year, so I think it's appropriate we reward our shareholders with a significant growth in the dividend, 10% growth in the dividend. That does have the effect of reducing our pay-out ratio back towards our long-term ratio of 65%. And we intend, even post the Reynolds deal, if it goes ahead, to maintain that 65% pay-out ratio.

Q: How do you see the outlook for 2017 overall?

A: I think the business will continue to perform very, very well. Performance I think in 2017 will be weighted towards the second half, much as it was in 2016. So it's a little bit early to be talking about currency yet, but if exchange rates stay where they are today it looks as though we will face something like a 2% hit on transactional FX but have a tailwind of around 9% on translational FX. And while trading conditions remain pretty tough out there, I'm still confident that we'll deliver another good year of earnings growth.

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in BAT's 2015 Annual Report, which may be obtained free of charge from BAT's website www.BAT.com and the proxy statement for Reynolds's 2016 Annual Meeting of Stockholders, which was filed with the SEC on March 23, 2016, Reynolds's annual report for the year ended December 31, 2016, which was filed on Form 10-K with the SEC on February 9, 2017 and Reynolds's Form 10-K/A, which is to be filed with the SEC on or before May 1, 2017 (such filings by Reynolds, collectively, "Reynolds SEC filings"). To the extent holdings of Reynolds securities by such parties have changed since the amounts contained in the Reynolds SEC filings, such changes have been or will be reflected on Statements of Change in Ownership on Form 4 filed with the SEC. Additional information regarding the interest of such parties will also be included in the materials that BAT intends to file with the SEC in connection with the Proposed Transaction. These documents (if and when available) may be obtained free of charge from the SEC's website <http://www.sec.gov>, or from BAT using the contact information above.

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