



British American Tobacco

Full-year results 2017

Interview with Nicandro Durante, CEO

2017 performance

Q: At the end of what's clearly been a busy year, how would you assess the performance of the business?

A: It was a great year for BAT. It was a transformational year for us. We not only delivered the financial numbers but we also delivered the biggest deal in tobacco history, the Reynolds American acquisition.

If you look at the numbers, the reported numbers, volume is up 3.2%, profit 40% and EPS 600%, of course, driven by the acquisition.

It was a great year in NGP [Next Generation Products] as well. I think that I have explained before but our launches in 2017 are working quite well. In vaping, mainly driven by acquisitions, we grew revenue 30%. In the case of THP [Tobacco Heating Products] we launched in six markets last year. The one that we have launched before, Japan, we still have supply constraints, but the brand is going from strength to strength. In January our market share was 4.1%, four months after the national launch in Japan. So a great year.

If you look at the underlying numbers, profit was up 3.7%, EPS constant rates almost 10% - 9.9% - and EPS at current 14.9%, the dividend is up 15%. It shows our commitment to continue to deliver value to our shareholders.

Markets

Q: It looks like price mix in 2017 was softer than it was the year before. Can you take us through that dynamic in a bit more detail?

A: You have to look at price mix in the year, because it's always the big question that we have in our results. Price mix this year was around 5.5%. If you look at the price mix over the last three years, which has been on average 5.6%, you'll see it was par, it was not that [much] lower. Also, this is the high end of our strategic metric. So, it was a good year in price mix.

I understand the question because if you look at 2016 in which price mix was 6.7%, there is a decline. There are good reasons for that. The first one is that we saw some absorption in excise in some markets. There was a competitive price environment in places like Russia, Italy and France.

The second reason is that we had some substantial excise increases in 2016 that reflected in 2017, in places like Brazil, in places like Pakistan and Malaysia.

The third reason for that, we had a substantial excise increase in GCC [Gulf Cooperation Council] after many years without an excise increase, with double price in GCC in the middle of the year and you saw a decline in the turnover in that part of the world.

On top of this, the majority of last year's launches in terms of THP, was toward the second half, the end of the year. You'll see the revenues growing in 2018.

Global Drive Brands

Q: The Global Drive Brands continue to take market share. Are you satisfied with their performance?

A: We had another great year for the GDBs. As you'll know, our strategy has been based on the growth of our GDBs, that is driving our corporate share. This year was no different. GDBs grew 110 basis points, which was the main reason for the corporate share to go up 40 basis points. A great performance.

If you look across the brands, Dunhill had another great year. It held its share in premium, but you have to consider that the whole premium segment has suffered as the down-trade occurred in many markets. The biggest markets for Dunhill, markets such as Brazil, Indonesia and Malaysia, we saw a substantial down-trading. That's why Dunhill lost 10 basis points. But I think that was a good performance for the brand in this kind of environment.

The other four Global Drive Brands - Kent, Lucky Strike, Pall Mall and Rothmans - had a fantastic performance this year. All of them grew segment share and overall market share. So, I'm very happy with their performance and I welcome the drive brands for Reynolds American that will make our portfolio even stronger.

Reynolds Acquisition

Q: How has Reynolds American performed?

A: I'm very happy with Reynolds American performance. If you look at the volumes, it declined less than the industry. Profit is up. It was a good performance in profit terms as well. The market share, this second half performance, was really, really good. They didn't grow market share in the first half, but the second half performance was really good. Corporate share was 20 basis points up and driven by their local drive brands, that was 40 basis points up.

Integration is going extremely well, and the synergies are above our expectations. We expect a little bit less than we have achieved in the first year, that was \$70 million. So, all in all, it has been a good half year with Reynolds.

Q: Quite a few investors remain wary of the FDA and its regulation of the tobacco industry. What's your view on the regulatory environment in the US?

A: As you know, we had the announcement from the FDA about regulation of the tobacco industry in July last year and I think it was a very positive announcement for the industry. And the reason why I think that was so positive is because it was the first time there was a recognition from the FDA about the risk continuum of the products and accept the harm reduction of tobacco products and the role that harm reduction plays in tobacco products. So, I think that was quite an important announcement.

We welcomed engagement with the FDA as soon as they announced the ANPRM with the consultation process. We would be more than happy to engage and welcome the opportunity to do so. Next step, we will have the substantial equivalence application for glo that should go before the end of this month.

Next Generation Products

Q: It's been a few months since your investor day, when you set some ambitious targets for your Next Generation Business. How do you feel about those targets now?

A: I'm very optimistic about our Next Generation Products in BAT. I'm optimistic because I saw the results of 2017, that, as I said, were really good. And I see the pipeline that we have for 2018, what makes me very optimistic about NGP in BAT.

You look at Vapour, for example, we grew quite well in 2017. We had some good acquisitions in this part of our business and I think that we are well set up for 2018. We have two very important developments. One is ePen3, which we are already testing, the early results are really good. And we have Raptor to be launched in the second half of the year, as we said at investors day in October. So, since October, I think that we have a little bit more confidence in the pipeline that we have, because we are already testing the products.

In the case of THP, as I said, the results are, in my opinion, stellar in Japan. We have a significant supply constraint across the THP space. In Japan and in other markets, for example, we are supplying one device per store per week and we got 4.1% market share nationally in Japan in January, four months after the national launch, which I think is fantastic. If you compare this to [the city of] Sendai, for example, after six months with three devices per store per week, we had 8% market share. It just shows the potential when you lift the supply constraints that we have.

That should happen in the second quarter of the year and that's why we said at investors day that the launches are going to be concentrated in the other markets towards the second half of this year. We are going at least for 14 new markets in the second half of the year, because the supply constraint, as I said, is going to be lifted during the second quarter. I'm very optimistic about the targets we gave, a target to ourselves of £500

million turnover in 2017. We met it and for 2018 we said £1 billion. I expect that it is going to be more than that, so I'm very optimistic about 2018.

Outlook

Q: So overall, how do you see the outlook for 2018?

A: If you start with volume, I think that the volume decline for 2018 is going to be similar to the one in 2017. If you take tobacco plus THP, I think that the industry should be declining around 3.5% but I expect, as has happened in the last seven years, that BAT do better than the market. Why? Because we are growing market share, our brands are in a very good position in all the categories. Not only in THP or combustible but also in vaping. So, I expect a better volume performance in 2018 for BAT than the industry. Price mix? We remain competitive, but some of the pressures that we had in 2017 probably will ease in 2018. So, I expect a little bit better price mix in general.

Looking in terms of the tax reform in the United States, that's a plus. We have a 6% benefit and we said that we are going to reinvest half of this in our business. And I also want to point out that profitability for 2018, because of the NGP investments, because of the pattern of market investment, is going to be skewed to the second half of the year. So, all in all, I am confident, that we will keep delivering high single figure earnings growth to our shareholders, as we have delivered in the last 10 years.

Interview with Ben Stevens, FD

Financial performance

Q: What are the key financial highlights of these full year results? Is the business performing as you expected?

A: I think these are an excellent set of results in a transformational year for BAT. Obviously, the acquisition of Reynolds has had a big impact on the reported results, but if you strip out the acquisition of Reynolds and you strip out the effects of currency, we've got turnover growing at 3%. We've got profit growing at 4%. We've got earnings per share growing at 10%. We've got the effect of currency added back, that's a 15% growth in earnings per share and a 15% growth in dividend, which demonstrates, I think, the confidence we have in the future of the business. Of course, all of these results have been achieved whilst investing very significant amounts of money in Next Generation Products.

Q: What impact has the volatility in the FX markets had over the last year?

A: Well, things have quietened down in terms of transactional FX. We had about a 1% headwind in terms of transactional FX in 2017 and we're looking at a similar sort of level for 2018.

In terms of translational FX, we've had a tailwind in these results. At earnings level it's about a 5% tailwind and at operating profit level it's about a 6% tailwind.

Q: Where are we today in terms of FX translation for 2018?

A: I think we're going to have a headwind this year if FX rates stay where they are today. Obviously, FX rates can move and it's very early in the year. But if the levels stayed exactly where they are today then we would have a headwind at earnings level of about 7% and a headwind at operating profit level of about 9%.

Margins

Q: You've grown underlying margin again this year, but can you continue to deliver margin improvement in the current environment and with significant investment to make in Next Generation Products?

A: Yes, I'm very pleased with the growth in operating margin this year. We're back to operating margin growth. Obviously, the Reynolds acquisition has had a significant effect on that, something like 250 basis points. But if you strip that out then we've had an underlying increase in operating margin of about 110 basis points. We've chosen to reinvest about 70 basis points of that in the investment behind Next Generation Products. But that still gives us an organic operating margin increase of about 40 basis points, which is just a whisker short of our 50-100 basis points a year.

Reynolds Acquisition

Q: From your perspective as Finance Director, how is the Reynolds acquisition performing?

A: The Reynolds acquisition is going very, very well. The integration benefits are on track. We've released about £70 million this year in terms of integration benefits and we're on track to deliver the £400 million that we've talked about when we made the acquisition. The acquisition's been earnings accretive this year and we're still on target to have about a 5% earnings accretion by the end of the third full year. Of course, the cut in the US tax rates has been a big benefit to BAT as well and has allowed us to increase our investment behind our Next Generation Products.

Financial outlook

Q: You've increased the dividend by over 15% and have remained above your 65% pay-out ratio.

A: Yes. We're moving to quarterly dividends and we wanted to make sure that our investors had the same dividend under the new quarterly dividend system as they would have had in the calendar year '18 under the old system. So, we will see the 65% pay-out ratio as something we'll gradually trend back towards over time. Of course, we see it as a floor, not a ceiling. So, if we do face a significant translational FX headwind then we'd move the pay-out ratio above 65% to make sure that our shareholders see a good increase in dividends in sterling terms.

Q: So, what's your financial outlook for the full year ahead?

A: I remain very confident of us producing another good set of results in 2018. We've got the benefit of the tax reduction in the US, we've said that will be about 6% accretive to earnings. About half of that we will let flow through to shareholders for returns now and half we'll reinvest in the business behind next generation products for longer-term returns for shareholders.

The business remains highly cash generative. So, our net debt to EBITDA on an annualised basis is about 4x at the end of this year and we see ourselves taking about half a turn off that each and every year, until we get back to our long-term target of 1.5x to 2.5x net debt to EBITDA.

I think this business is in robust good health and I think we're going to have another very good year in 2018.

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