British American Tobacco

Full-year results 2017

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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