

## **BAT preliminary results 2014**

### **Interview with Nicandro Durante, CEO, and Ben Stevens, FD**

#### **Nicandro Durante, CEO**

##### **Group performance**

**Q: The trading environment in 2014 was quite tough for many consumer companies. How satisfied are you with the Group's performance in the year?**

A: Yes, I'm very satisfied with the performance. If you look at the numbers on a constant currency basis they were very, very good in my opinion, a very strong set of numbers. Revenue was up 2.8%, operating profit 4.4% and EPS almost 8%.

And if we look at our operating margin growth it was 50 basis points, considering that you have a transactional impact in our numbers. And BAT has decided to grow dividends 4% this year.

And if you see that our EPS was affected by translational - it was 4% down because of translation - it just shows how strong we think the numbers are and the sustainability of the business is. So very happy with the numbers.

**Q: And you had a good volume performance in 2014. Do you see this trend continuing given the economic backdrop?**

A: Well, if you see what's happened in the last years, industry volume has been down in the last couple of years around 3%. Last year it was down 2.5% and BAT was 1.4%. And the reason for that is that we have been growing share. That's something that has happened in the last four years, consecutive years. We are very happy with that.

I think that for 2015 we will see a similar decline that we saw in 2014, around 3%. And I'd like to highlight that the main reason for the decline is excise-driven price increase in the biggest markets in the industry, places like Russia, like Brazil. In the case of 2015 we also have South Korea.

So if we strip out these numbers from the volume decline we can take out another 1% - 1.5%. So the industry will be declining around 1% to 1.5%. I think that for 2015 BAT is going to do better than that because we have very good share momentum and I see no reasons for not continuing this good performance.

**Q: It was another good year for the GDBs. Can this continue at this current rate?**

A: Yes, it was a fantastic year for the GDBs, with growth around 6% and, more importantly, 90 basis points of share growth. It was really a vintage year for our GDBs.

And if you look at the performance of the five of them they were very good. You take Dunhill, for example, we grew Dunhill in terms of share of volume and, more importantly, we grew in the right places.

Brazil's performance was fantastic. Indonesia is doing extremely well. In Indonesia Dunhill Kretek has already 3 share points in the country and now we launch Dunhill full-flavour Kretek, it's doing very well. In Brazil we grew 1.5 share points in 2014.

You go to Rothmans, it has been a star of the year. We have this new segment growing Value for Money and you take our fair share of the growth of the segment it is really good. Good launch and the brand performing well.

Lucky Strike is back to growth this year in terms of volume and share with the performance mainly coming from the west European markets and Latin America.

And finally we have Pall Mall, strong performance, almost 6% volume growth. And Kent that had volume decline mainly driven by the industry decline in Russia and Romania, but the performance of the brand across the world has been good in Middle East and Japan, where we see the fastest-growing brand in the market.

**Q: Now at the third quarter you talked about the pricing environment becoming more competitive in the second half of 2014. What's it looking like for 2015?**

A: Well, price mix last year was around 4.2%. That's quite a decent number. So it was not bad at all. If you look at 2015 we have taken already 70% of the pricing that you were expecting for the year. It's a better start for the year that we had in 2014.

I think that the environment for pricing is better than the previous year. We still have some skirmishes in places like Australia, but in general it's a very good price environment.

**Q: And have you seen an acceleration in down trading globally?**

A: We saw consumers being squeezed in 2014. We saw disposal income coming down in several markets in the world and because of that we saw the Value for Money category growing.

When you see the industry is declining 2.5% and the Value for Money growing 2%, yes, there was some down trading. It's very difficult to talk on average. We have just this market by market. So there were markets that were up trading, markets that were down trading and markets in which you had a polarisation.

Places like in Brazil, for example, we saw the premium segment growing but the Value for Money segment growing as well and the middle being squeezed. But on average I think there was some down trading in 2014.

## Market performance

**Q: So can you talk through the performance in your key markets?**

**A:** Well, let me go region by region. Let me start by Americas. And in Americas I think that we had many stars. This was a region that grew market share. Brazil did extremely well.

Brazil was -- this is the last year in which you have an excise increase above inflation. It was a five year plan. This is the last year of the plan. Next year we will probably have excise moving according to inflation. And in spite of that Brazil performed extremely well.

In Canada we had the second year with profit growth in Canada. Share performance was good as well. And in Mexico we grew share in 2.6 share points last year. That's a fantastic performance from Mexico with good profit growth.

EMEA had a very good performance in 2014 and mainly driven by markets such as Russia, in which you have outstanding profit growth in Russia despite the tough economic environment there. And good share growth mainly driven by Lucky Strike and Rothmans, mainly Rothmans.

And then we go to Turkey. We have a share stabilisation in the market after many years of decline - good performance in Turkey. We had some headwinds in South Africa, some competition in the low-price segment.

We go to Asia. Asia also had a very, very good year. Japan did very well. Malaysia did very well. The transformation portfolio in Indonesia has been just great.

And we had, on the other hand, in Australia some price competition at the bottom of the market. As you are aware, I mentioned this last year. We had one competitor playing alone in the low-price segment.

With the size of excise and price increases that you had in the last couple of years the segment was growing. We had to participate on that. We launched Rothmans in the first half and after eight, nine months we have 9% market share. The company is back to growth - very happy with that. Unfortunately, the price is still not moving in the right direction.

And in the case of Europe good performance in Europe. I think that countries like France, UK, Poland they all grew in terms of share in each of the three. The region was declining a little bit in the year, 20 basis points, but you can see exit share of 2014 against exit share of 2013 was stable.

And you had good momentum in the last four to five months of the year. So I'm very optimistic about in 2015 in Western Europe. As you can see, we had very good performance in the majority of our key markets.

## Excise

**Q: And, as you say, you've had to take excise-driven price increases in 2014 in some of your key markets, so what are the prospects for excise rises in 2015?**

A: Well, I have not seen an increase in the numbers of excise shocks across the world in the last couple of years. If anything, we have less excise shocks now than we had in the past.

The issue that we face is that excise shocks are happening in the biggest markets that we have in terms of volume pool, places like Brazil, like Russia. And this year we have South Korea as well. On top of the tree we also have the Australia is in the third year of the 12.5% excise increase. So four markets that's the ones that we know so far.

So I haven't seen the increase in the numbers of excise shocks. It's just happening at the same time in huge volume pools or in huge profit pools like in Australia. That's why we are feeling it a little bit more.

## Outlook

**Q: So the company's delivered a good performance in difficult trading conditions and you've had big FX headwinds. Do you see this continuing in 2015?**

A: 2014 was a good year for BAT, a very good year from my point of view. The underlying growth of the business, the underlying performance of the business was good, was very good. As I said at the beginning, all the performance indicators were good.

We were impacted by currency, not only translational, but also in transactional side and I think this will repeat in 2015. If you take the spot rate today you see less of an impact that you have in the previous year, but also an impact, but I'm confident that you have all the capabilities in place in BAT, with our people, with our brands in order to deliver another good underlying performance.

[End]

## Ben Stevens, FD

### Financials

**Q: How do you view the financial performance for the full year?**

A: I'm very happy with the financial performance of British American Tobacco in 2014. 2014 was a pretty tough year for many, many companies, but we've performed extremely well.

So revenue at constant currency is up 3%, profits up 4% and earnings per share is up 8%. And on top of the translational exchange, of course, we had a transactional FX hit as well. And if you add that back to earnings per share it grew by 9.5%, which is right at the top of our guidance range.

**Q: At the interim results you talked about substantial FX headwinds. What kind of impact have you seen in the second half?**

A: Yes, at the interim results we said that if exchange rates stayed where they were then we'd face something like a 12% headwind and it's turned out to be pretty much the effect.

So FX has been significant in 2014 and I think it'll continue to be significant in 2015. Again, if rates stay where they are today it'll have an effect on EPS at the translational level of 5%, but also transactional FX will get worse as our hedges roll off for the year. And we're expecting a transactional FX hit of around 5% this year as well.

**Q: The results show a margin improvement of 50 basis points and this is at the lower end of your 50-100 basis points' range that you indicated. Are you satisfied with that performance?**

A: Yes. We guide people towards an operating margin improvement of 50-100 basis points per annum on average. We never promise it in any individual year. I think the 2014 increase in operating margin of 54 basis points is very good, actually, because the transactional FX obviously hits operating margin directly. Again, if you exclude for that we'd come in well over 100 basis points for the year.

## Cash and debt

**Q: How do you feel about operating cash and the strength of the balance sheet at the year end?**

A: BAT is a very cash-generative company. So if you look at our operating cash flow it was at the 90% level to our operating profit, which is where we like to keep it. Slightly low at the free cash flow level because of the asbestos settlement we had on Flintkote and the Fox River settlement. But these things are one-off that relate to non-tobacco businesses and very many years ago as well.

So if you take that out our free cash flow to adjusted earnings was very close to the 80% that we target for the year and that allowed us to maintain our credit rating.

**Q: Do you have any plans to restart your share buyback in 2015?**

A: No. When we announced our intention to invest in maintaining our shareholding in Reynolds American after the acquisition of Lorillard then we said we would reconsider starting our buyback in 2016.

Of course, since then we've announced that we may well be making an offer for the minorities in Souza Cruz and if that goes ahead and if it's fully completed I think we'll be reconsidering our buyback starting again in 2017.

**Q: Now based on current spot rates BAT is facing another year when FX means that sterling EPS growth is modest. And given the dividend payout ratio rose in 2014 are you comfortable with it rising again in 2015?**

A: Yes. We said at the start of the year when we were facing a big FX headwind that we would continue to increase the dividend in sterling terms and that's what has happened this year, as we're proposing a dividend increase of 4% and we certainly have both the balance sheet flexibility and the cash to keep increasing the dividend in sterling terms even if we face FX headwinds both in 2015 and beyond.

**Q: So how is 2015 looking for the business?**

A: Yes, I think 2015 will be a strong performance for British American Tobacco. Obviously, we face some difficulties in terms of foreign exchange.

And because our hedges will have rolled off during 2015 the transactional impact of foreign exchange if rates stay where they are - and of course that's very uncertain - will be in the region of 5% on operating profit and at translational level on EPS about 5% as well, so quite a significant headwind this year.

But underlying performance I think will remain very strong so I'm looking forward to 2015 with some confidence.

[End]

