BAT half-year 2016 results

Nicandro Durante, CEO

Half-Year Performance

Q: How would you characterise the business performance over the last six months?

A: We had a very good first six months of the year, a very strong performance, mainly driven by organic growth. Volume was up 3.4%. Organically, it was 2.1%, so very good performance in an industry that I believe will be declining around 2.5% for the full year.

This has been driven by good market share growth and outstanding performance for the GDBs. Our share growth in the first half was 30 basis points, on top of the 40 basis points of last year. From the financial point of view, we have during the first half of the year a very good performance in terms of EPS growth.

Current was 10.9% and constant, 13.4%. If you consider that you have a transactional headwind in these numbers, the result would be 19% EPS growth, which is a really, really good performance.

Q: And you continue to take market share. Will that continue into the second half?

A: I believe so. We are very optimistic, because what's happening in the market is all related to investments that we have made in our brands, through our innovations over the last few years. And we keep innovating, keep investing behind our portfolio. The GDBs, that's the main driver of our performance in terms of volume, have grown extremely well. We had in the first half growth of around 11%. - at 10.8% - that’s quite good growth.

But if you look at the five years' period, the last five years, the GDBs have grown 6% CAGR per annum, which is fantastic. They have added 500 basis points of share growth in five years, and all the brands have performed well. All the brands have grown share, all the brands have grown volume, with the exception of Pall Mall where volume declined a little bit because of industry wide declines where the brand is very strong, such as in Pakistan.

But the GDBs now, they are around 47% of our portfolio, so I'm very optimistic that we'll keep growing market share and keep performing well.

Q: And how would you describe the pricing environment and what's happening to the geographic and portfolio mix?

A: We have a good price environment nowadays. Last year, it was 6% price-mix. This year, the first half was 4%. We think that it's going to be a little bit better in the second half, but the 4% was mainly driven by geographic mix. We have been growing very fast in places in which you have lower margins, but good opportunities for the future, in places like Pakistan, Bangladesh, Ukraine. So you have some more geographic mix now than last year, around the double. But this will moderate in the second half of the year.

We have taken already 80% of the pricing for 2016, and the environment is very solid, so I think that you have good price-mix for the year.

Markets

Q: You talked a little bit about your key markets there. How are you performing across the regions and what's the trading environment like?

A: The trading environment is tough out there, I have to say, challenging economic conditions across the world, in developing markets and emerging markets as well. But in spite of that, we have done well.

If we go around the regions in places like Asia-Pacific region, Kent in Japan or Dunhill in Indonesia, they are really driving the growth of that vision.

We face some headwinds there in places like Malaysia because of the sizable excise increase we had at the end of last year, and we saw some growth of illicit trades. But overall, the region is performing well, very good share growth and very good numbers.

In Americas, it has been impacted by transactional headwinds, the same impact that we saw in EEMEA as well, but Americas we had a growth in GDBs of 14% in the first half of the year and good performance, despite the challenging economic conditions that we see in places like Brazil and Argentina. But overall, the region is doing quite well in Mexico, in Chile and some other countries, and in Canada and some other countries in the region. And EEMEA, very good performance in Eastern Europe, places like Russia, Kazakhstan, some other countries, even Ukraine. The company is recovering quite well, with good market share growth in Ukraine.

Turkey has done fantastically well, so good performance in the region in terms of share, profit and volume. Profit is impacted, as I said before, for transactional headwinds. Western Europe, it was probably one of the best performances that we had in Western Europe in the last years. Very good volume growth, very good profit growth.

In terms of share, it's stable, but showing good signs of growth for the second half of the year, and the stars of the region has been places like Romania, Poland, France and some other countries, so good performance overall.

Next Generation Products

Q: How much progress do you think you're making with the NGP category, and is it meeting your expectations? And what percentage of BAT revenues is this likely to represent going forward?

A: It's difficult for me to make a correlation now with the size of this category against tobacco, because it's still a very small category, but it's growing very fast. The rate of growth of these categories are around -- of vaping, for example, is around 20% to 30% per annum.

In 2013, vaping category was around GBP1.3 billion. In 2015, it's already GBP2 billion, so it's a fantastic growth. We took our time the last five years to develop a very good portfolio of products. If we look at the performance of our vaping portfolio, it's really, really fantastic. I'm very happy with that.

We have launched in five markets outside -- in Europe during 2016. And the performance so far, as I said, has been excellent. In France, for example, after two months of the launch, we have a retail share of 5%. In Germany, we have a retail share of 8%. In UK, that had been playing in this category a little bit longer, 9%.

The test market that we went through in Florence in Italy showed very good results. We're expanding to the country. And in places like Poland, with the acquisition of Chic, we have already 65% market share and the acquisition of Ten Motives in UK will strengthen our supply chain. So very happy with the vaping category. It's going to grow very fast, and we want to be leaders there.

The second category is tobacco-heating device. In this category, we have two platforms. The first platform is the iFuse. It is a hybrid product with a cigarette and a tobacco-heating device, and we launched in Romania a couple of months ago. The results are encouraging. We are going to expand distribution now for the whole country.

The product is performing very well, very optimistic, and we're going to roll out these for other countries in the next year. And we have a platform 2. It's an electronic heating device that will be ready for launch at the end of this year. We’re very optimistic. All the tests that we have gone through with this product shows that it's really an outstanding product.

So I'm very optimistic about this category. I think that BAT is going to be very well prepared with these two platforms to play in these markets. We are already developing generation twos and generation threes. So a strong pipeline behind those two categories.

And you have the licensed medicinal products that should be launching in the market in the next 12 months, as soon as we comply with very strict manufacturing regulations. So we are playing in the three categories. The consumers will decide at the end of the day which is going to be the biggest one.

Regulation

Q: Now the implementation of plain packaging is accelerating. What are the lessons from Australia? Do you think the risks in the UK, France and Ireland are any different?

A: In the case of Australia, it was implemented in December 2012. And I have to say that what we saw in the market is downtrading and we saw as well growth of illicit trades that I think in the case of illicit trade can be directly attributed to the plain packaging.

But in the case of downtrading, the main reason for that, I think that was sizable excise increases in Australia, and this has driven consumers to look for lower-price brands. That's the situation in Australia.

The Australian government came with a post-implementation review in the last couple of months after three years of the implementation. I think that they failed to demonstrate, any link with what's happening in the market and implementation of plain packaging.

In the case in UK, in the case of France, for example, just to give you two examples - in the case of UK, you have already 55% of the portfolio in low-price brands. So you want to have in UK the same impact in Australia. I'm not saying that it won't have any impact, but I don't think that it'll have the same impact as in Australia. And also, illicit trade is already a high number here because of location wise, the geography of UK inside Europe.

In France, the same. Illicit trade is already a high number and in France we have very small price gaps between segments. So I don't think you'll have the same kind of impact in those two markets.

Acquisitions

Q: Do you still see M&A adding further value to BAT?

A: No doubt about that. The only problem is that you find deals that are financially and strategically attractive. If indeed there are some there, we will be very interested. We had last year a very good ear on M&A in BAT. We invested more than GBP5 billion in deals like the tie up of Reynolds and Lorillard, keeping our 42% shareholding of that company. Minorities in Souza Cruz, the acquisition of TDR in the Balkans.

We had the acquisition of the two e-cigarette business, CHIC in Poland and Ten Motives in UK. As you can see by our EPS growth, M&A has been quite an important component of the results in the first half, so very successful so far. If there are any good deals out there, we would be interested.

Outlook

Q: The comps will be tougher for you in the second half, so how do you view the outlook?

A: We had a very good first half of the year, and as I said before, it was driven by organic growth. I think this organic growth, this organic performance of BAT in

the second half, will continue. We always said that profit growth would be more skewed to the second half, and this is going to happen.

So I believe that you are going to have another good second half of the year, despite all the challenges that you are facing across the world in terms of disposable income, rates of unemployment in big markets. But even though, I think that we will have a second half that will be strong and will meet our strategic goals.

Ben Stevens, Finance Director

Earnings

Q: What are the financial highlights to these half-year results and how do they compare to the same period last year?

A: Yes, these are an extremely good set of results. Not only is volume up, share up, the Global Drive Brands up, but our revenue has increased at constant currency rates by 8%. Our operating profit, if you take out the effect of transactional FX, has also increased by 8%, and our earnings per share will be up by 11%. So we're very, very pleased by the first half of this year.

Q: How much of an impact has the volatility in the FX markets had post-Brexit, and will this alter your guidance for the FX over the full year?

A: We had a 6% transactional headwind on operating profit in the first half of the year, and our major currencies haven't moved that much against the dollar and against the euro, plus the impact of hedges of course rolling off. So it looks like we'll have something like a 6% headwind from transactional FX on operating profit for the full year in 2016.

Things are a little bit different in terms of translation, where sterling is important. So because of the recent weakness in sterling, where we faced a 4% headwind on translation in the first half of the year, it looks like this will turn into a tailwind for the full year on operating profit of about 4% and at earnings level, probably around 6% tailwind for the full year 2016.

Margin

Q: How much of an impact has transactional ForEx had on margins and what's the outlook there?

A: Obviously, if you're facing a transactional FX headwind, then that's very difficult to grow operating margin, and we've seen that in the first half of this year. But the good news is that the underlying operating margin continues to grow, so we expect that by the time you've taken out differences in the nature of the business from the mergers and acquisitions that we've done during the course of the year and taken out the impact of transactional FX rates, our underlying operating margin has grown by about 50 basis points in the first half of this year.

Q: Now you've largely completed the rollout of your SAP system. What's left that will still drive margins then going forward.

A: Yes. We've still got to deploy SAP in Indonesia and in the new acquisitions in the Balkans. There's still a little bit more deployment of SAP to come, and we expect to go live in those markets on the 1st of January next year. Then of course, having deployed SAP, there's a lot of value we can then build into our shared service centres. So we're just starting, for example, building HR shared services on top of our financial shared service centres. So quite a lot to come in terms of the rule-based activity in BAT that we can put into our shared service centres.

And of course, there are other areas where we're looking to improve margin, as well. For example, in our factory footprint, where we've made some announcements recently.

Balance Sheet

Q: Now the dividend payout ratio is creeping up. Will that continue?

A: Yes, we've always said that the priority for us in terms of balance sheet usage is the dividend. We like to keep the dividend ticking ahead, even when we're facing a big FX headwind, which we have done for the last few years, and that's led the payout ratio to grow over the years. Now, as we see an FX tailwind coming, we've always said that we expect to pull back slightly on the payout ratio and return to what we see as a long-term sustainable payout ratio for the dividend, which is 65%.

Outlook

Q: Given the strength of the business and the volatility within the currency markets, how do you view the financial outlook?

A: Well, of course we delivered a very good set of results in the first half of the year, despite facing a 6% transactional FX headwind. That FX headwind will continue in the second half. But despite that, the business is performing extremely well, volume is growing, share is up and the Global Drive Brands are really driving the performance of the business.

Now, we've got some quite difficult markets, places like Brazil, Malaysia, pricing in Australia, so it's still a tough external environment out there, but I am confident that we will have a good set of results in 2016.

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