BAT full-year 2016 results

Nicandro Durante, CEO

2016 performance

Q: Let's start with the results. How would you assess the performance of the business over the year?

A: 2016 was a great year for BAT, as you can see from the numbers. We have delivered very good revenue growth of 7%, mainly driven by the corporate share gains that we had in the market. We had slight growth in volume and market share growth of 50 basis points, and also a very good price mix for the year of around 6.5%. So a very good year indeed.

The Global Drive Brands performed extremely well, 100 basis points growth, another 7.5% volume growth. Another outstanding year for our Global Drive Brands.

Profit-wise, very good, 10% in current terms, 4% in constant terms. And if we look at the EPS growth for this year it was nearly 19%. And 10% at constant [rates of exchange] was an excellent result and that's why we have decided to have a dividend increase this year following the EPS constant at 10%.

So, indeed, it was a great year for BAT.

Q: Are there any markets that you are particularly excited about, or indeed, concerned about?

A: In general, we had a great performance in all the four regions in BAT and that's why we had such a fantastic underlying performance. But if you go region by region, if you take Asia, for example, we had Japan, another year of share growth, an outstanding result in the Japanese business. Kent has performed extremely well there. South Asia, for example, Pakistan – share growth, profit growth, outstanding numbers. And I think in general Asia had a good performance. We had the downside of Malaysia this year because we had a huge excise increase at the end of 2015 and you had huge declines in volumes last year because illicit trade went up. But, in general, the region performed extremely well.

Americas, we cannot talk about Americas without talking about Brazil. It was another difficult year in Brazil because GDP was down. Disposable income in the country was coming down as well and I think that was a tough year for our business there. Despite that, we had a very good underlying performance in our portfolio. Our brand Dunhill was growing market share in a market that is declining, the premium segment, by 50 basis points. Lucky Strike had very good growth and our share in the ‘value for money’ segment has increased during the year. So it was good underlying performance for Souza in a tough environment.

Canada, another great year after many years in which we had some problems there in terms of profitability for that organisation. It was the fourth year of profit growth. And I could talk about other markets such as Chile, Venezuela, Central America. Good performance overall in a region that was under a lot of pressure in terms of the market economic environment.

In EMEA, we had another good year after an outstanding 2015. You take Russia, for example, share was up 140 basis points with very good profit growth. We were growing volume in a market that was declining. We had a great performance in Turkey, the third year in which we were growing market share strongly in Turkey. And then we had good performance in places like Ukraine. So very good indeed.

In Western Europe, a great year. We had share growth in Western Europe. [If you look exit against exit it was even better.] We had great performance in places like Germany, Romania and France.

So overall in BAT, it was a great year for the regions and the markets.

Q: You mentioned the performance of the Global Drive Brands. How confident are you that you can maintain growth here and continue to take market share?

A: Well, that's a question that we are asked all the time because the Global Drive Brands (GDB) have performed very well for a number of years. If you take, for example, 2010 to 2015, GDBs were growing around 6% per year. That’s in an industry that was declining around 2%, 3%, so a great performance and we did it again in 2016. GDBs were growing 7.5%, 100 basis points in a very difficult environment. The industry was down 3%, even though the GDBs had this kind of performance.

I think that we have the right brand portfolio there with Dunhill, Lucky Strike, Kent, Pall Mall and Rothmans to drive the growth forward based on a fantastic pipeline of innovations and we have a lot of things in our pipeline for the coming years.

So I'm very confident that the GDBs will continue to outperform the market.

Reynolds acquisition

Q: Last month you announced that you had reached agreement to acquire the remainder of Reynolds American that you don't already own. Can you

explain the rationale for going back into the United States, a market you effectively exited some 12 years ago?

A: Well, in reality, just to clarify, we never left the United States. We had 42% in Reynolds, so we always had a big share of that organisation and we followed Reynolds very closely. That was important for our results as an associate. So we never left the United States. But we thought that it was the right moment, from a strategic point of view and a financial point of view, to go back and make a bid for the remaining 58% that should go for approval for shareholders in the third quarter of this year.

I'm very happy, delighted, that the boards of both companies decided to support this deal which I think is going to be a fantastic deal for both sets of shareholders. It will open up for BAT the possibility to explore with our brands, with our Next Generation Products' pipeline, the United States and also have an opportunity to take some of their brands, some Next Generation Products' pipeline worldwide. So I think that is going to be a great deal for both sets of shareholders.

Next Generation Products

Q: Can you give us an update on your Next Generation Products? In particular, you recently launched glo in Japan, how is that going?

A: It is doing extremely well, above our expectation, to be very honest. We launched this in December (12th month), so 10 weeks ago. In 10 weeks in Sendai, Japan, in the biggest convenience store there, we have 5.4% market share. It is above what we were expecting, so extremely successful. In the second biggest convenience store, we are there for six weeks and we have 4.9% market share. Those two convenience stores, they are 40% of the volume of Sendai, so it is an outstanding start.

The consumers are enjoying the smoke experience of our products, the simplicity of the products and so on and so forth. There are so many reasons that they are enjoying the product and the reviews that we have, the insights that we have, are extremely positive.

We expect to roll this out to the whole of Japan, a national roll-out, in the second half of this year. I hope that's the beginning of the second half, not the end of the second half. We are making plans. We have some improvements already. There is going to be a version 1.2, so it's going to be an even better product that we have. We've learned a lot in terms of the marketing mix, in terms of the product. In spite of being extremely successful, we want to do better. We are already working on generation 2, 3, and 4. So we want to keep the pipeline going for the coming years.

In terms of vaping, BAT is now, after three years, the biggest vaping company in the world outside the United States. We have an overall 8% share in the top 14 markets. That's 90% of the volume and we are doing very well. We just launched the Vype Pebble in Italy and some other markets in Europe. The first feedback that we have had from the consumers is that the product is doing very well. So we are very excited with our pipeline in both categories.

Q: Looking ahead, what's your outlook for the Next Generation Products category in general?

A: We entered the category because we think that there is a lot of potential there, so it is going to grow. It's going to grow from a very low base. You take vaping, for example, the CPTO consumer price turnover of 2016 is 60% higher than 2015. It's a lower base, but it shows the potential and the growth. So nowadays, outside the United States, this is around $4 billion CPTO. It's very small for the whole tobacco business, but it's growing very fast. So I think that this is going to be an important category in the coming years, and I think that we are very well positioned with our portfolio in vaping and in tobacco hitting products to be successful there.

Outlook

Q: How do you see the outlook for 2017?

A: It's going to be challenging because the currency trading conditions are challenging, but we are going into 2017 with good momentum. We are growing market share across the world. We are coming from a position of strength. It is always better to face the new year in a position of strength. We have a very good pipeline in the combustible business, some innovations that are coming to the market. In NGP (Next Generation Products), we have been very successful with our test market in Sendai, with glo. Vaping is growing. So I think that you are going to have another good year in 2017. But it is going to be skewed to the second half of the year because we are investing and launching some of these brands, some of these innovations in the first half. So it's going to be skewed to the second half. But I think that we have the products and the pipeline to drive another year of good earnings growth to meet our strategic metrics.

Ben Stevens, FD

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

A: Yes, I think these are an excellent set of results. Turnover organically is up by over 5%, 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. And 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 a 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: Yes, 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 account for the transactional effect and the effect of our acquisition activity, there was are reported drop of 90 basis points. But underlying the growth of 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 rate of around 2%.

Reynolds acquisition

Q: Can you outline the financial rational 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 and 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 4 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 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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