



Full Year 2019 Results Briefing

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Operator

Hello and welcome to the BAT 2019 Preliminary Results presentation. Throughout the call, all participants will be in listen only mode. Please note that this call is being recorded. I will now hand over to Jack Bowles, the Chief Executive.

Jack Bowles, Chief Executive

Good morning everyone, I'm Jack Bowles, Chief Executive and with me this morning to present our Full Year 2019 results is Tadeu Marroco, our Group Finance Director.

Before I start the presentation, I will take it that you have all seen and read the disclaimer on page 2 and page 3.

As usual, at the end of the presentation, there will be an opportunity for you to ask questions.

Last March we set out three clear priorities to transform our business and I am pleased to say that we have made good progress over the last year.

We delivered value growth from our Combustible business, gaining share globally with enhanced profitability. We are driving a step change in New Categories by launching new products and entering new markets, providing potentially reduced risk products to close to 11 million consumers.

Lastly, in September we announced some important organisational changes, which are largely completed. We have removed a net 2,300 roles and recruited an additional 350 managers across the organisation, creating the capabilities and resources to continue investing in New Categories.

This marks a significant first step in the journey towards making BAT a stronger, simpler, faster organisation, better equipped for the future.

And this is just the beginning of our journey. Our purpose is clear; we aim to build a Better Tomorrow, by reducing the health impact of our business through offering a greater choice of enjoyable and less risky products.

Our 2019 results reflected a strong operational performance across all our key financial and strategic objectives. As you will have seen from this morning's announcement, reported results were impacted by a number of adjusting items, the majority of which were non-cash.

To help you better understand the key drivers of this strong operational performance, we will focus on constant currency adjusted results for the balance of the presentation, unless stated otherwise.

I am delighted to say that we delivered another year of high single figure earnings growth.

Revenue and profit were both at the upper end of our guidance ranges, while Group value and volume share both grew.



Operating margin increased alongside significant investment in New Categories.

Our strong New Category revenue growth was achieved despite the impact of the US vapour category slowdown. This demonstrates the strength of our long term multi category strategy.

Our strong focus on cash generation has supported delivery against our priority to reduce leverage.

We have announced a 3.6% increase in the dividend in line with our 65% payout ratio and our commitment to delivering shareholder returns and dividend growth in sterling terms.

This means we have delivered on all the commitments we set out last year.

In recent years, a key pillar for our value creation has been our approach to sustainability. The known health effects of the cigarettes we sell remain our biggest challenge. However, with the investments we are making to grow our New Category business we now have close to 11 million people using non-combustible products across 45 countries, including a leading 3.5 million consumers in the EU alone and this continues to grow.

Within our agricultural supply chain, we aim to deliver a positive social impact wherever we operate. We strive for excellence in the management of our environmental footprint and have made some good progress.

Since 2010, we have reduced overall carbon emissions by 24%, water withdrawn by 34% and reduced waste to landfill by 60%.

Finally, we strive to operate to high corporate governance standards.

The broad range of external recognition we have achieved over the years is a testament to our progress to date.

BAT was awarded the Organisational Impact Award in the SEAL 2019 Business Sustainability Awards, putting us in the world's top 50 sustainable companies.

2019 also marks the 18th consecutive year that BAT has been included in the Dow Jones Sustainability index, and in 2019 was the only company in our industry to have been included in the world index.

In summary, we have made a lot of progress; however we are aware that there is a more to do and I look forward to telling you more at our Capital Markets Day in March.

We are delivering on our three priorities and our results today reflect the good progress we have made in building a Better Tomorrow. It is clear that these results benefit from a very strong performance in combustibles, the continued growth of our New Category products and an organisation that is already faster, more efficient and simpler.

Starting with value growth in our combustibles business, revenue grew strongly, driven by value share gains, strong brands, good pricing and improved geographic mix.



Cigarette and THP volume was down 4.4%, reflecting the effects of the previously announced one-off stock reduction in Russia, and lower industry volume in a number of low value markets, including Egypt and Venezuela. Excluding these effects, BAT Group volume was down around 3%, in line with global industry volume.

Looking into 2020 we expect global industry volume to be down around 4%, with the increase reflecting large excise driven industry volume decline in Indonesia and Turkey.

In Combustibles, our strategic brand portfolio continued to perform very well, delivering revenue growth of 5.6% in 2019. Total Combustible volume and value share were up 20 basis points. This was driven by strategic brand portfolio volume share gains of 70 basis points, benefiting from migrations in Brazil and value share gains of 40 basis points.

This now marks the 8th consecutive year of Group volume share growth, reflecting a strong track record of superior consumer insights and innovation.

Our US strategic brands continue to strengthen their position with growth in all key value metrics.

We gained share at the corporate level, in premium and with adult smokers aged 21 to 30. At 44% our leading ASU30 share is well ahead of our corporate share of 35%, demonstrating the strong outlook of the business.

The growth in New Categories revenue was driven by our multi-category, multi-market approach. We grew more than 20% globally in each category, and delivered double digit growth across all geographic regions.

It is worth noting that New Category revenue growth excluding US vapour was up 39%. This is in line with guidance given at the half year before the US vapour market contracted.

In vapour, we strengthened our global position and delivered constant currency revenue growth of 23%, despite the turbulence in the market. We saw the category return to sequential growth in key markets in Q4 2019.

We welcome the FDA's recent actions to clarify US vapour market regulation, and support regulation that seeks to provide quality products for adult consumption.

We are well positioned ahead of the PMTA deadline in May, and look forward to its enforcement. We estimate a potential \$1.5bn of revenue will become contestable in the US, post the deadline. We are in a very strong position, and we expect the benefit to materialise in 2021.

Turning now to THP, the category grew at a slower rate than previous years, with Japan and South Korea still representing over 60% of the global market. Improved consumer satisfaction for this category will be the key to its future success, given the satisfaction gap relative to cigarettes.



Nevertheless, we continue to see good opportunities for THP in specific markets, mainly in markets with low cigarette strength delivery levels and where there are fewer tobacco and nicotine other alternatives.

As a result, our priority is to focus on improving the satisfaction levels of our products, and to prioritise our investment on selected markets where we identify the greatest opportunities for category growth.

Modern Oral is a small but exciting new category that is growing rapidly where it is present, with 70% of global volume outside the US.

We are a global leader - a global category leader with a volume share of 47%, with strong marketing and supply-chain capabilities.

So we are committed to delivering a Better Tomorrow, and we are excited by the opportunities in New Categories.

The regulatory environment is dynamic, as shown by the recent actions in Russia and Mexico, and the FDA's intervention on vapour.

With short term visibility a challenge, it is important to be agile and responsive. Annual growth rates are difficult to predict, yet we are clear on our ambition to achieve £5bn revenue from new categories in 2023/'24.

We must retain the investment flexibility to allocate resources as necessary. This allows us to be in a position of strength, to invest in the business or to adapt to developments, while delivering on our financial targets.

We are committed to delivering 3 to 5% revenue growth, and continued margin expansion, with the benefits of Quantum providing both the capabilities and efficiencies to support additional investment as required.

We are committed to delivering high single figure adjusted EPS growth and continued strong cash generation, to drive further deleverage and dividend growth.

Looking into 2020, while vapour markets are showing sequential recovery, they have yet to return to the levels reached prior to the US vapour slowdown.

While we cannot predict the duration and extent of the Coronavirus, we have already seen some impact on our duty free business and the first signs of New Category supply disruption at retailer level.

While these factors are unpredictable, this will make first half New Category revenue growth difficult, given the likelihood of growing out-of-stocks and delayed new product launches. Nevertheless, we do not expect this to impact our ability to deliver on our financial guidance.

So, in summary, we are performing well, delivering on our three priority areas. The opportunities in New Categories remain exciting. As we consolidate our New Category brands, we are committed to investing further and building the capabilities required.



Consumer and market insights clearly demonstrate that our multi-category strategy is key to delivering long-term sustainable growth. This is central to our ambition to create a Better Tomorrow.

I will now hand over to Tadeu, who will take you through 2019 in a little more detail.

Tadeu Marroco, Finance Director

Thank you Jack. As we said at the beginning of the presentation, in 2019 we have again delivered on our financial commitments. And we have done this while continuing to invest significant additional resources in our future.

Margin improvement of 50 basis points was delivered alongside an incremental £500m marketing investment in New Categories.

Strong free cash flow after dividends of £1.9bn exceeded our guidance of £1.5bn. This underscores our ability to sustainably grow the dividend, maintain a 65% dividend payout ratio, and simultaneously reduce our leverage by 0.4 times at constant rates.

Total revenue grew 5.6%, ahead of our guidance range of 3.5%, driven by the strong performance in Combustibles and our growth in New Categories.

Profit growth of 6.6% was also at the top end of our guidance range with growth in revenue and operating margin, driven by strong performances across our markets.

There was a good performance across the regions In APME, total revenue grew by more than 5% driven by good price mix and growth in New Categories.

Value share increased by 30 basis points, led by gains in Japan.

Profit from operations grew nearly 8% with strong growth in Japan and the Middle East alongside additional investment in New Categories.

In AMSSA, revenue was up over 9% and value share increased 20 basis points, with a particularly strong performance in South Africa, returning to volume, revenue and profit growth, with a reduction in illicit trade.

Profit from operations grew 10% driven by growth in Brazil, Canada, Chile, Nigeria and Mexico.

In ENA, revenue grew 5%, driven by strong pricing across the region. Cigarette value share was marginally higher with strong performances from Romania, Ukraine and Russia.

Profit from operations was up 3% with good results in Germany, Turkey, Romania and Poland offset by the impact of the stock reduction in Russia and additional investment in New Categories.



Turning to our largest region, the US. Performance was strong with revenue and profit from operations up over 4% and 6% respectively. This was driven by the combustible business which grew revenue nearly 4% reflecting good pricing and a reduction in discounting, supported by data analytics. This more than offset volume which was down 6% on a shipment to wholesale basis. This was against an industry down 5.3%.

Looking into 2020 we expect industry volume to be down around 5%, a slight improvement on 2019. This reflects the benefit of a reduction in the impact from the growth of vapour, largely offset by the impact of legislation raising the minimum age to purchase all tobacco products to 21.

Profit from operations grew more than 6% driven by good revenue growth and cost savings, offsetting increased marketing investment behind New Categories.

Following the acquisition of Reynolds, annualised synergies, mainly in procurement, R&D and overheads, of over \$400m have been delivered a year ahead of schedule.

Operating margin was up 100 basis points to 48.5%

In US vapour, Vuse grew value share and reclaimed the number 2 brand position in the market, strongly outperforming the industry in the second half.

In the second half, Vuse grew value share over 8 percentage points to 21.2% driven by the success of Alto with value share up over 12 percentage points to 15.4%.

Closed systems now represent 60% of the US vapour market.

Outside the US, we strengthened our leadership position in vapour. In ENA, vapour revenue was up 30%, driven by Vype which grew revenue 110%. We are growing volume and value share in all the established vaping markets including the UK, France and Germany.

In newer vapour markets, Vype became market leader in Hungary, the number one brand in Belgium, and is showing strong early progress in Spain.

Finally, we completed the acquisition of Twisp in South Africa in Q4. This strengthens our network across stores and e-commerce channels, and gives us market leadership in vapour in South Africa.

In THP, Q4 saw the launch of our three new Glo variants; Glo Pro, the first product to use induction heating technology, Glo Nano, a design upgrade replacing Glo mini, and Glo Sens, a hybrid product.

Glo Pro has shown good initial traction with consumers, driven by the benefits of its induction technology, with consumers highlighting the more satisfying product experience, boost function and faster ramp up as key benefits.



Regarding glo Sens, after an encouraging launch, we have seen less traction in consumer uptake than we had anticipated. We are improving our in-market execution, broadening device penetration, improving trial to conversion rates and implementing plans to drive better consumer uptake.

Overall THP revenue grew by 23% with consumables volume up 32%.

In Japan, we reached a record BAT volume share of total nicotine of 19.2% in January. THP category growth in Japan has fallen from 67% in 2018 to 6.5% in 2019 due to market saturation. In addition, competitive intensity has increased, with a proliferation of new product launches.

These market dynamics look set to continue as we move into 2020, with THP category growth in Japan expected to moderate further.

Despite this, glo's latest weekly total nicotine share is now up to 5.2%.

Elsewhere, in ENA, the THP category is still small with concentration in just three markets representing 57%. We are making steady progress from a low base.

Glo has demonstrated particular traction in Eastern Europe in generally lower tar markets.

Category share in the capital cities of Russia, Kazakhstan and Ukraine is now at 10%, 32%, and 10% respectively.

Moving on to Modern Oral. In ENA, which accounts for two thirds of the category worldwide, our Modern Oral revenue was up over 240%.

In Sweden, LYFT is the leading Modern oral brand with a 58% share of category and in Norway BAT is the fastest growing company in Modern Oral with a category share of 71%.

After only six months of launch, we are pleased with the performance of Velo in the US, having achieved 10% volume share of the Modern Oral category, and 29% share of the growing under-6 milligram category.

In 2019, the under-6 milligram segment reached 34% of the category up 6 percentage points.

Having focused our initial launch rollout in the Eastern States, to test and learn, we are pleased to see significantly higher share performances in this area. We are unconstrained with manufacturing capacity of 2 billion pouches. We have yet to fully activate national support plans and will redeploy the learnings from the initial launch in states.

In Atlanta, where all three categories are present, we see a strong development of Modern Oral and vapour, with very little traction for THP.

In the last six months our US business has grown share of total nicotine in Atlanta faster than nationally.



Moving on to operating margin which was up 50 basis points. The 300 basis point incremental New Category investment was focused on developing and launching new products, platforms and digital capabilities.

This helped us drive robust new category growth in 2019, and has also strengthened our platform to support growth in the years to come.

This incremental investment was more than offset by the 390 basis points of margin support. This was driven by pricing and improved geographic mix, gross margin expansion, SKU rationalisation.

Looking into 2020 and beyond, the benefits of Quantum mean that we will be able to continue to invest for the future, and deliver margin expansion.

A key highlight of the group's performance in 2019 was its strong cash generation, resulting in deleveraging of 0.5 times at current rates, and 0.4 times at constant rates in line with our guidance.

Free cash flow after dividends of £1.8bn at constant rates was driven by operating cash flow conversion of 97%, ahead of our medium term target of 90% or more.

At constant rates, adjusted net debt fell £0.8bn driven by our strong cash flow. This was despite £0.4bn of other cash and non-cash items, mainly hedging, and the recognition of a higher lease liability on adoption of IFRS 16, which added £0.6bn to net debt.

At current rates, adjusted net debt reduced by a further £0.9bn to £41.7bn due to FX translation, resulting from strengthening of sterling against the US dollar.

In 2020, gross capex is expected to be around £650m, in line with adjusted depreciation. We expect operating cash conversion to be in excess of 90% and remain committed to a 65% dividend payout ratio with growth in sterling terms, alongside continued de-leveraging of the balance sheet.

De-leveraging the balance sheet continues to be a priority. With current FX rates representing a headwind, we expect to drive adjusted net debt, adjusted EBITDA down to around 3.2 times at current rates by the end of the year, and then to below 3 times by the end 2021.

On a constant basis, adjusted diluted EPS grew 8.4%, delivering on our high single figure earnings growth commitment. Adjusted diluted EPS was up 9.1% at current rates.

Net finance costs at constant rates increased, mainly due to short term funding of working capital movements and interest on leases under IFRS 16. We expect net finance costs to be stable at around £1.5bn for 2020.

Associate income increased due to a good performance from ITC, which was further helped by the Indian Tax Reform. The underlying tax rate decreased from 26.4% in 2018 to 26.0% in 2019.



I would expect the underlying tax rate for 2020 to reduce further to around 25.5%. This, in combination with stable net finance costs, means that in 2020 we expect a similar benefit to EPS growth from items below operating profit.

We expect another year of high single figure constant currency earnings growth, with results, in particular New Category revenue growth, weighted to the second half.

Based on current foreign exchange rates, there would be a headwind of around 4% on earnings, if FX rates were to remain unchanged for the rest of the year.

Thank you, I will now pass back to Jack for his closing remarks

Jack Bowles, Chief Executive

Thank you very much Tadeu.

To sum up, the business is performing well. We are delivering on our financial commitments and another year of high single figure constant currency earnings growth, while at the same time making significant additional investment for the future.

We will continue to focus on our three core priorities to create a Better Tomorrow. We are transforming the company with the consumer at its centre, building strong brands and delivering value from our Combustible business, providing the resources to invest significantly behind our multi-category business.

Looking ahead to 2020, we are confident of another good year of high single figure earnings growth. Our confidence in the future of BAT is reflected in another increase in the dividend.

Thank you and I will now open it up to questions.

Gaurav Jain, Analyst, Barclays

Good morning.

Jack Bowles, Chief Executive

Good morning.

Gaurav Jain, Analyst, Barclays

I have a few questions which are all interlinked. So can you talk of the US cigarette volume performance year to date? I know you mentioned that there is a supply constraint which is now happening in e-cigarettes in the US, so is it happening for you as well as for competition? And if it persists is there a benefit that might happen to US cigarette volumes?

Jack Bowles, Chief Executive

Yes, I mean related to the US market - so of course I'm not going to further beyond what we said earlier, but I think we that we do not see any material difference between Q4 and the performance of the business at the beginning of the year. So I think that the US market is coming out nicely of the crisis related to e-cigarettes.



Of course, the growth that happening at the moment did not recover fully from what has happened in the second-half of last year, but we see a good potential for the US market.

On your second question related to the supply disruption, first of all we have to be cognisant of the fact that it's a terrible thing that is happening related to that Coronavirus and there is lots of dead persons. And we're doing all the support and we're giving all the support that we can to our teams first, but also to all the partners that we're working with and all the manufacturers that we're working with.

Most of the factories are now open. Now yet we see here and there some tension in terms of our supply-chain, and some limited out of stocks in retailers in some geographies.

You just to have to remember that - I'm not going to comment on the potential out of stocks of competition - but as I said we see some in different places. First of all we have a very strong business worldwide. The weight of China in our whole revenue base is extremely limited and most - nearly all our factory footprint or manufacturing for cigarettes is outside of the area of China. And we do not see at the moment any inflection point apart from Duty Free, which of course is impacted by the reduction of number of travellers. But this is extremely marginal in our total business.

So that was your first two questions. Do you have more?

Gaurav Jain, Analyst, Barclays

Yes, so switching to Modern Oral in the US. So you have a 10%'ish share now after six or seven months of being in the market and there will be the bigger competitor, which will enter the market later this year. So how do you assess success in that market?

Jack Bowles, Chief Executive

Yeah, I think what's very important to us is that we're presenting three categories worldwide and we're growing share in these three categories. That's the starting point.

So we are not only delivering growth in these three categories but also very strong growth in combustible business.

I think that specifically to oral tobacco as we said, we are the leader worldwide in terms of oral tobacco. And even Scandinavia that is I would say the starting ground of all these products, we are winning against all competition in terms of Modern Oral.

In the US specifically we have very good performance with the Velo brand, and I must say that I'm very pleased with the results. We have no constraint in terms of our supply and as Tadeu explained earlier we took the opportunity to learn on that category as we do all the time, and we have now a distribution of more than 70% with an active distribution of around 15%.



If you take the position that we are for instance where all the different categories are present in Georgia and also in Atlanta, we have close to a 40% share in all tobacco. So I think that we have the potential and the runway to continue to accelerate in terms of New Categories.

Gaurav Jain, Analyst, Barclays

Good, thank you.

Jack Bowles, Chief Executive

Thank you.

Nico Von Stackelberg, Analyst, Liberum

Good morning.

Jack Bowles, Chief Executive

Good morning.

Nico Von Stackelberg, Analyst, Liberum

I have a quick question on the dividend growth. My impression was in a relatively bad year the dividend would grow about 4%. So it grew a little bit below that, and I was just wondering, could you explain what the rationale was?

Tadeu Marroco, Finance Director

The rationale is to deliver what we committed, a 65% payout ratio. That's exactly the 65% payout. We are for sure very diligent on cash as you can imagine, and we are striving to deleverage the company and we assess that is a good remuneration in terms of dividends and we are sticking to the policy that we have set ourselves.

Nico Von Stackelberg, Analyst, Liberum

And I guess my second question, I'm curious about product applications in the US and PMTA ...

Jack Bowles, Chief Executive

I'm sorry?

Nico Von Stackelberg, Analyst, Liberum

The product applications for PMTA.

Jack Bowles, Chief Executive

Yes, sorry.

Nico Von Stackelberg, Analyst, Liberum

Could you give an overview of what your priorities are in terms of PMTA, are there certain major categories that you see that you won't be PMTA in for example, Tobacco Heating Products, THP? Will that be a - PMTA product there and yeah, just generally speaking can you talk about Modern Oral PMTA?

Jack Bowles, Chief Executive



Yes, now I think that our first priority lies on e-cigarette and oral tobacco. We said repeatedly we will do tobacco mint and other flavours and we're selling these ones. We want to make sure that we're strong in this environment.

And in terms of THP we already have a product that is review with the FDA.

What's the most important to us is the fact that from a market that was extremely segmented or extremely atomised in terms of number of players and the number of SKUs on open system. Now you have in the US a market where 60% of the sales on done in closed system which plays to our strength.

Then the second thing is we see that there is contestable space that is going to happen by consequence of the filtering of the FDA process of \$1.5bn to which you will have most of the benefit that will come rather in 2021 and most of it in 2022. Why? Because it will take time for the FDA to process all the information that it will receive.

I remind you that we've already put some PMTA applications in the system in order to test the grounds more for the administrative side of it. And just the issued SKUs represent 150,000 documents and took more than 27 hours to download.

So it's going to be a heavy process and we're going to support the FDA as much as we can. And we are already in contact with the FDA to make sure that this goes as smoothly as possible.

Nico Von Stackelberg, Analyst, Liberum

And my final question is on the vapour opportunity in the US for profitability. I can see how this becomes a profitable segment after PMTA, but could you give any sort of colour from your side in terms of how you see the profitability of this category developing say on a five-year view please? Thank you.

Tadeu Marroco, Finance Director

There are a number of levers that we can action to improve profitability in vapour. One of those relates to the product cost in the whole supply-chain and is a constant topic for us to review what are the opportunities are out there to improve and reduce the costs and improve gross margins.

The second one is how can we improve our direct to consumer assets? And we're putting a lot of effort in terms of e-commerce and being more able to reduce the trade margins that are as a consequence of that.

And there is already a trend as I explained in the closed system which helps us. And for sure, PMTA will open up a contestable space around \$1.5bn. And we believe that we are very well positioned with the products that we have currently, and the momentum is there.

So I think that is all will play together because this will generate more scale and also revert in improved profitability.

Nico Von Stackelberg, Analyst, Liberum



So I guess the question is - for my model in five years from now, what should I be modelling roughly speaking? Can you provide maybe a range on profitability for the segment? Thanks.

Jack Bowles, Chief Executive

5 Billion in New Categories.

We have to take it step by step. You know, the regulatory environment is evolving rapidly and the level of taxation in the different categories - the three categories, THP you see that they are going more and more towards full taxation on tobacco. You have that already in North Asia, you have that already in the US.

In terms of e-cigarettes there was a fragmentation of the market that was very important, and now we see that there's a concentration in the closed system. There is more product stewardship and that will play to concentration. And as Tadeu said, the fact of having bigger brands, more economies of scale and distribution that will cost you less because now that we have age verification competitors that is applied then suddenly I'm in agreement with our marketing colleagues to go for e-cigarettes into e-commerce.

But we have to make sure that we understand - and it's not the time to give guidance related to these things - it's the time for us to take leadership in these different categories and to make sure that we have the right products and the right consumer.

What is the most important to me is that because we have been multi-category since many years now, we have reinforced our capabilities. As I said, we've recruited 350 managers in all of these areas of new categories going from product development to design, to insights. We are the only one to have four categories in sight that are available to us and have done pilots, market tests and launches that have been successful.

Just from memory, ePen3 and the equivalent of the Alto in Europe is Product of the Year. That means that the reception from the consumer is extremely good. From that base we grow share in these three categories and we'll continue to do so.

Nico Von Stackelberg, Analyst, Liberum

And a final question from me please.

When I look at the large gap between adjusted and reported profits obviously a lot of these one-offs are - they're generally one-off in nature and I appreciate that you've quantified them, which is quite useful so thank you for that.

But I guess the question is for the year ahead and maybe for a couple of years ahead could you provide us any sort of colour on what the gap may be or what is the restructuring charge you may foresee? And thank you, just generally if you could explain your thinking on that more.

Tadeu Marroco, Finance Director

The thing is what you see on the restructuring, we are increasing from 2018 mainly as a consequence of the project, Quantum, on the restructuring side of the element - of adjusting on the restructuring side. Other than



that the vast majority, like you said, is a non-cash item and very difficult to predict. And we - one of the biggest ticket items there was related to the charge in respect of the Quebec case, like we have disclosed already in the half-year.

In terms of cash flow, in 2019 we saw a slight decline in terms of adjusting items compared with the year before. And although we have big ticket items to cover in 2020, which is the Quantum itself plus the tax case in Russia, we have already been working and we do not expect to have a bigger drain in terms of cash for next year given the other actions that we are making.

From there, Nico, we have to continue with Quantum which is our restructure in progress. But it's difficult to estimate the overall adjusting item because there are elements there that are, like you said, very one-off.

Nico Von Stackelberg, Analyst, Liberum

Thank you, guys.

Sanath Sudarsan, Analyst, Morgan Stanley

I have three questions large on the US market. So first of all, you shared your views about the US cigarette volumes for 2020 where you expect it to be about 5%. Could you just help us understand how you're thinking about the drag or the reduced drag from vaping and the impact of Tobacco 21 on your numbers?

And maybe also ...

Jack Bowles, Chief Executive

Yes okay, can I start on that one? Then we'll go to the other questions.

Sanath Sudarsan, Analyst, Morgan Stanley

Sure, sure.

Jack Bowles, Chief Executive

The 20 - 21 is a very good question. Thank you very much for asking.

There you have already 15 states in the US that are above 21 years old. And we saw that the impact was very minimal. But for a responsible like us it's a very good regulation coming forward.

Then the second thing is you have to remember that in the US, we have a share above 21 years old of 44% adult share. So we are better positioned than our current total market share in the US.

So that was for your first question. Then your second question if I may?

Sanath Sudarsan, Analyst, Morgan Stanley

Yes, so basically also from a longer-term perspective you always said historically that you are adding consumers from the nicotine pool. How do you see that evolving in the US or have you seen it in 2020 or 2019?



And going forward post Tobacco 21 post PMTA, how do you see this consumer acquisition going forward?

Tadeu Marroco, Finance Director

Yeah, I mean without going too much into detail because that's forward-looking, but what we saw in 2019 with the crisis in terms of e-cigarettes is that it was not that consumers from e-cigarettes were rushing back to cigarettes, but rather consumers from Combustible were less going to e-cigarettes because they had doubt in terms of the product.

I think that the regulatory framework that has been put in by the FDA is a valid one, it's a first step - a very big first step in the right direction and there might be more to come.

Sanath Sudarsan, Analyst, Morgan Stanley

And so, you know, one of your competitors put out a comment at Cagney saying - by the end of this decade probably there'll end up being equal sized revenues in NGP and combustible in the US. Do you feel very strongly about that or how do you see the evolution of that market there?

Jack Bowles, Chief Executive

I think that I've been very clear at the beginning of my presentation for the first time in terms of our purpose and I take you back to that one.

I think what's important is we believe - we strongly believe in the quality of our tobacco business and we strongly believe that you have to have at the same time a strong arm in new categories.

There are three categories that are important because we don't believe that one size fits all. We do believe that the consumers are having some aspirations in terms of risk-reduced products and that depending on geographies, depending on culture, depending on excise environment, and depending on the regulatory environment you need multiple approaches.

Of course it takes a lot of energy, a lot of resources in order to cope with that. But I think it gives us a head start on all competition across the industry in terms of being successful for the future. And that's why I reiterate despite the crisis and the skirmishes that have happened last year and this year that we will achieve the 5 million moving forward as an ambition.

Sanath Sudarsan, Analyst, Morgan Stanley

And then I'm cheekily just asking the last one. On the leverage you highlighted you'll be below three times by 2021. Is there a target internally in terms of where you would like to be, or what's the optimum rate you would like to achieve?

Jack Bowles, Chief Executive

It's a very good question. I'm not going to give a target related to that. What I'm saying is one of the main reasons why we reduced guidance this year and the number of guidance that we say three to five in terms of revenue, a high single-digit in terms of EPS, the 65% in terms of dividend and the deleveraging is because I want to have a little bit more space to be able to take the opportunities in the market whilst continuing to deliver on the financial metrics of the company. And I will continue to do so.



The first year last year we had a situation that was more difficult, we gave more guidance. I think it's more reasonable now to be in a situation whereby I have a little bit more space in order to make the right calls for the business and to invest.

I'll just remind you that in 2019 we are delivering the financial results. And at the same time we invested 500 million more in terms of marketing investment. 500 million more.

And I will continue to invest in the new categories at the right pace in order to make sure that our multi-category approach is the right one and it is showing already that it is the right approach for the consumers.

Sanath Sudarsan, Analyst, Morgan Stanley

Thank you very much.

Jack Bowles, Chief Executive

Thank you.

Alan, yes? Sorry, Adam?

Adam Spielman, Analyst, Citi

As always, can I ask you three questions?

Jack Bowles, Chief Executive

Or one by one because they're always very sharp your questions and I want to make sure ...

Adam Spielman, Analyst, Citi

Sometimes.

The first question - can you talk about, in Japan you've been most successful in the little cigar category. Could you just ...

Jack Bowles, Chief Executive

Sorry, in the?

Adam Spielman, Analyst, Citi

With little cigars. This new ...

Jack Bowles, Chief Executive

Oh yes, yes, yes.

Adam Spielman, Analyst, Citi

Can you talk about how you've done so well and more importantly you expect that going forward sort of ...

Jack Bowles, Chief Executive



Yes.

Adam Spielman, Analyst, Citi

That's the first question.

Jack Bowles, Chief Executive

Okay, so let's start with that one, thank you Adam.

I think that there was an historical thing that was there in Japan which was the first low taxation for some cigarette products, normal cigarette products. And that has been closed and it will be closed gradually by the government in Japan.

The second thing is there was that opportunity related to these - I will say mini cigarillos in a way, but more in the sense of cigarettes - and we took that opportunity. Because to the difference of other players we consider that the Combustible business is extremely important. And that's why when we speak about our results in Japan, we say a 19.1 share in terms of total nicotine offered on the market.

That category in the same way as the lower taxation that has happened historically in Japan will close as it goes along. But it gives us, and it has given us the possibility to continue to grow in that category.

I think it was a very useful step towards having a better value share and a better market share in Japan.

Did I answer your question, Adam?

Adam Spielman, Analyst, Citi

I think so, very clearly.

Jack Bowles, Chief Executive

Thank you.

Adam Spielman, Analyst, Citi

The next question, probably the most important question of the three. Well I'll start with another one.

In menthol regulation by state ...

Jack Bowles, Chief Executive Officer

In menthol regulation by state - are you speaking about the US?

Adam Spielman, Analyst, Citi

Yes. Yes, so we're talking about the US. We're now seeing more states at least threatening to ban menthol. How concerned should we be about that?

Jack Bowles, Chief Executive

I think there are two things. One is - that's a very good question.



One is the fact that the FDA after so many years is still allowing menthol in cigarettes and also still allowing menthol in e-cigarettes. And that is extremely recent. So there is no new science related to that.

At state level or city level some decide to ban menthol - okay what's happening is that the US is 50 states and the borders are what they are in the US. So you see a, I will say a potential acceleration across borders and I don't think that this is going to be something that is extremely sustainable in the future.

But I understand why cities or states are taking the view. Are we for it? The answer is, no, because we believe in consumer choice. And there is no material scientific evidence but has said that there is a problem related to menthol.

Did I answer your question, Adam?

Adam Spielman, Analyst, Citi

I think so, yes.

Jack Bowles, Chief Executive

Okay.

Adam Spielman, Analyst, Citi

So the third question, more general. You've spoken before about creating a better process for innovation and perhaps more sharp commercial execution around the Next Generation products.

So can you just talk about how the process of developing new products - how the process is improving? Has any change happened in the last 12 months? How do you expect that to change going forward?

Jack Bowles, Chief Executive

Yes. Yeah, I mean what we have done is we've put a lot of investment in terms of insight. The area also where we've accelerated quite sharply is everything that is related to big data. And the social listening is also a part that is very important.

Now, further and beyond that on the definition - that's for the consumer - and remember we're the only ones who have data and information and insight on four categories. Further and beyond that what's very important for us is the 4 Ds of R&D were split in the company before. Now they are all in the same place. So there is one body, which is the New Category group, that is looking at all this with strong support from IDT, so digital and technology.

I think that what it gives us is the possibility to work much better and to understand much better the consumer needs. I think that the one of which that is maybe the most important one is the satisfaction that consumers get out of these products. And you know that in THP for instance, there is 25% of segment share, of total nicotine in Japan and that's the only country in the world.



You know that in Korea it has peaked at that point and it has reduced now to 8% despite players that are there, which includes the local strong company.

We know that Europe there is only traction in a very limited number of countries.

We know that the more you go into the scale of tar and nic, if you go to Canada for instance despite the fact that THP has been there three years earlier than e-cigarette. E-cigarette is now much bigger than THP.

We know that in the US, but that's only in its infancy. We'll see how it will develop. And I'm not undermining the possibility of THP that can grow in the US, but the environment does not seem very, I would say, favourable in the sense that you have two other categories that are extremely well-established already. And when we see that two other categories are well-established it's very difficult for a third category to grow.

So I think that what we've done in terms of our R&D and our understanding of the consumer has been massively stepped-up. And we've invested much more money in the course of 2019 in order to make sure that we deliver all related to that.

Adam Spielman, Analyst, Citi

And just to follow-up on that, should we expect let's say in vapour to see important new products? When are we going to see some results of a better process of innovation?

Jack Bowles, Chief Executive

Yeah, I think I don't want to go - it's a very question, Adam. I don't want to go in product definition because then I will give away too much.

But yet the reality is you have now the segment we're leader worldwide. You look at the segment itself, the number or the percentage of closed system is there, increasing and very strong.

It has a very, very important consequence which is the regulatory framework and the product stewardship. You have a device that goes with the liquid that goes with the system.

This is the future moving forward. After that you have to make sure that you continue to develop these products and the products that we have at the moment in the market will evolve in the next two, three, four years because there are a lot of cost opportunities and improvement opportunities in terms of satisfaction moving forward.

Adam Spielman, Analyst, Citi

Okay, thank you.

Jack Bowles, Chief Executive

Thank you. Other questions? That will be potentially the last question or last two questions from what Mike is telling me from the back.

Jon Leinster, Analyst, Société Générale



Hi, can I have a few if I may? I'll take them one at a time.

Jack Bowles, Chief Executive

Thank you.

Jon Leinster, Analyst, Société Générale

First of all a quick one.

Jack Bowles, Chief Executive

Unfortunately you have to go slow.

Jon Leinster, Analyst, Société Générale

In Canada has there been any progress in the discussions and is it possible to breakout what the profitability of Canada was in 2019 ...

Jack Bowles, Chief Executive

CCAA?

Jon Leinster, Analyst, Société Générale

Sorry?

Jack Bowles, Chief Executive

CCAA?

Jon Leinster, Analyst, Société Générale

Yeah. Has there been any progress in terms of formula resolution in Canada?

Tadeu Marroco, Finance Director

Well we have the - the industry is in the process of negotiation through a mediator. That was established with the plaintiffs. Not just in Ontario but all provinces.

The latest news we heard is that there was the stay of all the process was extended until September and we are confident that we can be able to come up with a negotiation that represents the growing concern for the players moving forward. But I cannot say much more about that because it's quite confidential the process now.

Jon Leinster, Analyst, Société Générale

Is there any - you mentioned the extension until September. Is that therefore ...

Tadeu Marroco, Finance Director

Yes, this is happening ...

Jon Leinster, Analyst, Société Générale

... the beginning of the process or is that a timeframe for a potential resolution?



Tadeu Marroco, Finance Director

No, it's just the fact that they have a stay in place trying to come to a type of agreement. But to be honest I don't expect anything happening in the short-term, I mean end of the year, but eventually a couple of years.

Jon Leinster, Analyst, Société Générale

Secondly, going back to heated tobacco, clearly your focus seems to be on Eastern Europe. Is - just to be clear, in 2020 when your investment outside of Japan and heated tobacco is going to be very much focused on Russia, Kazakhstan, the Ukraine, is ...

Jack Bowles, Chief Executive

Well yeah, I mean we're going to expand our footprint for the three different categories and we're going to make sure that we're successful where we're going. But I think we'll go step by step. And as I said earlier to the question of Adam, what's extremely important as well around the question, what's extremely important is that we've created in 2018 and 2019 the capabilities and the resources - put in place the resources so that we're able to continue to grow.

Even with the THP, you know, you remember I said last year we are using our current tobacco machines to do our THP products because I don't want to be in a situation whereby I'm ending up with a capex exposure that is much too high compared to the regulatory framework.

So I think that Tadeu said very clearly that the capex will be in line with depreciation. The first year in many years that we are able to do that in 2020 and that's very good news related to that.

So our geographical footprint will continue to expand, but we'll speak about that at the Investor Day.

Jon Leinster, Analyst, Société Générale

And lastly, on the sort of regulatory front and such, is there any sign that the people like - organisations like the WHO are moving to much more towards the sort of harm reduction view of the world, or do we remain stuck in a differential world where in particular transnational organisations still believe in quit or die?

Jack Bowles, Chief Executive

Yeah, it's a very good question. I think what you have to do is to follow the consumer first. And the consumers are buying the products that we're selling. We have very good product stewardship on these products and will continue to do so.

Secondly, we have a very responsible marketing approach to all the activities that we do. Why? Because that is about the sustainability of the Group moving forward.

And the third thing that is also very important is that we will go step by step in the development of these products and we engage with regulators as required, both the FDA or other bodies across the geographies in which we operate in order to have the right scientific base that is put forward to them and the right benefit of these categories that is put to them.



Jon Leinster, Analyst, Société Générale

Thank you.

Jack Bowles, Chief Executive

Okay, last one? No. So, very thank you very much.

I mean I must say as you know it's my first year as CEO and before that I was COO, so I know this Company very well. I know the muscle that this Company has. We have done a lot of restructuring in our business to become faster, simpler and more agile.

We're doing it. We're doing it in short periods of time. Why? Because I want to transform this Company fast. We have created the foundations in 2018 and 2019 to have a strong base on our tobacco business - very strong base on our tobacco business with huge revenue growth and with value share growth. And we are taking the resources from there in order to grow our New Categories.

We have invested 500 million more in 2019 in the New Categories. We grew share in the three categories. We have delivered within the guidance and will continue to perform in these new categories and grow share.

Of course there will be skirmishes all over the place because there's always a country that decides that regulatory framework has to change and there's always a country that will decide that more taxation is required from these different markets.

All in all what we want to create is a better tomorrow for society, for the stakeholders that we have and including the shareholders.

We have demonstrated in the last two years that despite the waves and despite the negative environment that has been there we have been able in 2019 to deliver our revenue growth at 5.6%, to deliver the dividend and to make sure that we continue to deliver the deleveraging of the Company. And we'll continue to do so.

Less guidance is the right thing to do because that gives me the flexibility in order to move forward. But we give you guidance on the most important elements. Then I will navigate in terms of the different opportunities because it is all the aim of gaining opportunities and flexibility in the organisation and our resource allocation.

We will continue to deliver as we said in 2020 in terms of 3 to 5 and in terms of high single-digit related to EPS.

Thank you very much.

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