2019 Half Year Results Presentation

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QUESTIONS FROM

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Gaurav Jain, Barclays

Adam Spielman, Citi

David Hayes, Société Générale

Nico von Stackelberg, Liberum

Richard Taylor, Morgan Stanley

Gerry Gallagher, Deutsche Bank

Operator
Hello and welcome to the BAT half year results for 2019. Throughout this all participants will be in listen-only mode and after there will be a question and answer session. Please note this is being recorded. I will now hand you over to Jack Bowles, Chief Executive. Please begin.

Jack Bowles, Chief Executive
Good morning everyone, I'm Jack Bowles, Chief Executive and with me this morning is Tadeu Marroco, who, from Monday, will succeed Ben Stevens as Finance Director.

I would like to take this opportunity to thank Ben for his immense contribution to the Group over a career spanning nearly 30 years. As you all know, at the end of this week and after 19 years on the Management Board, 11 of them on the Main Board as Finance Director, Ben will be retiring. He leaves with the best wishes of the whole Board for a long and happy retirement.

Before I start the presentation, I need to highlight the disclaimer on page 2 and page 3 which I will take as read.
As usual, at the end of the presentation, there will be an opportunity for you to ask questions.

As we said in March, we are focused on transforming the business by delivering value growth from our combustible business, driving a step change in New Categories and making BAT a simpler, faster organisation, better equipped for the future. We are sharpening our operating model and reducing complexities. This is providing the capabilities and resources to invest in New Categories AND grow operating margin. Our review of the organisation is well advanced. We are looking at the number of business units, reducing organisational layers and simplifying processes, while further leveraging our shared service centres. We will update you on our progress when appropriate. Turning now to the results…

I am very pleased with the first half. We had a strong performance in combustibles and industry dynamics remain robust. Our combustible business continues to drive the financial performance of the group and we are performing well. We have continued to grow value share and our volume share is improving.
In New Categories, revenue was up 27% and we are on track to deliver full year revenue growth around the middle of our 30-50% guidance range on a constant currency basis. Over 9m consumers already enjoy our potentially reduced risk products. While I recognise there is more to do, we expect a strong acceleration in the second half. This is driven by the impact of the full year of additional investment and new product launches, which I will cover in more detail later.
In addition, we set some stretching guidance at our Capital Markets Day in March. I am pleased to say we are delivering on our financial objectives.

Revenue, margin, profit and EPS growth are all in line with the guidance. We have done this while at the same time significantly increasing investment in the business.
Cash and de-leveraging the business is a clear focus for us in 2019. We continue to be confident of reducing our leverage by 0.4 turns, excluding currency translation. Overall the business is performing well and we are on track for a good year.
I will now pick up some of the key themes of the first half in a little bit more detail.

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As I said, we had a strong performance in combustibles. Total cigarette and THP volume declined 3.5%, broadly in line with the estimated industry decline. We continue to expect overall industry volume to be down around 3.5% for the full year. Cigarette price mix was strong at 7%, driven by a good pricing environment. Corporate value share is up 10bps and the Strategic Brand portfolio delivered strong growth in both volume and value share.
Corporate volume share improved in Q2, and share in the first half is now level with last year. This was achieved even though we have reduced our combustible SKUs by 10% over the last 12 months, excluding the TPD implementation in Europe.

In the US, we are winning where it matters, with growth in value share, premium share and ASU30 share. This was driven by good performances from Newport and NAS, which both grew volume share in the premium segment. Revenue and profit both grew strongly. This was driven by good pricing, reduced discounting and improved mix. There was some additional benefit from the timing of expenditure and the effect of the Vibe recall last year.
Volume was down 6% mainly due to industry contraction as we concentrated on building value share against volume share. This was against an industry down 5.4%. Following the additional price increase taken in June, we now expect full year industry volume to be down around 5.5%. The US regulatory agenda continues to follow a robust process and is therefore moving slowly. There have been no material developments in the US FDA regulatory agenda on either menthol or nicotine. In vapour, we believe we are well positioned to meet the new May 2020 deadline for PMTA submissions.

As I said at the Capital Markets Day, I am looking to drive a step change in our new categories performance. I firmly believe that a truly global group like BAT needs to be strong in THP, Vapour and Modern Oral. I am pleased to confirm that we expect to deliver on our guidance of New Category revenue growth around the middle of our 30-50% guidance range on a constant currency basis. In the first half, New Category revenue grew 27% on a constant currency basis.
Vapour revenue was up 58% with good performances from Vype in Europe and Canada and Vuse in the US. This was despite Q1 Vuse sales being impacted by the Vibe restocking and trade uncertainty around potential vapour regulatory developments. Modern Oral is the fastest developing of the New Categories. We grew revenue by nearly 300%, mainly due to growth in ENA, and new launches, including LYFT in Russia. I am very excited by our rollout plans for Velo in the US, which started last week. THP consumables revenue was up 15%. Device sales were scaled back in anticipation of the launches of glo pro and glo nano in the second half. As a result, THP revenue rose 4%. This is expected to accelerate significantly in the second half, driven by new product launches. As you will see later, we have a lot of activity planned for the remainder of the year and we expect a strong second half.

Before we get into some of the detail on New Categories, I would like to talk about our brand portfolio. Following the acquisition of Reynolds, we have the opportunity to rationalize our large New Category brand portfolio, focusing on core drive brands and fewer SKUs. We have therefore decided, subject to regulatory considerations to consolidate and rationalize our vapour, THP and modern oral brand portfolio into three global brands: In vapour this will be Vuse; in THP it will be Glo; and in modern oral, Velo.
This consolidation will be completed by the end of 2020. This will allow us to focus our resources and internationalise our consumer propositions, creating strong global brands. I will now move onto the New Categories in more detail, based on the existing brand line up.

In Vapour, Vuse Alto is performing well in the US and is up 320 bps since the beginning of the year. Awareness for the brand is still low at 30% and active distribution is only around 25%, so there is significant opportunity for future growth. Our focus is therefore on building the Vuse brand through increased digital and face-to-face consumer activities. We have a significant uplift in support planned in the second half.
In ENA, we continue to lead the category. In the UK, vapour represents 25% of the total nicotine market and we have a value share of 39%. Vype achieved a record value share of 11.6% in June. This was driven by the success of Vype ePen 3, which grew value share by 410bps. In France, Vype reached a value share of 17.3%, led by ePen3. We are now the number one player in the retail vaping market in France. Elsewhere, in Germany, Vype reached a 12% share of total vapour consumers. In Canada, Vype reached a 21% value share, driven by the successful launch of ePod at the beginning of the year.

In modern oral, we are growing share rapidly in both the established oral tobacco markets in Scandinavia and new oral markets like Denmark and Switzerland.
We are market leaders in the modern oral category in both Sweden and Norway, with a 57% and 73% volume share respectively. As you can see from the slide, this is driving strong growth in our share of the total oral category in both markets.
In Switzerland and Denmark we are also leading the development of the category with our modern oral offerings achieving 42% and 67% volume share of the total oral category, respectively.
Modern oral is an exciting, fast growing category with significant consumer appeal. There are no device requirements and no limitations on where and when consumers can enjoy the products. We believe the category has significant untapped potential. We are performing extremely well, with revenue up almost 300% in the first half.

Ultimately, New Categories are all about expanding our share of the total nicotine spend by consumers. I am delighted to say BAT remains the fastest growing nicotine products company in Japan. Our overall share of the total nicotine market grew by 80 basis points this year. In July, we reached a weekly record of 18.3%, up 160 basis points. This has been driven by growth in both THP and combustibles. glo is performing well in Japan, where THP now represents 24.4% of the market. glo has captured 28% of segment growth since Q4 2018. Share in June is 5%, up 30bps despite significant competitor activity. In other markets, we have made good progress in a short period of time. However, let us remember that Japan alone continues to represent more than 60% of worldwide THP volume. As a consequence, we will first prioritise Japan for our THP innovations, followed by launches in ENA.

We have a strong pipeline of product launches and marketing support planned across New Categories in the second half.
glo nano is our new slimmer device addressing affluent explorer consumers' demand for a stylish single day usage product. glo pro utilises induction heating technology. This delivers better satisfaction and rapid heating for a quicker taste release. glo sens combines vaping technology with real tobacco, creating a bridge between THP and vapour for a satisfying, full taste experience. We plan to launch glo pro, glo nano and glo sens in Asia in the second half.
These new products, combined with our newly launched flavours, will deliver consumers better satisfaction and design. We are the only company to offer flavour capsules in Japan, which already represent 22% of our sales.

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We also have significant vapour activity planned for the second half. We will begin rolling out a new global Brand positioning and campaign unifying Vuse and Vype and supporting the migration of the portfolio to the Vuse brand by the end of 2020. This will be backed by significantly increased brand building activity. Following our consumer segmentation, we are further strengthening our vapour product portfolio. In the US, we plan to roll out 2.4mg nicotine variants of Vuse Alto to address an emerging segment for lower impact products. In addition, we have just commenced a special promotional offer of 99 cents for a Vuse Alto power kit. This is in response to the current competitive pricing environment and to drive awareness and trial. We also plan to launch an upgraded device for ePen3 with better battery life and improved functionality, together with a new range of flavours.

Finally, we are excited by the modern oral opportunity in the US and we have ambitious plans for Velo, our modern oral nicotine product. The rollout is already underway, with a rapid distribution expansion, supported by digital, radio and tv advertising, and direct consumer engagement. In addition, we expect the outcome of our MRTP application for Camel Snus, by the end of the year. This could give us a major opportunity to further develop this important potentially reduced risk product category. Outside the US, we have a number of new market launches for EPOK and LYFT planned in the second half.

So, in summary, we have significant activity planned, spanning all three of our New Categories, and we are confident this will drive an acceleration of our growth in the second half.

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

Tadeu Marocco, Deputy Finance Director

Thank you Jack. I am delighted to be taking over from Ben as Finance Director. I have worked with Ben for many years and he has been a great mentor to me. I am honoured to be succeeding him. My focus will be on delivering a stronger, simpler, faster, organisation, ensuring we can free-up resources for investment, while generating cash to de-lever the balance sheet.

As we grow our New Categories business, I will be driving efficient and effective resource allocation to ensure we maximise returns on investment. This is vital as the complexity of our multi-category business increases. This virtuous circle will increase operating margin, supporting our ambition to expand margin by 50-100bps per year. It will also drive the 0.4 times annual reduction in leverage ex-currency we are targeting, fund increased investment and deliver investor returns. I will now turn to the numbers…

Revenue grew 4.1% on an adjusted constant currency basis. This was driven by a strong adjusted revenue growth of 5.2% in Strategic Combustibles. I should remind you that combustibles still represent 92% of our business.

There was a good performance across the regions on an adjusted constant rate basis.
In APME Volume including THP was down 2.3% and revenue grew 1.6%. Good pricing was partially offset by lower sales of THP devices ahead of new product launches planned for H2. Despite increased marketing investment, profit from operations was up 4.6%. In AMSSA volume was down 3.5% and revenue was up 7.5% driven by strong pricing and higher revenue from New Categories. Profit from operations was up 0.8% with

good performances in Canada, Nigeria and Kenya, partially offset by significantly increased marketing investment. In ENA, volume declined by 4%. Revenue was up 4.6%, with good pricing in combustibles and a more than doubling of our revenue in New Categories. Profit from operations was marginally higher due to the impact of increased investment in New Categories. As Jack has already covered, in the US we had a good performance, Revenue grew 3.7% driven by strong pricing, reduced discounting and improved mix. Profit from operations grew 11.2% benefiting from the timing of investment and MSA costs, and a prior year comparator impacted by the Vibe recall.
Overall, we plan a significant increase in New Category spend in the second half, in particular in the US in support of Vuse Alto and the rollout of Velo. This will result in a more balanced performance across the regions for the full year.

I am delighted, that after several years of transactional FX impacts, we are back on a path of consistent margin growth. On an adjusted basis, margin grew 110 basis points, ahead of our guidance. This was after absorbing the increased investment in New Categories, which was a headwind of 110 basis points.
We made good progress on margin. We are on track to deliver on our guidance of 50-100 basis points of margin improvement for the full year, alongside the increased investment we are planning for the second half. Our growth in adjusted revenue and good cost management delivered a 5.9% increase in constant currency profit from operations.

At constant rates, Adjusted Net debt at the half year was £2.1bn higher than year end 2018 levels. This was driven by the timing of the MSA payment which occurs in the first half and the implementation of IFRS16, which increased reported net debt by 0.6bn. First half operating cash conversion was 66%, reflecting the normal timing of MSA payments in the first half. This is similar to H1 2018, if we adjust for the impact of the early MSA payment in Dec 2017.
We expect a strong second half cash performance with a full year operating cash conversion in excess of 90% and a net capex of around £800m, allowing us to meet our target of £1.5bn of free cashflow after dividends.

We are committed to de-lever at 0.4x to a ratio of 3.6x at the end of 2019, excluding the impact of currency translation. This is based on delivering strong EBITDA growth and free cash flow after dividends of £1.5bn. We remain committed to growing the dividend and a pay-out ratio of 65%.
On a constant basis, adjusted diluted EPS grew 7.1%, delivering on our high single figure earnings growth commitment. With a currency tailwind of 1.7 percentage points, adjusted diluted EPS was up 8.8% at current rates.
This was driven by growth in operating profit and a good performance from ITC.
Net finance costs increased mainly due to lower investment income and the impact of translational FX from the relative weakness of sterling against the US dollar.
We continue to expect the full year net finance charge to be around £1.5bn
We also expect an effective tax rate of 26% this year, down from the 2018 level of 26.4%
On currencies, if rates were to stay where they are today, the translational FX impact on full year results would be a tailwind of around 3% on operating profit and EPS.

So, this was a strong first half with revenue, margin, profit and EPS all delivering in line with the guidance we gave.

In March, I stood up and gave stretching financial guidance for the full year and I can confirm that we are on track to deliver against this.
In constant currency, we expect revenue growth in the mid-upper half of our 3-5% range, adjusted profit from operations growth in the upper end of our 5-7% range and continued delivery of high single figure earnings growth.

Thank you and I will now pass back to Jack for a few closing remarks.

Jack Bowles, Chief Executive
Thank you Tadeu,
In summary, I am determined to make BAT a winner in all nicotine categories, transform the business and build a BAT a stronger, simpler, faster organisation. Our combustibles business is performing very well, pricing is strong and market declines are in line with historical levels. We continue to build on our strong position in combustible tobacco. As we step-change in New Categories, we will build strong global brands and provide consumers with great new potentially reduced risk products, increasing the opportunities for our 150m consumers to enjoy our products. We have work to do in New Categories, but I am excited by our pipeline of product launches for the second half and into next year. I am confident we will deliver a strong second half with full year revenue growth around the middle of our 30-50% guidance range. I am committed to delivering high single figure adjusted diluted EPS growth on a constant currency basis, strong cashflow and tight cost control, while investing further in the brands and capabilities to build a global multi-category business. I am looking forward to a strong second half and delivering on the full year guidance we gave in March.
Thank you. I will now open it up for questions.

Operator
Thank you. Ladies and gentleman, if you wish to ask a question could you please press zero and then one on your telephone keypad and if you wish to withdraw that question you can always do so by pressing zero and then two to cancel. There will be a brief pause while the questions are being registered. Our first question is over to the line of Owen Bennett at Jefferies, please go ahead your line is now open.

Owen Bennett, Analyst, Jefferies
Morning guys and I hope you're all well. I just have a couple of questions on reduced risk in the US and first one, I'm just hoping you could talk a bit more about the competitive environment in vapour. So I see with the recent Nielsen numbers Enjoy seems to be having a bit of success, so just some comments on that. Then secondly, you spoke about moving to 99% of Vuse power kit, is that something that everyone has done at the moment in terms of move to that price point?

Jack Bowles, Chief Executive
Yes, thank you for the question. I am not going to comment on competitive activities but what I can tell you is that Alto is performing well. That there are some price skirmishes in the market and we will respond accordingly in the limited geographies and we will make sure that we continue on our path of growing Alto in the US market. The brand is growing strongly. We will do more investments in the second half as we said in the presentation and we will make sure that the Vuse brand is growing significantly in H2.

Owen Bennett, Analyst, Jefferies

Okay. Just a quick follow up, obviously Altria reported numbers, they're talking up the opportunity around IQOS and Heated and say that there is quite a significant opportunity there. I was just wondering to that extent, why you continue to be quite quiet around plans for Eclipse slash Revo. I know you say that you want to focus on a modern oral but it just seems a bit strange to me to ignore a category or at least be a bit more vocal around your ability to compete in that segment if you needed to.

Jack Bowles, Chief Executive

I think you have to consider all of the facts, that the categories that are emerging and strong in the US are already established, like the Vapor category. Then, on top of that, we see a great opportunity in oral tobacco, no devices, you can use it everywhere and we consider that these should be the two points of focus for the time being. We have the product that is there in the US but I prefer to focus my resources and make sure that we are successful in the vaping category, that is the biggest category in terms of new categories at the moment and oral tobacco, that has a lot of potential going forwards.

Owen Bennett, Analyst, Jefferies

Cool, thanks very much. Appreciate it.

Operator

Okay, we are now over to the line of Gaurav Jain at Barclays. Please go ahead sir.

Gaurav Jain, Analyst, Barclays

Thanks a lot for taking my question. So you know the long-term US volume market decline was recently updated by Altria from -4% to -6% and they gave a number of reasons including higher cannibalisation of e-cigarettes, also IQOS cost taking off in the US, do you have any view on why the long-term US cigarette volume declines pan out and how should that impact your long-term EBIT growth in the US? Thank you.

Jack Bowles, Chief Executive

Thank you very much for your question. Our view related to the market goes to the end of the year and we stay around 5.5%. Why? Because there has been an additional price increase in July, that's the inflection between the previous guidance and the 5.5% that we are giving now. We don't see any major shifts in terms of the e-cigarette development in the US and also we see that since the beginning of the year, the price of petrol has increased significantly from $2.5 to $2.9 recently and these are the major drivers in terms of the size of the market. After that, we will have to see what happens with the pricing in the market and with the development of e-cigarettes and all tobacco in the market.

Gaurav Jain, Analyst, Barclays

Sure and if I can ask a question on leverage, so you have reiterated a leverage reduction target and investors are worried about your high leverage in that context when the industry is changing so rapidly. Is there an opportunity for you to accelerate your leverage reduction target maybe by reducing dividend growth or through working capital improvements? There is margin gap between you and Altria and the US so why can't that be closed?

Tadeu Marroco, Deputy Finance Director

Yeah, we have plans to strengthen our cash generation from next year onwards. I think that we have opportunities, we guide this year that we will have above 9% conversions. We think that from next year onwards, we can be a bit more optimizing working capital and capex and bring this target to at least a 95% growth and this will give us the reassurance of the one and a half billion free cash flow after dividend generation. You have to consider that over time, as the profit grows, this number will also be growing over time, so we are pretty confident that with the combination of strong cash generations like is BAT today, with the strong earnings that we have already guided, we will be able to de-lever 0.4 and by the end of 2020, we should be very close to the three tiers in terms of ratio.

Gaurav Jain, Analyst, Barclays
Sure and if I can ask one last question around Velo launch in the US? So you know the margins on your smoke list of tobacco products are pretty high, is there a risk that Velo is going to cannibalise your own business before it goes into the growth opportunities that are available in the market?

Tadeu Marroco, Deputy Finance Director
No, we see it that there are a lot of complementary because of the moments of users from consumers so we don't see this as a direct cannibalisation at all. It's very different from THP. And we actually also have very strong margins in these types of products. I know that the US combustible is also very high but we are less concerned about that because we don't see this level of cannibalisation being that much.

Gaurav Jain, Analyst, Barclays
Sure, thanks a lot.

Operator
Okay, we are now over to the line of Adam Spielman at Citibank. Please go ahead sir.

Adam Spielman, Analyst, Citi
Thank you. Thank you very much. My first question is really about marketing spend. You said that in the first half, US profits were perhaps a little bit higher than usual because of reduced marketing spend and then you sort of said in the second half, marketing spend would increase in the new categories. So one question is, are you able to quantify in any way at all the impact of the reduced marketing spend in the first half and equally in the second half? So that would be my first question.

Tadeu Marroco, Deputy Finance Director
Adam, actually we didn't reduce marketing that much in the US in the first half. What we were saying is that in the second half we are for the increase of marketing investments. The performance in the US was pretty much driven by the fact that we have a very strong pricing with less discounts, in proven mix we grew value share by 30 basis points. So all these contributed and on top of that, we had some timings, some one-offs that I would say, related to the Vype recall. Remember that we are lapping with the last year where we had to stop selling the product and at the same time we had the write-off costs related to the recall. And on top of that, we had MSA charge movements that also impacted favourably the US in the first half. What we said is that in the second half, we don't have these one-offs in the first, and on top of that we are increasing further the investment behind new categories in the US specifically.

Adam Spielman, Analyst, Citi
And are you able to quantify that in any way at all, the increase in investment?

Tadeu Marroco, Deputy Finance Director
Well, the only thing I can say to you is that these one offs that we have, if you strip off the one offs in the first half of the US, you still would give a high single digit operating profit, but it will not be the double digits you are seeing in the report today. But you have to take into consideration as well that there were some movements in terms of the one offs in other regions, so I expect that at the end of the year, that we will have a much more balanced profits across the regions in BAT.

Adam Spielman, Analyst, Citi
And I suppose that perhaps answers what was going to be my next question because my next question was going to be, if your marketing spend goes up in the second half, is there anything to offset that with lower costs to ensure that you get to your guidance and so is the answer to that fewer one offs or how should we think about what offsets the increase in marketing?

Jack Bowles, Chief Executive
Adam, this is Jack. I think your question is very important. What we want to do is to invest the right amount of money in the business. We have new launches that are coming through, we want to make sure that we put sufficient resources into that. The second point is that we are very committed to delivering the financials for the full year and we have the space to continue to invest more in the second half of the year. We believe that the offers that we have for the consumers for the second half are very powerful to look at the different segments that we are going after. I think that we have the possibility to deliver the financial results and to invest. Of course as you are saying we are doing huge efforts in terms of costing, there is a reorganisation of the company that we are undertaking as we speak but also we are reducing the number of SKUS as I said, in combustibles we are reducing the number of SKUs in new categories and we are making sure that we are sweating our cost base as hard as we can.

Adam Spielman, Analyst, Citi
Okay, thank you. Thank you very much. That's very clear Jack. So one final question from me, I noticed that if I look at your new category sales half on half, they are quite volatile. So an example for that is that if I think about e-vapour for the US, it was quite low in the first half of last year but it jumped up a bit and sequentially its fallen a bit and I guess that's to do with pipeline effect. I assume there are going to be more pipeline effects in the second half as you launch new products in Japan and also some of the new e-vapour products globally. I was just wondering if you could just talk to that in any way, if you can somehow just aggregate what is really going on in an underlying basis vs pipeline filling? Because as we do our models it is quite confusing seeing this volatility in the line items.

Tadeu Marroco, Deputy Finance Director
Specifically in the US, the major driver for the variants that you are referring to is related to the Vype recall and if you strip it out the numbers would be very different when you compare the second half 2018, to the first half 2019. So you have to take this into consideration. There is an element of pipeline but I don't think the element of pipeline would be strong enough to justify any major swings such as the ones that you referred to.

Jack Bowles, Chief Executive

What you have to consider Adam is that is why we gave guidance of 30% to 50% on average in the years to come. What is important to consider is that there is a lot of fluctuation related to new launches, our new launches, competitive launches that creates distortion on the monthly basis. Nonetheless, we confirm and we affirm that we are going to deliver the middle of the range of 30% to 50%. That is important to us and we are putting a lot of effort into that. I vividly remember your question yesterday where you said that we have to make sure that we can balance additional investment and not only deliver financial results at the end of year that is what we are doing. I took your advice, Adam.

Adam Spielman, Analyst, Citi

Thank you very much, thank you for answering so clearly.

Operator

We are now over to the line of David Hayes at Société Générale, please go ahead your line is now open.

David Hayes, Analyst, Société Générale

Thank you very much. Hi everyone, I am going to go for three questions if I can? Firstly, just on pricing, the outlook for the full year, I wonder whether you can tell us what percentage of pricing you have already taken for this year and what the outlook is for pricing for the full year.

Secondly, you just mentioned again about the cost savings and the reduced rationalisation of the portfolio, is that having any effect on volumes negatively or would you expect that to have any effect on volumes negatively in the second half as you go through that process?

And then thirdly, just on the FDA update on nicotine and menthol, both you and Altria seem very confident that there won't be any more updates before the end of the year. I just wonder whether you take that to mean anything in terms of what is going to be the outcome of the proposals? Thanks very much.

Jack Bowles, Chief Executive

Okay, sorry I was trying to get the first question first before the others but I am going to pick up two, the first one and the last one. The second one I didn't hear so I leave it to Tadeu. The first one was related to the pricing, where are we in pricing. We had 78% of our pricing in the first half of the year. So that's a very strong position and we are happy with that position. So still some to go for the second half of the year.

The second thing is related to the FDA, very clearly, as we said during the presentation, I will say the the doomsday scenario that has been spoken about in the last three years is not yet materialising. We are very confident in the robustness of the process of the FDA in terms of a regulatory framework and we do not hear at the moment any significant movements related to neither nicotine reduction nor a menthol ban. Of course, there will be some things happening in terms of e-cigarettes in the US market but we consider and we consider, rather than but, and we consider that we will be in a good space for the new deadline that has been fixed, which is the summer of 2020. I think that we have a robust portfolio that continues to grow and we have new opportunities to grow further and beyond. As I said for e-cigarettes, especially for Alto we have brand awareness of around 30% and an active distribution in the market of around 25%, that gives us a lot of space to invest and to grow the brand in the US.

The third question I didn't hear I'm sorry because I was trying to get the questions one after the other. Tadeu?

Tadeu Marroco, Deputy Finance Director
To confirm, I think that you are referring to the volumes and the implications on volumes due to the pricing, is that right?

David Hayes, Analyst, Société Générale
No, it was more or less the SKU rationalisation, the portfolio rationalisation which obviously is helping the cost save generation. It's just that as you go through that process will it have a negative volume impact for either or does that have an impact negatively in the second half as you rationalise the portfolio and take some of those SKUs out of the market?

Tadeu Marroco, Deputy Finance Director and Finance Director Designate
Yes, we don't see any major impact from rationalisation of the portfolio volumes, what we are seeing is that there are some specific markets where for different reasons mainly related to tax increases and we are losing volumes in a very low, low value, low margin. Markets like, for example, Bangladesh where we had an excise increase in the second half of last year, which raised the floor of the market by 30% and the illicit trade grew tremendously sharply in that period and the market went down 10% and we are market leaders there.

Venezuela where we also are market leaders and there is a massive issue related to the economic and social problems in Venezuela right now. And Egypt also took some pricing in the low ends are hitting us where we were leading in the low end of the segment. So this is a drag that could add up to close to 2% of our report, 3.5% now and the big part of this drag will probably continue over time because these are situations that we don't see unwinding for the rest of the year. But as I said at the beginning, they are very low margins, low value and there is minimal impact in terms of the Group financials related to those volumes. In terms of the portfolio rationalisation, we are not seeing any downside materially related to that.

David Hayes, Analyst, Société Générale
Okay that's great, thank you.

Operator
Okay, we are now over to the line of Nico von Stackelberg at Liberum, please go ahead Nico your line is now open.

Nico von Stackelberg, Analyst, Liberum
Thank you. Good morning guys. You basically said that you are not aware of plans for the FDA to advance the rule making process on nicotine. Now the FDA or former members of the FDA have publicly said that they expect a preliminary rule at least to leave the FDA for HSS. And Altria also said that the FDA may publish a nicotine rule by the end of the year. So just trying to appreciate maybe dictions coming into play here but what's the difference between your view and Altria's and sort of what's been said? Then I have two more questions but maybe just one at a time.

Jack Bowles, Chief Executive

Yes. Thank you very much. Yes, I mean the FDA, as we said, did not make any moves to neither nicotine nor menthol and we do not hear anything about that in terms nicotine – in terms of e-cigarettes, sorry. Of course I mean we have always said that we need a more efficient regulatory environment relating to e-cigarettes especially related to the epidemic of underage usage. We have always been extremely clear that we will not have some activities in there and our marketing codes that we have in the Company is very strict related to that. We have never considered promoting our products to underage smokers or underage users and we will continue to do so.

In terms of further regulatory activities related to e-cigarettes, we are very well equipped with the approach that we have in the market to respond to these kinds of evolutions and as for instance the evolution happened related to 2020 and the new deadline, then we're ready to cope with that. We are a strong company with a very strong R&D and with very strong capabilities in the US to respond to that environment.

Nico von Stackelberg, Analyst, Liberum
Okay. The next question is on cash generation in general. So you have given some numbers here and they are quite adjusted and I was just wondering if maybe you could help out on just a statutory basis maybe or statutory on constant rate basis. But could you just help me with the cash flow from operations in terms of where you see that by the end of the year? Of course, MSA payments - I'm not interested in the MSA payments. I've realised that was a bit technical for the first half but the working capital is a little bit lower than I had expected so can you just help me square that please?

Tadeu Marroco, Deputy Finance Director
Yeah Nico, we have a distorted and difficult read of the cash flow because of the MSA payments that was done in December '17 that impacts the first half of last year when you compare this period with the previous periods. But if you take this apart and we try to do that when we report on a normalised basis, there is basically one movement to high movement in terms of working capital. This is basically inventory movements. Our conversion this time was around 66%, last year was slightly better around 70%. We expect that it should be above 90%, I would say, I'm expecting it to be between 94%, 95% for the end of the year. And from next year onwards, like I said before, we are targeting a threshold of 95% in terms of conversion of breaking cash flow.

Nico von Stackelberg, Analyst, Liberum
Excellent, thank you. Finally, just a quick one, we discussed this before back in March but the PMTA for glo. I was just wondering, do you have an update here? And I mean, it seems like it's taking a little while to get that application through. Why is it taking so long? Is it sort of thinking around which product do you PMTA or what is the general thinking there? Thanks.

Jack Bowles, Chief Executive
PMTA of THP?

Nico von Stackelberg, Analyst, Liberum
Of – yes, exactly THP in the US, so glo, yes.

Jack Bowles, Chief Executive

It's a good question, we already have a product that went through PMTA so we are covered with that, I do consider that the objective is to have the best product that is put in the PMTA and it takes a bit of time. I'm not concerned related to that because the market in the US is already very strong in terms of new categories and the leading categories are by far e-cigarettes for sure where our performance is improving and oral tobacco that is something that we see has a very big potential in the US. I am not concerned related to that for the time being.

Nico von Stackelberg, Analyst, Liberum
Okay. Thanks guys.

Operator
Okay before going on to the next line which is Richard Taylor at Morgan Stanley, if you have any further questions and haven't already pressed zero and then one to join the queue. Richard, over to you.

Richard Taylor, Analyst, Morgan Stanley
Good morning everyone, thanks for the question. Firstly, can you give us an update on the developments of modern oral in Europe excluding Scandinavia, any positive developments we should be thinking about?

Jack Bowles, Chief Executive
First of all, I mean we're having a very good performance in Scandinavia even in traditional snus markets where snus can be up to 50% of the total market. It's a category that is growing because there is a consumer need related to that. The second thing is, from the experience that we have in Switzerland, we saw that the category is growing very fast and now that category of oral tobacco is bigger than THP in Switzerland. Last point, as I highlighted in the presentation, we are doing trials in Russia at the moment and we see that after some weeks we have 25% of the category so we do consider that we have extremely good products, we have very good IP also related to these products and we have the capability to roll out. The benefit of this category as we will know is that there are no devices and the margins are extremely good. So we do believe that the potential outside of Scandinavia is big and that is why we are launching Velo in the US and we expect strong results for the second half of the year related to the Velo launch in the US.

Richard Taylor, Analyst, Morgan Stanley
That's very helpful, thank you. And then, how should we think about the phasing of the investments in terms of US versus the rest of the world through the rest of the year please?

Jack Bowles, Chief Executive
This is competitive information so I would not go there but what I can reaffirm is that we have invested more in the first half of the year. Also slightly more in combustible business in order to make sure that we continue to do the right job in combustible business. So we did not reduce investment in combustible business, we've increased it slightly in the first half of the year and then we will roll out the different plans that have presented earlier in the presentation. It is not a question of allocation of resources between the US and the rest of the world but more covering the consumer needs and doing the right launches for the different new innovations that we have. We will have also, for 2020, a stronger pipeline in order to be successful in the market.

Richard Taylor, Analyst, Morgan Stanley

Okay and that's very clear. And then these two questions are related, two last questions are related. It will be very helpful if you could give us guidance on your expectations for net debt to EBIDTA for the full year on a mark to market basis. I can see the currency adjusted basis, but it would be very helpful on a mark to market basis.

And then I suppose this is a follow up to Gaurav's question earlier, Jack at your Investor Day you said that you wanted to prioritize de-leveraging and I wrote down you saying that this huge debt allows me to bring a sense of urgency and focus to the people of BAT. It looks like growing EBITDA faster is your plan A but it isn't really speeding up the de-leveraging so what other options should we be thinking about? Is it accelerated cost savings, is it something with a dividend, is it brand sales, asset sales? It would be great if you could give us some colour into your thought process here please.

Jack Bowles, Chief Executive

Let's start from the beginning. First we are doing a lot of efforts in terms of-- I will not give breakdowns or directions related to that because that's forward looking but we are doing lots of efforts in terms of our cost base. As I said, we are reorganizing the Company to be a more effective and efficient organization and to declutter the organization, that will bring some savings. We are doing a lot of efforts in terms of reduction of our Capex moving forward, because we have done a lot of investment in the last two years in terms of Capex. Now it's time to harvest on that. We are going to continue to reduce the number of SKUs in both categories and combustibles in order to free up some cash. All of the other options I am not going to comment on because it is not the right time to do it.

Tadeu Marroco, Deputy Finance Director

Looking at your request Richard, I can even tell you where we stand now, but it's really not helpful because BAT is a very cash generative company at the second half of the year because we are just lapping the MSA payment and a lot more cash will come – it will be generated until December. And also we expect to have a stronger second half in terms of earnings compared with the first half. And so we are on track to deliver the GBP 1.5 billion free cash flow after dividends. And with the stronger earnings in the second compared with the first half to deliver the upper range of our guidance in terms of earnings that we will be able to deliver at 0.4, at currency neutral. But as you rightly point out, 31st of December is a key date for us in terms of exchange rate so everything that I can say from there is purely speculation.

Richard Taylor, Analyst, Morgan Stanley

Okay, thanks very much for the questions and answers, cheers.

Operator

Okay so we have time for I'm afraid one final question so we are going to go to the line of Gerry Gallagher from Deutsche Bank, please go ahead sir your line is now open.

Gerry Gallagher, Analyst, Deutsche Bank

Thanks very much, I have more of a comment to make rather than a question. I couldn't let todays call go by mentioning Ben on behalf of the investment community, on behalf of everybody on this call and those that can't make it, I just want to offer Ben all the very best for a long and fulfilling retirement and I'm very conscious that a number of people on this call haven't been involved in BAT as long as I have and a number of other people who cover the company so I just wanted to outline for those people what Ben has been up to through his career at BAT just so that they can understand the impact – the very positive impact he has had on the business.

As Jack said, Ben joined in 1990 but I think that it's important for people to understand that Ben has been far from a career accountant. He has had roles in marketing, he's run the business in Pakistan and Russia, and he has run corporate affairs. Ben was in charge of merging Rothmans and BAT in 1999 which was a transaction that happened very quickly after the demerger of the insurance businesses in 1998 and my recollection of the time was that that deal was kept incredibly tight amongst a few people at BAT and for Ben to take that up and do the excellent job of integration that he did is extremely commendable and noteworthy. That was one of BAT's major acquisitions that we've seen over the last 20 or 30 years.

And he has also been in charge of strategy, M&A and IT. And 2004 he went off to run the European business before becoming CFO of the business in 2008, 11 years ago and that is something that I will come back to in a second.

Clearly a CFO can't be judged and shouldn't be judged by the numbers alone, far from it. But I just want to highlight one, which is one that most people would say that Ben had most control over and has had also in a number of his roles in the past. The year before Ben became CFO the margin for BAT was 30.5%, the margin at the end of 2018 was 42.6%. And I think as we've heard today, he set the business up to be in a position where, post his retirement, the business is in good shape to continue to drive the margin of business higher, whilst maintaining the momentum sustainably in the top line of the business and I think that is to be commended.

One final point I do want to make, you may recall when Nicandro retired, I said to Ben that he should be very worried because I'd known him longer and he's been around longer in terms of exposure to the investment community. Well, the reality is, I have nothing I can say that can wind Ben up and I think the reality of that, and the reason for that is, you are just a decent bloke and I've had a lot to do with you over the years but I've enjoyed our time together. As a CFO of a business like BAT over 11 years, you have had 22 half year and full year results, but the reality is you have had a lot more than if nothing other than before very recently you had the quarterly updates as well. I hate to think how many questions you've had from people on this call and people in the past and you've handled them all with extremely good grace when we all know that some of them were, if not stupid, pretty close to stupid and the grace with which you have dealt with them on each and every occasion is to be commended.

So with that Ben, my very sincere – and on behalf of everyone, wishes for you, your family as you move forward into the next stage of your life. Thanks very much Ben and good luck.

Ben Stevens, Finance Director
Thanks Gerry, I appreciate your comments.

Jack Bowles, Chief Executive
Thank you very much Ben. Yes, an amazing career with BAT and best of luck for your retirement and using your magnificent new boat. Thank you very much for listening. If you have any follow-up questions please contact the Investor Relations team. I am looking forward to a strong second half and delivering on the full-

year guidance we gave in March. We look forward to speaking to you in February next year at our preliminary results announcement. Thank you very much.

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