Finance Director’s overview

“The Group again delivered growth across all key performance indicators”

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Finance Director

Strong performance across all measures

Despite external challenges, translational foreign exchange headwinds of approximately 6% on revenue and profit from operations, and further investment in PRRPs, the Group again delivered growth across all key performance indicators in 2018.

Since the Group’s 2018 results are, on a reported basis, influenced by the full year inclusion of RAI (compared against five months in 2017), the results are also provided with a comparison on a representative basis, as though the Group had owned RAI and other acquisitions for the whole of the 2017 comparator period. This will provide readers with an understanding of the Group’s performance inclusive of RAI and other acquisitions in both 2017 and 2018.

Increase revenue and profit from operations

Revenue grew by 25.2% in 2018 to £24,492 million (2017 was up 38.5% at £19,564 million) largely due to the acquisition of RAI, concluded in July 2017. Adjusting for the impact of acquisitions, excise on bought-in goods and the impact of currency, adjusted revenue grew by 3.5% in 2018 on a representative constant rate basis, while 2017 had seen an increase of 2.9% (on an organic basis). This 2018 growth was driven by price mix (6% on combustibles) and the growth of vapour, THPs and modern oral, which more than offset a decline in combustible volume.

Profit from operations was up 38.5% (2017: up 38%), as the inclusion of 12 months of results from RAI and growth in revenue more than offset the ongoing investments in THP and vapour, the amortisation of acquired brands and the costs incurred as part of the Group’s restructuring programme.

Adjusted profit from operations grew by 4.0% on a constant currency representative basis (2017: up 3.7% organic, at constant rates).

A full reconciliation of our results under IFRS to adjusted revenue and adjusted profit from operations is provided on pages 258 to 261. Against a backdrop of challenging conditions, notably the foreign exchange headwind, all regions performed well (as described on pages 43 to 47), growing adjusted profit from operations at constant rates of exchange on a representative basis, while investing in THP and vapour. This continues to demonstrate the ability of the Group, due to its geographic diversity, to offset the challenging environment in a number of markets.

Our operating margin increased by over 500 bps. This was driven by the positive mix effect from the consolidation of a full year’s results from RAI, while certain purchase price accounting adjustments that affected 2017 did not repeat. On an adjusted, representative basis, operating margin increased by 40 bps, as the Group continued to drive margin improvements while investing in the roll-out of PRRPs.

EPS movements reflect strong fundamentals

Net finance costs increased by £287 million to £1,381 million driven by the full year interest charge incurred in the year on borrowings of £47,509 million. Our banking facilities require a gross interest cover of at least 4.5 times. In 2018, our gross interest cover was 7.2 times (2017: 7.8 times, 2016: 12.2 times).

On a reported basis, basic EPS was 86% lower than 2017 at 264.0p, as the prior period (up 633% against 2016 at 1,833.9p) was materially affected by a deemed gain (£23.3 billion) on the disposal of the Group’s holding in RAI, required as part of the acquisition accounting. In 2017, the Group also recognised a deferred tax credit (£9.6 billion) related to the tax reforms in the US. Excluding these and other adjusting items, the effect from the consolidation of a full year’s results from RAI, while certain purchase price accounting adjustments that affected 2017 did not repeat, operating margin increased by 40 bps, as the Group continued to drive margin improvements while investing in the roll-out of PRRPs.

Cash flow generation drives deleveraging

In 2018, net cash generated from operating activities grew by 93% to £10,295 million. This was principally due to the inclusion of a full year’s cash flow from RAI, the timing of payments related to the Master Settlement Agreement (MSA) in the US, the cessation in 2017 of payments in relation to the Quebec Class Action and the ongoing cash generation in the rest of the Group.

Adjusted cash generated from operations (as defined on page 264) was £8,071 million, which represents an increase of 146% over 2017, or 158% on a constant rate basis. Excluding the timing of the early payment of the 2017 MSA liability, paid in 2017 and tax deductible at 2017 tax rates, adjusted cash generated from operations would have increased by over 43%.

Based upon net cash generated from operating activities, the Group’s cash conversion ratio increased from 83% in 2017 to 111% in 2018. Excluding the MSA timing impact, operating cash flow conversion ratio (as defined on page 263) increased from 97% to 100%.

Adjusted net debt to adjusted EBITDA, as defined on page 266 provides a measure to assess the Group’s ability to meet its borrowing obligations. The Group continues to focus on a balanced approach of deleveraging, while investing for the future and providing a return via dividends to shareholders. In 2018, the adjusted net debt to adjusted EBITDA ratio improved from 5.3 times to 4.0 times. Excluding the effect of currency, this would have been an improvement to approximately 3.6 times.

Delivering today and investing in the future

The Group continues to deliver against the financial imperatives, which supports the growth in dividends while deleveraging and investing in PRRPs for tomorrow’s success.