Financial Review

Finance and Transformation Director's Overview

"In this pivotal year, we have grown New Categories revenue, invested in the future of the business and deleveraged. This has allowed us to continue to reward shareholders with higher dividends and announce a £2 billion share repurchase programme. We believe we are well placed to maximise our future potential."

"Revenue growth from New Categories performance and strong combustibles pricing, particularly in the U.S., more than offset by foreign exchange headwinds."

@"We have increased our Quantum enabled savings expectations from £1 bn to £1.5 bn."@

"Profit from operations was up 2.7% (2020: up 10.5%), as growth in revenue and reduction in losses from New Categories, a strong combustibles pricing environment and operational efficiencies were partly offset by foreign exchange."

Group Transformation Underpinned by Financial Delivery

2021 was a pivotal year in our transformational journey. We have delivered a step change in New Categories, reconfigured our business capabilities for the future, delivered value through combustibles and deleveraged the balance sheet. We believe these achievements position us well for the future, and have allowed us to deliver growth in our key financial indicators (excluding translational foreign exchange impacts) in the year.

Pricing and New Categories Drive Revenue Growth

Revenue declined 0.4% to £25,684 million compared to 2020 (while 2020 was marginally lower than 2019, down 0.4% to £25,776 million).

Revenue from New Categories was up 42.4% in 2021 and 14.9% in 2020, while combustibles pricing remained strong (particularly in the U.S.), with Group price/mix of 4.3% in 2021 compared to 7% in 2020. Price/mix was lower largely due to negative geographic mix as markets began to recover from the impact of COVID-19, the impact of structural excise changes and a competitive environment in Australasia (estimated at £260 million) and the disposal of the Group's operations in Iran. These were partly offset by the benefit of trade inventory movements in the U.S. (the impact of which is estimated to be £200 million and expected to unwind in 2022). A translational currency headwind, due to the relative strength of sterling, negatively impacted both periods, by approximately 7.3% in 2021 and 3.5% in 2020.

On a constant currency basis, revenue was up 6.9% in 2021 and 3.3% in 2020, with 2020 also negatively impacted by COVID-19 (approximately 2.5%) due to the disruption and restrictions affecting certain markets (including South Africa and in Global Travel Retail).

Growth in Profit from Operations While Investing in New Categories

Profit from operations increased by 2.7% to £10,234 million, with 2020 up 10.5% to £9,962 million. Revenue growth, a reduction in losses from New Categories and operational efficiencies achieved under the Group's restructuring programme (Project Quantum) were partly outweighed by the translational foreign exchange headwinds and a transactional foreign exchange headwind of 1.7%. 2021 included a number of one-off items, including in respect of the disposal of the Group's subsidiary in Iran (£358 million related to foreign exchange losses and asset write-off costs), an impairment charge of £54 million in Peru and a combined credit in the U.S. of £94 million (related to the partial buy-out of the pension fund and the finalisation of the dissenting shareholders litigation). However, these were lower than those recognised in 2020 in respect of goodwill impairment (£209 million largely related to Malaysia) and charges in the U.S. (£400 million) largely related to the state settlement agreements in respect of brands sold to a third party in a prior period.

Our operating margin was 120 bps higher at 39.8% in 2021 (2020: up 380 bps to 38.6%).

On an adjusted constant currency basis, profit from operations grew by 5.2% (2020: up 4.8%). This was driven by higher revenue and efficiencies delivered in both 2021 and 2020 as part of Project Quantum @(which increased its delivery expectations from £1 billion to £1.5 billion)@ and lower losses from New Categories. Adjusted operating margin (at current rates) fell 70 bps to 43.4% (2020: up 100 bps to 44.1%), partly due to the proportionate growth in New Categories revenue (with the Group continuing to invest in those categories), higher revenue in lower margin markets and a transactional foreign exchange headwind of 1.7%.

Financial Review

Finance and Transformation Director's Overview Continued

"Dividends per share increasing by a further 1.0%, underpinned by the financial strength of our business."

"Cash flow generation remains extremely robust, allowing us to deleverage while investing for the future."

"We remain committed to consistent and sustainable long-term 3-5% revenue growth (excluding currency) and a growth in dividend."

"The Group continues to deliver against the financial objectives. This has allowed the Group to continue to reward shareholders with growth in dividends and announce a £2 billion share repurchase programme all while investing in A Better Tomorrow™."

Future Funding De-Risked Through Proactive Action

Our liquidity profile remains strong, with average debt maturity close to 10 years and maximum debt maturities in any one calendar year of around £4 billion.

In September 2021, the Group issued perpetual hybrid bonds totalling €2 billion. These euro-denominated securities contribute to a more efficient alignment of the Group's earnings currency. They also contribute to the diversification of the Group's sources of funding and further strengthens its capital structure. The issuance provides the additional benefit of supporting the deleveraging journey with the addition of a small benefit to the credit metrics. @Our medium-term rating target remains BBB+/Baa1, with a current rating of BBB+/Baa2@*.

Net finance costs in 2021 were £1,486 million, a decrease of 14.8% on 2020 (£1,745 million, itself an increase of 8.9%). The reduction in 2021 was partly driven by a foreign exchange tailwind. However, 2020 included net charges of £142 million in respect of the early redemption and tender offer in that year as the Group reduced future refinancing risk by raising £8.9 billion in the US dollar, euro and sterling markets, using the proceeds to repurchase and redeem £3.1 billion of bonds. This de-risked the future repayment profile by securing lower interest rates and future liquidity in uncertain times. On an adjusted, constant rate basis, net finance costs declined 4.5% in 2021 (2020: up 5.9%).

As part of the Group's de-risking of future funding, during 2020 gross interest cover ceased to be a covenant in the Group's debt facilities.

EPS Growth Underpins Dividend Increase

On a reported basis, basic EPS was up 6.0% at 296.9p (2020: up 12.1% at 280.0p) with diluted EPS up 6.0% to 295.6p (2020: up 12.0% to 278.9p), largely due to the net reduction in adjusting charges in 2021 and lower net finance costs, which more than offset the impact of foreign exchange on the Group's operations.

Excluding the adjusting items (discussed on pages 76 and 77) and the effect of foreign exchange on the Group's results, adjusted diluted earnings per share, at constant rates, increased by 6.6% to 353.5p, with 2020 ahead of 2019 by 5.5%.

Cash Generation Drives Debt Deleveraging

We continue to focus on a balanced approach of deleveraging, while investing for the future and providing a return via dividends to shareholders.

The Group's cash conversion ratio, based upon net cash generated from operations, was 95% (2020: 98%) @and the operating cash conversion ratio was 104% (2020: 103%)@. The Group realised £9.7 billion (2020: £9.8 billion) of net cash generated from operating activities, @ or £2.5 billion (2020: £2.6 billion) of free cash flow after dividends – which is a measure the Group uses to assess total cash generated by the Group with which to repay borrowings.@

Consequently, in 2021, total borrowings (including lease liabilities) have reduced from £43,968 million in 2020 to £39,658 million in 2021, due to the net repayment of borrowings in the year (including refinancing via issuance of perpetual hybrid bonds) and a currency tailwind of £409 million (2020: tailwind of £219 million). @We continued to deleverage our balance sheet with adjusted net debt to adjusted EBITDA ratio improved from 3.3 times to 3.0 times.@

Active Capital Allocation Framework

Our deleverage and cash flow generation provide the flexibility to adopt a more active capital allocation framework to deliver long-term value for shareholders.

This will include:

- continuing to grow the dividend;
- maintaining our target leverage corridor @of 2-3x adjusted net debt / adjusted EBITDA@;
- potential bolt-on M&A opportunities; and
- share buybacks to enhance shareholder returns.

The Board will prioritise capital allocation opportunities each year in-line with this new longer-term active capital allocation framework, while continuing to take into account macro and fiscal influences, and potential regulatory and litigation outcomes.

As a first step, we have announced a dividend increase of 1.0% to 217.8p (with a dividend pay-out ratio of 66.2%) and a £2 billion share repurchase programme for 2022.

Tadeu Marroco
Finance and Transformation Director

* A credit rating is not a recommendation to buy, sell or hold securities. A credit rating may be subject to withdrawal or revision at any time. Each rating should be evaluated separately of any other rating.

@ Denotes phrase, paragraph or similar that does not form part of BAT's Annual Report on Form 20-F as filed with the SEC.