

## **Morgan Stanley Consumer Retail Conference**

### **Presentation by Ben Stevens, Finance Director**

Good morning everyone.

It's two years since I was last presenting at this conference. I seem to recall that in November 2008, it was exceptionally cold in New York. The chill was more than climatic. There was also a downbeat sense of uncertainty in the face of a deepening recession. Lehman Brothers had collapsed and governments were faced with the dilemma of having to support the global financial systems. The mood was certainly more pessimistic here than in London. As is often the case, London was just a few months behind New York and it became equally depressed.

It's fair to say that, had I been here a year ago, I would have hoped that by now the recovery would be in full flow. That's certainly not the case here or in the UK. Although the equity markets have recovered to the pre-Lehman crash levels, confidence remains fragile and the consumer, in many countries, is still coping with high levels of unemployment and is faced with government imposed austerity measures which impact disposable income.

As we have seen over last two years, the strategies we have in place, our brand portfolio and geographic spread put British American Tobacco in a very good position to weather the uncertainties and continue to deliver superior returns to our investors. And this is what I intend to discuss with you this morning.

For those of you here not so familiar with British American Tobacco, I will give a brief overview of the Group, take you through the strategy because I believe understanding the strategy is key to understanding the potential of the business and before I take questions and answers, I will comment on the current business environment and outlook.

But first, let me take you back to what I said two years ago. We drew upon our experience in previous economic downturns and I put up this slide.

As you will hear, tobacco has been more resistant than most other consumer categories to the recession but volumes demonstrate that we're not totally immune from its effects.

Our geographic diversity has been a very important factor in the delivery of strong results over the last two years.

The brands have been remarkably resilient and where there has been down-trading, the low price brands have been more affected than premium brands, largely from the growth of illicit trade.

Unemployment has been the key factor in many markets. It has provided the catalyst to down trading and lower volumes.

Our balanced portfolio covering premium, mid and low price categories has brought an important defensive quality to the business in the downturn and will favour British American Tobacco in the recovery.

Those comments still hold true today.

This is the Group today. The facts illustrate the scale of the Group. Scale is important and a key factor in our ability to grow the business.

We are the second largest listed tobacco Group in the world with over 250 brands. However, the focus is on our four Global Drive Brands (Dunhill, Kent, Lucky Strike and Pall Mall) as well as Vogue and Viceroy.

I will talk about the brands in more detail later.

We operate in over 180 markets and have leadership in over 50 markets – an important factor when considering pricing power.

There are more than 60,000 employees.

The ratio of gross turnover to net turnover is an important factor in the economics of tobacco and the industry's ability to take prices up.

Market cap – a moving feast but British American Tobacco is certainly in the top 10 in the FTSE100 with a current market capitalisation in excess of \$78 billion at £24 per share.

The \$78 billion market capitalisation is the result of a decade of consistent market outperformance. Since the year 2000, our share price has risen an astonishing ten fold. With dividends, that translates into a total shareholder return of 25% per annum. We believe that the successful execution of a consistent strategy is a major factor behind British American Tobacco's success.

The test of the business strategy is whether it can deliver in bad times as well as good. Over the last two years, we have shown that the strategy works well in difficult times.

We seek to build shareholder value through focusing on the three pillars of Growth, Productivity, Responsibility supported by a Winning Organisation.

Our Group vision is to achieve leadership of the global tobacco industry in order to build shareholder value. We define leadership both quantitatively and qualitatively.

Quantitatively, we seek to grow volume share among our international competitors. Our share of the value of the market is also important. But the quantitative measures alone do not create an environment for sustained success. We take a long term view, also focusing on the quality of our business and how we work.

Qualitatively, we aim to lead our industry in: product development; being the preferred partner of key stakeholders and in demonstrating responsibility.

Growth means focusing on growing our share of both the volume and value of the global tobacco market, through organic growth and mergers and acquisitions.

For organic growth, we are concentrating on strategic segments of the market that offer the best prospects for long-term growth, using the global drive brands and innovation.

Mergers and acquisitions can also provide us with growth opportunities, provided they are a good strategic fit and financially attractive.

Since 2008, we have completed acquisitions in Scandinavia, Turkey and Indonesia and we are on the look out for more opportunities.

Productivity is about leveraging our global resources effectively and efficiently to increase profits and generate funds to reinvest in our business.

Because our products pose real risks to health, we strongly believe that our business must demonstrate responsibility in everything it does. Our commitment to responsible behaviour is integral to our strategy.

We have a sustainability agenda that addresses key business-related social, environmental and economic impacts in ways that aim to build value for all our stakeholders, including shareholders.

Our sustainability agenda covers working to develop reduced risk products, the way we operate in the marketplace, responsible management of our supply chain, addressing our environmental

impacts and developing our employees within a great workplace culture.

A winning organisation means making sure we have outstanding people and the right working environment to deliver our vision.

Our employees come from very diverse cultures and backgrounds, and we welcome and benefit from the breadth of different ideas and experiences they bring. They are vital to the future success of the organisation.

In terms of delivery, the strategy has enabled the Group to meet shareholders' expectations during the difficult years of the recession.

The very strong growth in adjusted earnings is reflected, through the 65% dividend payout ratio, in a 50% increase in dividends over the last two years.

For the last 6 years or so, these have been our medium to long term targets, and during the recession, the business has continued to outperform them.

The goal of high single earnings growth over the medium to long term has been the Group's publicly stated objective ever since

1998, when we spun off our financial services businesses to focus on the less controversial area of tobacco.

From the year 2000 to 2008, revenue growth was driven by: volume growth in the newly opened up markets in Eastern Europe; portfolio mix improvements as consumers traded up, partly offset by adverse geographic mix. Pricing during these years was relatively modest.

Following the consolidation of aggressive volume players such as Gallaher, Altadis and Skandinavisk Tobacco, pricing has become the key driver of revenue growth.

The recession has clearly had an impact on volumes. Organic volume growth began to slow down in 2008.

Although consumers have traded down, some into roll your own and illicit trade, our premium volume has held up well.

This is due to the success of the drive brands, the strength of innovations and the balance of our portfolio.

Despite the lower volumes, a strong pricing environment has enabled us to grow revenue significantly ahead of the medium to long term target in 2008 and 2009.



Strong revenue growth mainly driven by pricing, together with the delivery of cost savings has meant that profit from operations, at constant rates of exchange, has remained on target.

At the adjusted earnings level, the growth has been significantly ahead of the high single figure target.

Certainly, the economics of tobacco help, for instance, the high level of duty means that relatively small price increases to the consumer can bring a significant benefit to margins.

Nevertheless, there are other important factors that distinguish British American Tobacco from other consumer companies.

We operate in some 180 markets around the world and we have a high bias to developing markets. Approximately three quarters of volume and almost two thirds of profit is derived from developing markets. Furthermore, our top 5 markets, shown on this slide:

Canada, Brazil, South Africa, Russia and Australia, which accounted for more than 40% of adjusted operating profit in 2009, are all commodity based economies, with strong currencies and, with the exception of Russia, have experienced a relatively shallow recession.

Our brand portfolio is well positioned. British American Tobacco's volume is evenly split across the price segments so we can catch our fair share of those trading down as well as those trading up during the good times.

We have continued to invest in our brands, including the premium brands to ensure that we are stronger coming out of the recession than we were going into it. The global drive brands have continued to grow.

We pride ourselves on our marketing expertise. We have successful global partnerships with key accounts such as Shell and some major convenience store franchises. These partnerships are mutually successful and British American Tobacco is rated best overall supplier consistently in many key markets.

Direct store delivery to retailers has been extended to encompass more than 50% of our global volume, providing us with a real competitive edge in the most heavily regulated markets where the retailer is the only touch point with the consumer. The closer we are to the retailer, the closer we are to the consumer.

Being consumer driven means that we have to understand changes in consumer trends and tastes and respond accordingly. We have invested heavily over the years in developing our understanding of the needs of the consumer. That has enabled us to become the industry leader in innovation.

After some years of skepticism from analysts, investors and our competitors, almost everyone is acknowledging the success of innovation in tobacco. As they say, imitation is the sincerest form of flattery.

Groundbreaking innovations such as the super slims king size Nanotek are now being rolled out by our competitors. However, Nanotek accounts for 16% of Kent's global volume and has reached a 1.2% share in Russia, at a price premium to the parent brand.

The unique Dunhill Reloc freshness pack reflects the simple idea of respecting the quality of the leaf used in Dunhill cigarettes and ensuring constant humidity and freshness with a sealed inner pack. This has been a hit with consumers, particularly those in the Middle East, where it has recorded a near 10% share in GCC.

Reloc has also been a factor behind Dunhill's share growth in Malaysia this year.

Since the launch of Kool Boost with filter capsule technology in Japan in 2007, convertibles now account for 35% of our Kool volume. Convertibles have now been rolled out in Kent and Lucky Strike formats in Eastern Europe, Korea, France and parts of Latin America.

Innovations grow the top line. When used to reinforce "premiumness" they lock consumers in the premium segment. If the consumer trades down, the consumer must sacrifice something. They also provide consumers with the incentive to trade up.

Notwithstanding the recession, British American Tobacco's global drive brands, which are mostly premium priced, have continued to grow. They are up 8% so far this year and have continued to outpace the equivalent brands of our competitors.

Innovations do not come without cost. We have to invest and free up the financial resource to continue to invest for growth.

That's why our productivity programmes are so important. They enable us to grow earnings and invest in future growth. We are

well into the second 5 year programme to deliver an operating margin of 35% by 2012. I am very confident that we will achieve that goal. As you can see from this slide, we have made very good progress since we started on the first 5 year plan in 2003.

The first programme focused on overheads and indirects and our factory footprint.

The current programme is focusing on smarter operating platforms, shared services and delayering management structures. But we are working on longer term projects which will provide the cost savings and margin enhancements in 2013 and beyond.

I said I would close with some comments on the current operating environment and the outlook.

There's no doubt that this recession is persisting longer than we thought. It continues to have an impact on consumers as governments turn to addressing deficits and launch austerity programmes. Until employment levels begin to recover in some markets, the financially stressed consumer will look to cheaper products, including illicit trade. British American Tobacco's geographic diversity mitigates this impact to some extent.

The pricing environment continues to be favourable. In 2009, we had 8% of pricing contributing to revenue growth, in the first half of 2010, it was around 5½%, still well ahead of historic levels. In consumer price terms, prices have risen by similar levels in 2010 as 2009, but governments are taking a higher proportion of the price increase through excise hikes.

I have described the recovery as “bipolar”. Many economies continue to struggle, including many developed economies in the West. The speed of recovery is mixed and British American Tobacco is well positioned in many of its key markets. Added to all of this is the uncertainty of foreign exchange.

I am satisfied with our competitive position. The global drive brands have good momentum and the Group continues to grow its share in its top 40 markets. The innovations pipeline is strong and will continue to play an important part in growing the top line. As we said in our trading update last month, we’re on track for another good year of earnings growth, supported by strong cash flow and cost savings. And, finally, the balance sheet is in excellent shape to take advantage of any acquisition opportunities that may arise.

On that note, I will pause for questions. Thank you.