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Transcript

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CORPORATE PARTICIPANTS

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Finance and Transformation Director

MODERATOR

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Gerry Gallagher, Deutsche Bank

Good morning, everybody. My name is Gerry Gallagher. I'm a member of the consumer staples team at Deutsche Bank based in London. I'm sure you've been introduced to the conference by Steve, before me in this room, but it's nevertheless, I'd like to reiterate my very great pleasure to introduce people back to Paris after two years away, this is our third year from our prior conference and it's great to have everybody back in the numbers that we do have them back. It's my very great pleasure this morning to introduce you to Tadeu Marroco who is the CFO of British American Tobacco. The format of today's session will be a fireside chat. Tadeu will start with a few opening comments and then we will go into a Q and A session led by me. But at some point I will open to the floor. Please don't be shy, ask any questions you have, and we're scheduled to finish in just under 40 minutes from now. So with that over to you Tadeu.

Tadeu Marroco, Finance and Transformation Director

Okay, thank you very much. Good morning, everyone. It's great to be here face to face in person after two, two and a half years or so. So look, just few words from my side. We are very proud in 2022. The BAT transformation continues at pace when Jack Bowles took over as CEO back in 2019, he set out very clear three objectives for the group. One of them is to [inaudible] the performance in the new categories, and we are continuing to have now strong growth in the new categories. Last year in 2021, we grew by 50% our revenues in new categories. He also set out the importance of value generation and combustible to fuel the growth in new categories and we are doing extremely well in combustible as well. Exactly for following this role of generate the funds necessary for us to continue to transform the company and expand in the new categories.

And finally, he set out the objective to simplify the organization. We put in place the project Quantum. Project Quantum was about trying to really simplify the way we work, create more empowerment and responsibility to our markets, and at the back of that all generates savings and we are now just reviewing our latest targets. We expect to generate a minimum of 1.5

billion pounds in savings up to the end of 2022. So all of that at the back of generating strong cash generation, the cash flow, the cash conversion has been above a hundred percent on the average of these last three years, a lot of focus on that. That is allowing us to continue with our progressive dividend policy, as well as introducing a 2 billion pounds buy back recently. Now we know that this horrible conflict in Ukraine is exacerbating all the inflationary pressures and the interest costs are going up.

So we are not immune to that, but we are well prepared. As a consequence last week, I just confirmed in our pre close that we are keeping our guidance, no matter the timing of the transfer of a business in Russia. Because we had at the back of a mote category working category strategy that is clearly working, a strong portfolio of global brands, and also a very cash generative company. So all in all, we are moving now to a faster transformation phase. This means that the new categories will become more and more relevant in the algorithm of the group. And we are pressing ahead with our ESG targets in order to conclude the journey of a better tomorrow. So I'm going to stop here and I know there is a lot of questions coming my way, so I'm going to join with Gerry and then we go through the questions.

Gerry Gallagher, Deutsche Bank

Tadeu, thank you for those opening remarks. I'm just going to pick up on some of the comments you made. You characterized 2021 as a pivotal year for the business when you transformed or transitioned the business to move it forward. But you're now talking about faster transformation. Can you tell me what that means in practice and how it will be evidenced in the group's performance?

Tadeu Marroco, Finance and Transformation Director

Yeah, the pivotal year, 2021, we defined three major objectives. The first one was to really get traction in our revenue growth in terms of new categories. So we came since the back of 2020 with a much stronger pipeline in every single category and we were able to generate a [inaudible] in the second half of 20, a

very good growth and this continues throughout 21. So in 21 for us was the consolidation of the strength that we start seeing 2020. The second objective of our pivotal year was very important because we have accumulated losses until 2021, in order to generate the capabilities necessary to create those three global brands in each of those new categories. In 2021 was the first year where this loss start reducing, and this will be a trend moving forward. And third, we have set ourselves targets to reach after the acquisition of Reynolds back in 2017, to leverage the company and reach a corridor between three to two times [inaudible].

Tadeu Marroco, Finance and Transformation Director

And again, we reached that in 2021. So this was what we call the pivotal [inaudible] because this allow us to have much more flexibility in terms of capital location. And the reason why we restart our buyback program was exactly due to that. Now faster transformation is our recognition that the new categories will become more and more relevant for the group results moving forward. We expect to more than double our performance in terms of revenue. We are today around 2 billion to up to 5 billion or beyond 5 billion by 2025, this will be a growth above 25% on a [inaudible] base. And these will translate into more and more relevance of the group revenue performance. At the same time, this 1 billion loss we expect to eliminate completely by 2025. And again, we'll be very creative in terms of profit growth for the group from now until 2025.

Tadeu Marroco, Finance and Transformation Director

And finally the capital location framework that we set that will be much more flexible. Every single year we are going to make an assessment in terms of what are the market and fiscal conditions, what are the regulatory litigation outcomes, and see how we're going to reallocate our capital in terms of progressive dividends in terms of share buy back in terms of doing M and A [inaudible], which will have an important role on the beyond equity phase of the company. And also paying down debts to keep us within this three to two. So when you pull all this together, the relevance of new categories on the

revenue side, on the profit side and this flexibility of capital location, that's why we call it faster transformation.

Gerry Gallagher, Deutsche Bank

Okay, thank you that was very clear. Very helpfully, last week you gave us a trading update, which characterizes steady as she goes. So I'm not going to focus on too many, if any, at all short term questions going to keep it bigger picture or more strategic. And in that vein, could you just help us understand a little bit about Quantum? So you talk about taking complexity out of the business, but at the same time, the business is got the combustible elements and you've got the new categories, the vaping, tobacco heated products, and also modern oral. So while you're taking complexity out on one level with Quantum, it feels like the business underlying is becoming more complex. So could you help us reconcile those two things?

Tadeu Marroco, Finance and Transformation Director

Yeah. Quantum the whole objective of Quantum, for sure that we are generate a large savings and this was always part of the equation, but the major importance of Quantum is to increase the agility of the company, the [inaudible] market. So we reduced by 40%, the numbers of direct units report to the regions, and by doing that we create more empowerment to our area directors on the ground cause they are the ones that really need to be on top of managing the day to day of these [inaudible] categories. So we create a lot of, we review the matrix of accountabilities and gave them much more power to make day to day decisions so they feel robust support in order to navigate through these more complex environments. So as a consequence of that, we review the numbers of layers that we have in the group.

Tadeu Marroco, Finance and Transformation Director

We move 25% of our management population out. This equates to something like 2,500 managers out of the organization. We review span of control, and we also brought a lot of new people into the organization. So since 2019, we brought 1000 new managers into BAT and those new

managers are bringing new skill sets. Plus we have to invest much more in terms of innovation, in terms of science, in terms of ESG, in terms of patents. So we had a number of areas, digital is another one, that we had to put a lot of emphasis on in order to be successful in these new journeys of new categories.

Tadeu Marroco, Finance and Transformation Director

So what allowed us to simplify the business, giving more empowerment to our people, increase their agility at the same time, bringing some new skill sets, and as part of the program, we also launch a very aggressive productivity program. So we reduce substantially the numbers of SKUs in our combustible business in order to simplify it, our footprint. And the consequence of that is the numbers that you have just seen and we are doing this extremely well, and it's one of the reasons why we feel very resilient business should navigate through all these uncertain times that we have and still keep our guidance for 2022.

Gerry Gallagher, Deutsche Bank

Okay, thank you. The next question I'm going to ask, I'm doing three fireside chats through the course of this morning to three tobacco companies. I'm going to ask this question to all three of you. I've already asked it to one. I'm going to ask it to you today. I suspect the answer will be broadly the same, but I'm going to ask it anyway. So the question is this: for multiple decades, and it's why the industry works, you've been able to have strong pricing, but it nevertheless is the case that maybe over the last 10 years or so, the pricing in tobacco has benefited from the underlying dynamics of how tobacco works, but supplanted by there being very low inflation elsewhere in the world and tobacco maybe being able to leverage its position. As inflation picks up what is the risk that the relative ability of tobacco to raise prices or for that matter, the absolute ability for tobacco to raise prices, is compromised because inflation is all pervading and is now in the system from a consumer perspective where it wasn't before, and you were able to

leverage the categories, characteristics, to raise prices, is pricing going to be...compromise moving forward.

Tadeu Marroco, Finance and Transformation Director

That's not what we have seen, and that's not what we saw in previous inflationary periods and recessionary periods. The industry in general has been very resilient. And if you bring back to our reality today, the elasticity is still very benign across the world. You go to the US, for example, it's 2.4 elasticity in the US. Which means that there is still a lot of space for pricing. And in our particular case, we have a very rounded portfolio of global brands with well represented brands in every single price point.

One thing that we have today we didn't have in the past is a data analytic tool, that is a revenue growth management to allow us to have a very granular visibility in terms of elasticity, even by channel or geography in the US. For example, in Australia that we are now rolling out for the rest of the group, and this is allowing us to navigate well through this. And we have to remember that given the characteristic of exercise, we really don't need to pass on all the inflation for the consumer as a manufacturer. And this is one of the elements that has helped the industry in the past and will be the case for the future as well.

Gerry Gallagher, Deutsche Bank

Okay. That's very clear. Moving on, just not touch on Russia and Ukraine, but in a group context. So previously you've talked about generating 40 billion sterling, a free cash flow over the next five years. And just to put that into context, that's about 50% of your market cap, or about 35% of your EV. That is pretty impressive stuff or reflection of how cheap your stock is, depending on which way you want to look at it. Could you talk about that 40 billion number in the context of what's happening in Russia and Ukraine, and whether we need to think about that number moving forward?

Tadeu Marroco, Finance and Transformation Director

Look, we disclosed that Russia and Ukraine is around 3% of our group revenue, in terms of profit to be slightly lower than that. Is more in the ballpark of 2%. So in the broader terms, is not a massive financial hit Russia specifically for us, given the exposure that we have now to likes of US after the excision in 2017. If you see... And I mentioned this briefly about our cash conversion, we have been able to convert 100% of the profit we generate into cash. And as a consequence of that, our free cash flow today sits around eight billion mark.

So the 40 billion is something completely doable. In our capital allocation we have something like 25 billion-ish of debt that will be paid now as dividends. So it's left 15 billion for the next five years for us to decide between share buyback, between paying down the debts and keep us in the corridor of two to three. Or eventually do some spot on acquisitions that will be more and more relevant for the Beyond Nicotine space, not necessarily the new category space. So we feel very comfortable about the 40 billion mark.

Gerry Gallagher, Deutsche Bank

Okay. You kind of answered my next question, but I'll ask anyway in the sense of maybe you can elaborate a little bit. You raised a dividend by a small amount last year, 1% I think was the number. You've announced a buyback. You're at the 65% payout level. You're at the top end of your two to three range on the net debt to web ITAR. Sterling is cratering every day. Great for the P&L, not so good for the balance sheet, depending on where it is on the 31st December, who knows. What does all that mean in terms of how you balance the dividend, the share buyback and paying down the debt?

Tadeu Marroco, Finance and Transformation Director

Yeah, this will be... The reason why we didn't make a kind of a long term commitment, some other companies have done like share buyback or backs for three, five years, we are transforming. So we want flexibility. We want to be able to, if we see and identify a particular target, for example, in Beyond

Nicotine we are able to do it properly. So we don't need and we don't want to have a straight jacket leading with capital allocation. So the dividends is basically [inaudible] for us. In terms of payout if you go back the last 10 years, the payout of the group has been 67.7%. We have a long term guidance of 65% payout. Currently, we are sitting at above 66%. So if you see us going below 65 in next year, is not a problem.

Tadeu Marroco, Finance and Transformation Director

And we'll be compounding that as part of the broader decision capital allocation, but with an increasing starting base, that's what we committed to. A long term 65% payout and the increasing starting terms. And then as a consequence of that, we will be seeing what is left and decide based on litigation outcomes like I said before, regulation outcomes. What can be afford in a particular year in order not to jeopardize the transformation. The first priority of the group is to transform, and we want to use all the leverage possible to accelerate this transformation.

Gerry Gallagher, Deutsche Bank

Okay. I've got a couple of more questions from a very big pitch perspective, before I maybe open to the audience and come back again. And this is something that doesn't get asked very often. ITC, the strategic rationale of holding that stake, if we were having the conversation 10, 12, 15 years ago... As I would've done with your predecessor, shows how old I am. The answer would've been something along the lines of there's a strategic rationale around India, the market may open up, the ownership rules may change and we're in there for the long haul. Well, many would argue... And I had that conversation 15 years ago. 15 years is probably the long haul. When does the strategic rationale of holding the ITC stake manifest itself, and if it doesn't what do you do?

Tadeu Marroco, Finance and Transformation Director

Yeah. Look Gerry, India will be the largest country in terms of population in this decade. So it's not one more country, so start there. ITC is performing well. You see their share price is back

to the pre-pandemic levels now. And we believe that in new categories we might have opportunities in India. The oral tobacco size of India is largest than the rest of the world, as big as that. So, if you add all that... So we talk about modern oral in the US, in the Europe, if you add all that across the world, India is still larger than that.

So we believe that we might have opportunities there. And that's the strategic reason why being there at this point in time. I don't know if we're going to stay another 15 years or not, but the fact is that you note that there is a ban for foreign direct investment in tobacco in particular. So it's hard to get assets to that market. It's hard to pull out, but we are satisfied with the performance of ITC for the time being. And we are hopeful that these new categories could present towards a strategic opportunity in future.

Gerry Gallagher, Deutsche Bank

Good answer. For what it's worth, I'll give you another five years before I ask it again. One other bigger picture question I want to ask, and I have to ask it. This presentation, this conversation's about you but what happens in the wider industry impacts on you guys. Could you give us your take on Philip Morris, Swedish Match, assuming the transaction completes and we don't know that yet, but let's assume it completes. Could you talk a little bit about how you see that changing the industry framework? If at all, does it just accelerate what was going to happen anyway? Could you just talk about that from your perspective?

Tadeu Marroco, Finance and Transformation Director

Look, yes. It's difficult for me to talk about-

Gerry Gallagher, Deutsche Bank

I'll appreciate.

Tadeu Marroco, Finance and Transformation Director

...someone else views. But the fact is that becomes quite apparent that the realization that this is a multi category game

and not at single category is clear. And this is what BAT has been saying since day one. At the beginning, a lot of people was criticizing, "Wow, why you guys decide to go for all three categories? Why you haven't done one by one?" Well, we decided to do that because at the end of the day consumers are not homogenous, first. Second, we know that the cigarettes has different levels of taste and strength in different markets, which means that you'll need different solutions to satisfy consumers. And we know that the regulatory environment is different in different markets. So we always knew that these would be a multi-category game. So we have been busy doing that and is costly.

Tadeu Marroco, Finance and Transformation Director

I take this, it's costly. That's why we generate a billion loss up to 2021. We have been building strong global brands in each of those categories. So when something like that happens, I'm not concerned at all. You see? So we have a very well positioned modern oral offer outside the US. The US is a different situation because... I don't know if some of you know, but the products that are in the US today are the ones that has been in the US since August 2016. It's not the ones that you see growing everywhere in Europe. So the level of moisture of the products in the US are much lower. As a consequence, the number of poly users is 95% of the consumers. 95% of the consumers are modern oral in the US, are poly users. They are not single users. And the average daily consumption is between two to three pouches whilst in the Scandinavia market for example, is six to seven.

Tadeu Marroco, Finance and Transformation Director

So this is a clear indication that the satisfaction is not there. So to compensate that you have a number of discounts, and the value is not there either. One and a half percent of the total nicotine market is modern oral today. Although, all the buzz around modern oral in the US is just one and a half percent, vapor is 80%, traditional oral is another 9%. So we have something like 20% Reds of the US in non-combustible, but modern oral is one and a half. So what we want to do in modern oral is to bring our excellent products that we have

outside the US to the US, but we need PMTA for that. So we have Reds start applying PMTA, filing PMTA, but this takes time. When the time comes, then we're going to reverse...reverse our focus on modern art. By the time being the focus has been more in vapor, and vapor in the US, we are very pleased to have achieved leadership position in the manual channels with views.

Tadeu Marroco, Finance and Transformation Director

And this will not change the other things that we have filed for our PMTA application for glue, our THP product. As you know, we have discussed before, we are not a big believer of THP in the US, 'cause the gap between satisfaction in terms of tarinicotines of cigarettes in the US are very high, between 14 to 60 milligrams. And we know that when you have this level, so of tarinicotines like Canada, it's very difficult to get traction into HP. And we know that when you have a very well established vapor market, consumers are not willing to move away from vape and get their hands again on the tobacco rod, this time to heat as opposed to burn.

But it's still a tobacco rod. So that's why you see not much traction in this country here of THP. It's a very strong vapor market as well. We also see not much traction in their case, a strong vapor market.

So, but we apply anyway, the painting law, 'cause we want to be present there in case this situation changes in futures, like an insurance, and also to have that advocacy of the FDA suggesting that is a big belief of risk continuum that can help us outside the west in terms of engagement. So our strategy doesn't change.

Gerry Gallagher, Deutsche Bank

That's a very good answer. It's quite a difficult question. You turned it to talk about the positives of your business and that was very good indeed.

Tadeu Marroco, Finance and Transformation Director

That's what Mike does.

Gerry Gallagher, Deutsche Bank

Yeah.

Tadeu Marroco, Finance and Transformation Director

I try to.

Gerry Gallagher, Deutsche Bank

I can tell. Good answer. Joking aside, moving on on taking the themes of that, of your answer there and the transition to the new categories. How far away are we from BAT potentially being a consistent over the medium to long term volume growing business?

Tadeu Marroco, Finance and Transformation Director

Well, I think that this is, it's in our hands. If you see, we want to move from a revenue and value growth company, dealing with a declined product that has a negative health impact on society, towards revenue and value growing company, growing volumes, and having a positive impact on society. This a completely transformation.

The quality of the revenue growth of BAT moving forward will be much less dependent on pricing, 'cause the algorithm of cigarette has been very clear. We all know for years, no? Has been a product that decline over time with a massive pricing power that more than compensate that enhance you to generate revenue, and then you make tweaks here in your cost base, you generate profit kickers and you are there in the media high single digit February. In new categories is very different, 'cause in new categories you really have possibility to grow volumes. So your revenue growth will be much more linked to the volume material you grow, as opposed to the pricing that you need. The quality is completely different, is completely different, and let's face one thing. We have 1.1 billion consumers of cigarettes in the world today, 85 million of non combust, 85 million. So we expect these 85 million to

translate into something like 140 million by 2025. This is still a small fraction of the 1.1 billion.

So all we need to do is to grow in that space. For us to achieve the 5 billion, by the way, we need to grow around 26% of, take 26% of these growth. Today, new categories involve money wise represent 15% of the total nicotine new categories. In 2025, we expect this should be around 20%, 22% to be precise. So if you take something close to 30% of this growth, we are already the 5 billion. So the answer is yes, we are able to transform this company into a volume growth company and we have plenty of space to do that.

Gerry Gallagher, Deutsche Bank

Okay. Before I open up to, maybe there's a question of truth on the floor. We'll find out. Just one last question, I'll said there'd be two, I think I've now asked three. You've talked about building an ecosystem of capabilities in beyond nicotine. Could you help us understand what you mean by that? How you frame that, what that means for the group moving forward. Just give a bit more color to that?

Tadeu Marroco, Finance and Transformation Director

Yeah, look, we are seeing a lot of interesting consumers on wellbeing and simulation. And what we are trying to do with the new categories is to fulfill consumer moments that has been lost by consumers with the regulation in cigarettes. So we bring these consumer moments back and we want to fulfill even more with the beyond nicotine space, at least for our strategy. So we have been used the, we have been leveraging the capabilities of the group on R and D in terms of science, in terms of distribution, to identify opportunities in that space.

Tadeu Marroco, Finance and Transformation Director

So we have signed development agreement with the Organigram. Organigram is a licensed cannabis producer company, Canadian company. And we want to understand more about this in order to be able to be there in case the regulatory environment evolves. And we are also using our corporate venture capital that we set up in 2019 to be able to

explore opportunities in that space of natural written moods enhancement on edibles, on orals and beverage, and trying to see if we can have, you know, leverage on that based in the synergies that we can find the group.

Tadeu Marroco, Finance and Transformation Director

So it, I think that will be a more inorganic play as opposed to organic one. And what this point in time we want is to set the foundations right. So we have the possibility to move now from combustible to non combustible nicotine products and the going beyond that in the future. I think that will be, I think what I'm trying to say to you is that this group in the next five, ten years will be a very different one that we know today,

Gerry Gallagher, Deutsche Bank

Right, just to follow up on that, and again, it's something I've asked somebody else already this morning in the context of how the business changes, though, it will remain a consumer facing business. You won't deviate from that?

Tadeu Marroco, Finance and Transformation Director

Absolutely. We are consumer company. Most of all, we are consumer company. That's why I was referring before to the consumer moment. So all of this is linked with our, first of all, purpose to reduce the health impact of our products, 'cause today we have the technology and we have the consumer willingness to try these new products, and they are much more health conscious than they were before. And you are seeing this in many industries, you see this in beverage, for example, you see zero alcohol in beverage, in beers, you see this in food, less sugar. So consumers are much more willing to try these products.

And we had the technology that we didn't have in the past. So we are putting all those things together in order to transform, but we are at the end of the day consumer comes. So what we need, we know how to do is to navigate through very tough regulatory environments 'cause of our background, which would be great for us to set their agenda with regulations

moving forward. And we know how to build brands. That's what we did in cigarettes, that we are now doing new categories and that we'll be doing in the onicotine.

Gerry Gallagher, Deutsche Bank

Great. Thank you. Just under 10 minutes left, before I move on, I've got plenty of questions. Is there anybody in the audience burning to ask a question of Tadeu? We've got one just there.

Speaker 1:

Investors are often constrained with their ESG mandates and investments. So how do you talk to investors about the ESG footprint that you think is important in five years time?

Tadeu Marroco, Finance and Transformation Director

Yeah, the ESG is clearly a massive important factor for us. The good news is that I was referring to the purpose of the company. All these strategies that we are referring to, we will address the major elephant in the room that when we deal with ESG, cause EHG for BT is not new. We were one of the first companies, if not the first to introduce a corporate responsibility reports back in the 2000, early two thousands, we have been for 20 years in a row in the down John sustainability index. It's the only tobacco company with all these track records. We have clear targets in terms of environmental. We want our, for example, footprinting operations to be carbon neutral by 2030, we are working hard in order to make sure that the people that works for us in our supply chain has the better treatment as possible, dealing with things like random child labor and all that. And the government to ensure that we have robust governance to apply for the coast standards in which we do business.

Now, the biggest elephant in the room is the product and the reason why we have invest so heavily on that, just, and I mentioned that last week we have invested just at the first half of the year, a billion pounds in the three new categories. So yes, we are in 2 billion. This is something like 12%, 13% of our total revenue. But if you deep dive into the group level numbers

into more specific market numbers, you'll sit at the transformations as well, ongoing.

In Japan, for example, we have more than 40% of our revenues in these new products. In the UK, 40%. In Sweden, where it's all about oral, is 65% of our revenues are right there. By the way, Sweden has been promoting Aro Tobacco for many years. The level of incidents in combustible now cigarettes is 7%. And you know that when you reach the 5% mark, they say free smoke, no? That's what they are trying to achieve in UK and all that. And they migrate most of them towards Aro. So which by the way, you make more money out of than cigarettes.

So, it's not that you are doing that as opposed to the financials. The whole thing is that you do the transformation, you have this massive positive impact and you preserve your financial algorithm as a consequence of that, as well. So, the transformations are already happening and that's why you are seeing new investors come along to us and be much more comfortable than before. As we have been able to recruit, I was referring to 1000 people. These 1000 people came from completely different industries. They came from Indus Pharmacy, they came from electronics, from digital. These are people that would never approach BAT 15 years ago, like we were referring to. Never. They would never. They would never be associated with BAT. And why they're coming? Because they feel excited about the transformation. About the opportunity to make this impact on society. And so I think that, answering your question, ESG is center front for what we do and it's not just about the ESG that you are usually relate to, but also about the product. Yes?

Gerry Gallagher, Deutsche Bank

We have one more. Over here, sorry. We'll come to you in a minute. Sorry.

Speaker 2:

Thank you. There's currently an increasing fear of a new recession and you just described the transformation. How

would you describe your new products, reacting to less consumer spending where pockets are challenged with the high energy cost, etc., versus the incumbent ones?

Tadeu Marroco, Finance and Transformation Director

Yeah. Look, the recession... We are not immune to that. You are absolutely right. If you go to our US market, for example, it's a good case. We note that there is a big correlation between oil price and consumption of cigarettes and inverse relations, so we see a lot of weakness now in the US, in terms of volume. On the other hand, like I said before, we had a lot of pricing power still to come because the affordability level is very benign and with all these tools that we have developed in terms of analytic, what we can do is to understand the consumer purchasing power in a very granular base and then look from different discounts and in terms of fulfillment of the consumer needs.

The US, in particular, is the most affordable... Cigarettes, the most affordable market in the world, second to Japan only in the US and it's the most profitable market in the world. And the dynamic about how we price up our products because of the excise structure allow us, like I said, not to be able to pass on all the inflationary pressure we are facing, because we have some of the markets with the specific excise, so we take more every time you pass to consumers. So, the consumer doesn't need to face all this increase in price.

So, as we proved in the past, we had been in inflationary pressure, because we forget that because it's a long way since the financial crisis, that we are seeing low levels of inflation and all that. I'm Brazilian, I came from Brazil. I know how inflation works quite well, believe me. And this industry has been always navigated quite well on inflationary pressure, so we are not immune to it but I think that we... That's why we are confident to validate our targets for this year anyway.

Gerry Gallagher, Deutsche Bank

Thank you, Tadeu. We've got one down here.

Tadeu Marroco, Finance and Transformation Director

Yes.

Speaker 3:

So, two-parter. The first part is to clarify something that you were just mentioning. What have been your incremental insights on the US consumer over the last six to nine months as inflation's become increasing the pressure on the pocket? And then, to the ESG question, I was impressed to hear a billion dollars of spend on ESG in the first half of the year. Can you help me understand, directionally, how much of that runs through the PnL, through expenses, versus capital investment? What are a simple pie chart of the investment allocation of how that billion is spent? Is it really R&D? Is it sales force?

Tadeu Marroco, Finance and Transformation Director

Okay.

Speaker 3:

That'd be helpful.

Tadeu Marroco, Finance and Transformation Director

Yeah, yeah. Sure. Look, the 1 billion is all PNL, we are not talking about CapEx and this is a combination. I would say something like 20% of that on the discounting, because the discounting for us has been a good strategy that worked well. Remember, in some of those markets, we had been second. If you go back three years ago, when Juul was leading in the US, clearly everybody was telling us, "You'll never be able to get anywhere close to Juul," and today we are the leaders in the market in the US. And one of the reason why we're able to do that is not just cause we have the better product in the US, but also cause we were able to acquire consumers. So, these consumer exhibitions for them to try or test the product has to do with levels of discount. We usually don't discount the consumables, either tobacco heating product or vapor, but we discount device at the first moment.

And then after that, if you go to the US today, the labs of discounting device of Vuse are nowhere near what was before, so we still have a lot of geographic expansion happening as we speak. Not just in US vapor, it's not the case, but more necessarily in the THP on the markets. So, discount is still a number that plays a role, but the biggest spend is in R&D. We have stepped up our investment in R&D. We have just opened up a new hub in China to be closer with suppliers, so we are able to develop a stronger pipeline and making sure that, for every single of these categories, we have a rhythm of reaching at every single year with novelties in the market.

And that's what you expect to see BAT moving forwards. So, we have this step up. It's clearly the investments in R&D and then we have the usual marketing spend that you would expect, in a way that is much brighter than we used to be in combustible. Plus, today you can do the sponsorship in place like Formula 1, you can do above the line, you can do below the line, you do social media. Things that was impossible even to get closer to in combustible. Okay? And by the way, we expect to invest more in the second half, as I said last week, because we are coming to the market with new launches and new marketing activations to making sure that we keep the momentum going.

Gerry Gallagher, Deutsche Bank

Right. The timer's at zero, but we've got coffee next and I'm going to take advantage of that by asking one more question and it's a regulatory question. So, we've got the mental debate in the... So, we look at the US. Depending where sterling is, it could be 50% of your business this year. We've got the mental question, we've got the comments around "minimally addictive" that were made this week in nicotine, in cigarettes, and then we've got the age situation in the UK. Which you could argue, from a UK-centric perspective, is positive for you guys, but I think, based on comments Kingsley's made in the press, that you would be against that age transition in the UK. So, the question is where do you feel we sit from a regulatory

perspective in the industry? I appreciate that's a global question that's much more complicated than that, but could you help us frame how BAT thinks about the regulatory environment?

Tadeu Marroco, Finance and Transformation Director

Well, we believe that the debate will be much more science-led in the future and that's one of the reasons why we have been invest so much in science, in these new categories, because clearly these products are much less harm than combustible. Unfortunately, you still have entities like WHO that has a different view, but what we are seeing more and more in different markets is that we are getting traction in this. Understand the UK is a very good example, very progressive markets. Now, the government out there, in the Khan report you are referring to, they also say that they should stimulate vaping. And by the way, vapor to date for BAT is 40% of our revenue. That's what people don't capture. The size of the prize for us, and I'm talking more, a bit, financial because I'm a CFO, anyway, is Europe. BAT has been very predominant in the low value for money of cigarettes.

We will never be able to develop, really, a strong premium pipeline of combustible brands. So, the migration to those categories for us is massively creative. In tobacco heating products, in vapor and all that. But on the regulatory front, if you see more and more cases... France, for example. The Institute of Cancer in France is very supportive of vaping already. They came out very loudly about that. New Zealand, that wants to do the very draconian age on their cigarette. They are also very supporting vapor. FDA, they clearly see the risk continue. They have read an MRTPs for our tobacco heating products. They have read approved PMTA for vaping, which is a recognition that those products are much less harm than combust.

So, I think that what we'll be seeing over time is there are more science-based discussion and, hopefully, more and more governments understanding that instead of going for big

excise hikes, for example, that what it makes is basically bring illicit trades. Or going for draconian measures like levels of nicotine that we don't even know how to do it properly, to be honest. Then you'll get into this whole area of genetic modified leaf and all that, the whole chapter on that. It's much more effective to implement a clear tobacco reduction, a harm reduction strategy and that's why I was referring to Sweden. That's where you really make the big inroad in tackling the combustible problem. Okay?

Gerry Gallagher, Deutsche Bank

Great. I've exhausted my time. I've taken a bit more time than I should have done. Tadeu, thank you very much and thank you everybody else.

Tadeu Marroco, Finance and Transformation Director

Thank you. Thank you so much.

Gerry Gallagher, Deutsche Bank

Thank you.

Tadeu Marroco, Finance and Transformation Director

Good job.

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