

2021 Full Year Pre-Close Conference Call Transcript

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CORPORATE PARTICIPANTS

Tadeu Marroco

Finance and Transformation Director

Mike Nightingale

Head of Investor Relations

QUESTION AND ANSWER PARTICIPANTS

Gaurav Jain, sell-side analyst, Barclays

Nik Oliver, sell-side analyst, UBS

Richard Felton, sell-side analyst, Goldman Sachs

Rey Wium, sell-side analyst, Standard Bank Securities Group

Jonathan Leinster, sell-side analyst, Société Générale

Operator

Hello, and welcome to the BAT Pre-Close Trading Update. My name's Rhianne, and I'll be your coordinator for today's event.

Please note, this call is being recorded and, for the duration of the call, your lines will be on listen only. However, you will have the opportunity to ask questions at the end of the call. This can be done by pressing *1 on your telephone keypad to register your question.

For now, I'll hand you over to your host, Mike Nightingale, to begin today's conference. Thank you.

Mike Nightingale, Head of Investor Relations

Good morning everyone, I'm Mike Nightingale Head of Investor Relations and with me this morning is Tadeu Marroco, our Finance and Transformation Director. Welcome to our 2021 Full Year Pre-Close conference call. I hope you are all well and I would like to thank you for taking the time to join us this morning.

Before we begin, I need to draw your attention to the cautionary statement regarding Forward-Looking Statements, as well as the notes and disclaimer contained in the trading update.

I will now hand you over to Tadeu who will say a few short words on current trading, before opening it up to questions. Unless stated otherwise, our comments will focus on constant currency adjusted measures, and all - share data is year-to-date average, to September 2021.

Tadeu Marroco, Finance and Transformation Director

Thank you, Mike.

Good morning everyone and welcome.

At the start of the year, we said that 2021 would be the pivotal year in our journey to transform BAT and build A Better Tomorrow. And the business is delivering on that.

- Firstly, strong New Category revenue growth continues to be driven by accelerated consumer¹ acquisition this year, and we are making excellent progress towards our 2025 £5bn revenue target.

- Secondly, with increased scale and operating leverage, New Category losses start to reduce this year. This is a key first step in our pathway to profitability by 2025
- And finally, our strong focus on cash flow and deleverage means that we anticipate reaching around 3x Net Debt² /EBITDA³ by the year end.

This is important as it provides us greater capital allocation flexibility as we enter 2022.

Taking each of these in turn.

The first key driver of our pivotal year is our accelerating New Category performance.

This is driven by continued strong consumer acquisition. In the first nine months, we have added 3.6m consumers¹ of our non-combustible brands, reaching a total of over 17m consumers in September. This is already more than the growth over the full 12 months of last year and is driving continued strong volume and revenue growth across all three New Categories.

We are building strong global New Category brands of the future. Vuse, is a great example, with the brand achieving global value share leadership⁴ in Vapour in September, and also becoming the first global carbon neutral vaping brand that has been independently validated⁵

With our products available in 77 category markets across 55 countries globally, we are leveraging our established multi-category consumer-centric approach to provide consumers with a wide choice of scientifically substantiated reduced risk alternatives.

And the rapid digitalisation of our business is increasingly important in accelerating our transformation. Revenue Growth Management and Marketing Spend Effectiveness are now being applied across the New Categories, enabling us to generate higher returns on our investment, and drive our improvement in profitability.

Our New Category performance over the second half is being fuelled by our further increased investment.

Vuse is fast approaching value share leadership in the US and is now leader in 26 states. In all our other T5 markets, Vuse continues to extend its value share leadership position, with the global brand migration from Vype now successfully completed.

In October, Vuse Solo received the first of its kind US FDA⁶ vapour marketing authorisation, confirming that the marketing of Solo products is appropriate for the protection of public health. The Vuse Alto PMTA, submitted nearly a year after Vuse Solo, shares the same foundational science, giving us confidence in the quality of our other applications.

In THP, the continued success of glo Hyper is driving category volume share growth in consumables across every one of our Top 9 markets, reaching an overall 17.7% category share, up 4.5 percentage points.

In Japan, driven by the ongoing success of Hyper, glo is growing THP category volume share, which is up 170bps, reaching 21.1%. glo's total nicotine volume share is up +120bps to reach 6.6%.

In ENA, which now represents 50% of our THP volume, glo Hyper continues to accelerate volume and revenue growth with consecutive quarter on quarter share gains in key markets. In Russia and Ukraine, we have nearly doubled our consumable category volume share, with category volume share in both markets now around 20%.

Across our top 9 markets, which account for over 95% of our THP volume, our consumables price is on average at an index of 90 to our main peer.

glo Hyper is now available in 22 of 24 glo markets globally, with further market rollouts planned for 2022.

In Modern Oral, we are extending our international volume share leadership. Our overall category volume share in our top 5 markets ex US reached 68.9% up 140bps. These markets account for more than half of Top 5 modern Oral value.

We are particularly pleased by strong performances in Sweden and Norway, where our Modern Oral category volume shares of 59.5% and 63.8%, were up 5.6 and 1.7 percentage points respectively.

In a highly competitive market in the US, while Velo year to date volume share growth has slowed since the half year, we have still achieved 5.5 percentage points growth to reach 13.1%.

Overall Modern Oral category volume share in the top 5 markets was 36.1%, down 0.5 percentage points driven by the increased weight of the US market where we have lower share.

Turning now to improving New Category profitability, the second key driver of our pivotal year.

While we are continuing to increase our investment in New Categories, we are leveraging our increasing scale and expect our New Category business to contribute to profit growth in 2021, as losses start to reduce for the first time.

For the 2022 financial reporting period, we will disclose New Category contribution to group profit to provide investors with increased visibility and clarity on our pathway to New Category profitability by 2025.

We have invested and built significant IP in all three of our New Categories. This is essential for the long-term profitability and sustainability of our business and is critical to our work on tobacco harm reduction.

We have many patents registrations across the world, some of which have been the subject of litigation.

In the US we have successfully asserted our patents in THP, with the recent determination by the ITC that the competitor's products infringe two valid patents owned by Reynolds.

In Japan THP patent litigation brought by both sides is ongoing.

In the UK, there has been one substantive decision against us regarding the validity of two UK THP patents in the same family. Four of our competitor's flagship THP patents have also been found to be invalid in the UK.

In Germany our product, Vuse ePod was found not to infringe a competitor vapour patent. Other than this, there have been no substantive main judgements on the merits in Europe.

Patent registrations are unique to their jurisdiction, so judgements concerning patent validity in one country have no legal bearing on validity in another.

We believe we have strong patent protection for our New Category products, and our litigation record in this area to date has been strong.

Finally, turning now to the third driver of our pivotal year - our focus on cashflow and deleverage.

With strong Full Year operating cash conversion expected to be in excess of 90%, our year end Net debt² / EBITDA³ would be expected to already be below 3x at constant rates, reducing by more than point 4 turns.

As we approach the year end the ratio becomes sensitive to the differences between USD spot rates and average rates throughout the year, with the gap widening in recent months as the USD has strengthened. Despite this we expect Net debt²/EBITDA³ even at current⁷ spot rates, to be around 3x at 3.1x.

We recognise the clear value of a share buyback at the current valuation. We also continue to be clear on the need to deliver on our 2021 commitment to reduce leverage to around 3x. As we enter 2022, and as our leverage approaches our medium-term leverage target corridor of 2-3x, we anticipate having greater capital allocation flexibility.

So, our pivotal year is on track.

We are also on track to deliver on our financial guidance. We continue to expect constant currency group revenue growth in excess of 5%, benefitting from the strong New Category performance, which is now a sizeable contributor to group revenue growth.

We now expect Full Year tobacco industry volumes to be broadly flat, an improvement from the previously forecasted decline of around -1.5%. This improvement is mostly due to a strong industry recovery in Indonesia, driven by the low-price segment, which will not benefit our volume. We maintain our expectation for Full Year US industry volume decline of around -5.5%.

Robust combustibles revenue growth is expected to be driven by strong pricing, as we continue to drive value growth, with cigarette value share up 10bps. We expect this to be partly offset by the mix effect of volume recovery post COVID and share growth in key Emerging markets, including Bangladesh and Pakistan, as well as lower volume in the US.

Our US business continues to perform well driven by good pricing and share growth, with value share up 50bps and premium share up 60bps. This is being driven by the continued strong performance of Newport and Natural American Spirit.

We expect to generate savings of £1bn from Quantum, one year ahead of plan, and we are confident in achieving our upgraded target of £1.5bn by the end of 2022.

Overall, this strong operational performance is allowing us to absorb a large one-off profit⁸ headwind of £260m for the full year.

This includes a £220m impact from excise and competitive pricing in Australia in H2, an increase from the £170m excise impact previously stated at our interim results, together with a £40m impact from excise in New Zealand.

As a result, we are maintaining our expectations for mid-single figure constant currency adjusted diluted EPS growth for 2021.

Applying current foreign exchange spot rates⁷ of 1.32 as of December 3rd, we continue to expect a transactional headwind of around -2% on adjusted profit growth for FY21, and a translational headwind of over -7% on adjusted diluted EPS, and around -9% on and New Category revenue growth.

Overall, we are confident in delivering our financial guidance in this pivotal year.

The core of our transformation is to build A Better Tomorrow, and that is now deeply embedded throughout the business. Our strong New Category growth is a demonstration of our transition and is central to our Purpose to reduce the health impact of our business.

And to deliver on this ambition, we continue to develop a substantial body of scientific data for our reduced risk products across each New Category.

This includes the 180 day results from our landmark 1 year clinical study on glo, published in July⁹, which demonstrated that completely switching to glo resulted in positive changes to all indicators of potential harm compared to smoking, with the majority similar to quitting smoking.

During the year, we have continued to make good progress towards our other ESG objectives. In addition, we recently signed up to the UN backed Race to Zero global campaign.

The next phase of our journey to create a sustainable Enterprise of the Future is being driven by our transformation programme Quest. Digital, technology, and innovation will drive that transition, leveraging our agile organisation and building on the success of Quantum.

Our focus on scientifically substantiated, reduced risk tobacco and nicotine products¹⁰ continues and we will not stop there.

We are expanding our portfolio 'beyond nicotine'. That means delivering products that stimulate the senses of adult consumers, while enhancing satisfaction, enjoyment and wellbeing.

The BAT of tomorrow will be a high-growth, consumer goods company: global, consumer-centric, multi-category, with sustainability at our core.

Thank you and I will now open the call to questions.

Operator

Thank you. So, as a reminder, if you would like to ask a question or make a contribution on today's call, please press *1 on your telephone keypad.

Our first question this morning comes from the line of Gaurav Jain from Barclays. You're now unmuted. Please go ahead.

Gaurav Jain, Barclays

Good morning, Tadeu. Thanks a lot for taking my questions. So, I have a few questions. One is, you know, on the leverage and share repurchase, so could you, please, again, comment on what your leverage is at that end of the year? And, I thought that, because of the Hybrid debt issuance, it would be south of 3x, but it seems to be slightly ahead of it. So, what's the leverage?

And then, how does one think of share repurchases going forward. Would you like to keep this flat leverage and free cash flow after dividends? You know, investors should expect all of it comes back in the form share repurchases or you would like to de-lever along that corridor?

Tadeu Marroco, Finance and Transformation Director

Okay. Thank you, Gaurav, for your question. Look, the Hybrid is a more niche product. We did the Hybrid with the intention, actually, to reach out to new types of investors that we haven't had the opportunity before, which we did successfully. And also to provide a better match in terms of hedging with our euro debt, because we didn't have much euro capability to issue senior debt.

But the total magnitude of it is not, in the great scheme, is not that relevant. So, you would expect some benefit, more or less 0.1 turn, but the fact is that we are seeing big headwinds in terms of currency.

As I expected in the statement, and you know that we are now subject to the spot rate of US dollars at 31st December, what we are seeing now is, after a stronger pound throughout the year, we are seeing weakness more recently. And this creates pressure on this indicator of net debt to EBITDA because the net debt is translated into the 31st of December spot rate while the EBITDA earnings is the average of the year, which was, you know, a stronger pound. So, this has more than offset the potential benefit that we saw from Hybrid. That's why we are mentioning the circa 3x at this point in time.

So, in terms of the expectation, we will be satisfied within the range of 3 to 2. We are not making any type of commitment to go to, for example, low end of the range or all that. We want to be in the range, we think that it's important that we reach the range, and having the flexibility I was referring to, to make other types of call in terms of capital allocation.

You'll note that we are quite committed, and we understand the important of dividends for many of our shareholders, and we are also very clear in terms of delivering our commitment to the leverage the company after the acquisitions of Reynolds. So, that's why we are putting so much emphasis on cash generation, and we have a massive cash generative company today, after the acquisition of Reynolds, with a very strong conversion, and we have all the possibility to keep that.

Our debt, moving forwards, is very well-managed. We did a liability exercise last year. We carried some of the most expensive debt to '22/'23. So, the in every single year, moving forwards, we'll have a pick-up debt of £4bn in which more than half of that we can generate organically. So, it's completely manageable within our Group finance.

We have a good match between currencies in terms of debt and earnings, and our interest cover is very healthy at approaching 4 - 8 times. So, all the metrics on treasury is quite substantial. So, for me, within the range of 3 to 2 is enough to have that flexibility that we are referring to.

And we understand that there is a lot of attention for buybacks given the share price, and the main Board is quite sensible to that as well - we have done in the past - we understand the value of that, and this is one of the considerations that we'll take as we close the year.

Gaurav Jain, Barclays

Sure. Thank you. My second question is on cigarette pricing in the industry. So, your key competitor is now saying explicitly that they don't think they need to take a lot of cigarette pricing because of the mixed benefit that they are seeing from IQOS, and how do you think of cigarette pricing, you know, outside the US as you go forward?

Tadeu Marroco, Finance and Transformation Director

The price environment is still very healthy. If you see what we expect to achieve in '21, it's an even higher level than we had in 2020, and we, in particular, in BAT, we are quite pleased with the strong portfolio that we have. We are now reaching 7% of our portfolio, what we call our global-drive brands, and well represented in the very different pricing categories, and we are rolling out the data analytics too that we developed in the US across the world. That gives us a better chance to leverage on the strength of our portfolio.

So, we believe that we have a strong foundation to continue delivering the results and the value that we expect to deliver in this, aligned with our strategic objective of BAT, from Combustibles moving forward.

Gaurav Jain, Barclays

Sure. And my last question is on Germany, you know, the recreational cannabis legalisation proposal that is there. So, clearly, in Canada, you did not participate directly, and you have an investment in one of the companies there, but Germany is a much bigger and more important

market. So, would you look at participating in the cannabis market in Germany if it were to really legalise next year?

Tadeu Marroco, Finance and Transformation Director

Look, Gaurav, this is a continuous reassessment that we make on that space. We saw the opportunity in Canada because we liked the OrganiGram as a company. We thought it was well-positioned to grow in the future. So, we entered also in a product development collaboration agreement with OrganiGram that leveraged the combined expertise in terms of base science and product development, with the initial focus on CBD. And we are satisfied with these levels of investment that we have.

We have to see the evolution of cannabis moving forward, the legalisation, because you know that have some restrictions here in the UK where we have to comply with and all that. So, we will continue to be prioritising that, the level of compliance, but we have to keep assessing the opportunity out there.

So, it's very early to say that we want to take part on this. We have to understand first the dynamics of the markets.

Gaurav Jain, Barclays

Sure. Thanks a lot, Tadeu.

Tadeu Marroco, Finance and Transformation Director

Thank you.

Operator

So our next question comes from the line of Nik Oliver from UBS. Nik, you're now unmuted, please go ahead.

Nik Oliver, UBS

Good morning, Tadeu and Mike and thanks for the questions. Two from my side.

Firstly, another one on pricing, but this time the US. So I guess we've seen I think three price increases near to date in the US, so I think there was four last year. Just you know, what's giving you the confidence to push so hard on price, and any changes you've observed on elasticity, you know, either nationally or at the regional level?

And the second one on Modern Oral. You mentioned in the US, you know, it's a highly competitive market. I'm just interested whether there's any plans for a PMTA on the non-USA Velo going forward?

Tadeu Marroco, Finance and Transformation Director

Okay. Thank you, Nik. Look, Nik, the US, we are very, very pleased with the performance of our portfolio in the US in the first place. As you saw from the announcement, we have now grown premium share by six basis points, the value share is 50 basis points. We are not seeing any down trade in our portfolio.

We are well represented in all the different price points with the introduction now of the Lucky Strike at the top end of the portfolio in which we have deployed tactically in some of the states where we see stronger competition from these known big-three brands.

So we are very pleased, and this gives us reassurance that we can still pursue a value from the market given the fact that in the elasticity is still very benign. We haven't seen any major difference in terms of elasticity in the US, it's around 0.4 which is an indication that there is still a lot of pricing power in the US to go after.

And on top of that, like I mentioned in the previous question, we have developed a very strong analytical tool that we call Revenue Growth Management Tool, that allows us to have a very, very granular visibility of competitiveness in pricing, even at postcode, or different channels or key accounts, and we can react to any lack of competitiveness in pricing and change in trade terms, for example, very fast.

So when you put all this together, we feel comfortable in taking the value out of the market and that's exactly what we are doing in line with the comparatives of the group.

Now in terms of Modern Oral, the US Modern Oral category remains highly price competitive, and it's a very, very small one. Just to give an idea, it's only around 20% of the value of the Vapour category, for example to provide an idea. It's the value I think that reached now something like 1.5%, around 1.5% of the total Nicotine value. And it's a continued low average daily consumption with the vast majority of consumers, poly-users with all the nicotine products. Just to provide some information, for example, the average daily consumption in the US of Modern Oral is around three pouches while in Sweden it's nine and Denmark is eight pouches.

So it's a segment that is still in its infancy and trying to mature. We have learned a lot in the last two years at the acquisition of Dryft, there are clearly some areas that we want to improve in terms of our product mix and consumer acquisition.

And you were referring to PMTA of our international products and clearly, it's something that is in our strategy, because as you know, we have leadership in our Modern Oral products outside of the US because basically they are the best-in-class, and we want to bring those products in the US. There is a process to go through, the PMTA is there but there is science that we need to deploy, so there is some time that we need to materialise that.

And meanwhile, our priority also has been where we see the biggest opportunities to switch smokers in the US, which is Vapour, which we are doing extremely well and are now leaders in 26 states, we're very close to taking leadership in the market. So, we are very pleased with the progress we are making in our non-combustible business in the US.

Nik Oliver, UBS

Great, thank you. That's really clear.

Operator

So our next question comes from the line of Richard Felton from Goldman Sachs. You're now unmuted, please go ahead.

Richard Felton, Goldman Sachs

Yeah, good morning. Two questions from me please. My first question is on potential changes to federal excise taxes in the US which could, if they are implemented, have a very material impact on the Modern Oral and Vapour categories. Could you maybe share some thoughts on how you see those potential changes impacting those categories? And specifically I guess my question is how important is price in the consumer's decision to switch from smoking to Vapour for instance?

Then my second question, you've confirmed that New Categories will contribute to profit growth for the first time this year as the losses begin to reduce. Is there anything you can share at this stage on how big that impact is going to be for EBIT growth this year? Thank you.

Tadeu Marroco, Finance and Transformation Director

Okay, Richard. Look, just on the first one, I think that it is premature to speculate what will happen in terms of the federal excise tax. And we saw a bill that went to the law house which is different from the one that now is in the senate. And you are right, the current view is expecting increasing in excise in smokeless products mainly which doesn't make much sense in terms of the risks continue - or the benefits for health for consumers. That's the only comment that I can make for you at this point in time, but I think that it's very, as I said, very early on to make any conclusions of the outcome of that. There is still a lot of negotiations and debates we're going through.

So for sure that price is an important element of this transition. That's why we believe that common sense will prevail at the end, and they will not jeopardise all the, probably not jeopardise all the transitions that have or are happening in terms of incentivising the alternatives to cigarettes in the US. So - but to be seen.

On the last, we are not providing any disclosure in terms of the magnitude of the loss reduction, but the important point is that from now on, from 2021 onwards New Categories will be accretive for the profit of the group.

So it has already material in our revenue growth, that's one of the reasons why we have upgraded our guidance for revenue of above 5%, it's exactly that. You're already seeing a material impact of revenue coming from New Categories and this will slowly build from the profit side as well.

So from 2022, as I said in the statement, we'll provide now a full disclosure about the profit impact on New Categories, so you'll know exactly where we stand on that. But we are very pleased with the progress we are making in terms of margin improvement across the patch, mainly on the Vaping business. As you'll know, we have some leverage to play, which is materialising. The cost of products, for example, reducing as a consequence of more automation and the trade margins improving as a consequence of the deployment of revenue growth management which translates into new offers for consumers in different pods and formats and price intake for example. And in Device, we are starting to recover price in Device.

In consumers, we have never taken discounts when we are also increasing our price in our consumers. So when you put - and the improvement that we are making now in the e-commerce side which is one of the top-branded websites that we have out there. So we are very pleased with the performance we are making in e-commerce.

So when you put all this together the margins in Vaping are being a big driver of this recovery in terms of profitability across the New Categories. And we are very pleased, but we want to see this in more detail from next year onwards.

Richard Felton, Goldman Sachs

Great, thank you very much.

Operator

our next question comes from the line of Rey Wium from SBG Securities. You're now unmuted, please go ahead.

Rey Wium, SBG Securities

Hi, Tadeu and Mike. Thanks for the questions.

Tadeu Marroco, Finance and Transformation Director

Hi, Rey.

Rey Wium, SBG Securities

Just a few quick ones. I just want to get an understanding of your commentary around cigarette volumes. You said the industry you expect to be largely flat. You also talk about your value share is up ten basis points but there is not a reference to your actual volume share. I don't know if you could maybe just elaborate on what we can expect on the volume share, maybe?

Tadeu Marroco, Finance and Transformation Director

Okay, sure. Rey, so yes, what we said is that the major driver is compared with what we have guided before, in the interim results is the improvement in Indonesia. And the consequence of that is basically, the reason for that is basically the government hasn't enforced the minimum price yet, so the industry hasn't taken the price and so there is clearly a trade-off there between value from our side and volume. So, you have more volume with less value.

For BAT there's not much relevance because we don't have much presence in that market in particular. That's why we called the attention for that.

Rey Wium, SBG Securities

Thank you.

Tadeu Marroco, Finance and Transformation Director

On the Cigarettes, the way that we are measuring now, Cigarettes, the market share given the transition between Tobacco Heating Products with Cigarettes is putting all of them together. And as we stand today, year to date, we have a ten basis point increase in market share.

Rey Wium, SBG Securities

Okay, excellent. And just to get an understanding of the profit drag in Australia and New Zealand, I mean the increase of about £19m since the half year. I mean you probably more or less knew the impact of the excise situation. Is it therefore fair to assume that this additional increase in the drag is the result of price competitiveness?

Tadeu Marroco, Finance and Transformation Director

Yes, we have quoted already in the interim an expectation of £170m as basically a consequence of excise. And what we saw as we moved around

the second half is the impact of excise that materialised as we were expecting, but also a very competitive pricing environment. So we had to react to some of the actions taken by competition there and this reflected in higher losses in the market.

We are also quoting New Zealand, that also changed the excise. But let me tell you, the excise is a headwind in the short term but it's beneficial for the long term of the business. But what we have seen is an ad hoc excise increase since 2012 when the government introduced a package in that market, and this has stopped now. So it's good for the sustainability of the business in the long run, it's bad in terms of impact in the short term.

And that's one of the reasons why we kept our mid-single digit performance this year. We had this impact, we quoted also transactional FX, we had already said that some time ago since the beginning of the year. The transactional FX this year is quite substantial, it accounts for close to 2% of our operating profit.

And we also had to deal, for example, with our Iranian business that - which we divested the Iranian business in August this year. So, we are lacking that as well.

So, and the fact that we still are not out of the woods in terms of COVID. India in particular has been badly impacted and this reflects in ITC performance, hence our difference between operating profit in EPS. But remember that we report ITC numbers with six months' lag, so we are still reporting in a very difficult environment for ITC as a consequence of COVID in India. And that's why we decided to keep the mid-single digits for this year.

Rey Wium, SBG Securities

Thank you. And could you just confirm did you say the market share in Tobacco Heating Products in Russia and the Ukraine was around about 20%?

Tadeu Marroco, Finance and Transformation Director

Yes, and our share in the THP category in Russia, Ukraine, also Romania is around 20%. Japan is slightly above that as you saw in the statement.

Rey Wium, SBG Securities

Yeah. Excellent, thank you.

Operator

So, our final question comes from the line of John Leinster at Société Générale. You're now unmuted, please go ahead.

Jon Leinster, Société Générale

Thank you very much. Good morning, gentlemen.

Tadeu Marroco, Finance and Transformation Director

Hi, John.

Jon Leinster, Société Générale

Yeah, two questions if I may. The first one, a number of your competitors have said they've got problems in terms of supply-chain with semiconductors which will limit their growth in terms of Heated Tobacco, and I suppose potentially some of the more advanced Vaping products. Is that an issue that you have going into 2022 or indeed in the second half of this year?

Tadeu Marroco, Finance and Transformation Director

No, it's not. We have a very strong supply-chain management and engagement with our suppliers in terms of Tier 1, Tier 2 with a product that allows us a lot of flexibility and we could accommodate all these pressures that you are reading in the news in the sense that we are not seeing any headwind coming from that.

Jon Leinster, Société Générale

Okay. Secondly, again I suppose on input costs are clearly a feature of the day for consumer goods in general. Looking forward into 2022, do you foresee any major increases in costs or input costs going into 2022?

Tadeu Marroco, Finance and Transformation Director

Yeah, we definitely see an increase in costs for next year. But remember that we have vertically integrated leaf operations, so this is being helped by the devaluation of Real in Brazil because this is the major source of leaves that we have in the Group, so we mitigate some of this impact there.

The impact is mainly on the labour costs and the factories, but also freight in general. And we expect the inflation overall will be double than one that we faced in 2021, but we have as a consequence of rolling-out Quantum, and you saw that we have just upgraded our target from £1bn to £1.5bn. We expect to generate savings to mitigate all these cost impacts for next year.

Jon Leinster, Société Générale

Thanks. And then also clearly, you've been looking at the Nicotine Pouch products particularly, even in some of the emerging markets and some of the non-Scandinavian European markets. Can you give feedback on the size of the markets in the sort of non-Scandinavian European, but also any feedback you can give on whether the trials in some of the emerging

markets have been successful or whether the product needs to be adjusted?

Tadeu Marroco, Finance and Transformation Director

Yeah look, we are excited about this opportunity in the emerging markets. We believe that the affordability that is allowed by Modern Oral is a good match with some of those markets. Mainly, for example, the ones that you saw a lot of cigarettes being sold by stick, where affordability is an issue because in those markets you can provide for example these Nicotine Pouches even in sachets if you want. So, we are in that market in the likes of Pakistan and Indonesia.

We are trying to do it in a very balanced way because in some of those markets there is already an Oral tradition, which makes it easier for this product to be accepted, some others not so you have to build the awareness of the product first.

We are really excited with the first results that we are having, but it's early days for us to make a meaningful difference in terms of volume. But it's building nicely - this business in some of those markets.

Jon Leinster, Société Générale

Thanks. And lastly, I mean clearly, glo Hyper has had good success in Europe and Japan. It's a similar question to one I think that was put forward with the European Nicotine Pouches. So are there any plans for PMTA for the US market?

Tadeu Marroco, Finance and Transformation Director

Yeah, the US market, I think we spoke about this before, we are not seeing any major attractiveness in terms of a THP in that market, which is not a surprise for us, because we know from experience that we've had before in the likes of Canada where the industry has invested a lot and the absence of any products from THP. That would be a hard-sell given the circumstances of - the characteristic of the market is a very high tie in nicotine markets in Cigarettes and where we have a very well-established Vapour market already.

So when the consumers had made already their call to move away from Cigarettes and into Vaping, for example, it's difficult to see them for example moving back to Tobacco rods. You still have to deal with Tobacco rods instead of burning it or heating it but it's still a tobacco rod, so we have seen that in Canada. That's the reason why in markets like France, for example, where a Vape is also well established, or the UK you haven't seen much progress on that.

So it's not a surprise to see that there is no traction in THP in the US markets, but we have plans to apply for PMTA in our own product there, because we believe that there's also an important movement in terms of FDA advocacy outside the US, to have that product approved in the US. So yes, we are on track to do that.

Jon Leinster, Société Générale

Okay, great. Thank you very much.

Tadeu Marroco, Finance and Transformation Director

Thank you all for listening and for your questions.

In conclusion, 2021 is the pivotal year in our journey to transform and build A Better Tomorrow. We are:

- Delivering strong New Category revenue growth, driven by accelerated consumer acquisition this year, resulting in further good progress towards achieving our £5bn revenue target by 2025.
- Secondly, with increased scale and operating leverage, New Category losses start to reduce this year. This is a key first step in our pathway to profitability by 2025
- And finally, our strong focus on cash flow and deleverage means that we anticipate reaching around 3x Net Debt²/EBITDA³ by the year end.

Importantly this provides us with greater capital allocation flexibility as we enter 2022.

And with that, I hope that you all keep safe in these uncertain times and would like to wish you and your families a very enjoyable holiday season.

Operator

Thank you for joining in today's call. You may now disconnect your lines. Hosts, please stay on the line and await further instruction.

END

¹Non-Combustible Consumer Definition: The number of consumers of Non-Combustible products is defined as the estimated number of Legal Age (minimum 18 years, US: 21 years) consumers of the Group's Non-Combustible products. In markets where regular consumer tracking is in place, this estimate is obtained from adult consumer tracking studies conducted by third parties (including Kantar). In markets where regular consumer tracking is not in place, the number of consumers of Non-Combustible products is derived from volume sales of consumables and devices in such markets, using consumption patterns obtained from other similar markets with consumer tracking (utilising studies conducted by third parties including Kantar). Target market for acquisition is existing adult smokers/nicotine users. The number of Non-Combustible product consumers is used by management to assess the number of consumers regularly using the Group's New Category products as the increase in Non-Combustible

products is a key pillar of the Group's ESG Ambition and is integral to the sustainability of our business. The Group's management believes that this measure is useful to investors given the Group's ESG ambition and alignment to the sustainability of the business with respect to the Non-Combustibles portfolio.

² Adjusted net debt is not a measure defined by IFRS. Adjusted net debt is total borrowings, including related derivatives, less cash and cash equivalents and current investments held at fair value, excluding the impact of the revaluation of Reynolds American Inc. acquired debt arising as part of the purchase price allocation process.

³ Adjusted EBITDA is not a measure defined by IFRS. Adjusted EBITDA is profit for the year before net finance costs/income, taxation on ordinary activities, depreciation, amortisation, impairment costs, the Group's share of post-tax results of associates and joint ventures, and other adjusting items.

⁴Based on Vype/Vuse estimated value share from RRP in measured retail for Vapour (i.e. total Vapour category value in retail sales) in the USA, Canada, France, UK, Germany. These 5 markets cover c. 75% of global Vapour closed system revenue.

⁵ Vuse's carbon neutrality has been independently validated by Vertis based on product Life Cycle Assessment data provided by an independent third party. This assessment takes into account the Group's purchase of carbon credits through reforestation projects

⁶ US Food and Drug Administration (FDA)

⁷Current exchange rates of USD/GBP 1.32 as at 3rd December 2021

⁸At constant rates

⁹<https://link.springer.com/article/10.1007%2Fs11739-021-02798-6>

¹⁰Based on the weight of evidence and assuming a complete switch from cigarette smoking. These products are not risk free and are addictive. Our products as sold in the US, including Vuse, Velo, Grizzly, Kodiak, and Camel Snus, are subject to FDA regulation and no reduced-risk claims will be made as to these products without FDA clearance.