



British American Tobacco Preliminary Results 2014
Thursday 26 February 2015

CORPORATE PARTICIPANTS

Nicandro Durante

Chief Executive

Ben Stevens

Finance Director & Chief Information Officer

CONFERENCE CALL PARTICIPANTS

Erik Bloomquist *Berenberg - Analyst*

David Hayes *Nomura - Analyst*

James Bushnell *Exane BNP Paribas - Analyst*

Jon Leinster *Panmure Gordon & Co. Limited - Analyst*

Adam Spielman *Citi - Analyst*

Jon Fell *Ash Park Capital - investor*

Chas Manso *Societe Generale - Analyst*

PRESENTATION

Nicandro Durante - *British American Tobacco plc – Chief Executive*

So good morning, everyone, and welcome to British American Tobacco 2014 full-year results presentation.

I am Nicandro Durante, Chief Executive of British American Tobacco, and with this me this morning we have Ben Stevens, our Finance Director. And as always, a warm welcome to those of you who may be listening to the conference call or watching via our website, bat.com. As usual, after I take you through the results presentation, there will be an opportunity for those of you in the audience to ask questions.

2014 has been a challenging year for consumer goods companies generally. Whilst the tobacco industry is more resilient than most, it is not immune from the macroeconomic environment. However, I am pleased to say that British American Tobacco has continued to perform well and the Group has delivered another good performance in 2014.

Although currency movements had a significant effect on our reported numbers, on a constant currency basis we grew revenue 3%, profit more than 4% and EPS 8%. This is a very good performance given the weak economic environment, significant excise increases in two of our largest markets and an increase in competitive price activity during the year.

Volume was down 1.4% against an industry down around 2.5%, as we continue to grow share. This was driven by another excellent performance from the global drive brands, with volumes up nearly 6% and share up 90 basis points.

Pricing in the vast majority of our markets remains strong, and price/mix of 4.2% for the full year reflects the later timing of price increases during the year. We've had good uplift in price/mix in the final quarter.

We continue to make good progress on our operating margin, which was up over 50 basis points to 38.7%. Exchange rates had nearly a 12% translational impact on reported EPS. However, I am pleased that on a constant currency basis we have again delivered on our commitment to high single-figure earnings growth with an 8% increase in EPS.

I will now hand over to Ben to take you through the numbers in more detail.

Ben Stevens - *British American Tobacco plc - Finance Director & Chief Information Officer*

Thank you, Nicandro, and good morning, everyone.

Looking at the Group's performance by region, Group cigarette volume was down 1.4%. This was driven by good performances from EEMEA and Asia Pacific, together with a slowdown in the rate of decline in Americas. Western Europe volume was impacted by continued industry decline driven by the weak economic environment, although there are signs that this is gradually improving.

EEMEA, Asia Pacific and the Americas all contributed to the good increase in revenue and profit, which at constant rates were up 3% and 4%, respectively. Western Europe revenue was 2% lower, mainly due to industry volume contraction and the partial absorption of excise increases in Italy and France. Adverse exchange rates affected all regions, resulting in reported revenue and profit down 8% and 7%, respectively.

I highlighted the impact of foreign exchange on our reported numbers at the time of interim results, and given the continuing appreciation of sterling, I'd like to do so again before we look at the regions individually.

Some of our major currencies, including the Brazilian real, Australian dollar, South African rand and the Japanese yen, have lost well over 10% against sterling, while the Russian ruble has fallen by nearly 50%. This resulted in a 12% reduction in reported earnings per share, which masks an otherwise very good 8% increase in EPS on a constant currency basis.

Predicting foreign exchange rates is a hazardous business, but I normally give some guidance on the translational impact on results if FX rates had stayed exactly where they are today. So the translational headwinds that we have faced over the last two years do look set to continue, and at today's rates, the headwind would be 7% at the operating profit level and over 5% at the EPS level.

However, the movement we've seen in transactional exchange rates also considerably increases import costs in local currency for items such as leaf, filter toe and wrapping materials. We do not strip out the effects of transactional FX in our adjustment from current to constant rates of performance. If we did, profit would have grown by 6%, the operating margin, which I'll cover in more detail later, would have been up nearly 120 basis points, and EPS would have grown by nearly 9.5%.

Obviously, given the scale of recent exchange rate movements, transactional FX is likely to be a bigger feature in 2015. Exchange rates are changing all the time. However, at current rates, transactional FX would be a drag on operating profit of over 5% in 2015. This of course is before any mitigating actions, repricing or cost reductions.

Now, moving on to the regions, AsPac performed well in 2014, growing volume, share and constant currency revenue and profit. Despite a challenging pricing environment in Australia, profit in constant terms was up 1.2%, due to good performances in Bangladesh, South Korea, Malaysia and Pakistan.

The significant devaluation of the Australian dollar and the Japanese yen meant that reported revenue and profit were down 7.9% and 8.6%, respectively. Volume was in line with last year, as industry volume decline in Vietnam and Australia offset good performances in Bangladesh, Pakistan and Indonesia.

In Australia, volume declined as the market contracted. A competitive pricing environment and some share loss in the first part of the year led to lower profits. However, Rothmans is performing extremely well and now has a share of 9% nationally, just six months after launch. As a result, we've stabilized corporate share and have seen growth over the final quarter of the year.

In Indonesia, volume increased due to continued growth of Dunhill and Club Mild, which more than offset the decline in tail brands and led to an improvement in profitability in this investment market. The two brands now account for around 80% of volume.

In Japan, a strong performance from Kent drove share to a new high of 12.3%. Performance in Bangladesh and Pakistan continued to be very strong, with good growth in volume, profit and share, although we're now lapping some very strong performances in the prior year.

The GDBs again performed very well, with volume up 6.5%, mainly driven by the outstanding performance of Pall Mall in Pakistan and the Philippines, Dunhill in Indonesia and Kent in Japan.

In the Americas region, reported revenue and profit declined, mainly due to exchange rate movements in Brazil, Canada and Venezuela. However, on a constant basis revenue grew due to improved pricing in the region. Good performances in Brazil, Canada, Mexico, Venezuela and Chile drove strong growth in profit. Volume was down 2.3%, mainly due to Brazil and Canada, which offset growth in Venezuela and Mexico.

In Brazil, strong pricing ensured good growth in revenue, and this together with cost savings resulted in profit growth at constant rates, despite industry volume decline. Share reached a record high of 78.4%, driven by the continued strong growth of Dunhill and local brands.

In Canada, profit in constant terms increased due to higher pricing and reduced costs. Volume declined following both federal and provincial excise increases, which also led to an increase in illicit trade for the first time in two years. Full-year share was lower, but share grew over the second half of the year, exiting at over 50%.

Mexico delivered another great performance. Profit grew strongly as a result of improved pricing and higher volume, driven by strong share gains, in particular from Pall Mall and Lucky Strike.

Excellent performances from Pall Mall in Mexico, Chile and Canada, and Dunhill in Brazil, drove overall GDP volume up by 10%.

In Western Europe, the majority of markets continued to be impacted by the weak macroeconomic environment, in particular the high levels of unemployment. Lower volume, competitive pricing actions and absorption of excise in some markets led to a small decline in revenue and profit in constant terms. At current rates, revenue and profit declined 8% and 7%, respectively, due to the weakness of the euro.

Volume in the region was down 5.9%, mainly due to market contractions in Denmark, Poland and Romania, offsetting growth in Spain and the UK. In Romania, we maintained our market leadership position, with Dunhill and Pall Mall both performing well. Pall Mall is now the fastest growing brand in the market.

In Italy, we made good progress with share growth in the final quarter of the year, as Rothmans continued to perform well. Changes to the excise structure have now unlocked industry pricing in the market.

In the UK, volume and share grew, with good performance from Rothmans. In Poland, profits increased, as did share, with a strong performance from Pall Mall.

In France, volume and profit were lower, impacted by contractions in the end market and industry absorption of an increase in excise. However, market share increased, driven by a strong performance from Lucky Strike.

The global drive brands performed well across the region, with flat volume in a declining market, driven by good performances from Rothmans in Italy and the UK and Lucky Strike in France, Spain and the Netherlands. Fine cut volume grew by 1.7%, as a result of increases in Hungary, Belgium, Luxembourg and Germany. The GDBs including fine cut were up 0.9%.

EEMEA delivered another outstanding performance, growing volume, share and constant currency revenue and profit. Reported profit and revenue were down, impacted by FX, in particular the depreciation of the Russian ruble. Revenue in constant terms was up 7%, driven by slightly higher volumes and good pricing, leading to a 9% improvement in profit in constant terms.

Volume from the region was up 0.3% to 227b sticks. This increase was mainly driven by Iran, Ukraine and Turkey. These upsides were offset by market contraction in Russia.

On a constant currency basis, Russia delivered double-digit profit growth in 2014, due to strong pricing. We also continued to grow share, driven by the strong growth of Rothmans and Lucky Strike. Volume was down over 10% in 2014, driven by industry contraction following the large excise driven price increases.

In South Africa, volume and share fell due to increased competitive pricing activity. In Turkey, I'm pleased to report that excellent performances by Kent and Viceroy helped grow volume and stabilize share in the market. Profit in Ukraine was up strongly, due to robust pricing and volume growth. Share also increased significantly, driven by Rothmans.

The GDBs grew nearly 8%, with strong performances from Rothmans, Pall Mall and Lucky Strike.

Now, turning to operating margin, we grew our operating margin by 54 basis points in 2014 to 38.7%. As anticipated at the time of the interims, this was driven by a strong performance in the second half of the year.

The rollout of SAP remains on time and on budget, and the new way of working now covers more than 60% of the business, following the successful completion of the rollout in Western Europe. Changes to the organizational structure resulting from the implementation of the single operating model helped drive a significant reduction in Group overheads.

In Asia Pacific, a continued strong performance in lower margin markets such as Pakistan and Bangladesh and growth in the low price segment in some markets did affect operating margin. All other regions contributed to the margin improvement.

In Americas, strong pricing and cost management in Canada, Chile and Mexico drove an excellent 190 basis points increase. In Western Europe, good pricing in Germany and Poland together with continued cost management meant an improvement of 40 basis points. Finally, in EEMEA, good performance in the Middle East, Nigeria, Ukraine and Russia enabled a solid 50 basis point growth despite significant transactional FX headwinds in Eastern Europe.

As you know, on average, we aim to grow our operating margin between 50 and 100 basis points a year, and I'm delighted that we have again achieved this.

Reported earnings per share was 4% lower at 208.1p, although it was 8% higher at constant rates. This was largely driven by the good profit growth supported by the performance of associates and the contribution of the share buyback program in the first half of the year.

We've improved our average cost of debt during the year, and this together with the cessation of the share buyback has reduced net finance costs. The underlying tax rate is marginally lower than this time last year, at 30.6%.

Now, moving on to cash flow, overall free cash flow is GBP2.5b. This is below 2013, principally as a result of non-tobacco litigation settlement payments. Depreciation is the largest component in the non-cash items, and this is slightly down on last year.

Working capital outflows are lower than 2013, largely due to stock builds linked to the timing of excise driven price increases. Gross CapEx is slightly below GBP700m, and this is partly offset by asset sales, giving a net CapEx spend of GBP627m. We expect gross CapEx to be around GBP750m in 2015, as we continue to support investment in the SAP deployment and innovation and next generation products.

Our operating cash flow conversion rate remains in line with last year at 91%, reflecting our ability to generate strong cash flows.

Shortfall fundings for pensions relate to the UK schemes and is below last year's contributions. Net interest paid is also lower than 2013 and partly reflects our cessation of the share buyback in July, as well as continued optimization of our debt facilities.

Restructuring and settlement outflows were higher than last year, driven by payments relating to the settlement of the Flintkote and Fox River non-tobacco legacy litigation cases in Canada and the United States. This delivers free cash flow of GBP2,507m.

Finally, I'd like to touch on shareholder returns. In 2014, we returned GBP3.5b to shareholders, which is 140% of our free cash flow, or just below 120% excluding the non-tobacco litigation payments. This reflects our confidence in the business performance, as well as our commitment to growing shareholder returns.

Net debt increased by GBP650m to GBP10.2b, and our credit rating was held at A3 by Moody's and at A- by Fitch and S&P.

As you know, we suspended the share buyback with effect from the end of July 2014, following the announcement of our intention to invest \$4.7b to maintain our 42% shareholding and support Reynolds' proposed acquisition of Lorillard. Earlier this week, we confirmed that we are considering an investment of another GBP2.3b to purchase the remaining 24.7% of Souza Cruz shares not already owned by BAT.

Should both the Reynolds and Souza Cruz transactions go ahead in full, BAT would in 2015 marginally exceed our net debt to EBITDA guidance of 1.5 to 2.5 times. We would therefore consider restarting the buyback in 2017.

We've always said our priority is the dividend, and that 65% dividend payout ratio is a floor, not a ceiling. At the interims, I reiterated our commitment to growing the dividend in sterling terms in 2014. We're therefore proposing an increase in the full-year dividend of 4%.

Thank you. That's all for now, and I'll hand you back to Nicandro.

Nicandro Durante - British American Tobacco plc – Chief Executive

Thank you, Ben. Ben has taken you through the numbers. I would like now to take you through a few of my highlights of our performance last year.

First, I am pleased that despite 2014 being a challenging year, on a constant currency basis, we continue to deliver good growth in revenue and profits and delivered on our high single-figure earnings growth commitment.

As we highlighted at Q3, during 2014, we have seen an increase in competitive pricing leading to growth in the value-for-money segment in some of our markets. However, we achieved good price in the vast majority of our markets, leading to a price index for the year of 4.2%. Geographic mix remains the main offsetting factor in price/mix, as we continue to grow strongly in emerging markets.

These results were delivered while continuing to invest significantly in a sustainable future for our business. This includes investment in growth opportunities in markets such as Indonesia, Russia, Japan, and new entries such as the Philippines and the next-generation product development.

We also continue to invest in our innovations rollout. This is reflected on our 10% share growth and the continued strong growth in the GDBs, which grew share by 90 basis points and volume by 6% to 278b. This is against an industry down by around 2.5%.

Now, turning to each of the GDBs, Dunhill had another good year, up nearly 3%, driven mainly by good performance in Indonesia, Brazil and Romania. In Indonesia, Dunhill grew volume by 29%, reaching a premium segment share of nearly 7% and a national share of almost 3%. The brand performed strongly in Brazil, growing 1.5 percentage points to reach a record exit share of over 12%. Dunhill was a key driver of the Group's 30 basis point share growth in the premium segment.

Kent global volume declined by 2.8%, mainly due to industry volume contraction in a number of its key markets, in particular Russia and Romania. This was partially offset by strong performance from the brand in Iran, Japan and Uzbekistan.

However, share remained stable, with growth in Japan, Turkey and Vietnam offsetting decline in Russia and Romania. In Japan, Kent became the fastest growing brand in 2014 through the successful introduction of tube filters and continuous growth of Kent Slim. The brand now has over 7% share of the market.

The rollout of tubes in Russia has led to a stabilization of share in that market, despite very high price increase as a result of excise rises, and Kent remains the leading brand in the premium segment. Kent is also performing well in Turkey, achieving a nationwide share of nearly 2%.

I am very pleased to say that in 2014 Lucky Strike resumed its growth momentum, with volume up 0.8% to 31b. Growth in Argentina, Spain, France and Russia more than offset the declines in Chile and Poland. The launch of Lucky Strike Menthol spearmint double capsule in France last year has shown promising initial results, becoming the most successful industry launch in France in the last five years, already reaching a market share of 0.44%.

Lucky Strike Additive Free and Convertibles continue to be key drivers of the brand's growth, with volume up 42% and 5%, respectively, in the year. Lucky Strike remains the additive free segment leader, with 35% share in the top 40 markets. Overall, the brand performed well, with share up 10 basis points across the top 40.

Pall Mall grew share and volume strongly. The brand continues to have great momentum, with volume up 5.6%, and including fine cuts Pall Mall reached a record volume, crossing the 100b sticks equivalent mark for the first time. This fantastic performance is driven by growth in key markets across all the regions.

The brand continues to perform very well in Mexico, with volumes up 30% versus 2013. In the Philippines, it is showing a great performance in the convenience channel, achieving leadership in 7-Eleven with 32% share. Overall, share grew by 30 basis points with very strong results in Pakistan, Mexico, Canada and South Africa offsetting decline in Italy and UK. Fine cut volume was also up by 5.4%, with growth in Germany, Hungary, Belgium and the Netherlands.

Rothmans, the most recent addition to our GDP portfolio, grew volume by nearly 40%, due to the success of new market launches. It is the fastest growing international brand globally, driven by its performance in Russia, Italy, Ukraine, the UK and Australia. The slimmer range has great momentum, contributing 31% of total volume during 2014, driven by successful launch of Rothmans Demislms in EEMEA. Share was up 40 basis points, driven by Russia, Italy, Ukraine, UK and Australia.

Other international brands' volume fell by 3%, principally as a result of market contraction, despite a good performance from our Chinese JV brands, State Express 555 and Shuang Xi. Together with the GDBs, international brands now account for almost 60% of BAT volume.

Over the last 10 years, the GDBs have more than doubled their volume, and since the strategy review in 2011, they have grown share by over 300 basis points. Given their geographic footprint, GDB volume in 2015 is likely to be affected by industry contractions in some of our key markets. However, investments behind the rollout of innovation continues, and the GDB carries good share growth momentum entering the year.

We have also made good progress during 2014 on our next-generation products development. Our continued focus on product research and development has begun to pay off. Last year, we launched two new Vype products, the eStick and the ePen. In consumer tests, both performed better than any comparable product on the market.

I am pleased to report that they have shown very encouraging initial results. Vype is currently the fastest growing e-cigarette brand in UK, more than tripling its UK market share to reach 6.5%, according to Nielsen. We have a compelling product pipeline for Vype and will be extending the range with new products during 2015.

We also made significant progress last year with Voke, our nicotine inhalation product. We were successful in gaining a UK medicines license for Voke, a first for any tobacco company in the world. We are now working towards a launch in 2015.

Finally, we are making excellent progress developing our pipeline for tobacco heating products, or THPs. We have three new product platforms in development.

First, a compact, easy-to-use electrical device that heats a unique tobacco stick. Second, a series of hybrid products that integrate tobacco and vapor technologies. And third, we are partnering with Reynolds American to commercialize products based on their Revo/Eclipse technology. We expect to consumer test our first THP during 2015, and if successful, we plan to launch in 2016.

Overall, we continue to make great progress in NGP. There is a long way to go, and we must be led by the consumer. However, we remain very confident in our ability to lead the development of NGPs globally.

In July, we announced our intention to invest \$4.7b as part of Reynolds American proposed acquisition of Lorillard, enabling us to maintain a 42% shareholding in the new enlarged Reynolds American. All shareholders' approval has now been obtained, and Reynolds is currently waiting for FTC approval. The deal remains on track to complete in the first half of the year.

As Ben has already mentioned, on Monday, following press speculation, we confirmed that we are considering making a public tender offer for the remaining 24.7% of the shares of Souza Cruz that BAT does not already own. This is a strategically attractive deal for BAT, as it will allow us more scope to leverage Souza Cruz's capability for the BAT Group, and better integrate the business into the Americas region.

As with any minority buyout, the synergies are more limited. This deal would be accretive to BAT, but by less than 1%. If the offer goes ahead, it will be at a price of BRL26.75 less any dividends paid by Souza Cruz, representing a cost of GBP2.3b for BAT in the event of a 100% take-up. However, no offer has yet been made. We have stated that we will clarify our intention within 30 days.

In summary, the business performed well and the Group has delivered another strong performance in 2014. On a constant currency basis, we grew revenue 3%, profit over 4% and EPS 8%. Volume was down 1.4% against an industry down around 2.5%, as we again grew share.

Global drive brands continue to perform strongly, with volumes up nearly 6% and share up 90 basis points. Pricing in the vast majority of our markets remains strong, and we continue to make progress on our operating margin.

Finally, in recognition of the good underlying performance of the Group, we have increased the dividend by 4%, and this is in line with our stated intention of growing the dividend in sterling terms and increasing the payout ratio in circumstances where a good underlying EPS performance has been overwhelmed by the negative effects of currency translation. This reflects our continued commitment to growing shareholders' return.

It's still early in the year, but at this stage we expect the industry in 2015 to face similar challenges to last year, with the external environment remaining difficult. Clearly, exchange rates are very volatile at the moment. However, as rates stand today, we face a significant transactional ForEx headwind.

If rates were to stay where they are today, operating profit and EPS would be reduced by more than 5%. This will impact our constant currency performance and will be in addition to the 5% translational impact on EPS that Ben mentioned earlier.

So far, we have taken about 70% of the price we have planned for the year, which is ahead of last year. However, first-half numbers will be against a strong volume comparator. This, together with increasing transactional exchange rate impact, will affect first-half performance. We therefore expect profit growth to be largely skewed to the second half of the year.

We are continuing to invest for the future in new launches, strategic markets developments, products and NGP developments, and the business is performing well. We have another challenging year ahead, but at this stage of the year, I remain optimistic on our prospects for another good year of earnings growth, excluding the effects of currency.

Thank you, and we now open up for questions. Mike, just along this row here, we'll have the first question.

QUESTION AND ANSWER

Erik Bloomquist – Berenberg Bank – Analyst

Thank you. Two questions, one for yourself and one for Ben, please. Firstly, could you discuss your earlier comments about markets having a variety of trading consumer impacts, some downtrading, some uptrading and some polarizing? Could you talk about which you're seeing and are any of those trends accelerating or decelerating?

And then, for Ben, my question is could you help us understand which countries are driving the transactional FX impact, and has BAT already taken pricing in some of those this year to mitigate that impact? Thanks.

Ben Stevens - British American Tobacco plc – Finance Director

You go first?

Nicandro Durante - British American Tobacco plc – Chief Executive

Yes. Well, in reality, Erik, what we saw in -- let me talk about the overall market first. Then I go to downtrade and uptrade in specific markets. What we saw in 2015, in reality, is some downtrading overall, and you look at overall market was declined around 2.5%. Premium was declined around 2%, but you saw the emergence of the value-for-money category that was growing 5%. So aspirational premium was growing more than 3%, 4%, and low price was average of the market, and this has happened mainly because the consumers are stretched, as we were discussing. Disposable income in the majority of the markets coming down, had still the economic crisis in Europe, so this is a reflect of all of this.

And BAT has tapped the segment with the launch of Rothmans, so we have taken our fair share of growth -- to be honest, more than our fair share of growth, because Rothmans is growing very fast. So we are using our market abilities to tap in this emergence of this segment.

When you look at market by market, we always have during the year markets that are uptrading, markets that are downtrading and markets in which you have a polarization. When I say a polarization, you see the premium segment growing and you see the value-for-money segment growing as well. So the mid segment is the one that's declining. One example of that is Brazil.

Brazil, you see the value-for-money segment growing, and then at the same time you see premium growing. And I have to say that we are taking all the growth in premium, because Dunhill, that is the most premium brand in the market from the pricing point of view as well, has grown from 10.5% to 12.1% at the end of the year. So it's a growth of 1.6%, which is phenomenal, 160 basis points, premium Brazil, it is really great, fantastic. So Brazil is a clear example that you have this polarization.

The same is happening, for example, in Romania, in which premium is growing through Dunhill and Kent but value-for-money is growing as well. On the other hand, you have markets in which you have some uptrading. An example of that, you see Colombia, you see France, these markets we saw some uptrading last year.

And you have several markets that downtraded because of the economic situation, and not only because of the economic situation, because sometimes it's self-inflicted by the industry. Australia is an example of that. You have a huge downtrading, self-inflicted, because you have the players playing in the low-price category, and you had it to answer. So Australia is one that we saw some downtrading. UK, we see some downtrading. Canada, we see some downtrading. So some markets, we see some downtrading. Okay?

Ben Stevens - British American Tobacco plc – Finance Director

Yes. Let me start with some good news. The good news is that the dollar is strengthening and the rupiah is strengthening, and that's why you see the translational impact on operating profit being greater than it is on EPS. So it's 7% operating profit, it's only 5% EPS, and that's the effect of the associates coming through.

The big currency devaluations we're facing, obviously it's the ruble. The average rate of the ruble in 2014 was RUB63. The latest rate is RUB96, so that's a big hit. Things like the hryvnia, the average rate was UAH20, the latest rate is UAH42, so these are pretty eye-watering rates. But even the real, average was BRL3.87, closing rate is BRL4.41. So it's a broad spread across major currencies that we're seeing a devaluation against sterling.

Now, the transactional impact, these are early days. For example, the hryvnia moved 20% against the dollar two days ago. So these are very, very volatile conditions. And we would expect to mitigate some of those transactional impacts with pricing and with cost reduction, but you can't just price on your own.

As Nicandro always says, we don't have pricing power. The industry has pricing power. And you've got to be careful not to move too far ahead of a very stretched consumer, so it's always a balanced effort you've got to make. But where we can, where we are experiencing significant devaluation, along with which will come significant levels of local inflation, we will try and recover that with pricing.

Nicandro Durante - British American Tobacco plc – Chief Executive

Yes, David?

David Hayes – Nomura - Analyst

Hi. Just to follow up on that, I guess, lots of moving parts. As you go into 2015, in terms of the margin this year, underlying up 110, more pricing potentially, potentially more cost savings, transactional feels like minus 200-ish, as it stands, based on what you've discussed. The question being, I guess, in terms of 50 to 100, is that doable on a reported basis with all those moving parts, do you think, to the point you just made (multiple speakers)?

Nicandro Durante - British American Tobacco plc – Chief Executive

Yes, transactional is nearer 300, as we speak. We hope to keep driving operating margin growth, and we look to drive it by 50 to 100 basis points a year. We've never said it would be 50 to 100 basis points each and every year. We say over time we will grow operating margin, and we look to it exceeding 40%. We've said that once it's exceeded 40%, we'll give further guidance, not necessarily that we'll stop growing operating margin, but we'll know a lot more about the deployment of SAP.

Now, we will continue to drive costs out of this business. I still believe that there's costs that we can drive out of BAT. It will certainly be helped by the deployment of SAP. We're live now in over 60% of our markets, so it's now through in Europe, chunks of EEMEA. Most of Asia is done.

Where we will end up on transactional FX, it's hard to say. It's only February. This time last year, I sat here and said I think we've got an FX tailwind behind us for the year, and see how things turned out. So it'll be tougher growing operating margin this year, if you're facing GBP300m of transactional FX, but we still remain hopeful to be driving costs out of this business and improving profitability.

David Hayes – Nomura - Analyst

Just to follow up, on next-generation product development, is that a cost that will be in this year or is that next year?

Ben Stevens - British American Tobacco plc - Finance Director & CIO

That will be a cost, particularly in the first half of the year, obviously, because we've got a winning set of products now and it's in our interest to roll those out as quickly as we can, so we're trying to expand distribution, which comes with a cost.

Nicandro Durante - British American Tobacco plc - Chief Executive

And my last one, just on Brazil. I guess the question is why now, apart from the currency, potentially? Is there anything that's changed as to why you now think about buying in the minorities?

And then to your point earlier, you talked about more integration. If you do the buy in, does anything change that you can highlight at this stage that means Brazil becomes a different entity or subsidiary for BAT?

Ben Stevens - British American Tobacco plc - Finance Director & CIO

I think it's -- we haven't even made an offer yet, so I just want to make that point. And as we've always said in terms of buying in minorities, the returns from buying in minorities are fairly skinny, because there are no real synergy benefits from banging together field forces or closing factories or whatever.

So we felt it was a good time to look to buy out the minorities of Souza Cruz, if we decide to make an offer. I think that it could form a more central part of our operations in Latin America, and that's easier to do if you haven't got leakage into minorities. So that's the thinking behind it.

James Bushnell - Exane BNP Paribas - Analyst

Hi. A couple of questions, please. Firstly, and sorry to do this to death on the margin, but ex the transactional impact, will you still be aiming for 50 to 100 basis points?

Ben Stevens - British American Tobacco plc - Finance Director & CIO

Absolutely.

James Bushnell - Exane BNP Paribas - Analyst

Okay. And then secondly, on your tobacco heating products, you showed a picture up there which I'm sure a few of us couldn't help noticing there's some similarities with the Philip Morris product. I wonder if you're able to say how is that being differentiated versus what's already on the market?

Nicandro Durante - British American Tobacco plc - Chief Executive

We have -- the concepts are the same, like e-cigarettes, but the delivery is different. For obvious reasons, I'm not going to disclose now what we have in the pipeline in greater detail, but the most important thing is that we are very advanced on the development. We are testing the markets already during 2015, and we are ready for a launch in 2016. We are learning with what's going on out there as well, so we are fine-tuning our products in order to have a very winning proposition.

We think that you can win this category. I always said, I have been saying this for the last couple of years, our ambition is to be the leader in next-generation products. That encompasses tobacco heating products and e-cigarettes, and I think that we can achieve that.

Just to show our capabilities, what we have in the e-cigarette area, for example, it took us some time to launch the products. I have been talking about that for the last two or three years, huge investments behind it and huge investments behind the tobacco heating products. But we just come to the market when we have a winning proposition. The products that are out there after the launch in November, we have tripled our market share in UK. We have 6.5% market share, coming from 1.7%, and we are growing by the week.

In grocery that we focus, we have 14% market share. In the pharmacy channel, is another focus area, we have 37% market share. And in convenience that we are not focusing because of distribution capabilities have to grow there, we have minimum share, 1%. So the possibility for growing very fast is significant. It just shows that our strategy is paying off.

James Bushnell - Exane BNP Paribas - Analyst

Sorry. Can I just ask, you mentioned as part of your three platforms you were likely to roll out Reynolds technology on Revo/Eclipse. You didn't mention Reynolds' e-cig product, VUSE. Would that potentially be in your plans if that collaboration is finalized?

Nicandro Durante - British American Tobacco plc - Chief Executive

We mentioned when Reynolds went through the potential offer, the offer to Lorillard, that we are looking for opportunities to work together in many areas, and this is one of them. But the heat -- tobacco heating products are a little bit more advanced. But yes, we are looking at opportunities that are out there with the VUSE technology as well. But we usually under-promise, over-deliver in BAT, so I don't want to promise anything.

Yes?

Jon Leinster - Panmure Gordon - Analyst

Jon Leinster, Panmure Gordon. A couple of questions, one on pricing. You mentioned that pricing has come in a bit earlier this year. Does that mean your expectations for the year in terms of price/mix is going to be higher than 2014, or will that be offset by the downtrading?

And secondly, as you mentioned, Ben, you gave a commitment on the sterling dividend growth for 2014. Is this something that at this stage you're prepared to give us for 2015 as well, or is that too early?

Nicandro Durante - British American Tobacco plc - Chief Executive

Okay, I will take the pricing question. Ben is going to take the other one. Regarding pricing, price is more solid this year than last year. With the exception of Australia, price is moving well across the world, so price is more solid.

It's very difficult when you are in February to make a prediction how price/mixes are going to work throughout the year, because you still have some pricing to go. We have the portfolio mix effect that you need to understand a little bit better. It's too early. And you have the geographic mix that you need to understand as well.

When I say that our price/mix last year was 4.2%, pricing was much more than that. But you have the impact of some portfolio mix, an impact of geographic mix there, so we need to understand how these three moving parts are going to work in 2015. But I have to say that if I look now, February 2015 across February 2014, it looks more solid, no doubt about that, but we have to wait and see.

Ben Stevens - British American Tobacco plc - Finance Director

Yes, Jon. We said last year that we want to reward our shareholders with a real increase in dividend in sterling terms. We've done that this year. We have a strong balance sheet. Obviously, we've looked forward to see what the impact of the Reynolds Lorillard deal and doing the Souza Cruz deal, if we do make an offer, would be. And I'm confident we can continue to reward shareholders with real increases in dividends in sterling terms, even if sterling continues to strengthen, because we've got a strong enough balance sheet and strong cash flows to deliver on that.

Nicandro Durante - British American Tobacco plc - Chief Executive

Adam. You have a question, Adam?

Adam Spielman - Citigroup - Analyst

This is Adam Spielman from Citi. Three questions, if I can. First couple are around Southern Hemisphere. Can you give us an outlook for Australia?

Secondly, in the document it said there's been I think some increased downtrading and competitor activity in South Africa, and I think you said other African markets, and so a little comment on that would be very nice too.

And then, thirdly, returning to the next-generation question, are you planning to build a plant to make the heat sticks anywhere, or how should we think about capacity?

Nicandro Durante - British American Tobacco plc - Chief Executive

Okay. Let me start with Australia. Okay. Australia, three or four years ago, we had a player in the market playing the low-price segment by itself. Because we had price increases in Australia, not moving that fast, the segment was growing and we were declining a little bit market share in the last three or four years, but not significantly, 3.3%, 3.4%, and we let it go because we didn't want to jeopardize the industry's profitability.

But what's happened, we had an implementation of the second year of the four years excise increase in Australia, 2.5% excise increase, as you are aware of, and the prices went up quite significantly and the segment started to grow very fast. So we had to participate in that, so that's why we launched at the end of first half of last year Rothmans. That was a very successful launch.

This brand now, after eight, nine months in the market, has 9% market share already. And BAT Australia in the second half of the year is back to growth, so this is very good. Unfortunately, the price environment is not very solid. Just to have an idea, recently, I think that one month ago we came with a price list -- a price increase. It was followed by one competitor, was not followed by the other. We had to roll it back.

So we are doing better in Australia. I think that we are preparing the organization for the future. I am very confident about the Australian market for the future, but the price environment is not very solid yet.

South Africa. The South Africa question, I think that when I was talking about low-price competition, it was related to South Africa, first of all. Let me talk a little bit South Africa.

We have seen some low-price competition in South Africa, driven by several reasons, first because of the strength of BAT in that market. We have more than 82% market share, so it's very difficult to compete against us there. We have outstanding capabilities in the market, outstanding portfolio, so it's very difficult to compete against us. Then, usually price is one of the tools that's used. And also the consumer in South Africa is especially stretched. We have some disposable income is not that -- the decline is happening.

So for those reasons, we have some low-price competition there, but the market is reacting well. As I said, the strengths that we have in the market allow us to face them, but this is not a new thing. This is happening for the last three, four, five years, and our position has been strong for those years. But yes, we have low-price competition, the same thing that you have in Canada, the same thing that you have in Brazil, the same thing that you have in several markets in the world. It's not a new thing.

So the third question is about NGP. We have been working very hard in the NGP, and we have made substantial investments in the last couple of years in manufacturing capabilities. And we produce our e-liquids inside BAT, and all the devices are with external partners.

In terms of THP, we are developing bespoke proprietary technology, and we are going to use our facilities to produce the products, so I don't expect huge investments going forward in our manufacturing facilities. So we are not going to build a specific plant for THP or for e-cigarettes.

Adam Spielman - Citigroup - Analyst

Can I just come back on South Africa? Two sub-questions, I guess. One is can you talk about the pricing environment in South Africa specifically? You talked about Australia.

And secondly, is there a single player? In Australia, there was a single player. I think you've said that it really triggered the downtrading. Is that also true in South Africa, or is it everyone who is growing in that or developing that spot?.

Nicandro Durante - British American Tobacco plc - Chief Executive

I wouldn't use expression growing there. We can use the expression of playing there, because they are not growing. We are doing very well in South Africa. Well, we have competition from local players, like in Brazil. We have competition from international players. And all of them are trying to play in the value-for-money category stronger, because it's a segment that they believe that can grow in the future. We have responded with the launch of B&H. We have responded with some actions in the market, and these actions are working quite well.

The price environment is moving in South Africa, but of course, if you have more launches in the value-for-money, you have a tendency of having a downtrading there. So there is some downtrade in South Africa, the answer is yes, but price is moving there. Okay? Should have been one of the markets when we have answered the question about downtrading. There are some downtrading there.

Any other questions? Yes, Jon?

Jon Fell - Ash Park Capital - investor

A quick one about Venezuela. Can you remind us what exchange rate you're using out there? And is there any cash that's stuck out there, or are you getting cash back from Venezuela happily?

Ben Stevens - British American Tobacco plc - Finance Director

The rate we translate Venezuela against sterling is 71.65. Obviously --

Nicandro Durante - British American Tobacco plc - Chief Executive

These go up by the minute.

Ben Stevens - British American Tobacco plc - Finance Director

Yes, that's the point. It does change by the minute. We're considering what happens in relation to the new rate, the Simadi rate that they've announced in Venezuela. Obviously, that's floating anywhere between 170 -- this is to the dollar now -- and 200, and obviously that's part of our consideration of the transactional FX that we highlighted this year.

Nicandro Durante - British American Tobacco plc - Chief Executive

Okay. One last question?

Chas Manso - Societe Generale - Analyst

Yes. Chas Manso from SocGen. On Russia, could you give us an update what's happening to the Russian premium segment and your share within the Russian premium segment? And given that pricing in Russia has been so strong for the last three years, given the pressures on disposable income, whether that's getting tougher going forward. That's the Russian question.

And just a follow-up on all these questions on mix. You've talked about mix a lot here. Do you expect the general mix drag for the industry and for you in 2015 to be greater than it was in 2014?

Nicandro Durante - British American Tobacco plc - Chief Executive

Okay. Regarding Russia, we have a substantial price increase last year, around RUB8 to RUB9. We have in January this year as well. We usually have a second one in the second half of the year. I'm talking about history.

So the consumers are in distress there, so we saw in Russia some downtrading. That's why the value-for-money category there is growing very fast, and that's why we launched Rothmans as an offer in the value-for-money category. You still have the low-price category is a little bit higher as an international offer in the value-for-money category. And it has been probably the most successful launch in Russia in the last years, so the brand is doing extremely well.

So I'm very happy with the performance of the Russian business. Profit growth was substantially higher last year compared to the previous year, so it's moving well from the profit point of view. The industry is taking prices.

Regarding the premium segment, we see a decline in the premium segment, but Kent has declined a little bit of share, 0.2% share down, because of the decline of the premium segment. But Kent inside the premium segment is stable. Our market share, if one of my colleagues here will help me, is around 44%, 45% of the segment, has been stable, around stable, and the brand has stabilized in the last part of the year, of 2014, even with the decline of segment.

So we put some innovations behind the brand, like capsules, so we have hope that the brand will go back to growth next year. But yes, we see some downtrading in Russia, but from the profit point of view the industry is taking price, and things are moving well from this point of view.

Regarding mix, well, the mix, we have two issues with our results in terms of the mix. The first one is geographic mix. That's not new. It's happening for the last years. BAT tended to grow more in developing markets, which is part of our strategy anyway. So the margins are lower, the potential of growth is higher. So this is going to happen over time, but we overcompensated this, because we obviously have an improvement in our portfolio mix in BAT, because the global drive brands are growing very fast.

Remember, 10 years ago, global drive brands was 20% of our portfolio, less than 20%. Now it's 40%, so it just shows how strong is the growth of our global drive brands. This year, global drive brands grew 900 basis points, 90% -- 0.9% market share. That is a fantastic performance. And this has helped to offset some of the geographic mix.

So, mix in terms of portfolio mix for next year, I believe that the value-for-money is doing very well. I don't see things changing dramatically from 2014, as I said in the beginning of my speech. I don't see things getting worse, but I don't think that you'll see in 2015 a huge growth in the premium segment and a decline in the value-for-money segment. I think things will stay as it is for the time being, because I don't see that on a worldwide base, consumers having more money to spend.

So I don't think that disposable income is going up on average across the world. We still have faced the problems in Western Europe. We're still facing the problems in Latin America. So I think that it's going to be more of the same for 2015 against 2014, not worse.

Okay. Can I have a last question here? David? The last of the last now.

David Hayes - Nomura - Analyst

Last of the last, exactly. Sorry. Just on the cost side, so a lot of these SAP facilitated costs feel very support service orientated. You said a couple of competitors in Europe in particular reconfigured production, closed a couple of plants, relatively significant. Is there more that BAT plans to do on the operational side? Is Europe something which -- I don't know if you can talk about it because of sensitivities, but is it something that we should be looking for over the next year or so, but we'll see also bigger things happening on the operational side of the business cost wise?

Ben Stevens - British American Tobacco PLC - Finance Director

Anything I say, obviously, is subject to information consultation rules in Europe, but obviously you'd expect a business with a declining volume base to be reviewing its footprint, not just in Europe but globally, and you can count on the fact that we're also doing that.

Nicandro Durante - British American Tobacco plc - Chief Executive

Okay. Thank you very much for coming. We appreciate that. If you have any other questions, you can ask Mike, and he will be ready to help you. Thank you very much.