

Preliminary Results 2023 Presentation and Conference Call

Event Transcript

Thursday 8 February 2024

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Tadeu Marroco, Chief Executive

Good morning, everyone. I am delighted to welcome you to our 2023 Preliminary Results presentation. With me this morning is Javed Iqbal, Interim Finance Director and Victoria Buxton, Group Head of Investor Relations.

I will begin with our financial highlights and the progress we have made against our key areas of focus this year. Javed will then take you through our financial performance in more detail. I will return to talk more about our glidepath to Building a Smokeless World, before we move to the Q&A session.

With that, I would like to draw your attention to the disclaimers on slides 2 and 3.

Let's begin with our 2023 performance. Our reported results reflect the impact of the non-cash impairment charge taken mainly against our acquired U.S. brands. We will focus on constant currency adjusted results, unless otherwise stated. I am pleased that BAT has delivered a resilient performance, in line with our guidance, reflecting the benefit of our global multi-category strategy. The breadth and scale of our global footprint, enables us to consistently deliver balanced results. This is demonstrated by our strong performances in AME and APMEA, delivering combined double-digit revenue growth offsetting the U.S.

Overall, we have delivered organic revenue up 3.1%, which excludes Russia and Belarus from both periods, profit from operations up 3.1%, or 3.9% organically, and diluted EPS up 4.0%, with organic growth up 5.2%. I am particularly pleased with our performance in New Categories, with revenue up nearly 18%, and 21% organically, with Vuse and Velo delivering strong volume-led revenue growth. Our consumer numbers reached 23.9 million, excluding 1.5 million consumers in Russia. We added over 3 million consumers year-on-year, with 1.1 million in Q4 alone.

At the half year, I shared a clear set of objectives to sharpen our execution and build a more modern and agile BAT. Over the last six months, working together with our broader teams, we have made good progress across these six areas of focus.

I will now share some of the highlights. First, I am delighted that we have reached New Category profitability two years ahead of our original target. This has been achieved while continuing to invest an incremental £300 million in 2023 for future growth. Our New Categories are meaningfully contributing to Group results, as we benefit from increased scale, with strong profitability gains driven by Vuse and Velo. We have sequentially improved our New Category contribution from a peak loss of £1.1 billion in 2020, to a small profit position in 2023, reflecting a £400 million improvement last year. It is important to note that while we expect New Category profitability to continue to improve each year, due to the phasing of investments the improvement in contribution year-on-year will not be linear.

We made strong progress in our top ten New Category markets, which generated about three quarters of our New Category revenue in 2023, with Category contribution margin now above 20%. The performance of these markets demonstrates that revenue continues to grow at pace, gross and contribution margins are expanding strongly with scale, and absolute margin levels are moving closer to the level of our combustibles business. This profitability at scale gives us confidence in our direction of travel as we expand our New Category footprint. And it also provides a clear line of sight for our pathway to profitability in less established markets moving forward.

Our second focus area has been to return our U.S. combustibles business to consistent value growth. Our commercial plans are already starting to deliver early signs of volume and value share recovery. Our volume share is up 40 basis points since January, driven by a 160 basis points increase in the premium segment. In addition, we are delivering value share gains, up 20 basis points since January, driven by a 60 basis point increase in our premium share, to reach our highest level in three years, driven by Newport and Natural American Spirit.

I want to share some more colour on the actions we are taking in the U.S. In premium, we have invested in Newport soft pack, creating a ladder portfolio, which has driven an acceleration in Newport's share of the premium segment. We are working through the targeted execution of this on a state-by-state basis, with a broader roll out planned in 2024.

Lucky Strike is the fastest growing cigarette brand in the market, and just three years after launch reached 4% national volume share at year-end. In addition,

we are sharpening our execution, increasing the number of trade reps by around 10%, further strengthening and simplifying our route to market, and upgrading our digital analytics. We are confident that these actions will further strengthen our portfolio over the medium to long-term.

Turning to my third area of focus, Heated Products, where I am determined to significantly strengthen our portfolio. Our recently announced global patent settlement is an important step forward, allowing us to further develop improved products and innovations in the Heated Products space over the medium term.

Meanwhile, I am excited about our newest hyper launch which delivers a total system upgrade. Our new device, glo Hyper pro, is a more premium offering, with new heat technology and longer lasting sessions. Our new supertob consumables have been redesigned to significantly improve both taste and flavour delivery.

In addition, we have launched our first to market tobacco-free consumables veo, with herbal substrate, in 11 European markets. And while it is still early days, we are seeing some promising results, including volume retention for our Heated Products in these markets.

These new launches are early examples of our improved innovation pipeline. And we are further strengthening our R&D, adding new capabilities, such as Device Engineering, and fully integrating our global teams to form a more collaborative network.

In addition, we are partnering with external industry leaders in complementary areas such as battery technologies and electronics manufacturing, to accelerate our pipeline.

We continue to execute our Product Lifecycle Management model with discipline, enabling us to launch stronger innovations at speed.

There is still work to do, but I am confident that we now have the right capabilities in place to drive a more rapid and meaningful innovation pipeline moving forward.

My next area of focus is to lead responsible New Category development. We need to gain a broad acceptance of our Tobacco Harm Reduction agenda and encourage a fact-based discussion on nicotine amongst key stakeholders. That's why I re-established our Corporate and Regulatory Affairs function and added a new Management Board position. We are clear that science should guide the development of regulation. This is why we believe that each smokeless product category should be regulated differently, proportionate to the associated risk and according to the evidence base.

I am determined to manage our transformation responsibly and transparently, through increasing our engagement with regulators, policy makers and other relevant stakeholders. The irresponsible marketing practices we see in some markets are totally unacceptable and we call for the support of governments and regulators to more effectively distinguish between responsible and irresponsible players. This will create a level playing field, addressing important issues such as underage access, and environmental impacts.

We are seeing encouraging progress with New Category regulation around the world, including recognition of the role of Tobacco Harm Reduction in major markets like the UK and New Zealand, new markets opening up to make smokeless alternatives accessible for consumers, and a growing multi-category footprint with 55 markets now regulating more than one New Category. I am proud of our more front-footed engagement and advocacy actions taken in the UK, when we launched a multi-channel media campaign urging for better regulation and enforcement around vaping products, so the vaping industry can support making smoke-free Britain a reality.

Looking ahead, we plan to launch our refreshed Responsible Marketing Principles and Code, demonstrating our commitment to a responsible New Category approach.

Effective enforcement is critical to the development of functional New Category markets. We are deeply concerned by the continued proliferation of illicit single-use vapour products in the U.S., which we estimate represent over 60% of the vapour market.

There are multiple levers available to government agencies, state and local authorities to ensure proper regulatory enforcement. During 2023, we saw a modest escalation in action against illicit products including almost 4 million

units captured or refused entry into the U.S., and about 5 million U.S. dollars in fines issued by the FDA. However, it is clear that much more needs to be done. Our U.S. teams are actively engaging with government agencies, and federal and state law authorities, using all the tools available to drive better enforcement and, importantly, a level playing field.

A recent example of progress is Louisiana, which has passed a state law establishing a directory of vapour products which have either received, or genuinely have a PMTA pending. Several other states have enacted similar laws with more bills pending. I am also encouraged that the U.S. International Trade Commission has taken up our complaint and is investigating the import of illegal single-use vapour products. While we have not seen any meaningful impact nationally to date, we can clearly see that the pressure for effective enforcement is building.

Now, moving on to my fifth focus area, to enhance our financial flexibility. We continue to deliver efficiencies through our established continuous improvement mindset.

We are on-track to generate at least £1 billion of additional savings by 2025, with nearly £500 million already saved in 2023. This has played a critical role in offsetting the inflationary pressures.

We continue to seek and evaluate all opportunities to enhance balance sheet flexibility and, as part of this, we regularly review our stake in ITC. We recognise that we have a significant shareholding which offers us the opportunity to release and reallocate some capital. Our shareholding in ITC has existed in one way or another since the early 1900s and was subject to numerous share capital changes and regulatory restrictions. We have been actively working for some time on completing the regulatory process required to give us the flexibility to monetise some of our shareholding and reallocate some capital. We will update you on this at the earliest opportunity.

In addition, we are further optimising our geographic footprint, and have exited around 35 markets. This is in line with our plan to exit non-strategic combustibles markets, where we don't see a near-term opportunity to execute our New Category strategy. This means we will be selling fewer cigarettes annually, with a limited impact on our P&L and resources are reallocated into higher return markets.

We have significantly increased our free cashflow generation, with four consecutive years of at least 100% operating cash conversion. This has enabled

us to return a total of £26 billion to shareholders over the last 5 years. We have made good progress on de-leverage, ending the year at 2.6 times adjusted net debt to adjusted EBITDA, closer to the middle of our 2-3 times target range. Over the next 5 years, we are on track to generate around £40 billion of free cash flow before dividends.

As we continue our transformation, our medium-term financial model will evolve. This will give us increased flexibility to allocate our capital to drive returns and reward shareholders, and includes continuing our 20-year track record of progressive dividend growth. Once the middle of our leverage target is reached, we will evaluate all options to return excess cash to shareholders, including the introduction of a sustainable share buy-back.

Moving onto my last area of focus, to develop a more collaborative and inclusive culture. Guided by our refreshed corporate values, I am clear that building on our strong foundations of integrity, collaboration and inclusivity, we will drive the culture we need to successfully transform BAT.

As part of this, I am delighted to welcome our new Executive and Non-Executive Senior Management members. They all bring diverse, high-quality industry knowledge and experience. Soraya Benchikh, our incoming CFO, will start in May. And I would like take this opportunity to express my thanks and appreciation to Javed for stepping up as Interim Finance Director alongside his ongoing role as Director, Digital and Information.

In summary, we have made significant progress on each of these areas of focus. However, there is more to do. I am confident that the choices we have made are building strong foundations for future growth, and will deliver sustainable value for all our stakeholders, while we continue to reward shareholders with strong cash returns.

And with that, I will hand over to Javed, to take you through the detail of our results.

Javed Iqbal, Interim Finance Director

Thank you, Tadeu, and good morning, everyone.

Our results, demonstrate the resilience of our business. We delivered organic revenue growth of 3.1% with New Category revenue up 21%, and combustibles price/mix of 6%. Adjusted profit from operations was up 3.1%, with operating margin up 60 basis points, driven by a strong improvement in New Category contribution, and our continuous focus on efficiencies. Adjusted diluted EPS grew by 4.0%, or 1.1% on a current currency basis. On an organic basis, excluding Russia and Belarus from both periods, adjusted profit from operations was up 3.9% and adjusted diluted EPS was up 5.2%. These results were delivered despite the absorption of a 2.5% transactional FX headwind.

We continue to drive strong organic New Category revenue growth. This performance clearly reflects the strength of our multi-category portfolio, driven by Vuse and Velo.

As a result, we continue to transform rapidly, with smokeless already reaching over 30% of our revenue in 24 markets. This represents nearly one-third of the 76 markets where we are currently present in New Categories. And our transformation is even more advanced in many markets.

Smokeless now represents 16.5% of Group revenue, up 1.7 percentage points from 2022. Excluding our U.S. combustibles business, smokeless now represents more than a quarter of Group revenue.

I will now share more details on our key category drivers. Market shares are available in the appendix.

In Vapour, we extended our value share leadership with Vuse to 36.1% in tracked channels in the key Vapour markets. We continue to make good progress on driving profitability, with Vapour now having a positive contribution in 4 of the 5 key markets. The fundamentals of the vapour category as a reduced-risk alternative for adult smokers are strongly positive. The total number of Vapour consumers is accelerating and Vapour is the largest contributor to active New Category usage, driven by both continued closed system and single-use vapour growth.

In the U.S., our PMTAs for Vuse Alto's two Tobacco flavour products remain under FDA review. These applications further built on the foundational science of our successful tobacco flavour submissions for Vuse Solo, Ciro and Vibe. We are confident of a successful outcome for the Vuse Alto PMTAs remaining under

FDA review, and consistent with the Agency's most recently communicated time frame, expect to hear in the coming months.

We are challenging the FDA Marketing Denial Order for Vuse Alto Menthol flavour and have recently been granted a permanent stay by the court.

Outside the U.S., we continue to approach the growing single-use vapour segment in a responsible way, in line with our International Marketing Principles and Underage Access Prevention guidelines, as well as participating in takeback schemes for responsible disposal.

In Heated Products, glo's reported revenue was down 2.5%, and up 4.1% on an organic basis. While our organic volume grew 12% and our share of the combined combustibles and Heated Product category continued to grow, glo's Heated Product category volume share was down 110 basis points to 18.2%. Continued category volume share momentum in key AME markets, including Poland and the Czech Republic, was offset by highly competitive markets in Japan and Italy. As Tadeu highlighted, we have more to do, but I am pleased to say that our newest innovations, glo Hyper pro and veo, demonstrate our ability to bring innovative products to the market. This will be further supported over the medium-term by our recent patent settlement.

Moving to Modern Oral, our portfolio continued to grow, with Modern Oral volume up 33.6%, and revenue up 39%, driven by further geographic expansion and innovation.

We continue to grow our volume share of Total Oral, while our Modern Oral category share was down, mainly impacted by the U.S. We are encouraged by the strong results from our recent Velo pilot in New York, featuring a more premium brand expression and design, and plan further roll-outs in 2024.

In addition, we remain confident of securing the PMTA for our Europe-leading Velo 2.0 platform to support our longer-term competitiveness in the U.S.

Outside the U.S., we maintained clear leadership of the Modern Oral category. I am delighted to share that in most markets Velo is contributing to the increase in category profitability with a fast payback period of less than 2 years. We continue to see a significant opportunity for Modern Oral in emerging markets - with strong volume growth in Pakistan and Kenya.

Now turning to combustibles. Our cigarette volume declined by 5.3% on an organic basis. Adjusted for markets exited during the year, and our volume declined 4.6% compared to an industry decline of 3.4%. This difference is mainly due to lower U.S. industry volume and share loss due to our premium positioning, and the impact of significant excise increases in Pakistan.

Combustibles price/mix remained strong, up 6%, with pricing offset mainly by geographic mix. Together, this resulted in a 0.6% increase in organic revenue.

Group volume share was flat, with gains in AME, offset by APMEA and the U.S.

Group value share was down 40 basis points, reflecting the impact of our commercial plans in the U.S. and losses in APMEA, while we held share in AME.

We are performing very well in combustibles outside the U.S., where organic revenue increased by almost 7%, with re-invigorated portfolios, refreshed brands and sharpened execution.

This demonstrates the benefit of our global footprint and our ability to deliver in challenging environments.

Turning now to the regions. In AME we saw an outstanding delivery in 2023. Total organic revenue was up 13%, driven by higher revenue from combustibles reflecting a resilient volume performance and pricing, alongside continued growth across each New Category, with revenue up 39%. AME is a true multi-category region and smokeless products now represent 23% of regional revenue in markets where we are present. Adjusted profit from operations was up 10%, driven by the improved financial performance in key markets.

Moving to APMEA, where we saw strong financial delivery. Total revenue was up over 5%, with a robust combustibles performance driven by pricing. Notably, pricing in Pakistan, more than offset the impact of excise-led volume decline, while volume growth continued in Bangladesh. Vapour and Modern Oral revenue were both up over 70%, which was partially offset by a decline in Heated Products mainly in Japan, resulting in 3% New Category growth for the region overall. Smokeless products now represent around 20% of regional revenue in markets where we are present. Adjusted profit from operations in APMEA was up 7%, driven by strong pricing and continued efficiency gains.

In the U.S., total revenue was down more than 4%, driven by continued macro-economic pressures and the impact of illicit single-use vapes. Despite this, Vuse extended its value share leadership of tracked channels adding 470 basis points to reach 45.6%, with revenue up 14%. In Modern Oral, Velo revenue declined, driven by lower volume. Adjusted profit from operations was marginally higher, up 0.4%, with our operating margin expanding by two hundred and eighty basis points, as Vuse profitability and efficiency gains offset combustibles' headwinds.

U.S. combustibles industry volume was down 7.5%, or 8.6% on a sales-to-retail basis, excluding inventory movements. Beyond market secular decline, industry volume was mostly impacted by a combination of macro-economic headwinds and the growth of illicit single-use vapes. On top of the industry contributors, our volume performance was impacted by lower volume share, as a result of our more premium skewed portfolio, and the California flavour ban. As a result, our combustibles volume declined 11.3% in the U.S. more in-line with industry decline if you exclude the deep discount segment where we do not participate.

Taking a step back to look at the broader U.S. context. While U.S. consumers faced strong macro-economic headwinds through 2022 and 2023, we are starting to see some very early signs of recovery, with gas prices stabilising and the gap between wage growth and inflation narrowing. However, consumer confidence is recovering more slowly and is still significantly below pre-COVID levels as consumers continue to be impacted by the cumulative effect of inflation and higher interest rates on elevated levels of debt, resulting in lower discretionary income.

Given this macro environment, the premium segment has remained under pressure through 2023. As Tadeu highlighted, our commercial plans are working and we are starting to deliver volume and value share recovery in the premium segment, driven by Newport and Natural American Spirit. In addition, Lucky Strike continues to perform well in the value segment. As a result, our volume share of the total U.S. market is starting to stabilise. While returning our U.S. combustibles business to consistent value growth will take time, we are making progress and we will continue to implement our plans carefully and thoroughly in 2024.

It is important to remember that, overall, elasticities remain stable compared with pre-COVID levels at minus 0.4 and affordability remains high. With our multi-category strategy and strong portfolio of brands, we are well-positioned to benefit from macro-economic improvement, and a recovery in the legal vapour market once there is effective enforcement against illicit products.

As announced at our Trading Update in December, we have taken a non-cash impairment charge mainly relating to our acquired U.S. brands. Following the completion of our detailed year-end finalisation processes and adjusting for FX movements, the total charge recognised is £27.3 billion. This recognises the current macro-economic pressures impacting the U.S. combustibles industry and change in consumption patterns post-COVID, combined with the growth of illicit single-use vapour products and uncertainty around the potential menthol ban. This approach is also consistent with our vision to 'Build a Smokeless World'.

Moving forward, our combustibles brands will be amortised over a maximum of 30 years. As a result, our annual non-cash amortisation will increase by around £1.4 billion from 2024, which will be treated as an adjusting item in-line with our accounting policies. Our acquired U.S. brands represent most of the Group brands and trademarks on our balance sheet and, as such, we do not anticipate similar combustibles brand value revisions moving forward. Importantly, these charges have no impact on our de-leverage, or our dividend and capital allocation flexibility.

Returning to Group performance, operating margin expanded strongly, up 60 basis points, while also absorbing increased inflationary pressures and a 2.5% transactional FX headwind on profit. This was supported by improving New Category profitability and additional efficiency savings.

Turning now to EPS, we delivered constant currency adjusted diluted EPS growth of 4% and 5.2% on an organic basis. This reflects our resilient operating performance, continued strong ITC delivery and a lower number of shares. These were partly offset by increased net finance costs. The underlying tax rate was 24.5%, and with existing tax rates, we expect a rate of around 25% in 2024.

Operating cash conversion was strong at 100%, reflecting our continued focus on cash delivery. As in 2023, we anticipate gross capital expenditure for 2024 to be below adjusted depreciation and amortisation at around £550 million, and net finance costs of around £1.9 billion. We continued to reduce leverage towards our target, and have a manageable maturity profile, with 98% of our net debt fixed, average maturity of just over 10 years and close currency matching.

Looking forward, we are making targeted investment choices to drive our medium-term sustainable growth algorithm. Together with continued macro-economic pressures in the U.S., these investments will impact our 2024 delivery. As a result, we continue to expect to deliver low-single digit organic revenue and adjusted profit from operations growth including a 2% transactional FX headwind.

With our performance second half weighted for both revenue and profit, mostly driven by the continued impact of macro pressures and illicit single-use vapes in the U.S., continued investment in our U.S. commercial plans mainly weighted to the first half, and the phasing of investment in AME and APMEA. Extrapolating current spot rates, we anticipate currency translation to be a 3% headwind on full year adjusted profit from operations growth.

Beyond 2024, we expect to progressively improve our delivery to 3-5% organic revenue growth, and mid-single figure adjusted profit from operations growth, on an organic basis, and at constant rates by 2026.

Finally, as we continue our transformation journey, we are focused on the importance of disciplined capital allocation and strong shareholder returns. We remain fully committed to a progressive dividend, and have announced a 2% increase this year, and once the middle of our leverage range is reached, we will evaluate all opportunities to sustainably return excess cash to our shareholders.

With that, I will hand back to Tadeu.

Tadeu Marroco, Chief Executive

Okay, thank you, Javed.

I would like you to take away two key messages from our presentation so far this morning. First, we have taken significant action to sharpen our execution and

we are making strong progress. And second, whilst we are facing some challenges, our performance remains resilient, reflecting the benefits of our broad portfolio.

I would now like to spend a few moments outlining the opportunity and pathway ahead for BAT, and why it is going to deliver strong outcomes for our shareholders.

First, the Nicotine market is growing. Based on our estimates using the latest industry data and trends, New Category revenue will be incremental to combustibles. And going forward New Category volume will offset the decline in combustibles as smokers continue to switch to Smokeless products. As a result, the quality of our top line growth will be much improved as it will be volume-driven.

Our multi-category strategy is the right way to access this growing market. Consumers are choosing different alternatives to cigarettes. Markets and consumers are not homogeneous. And no single solution is capable of meeting all consumer preferences.

In addition, data shows that as you move into higher tar markets, for example Canada and the U.S., there is a much higher penetration with Vapour. And Heated Products stand a greater chance of success, in lower cigarette strength markets. Japan is a clear example of this.

Executing on multi-category will deliver on our A Better Tomorrow purpose. We are committed to our new vision to Build a Smokeless World and to become a predominantly smokeless business, with 50% of our revenue in smokeless products by 2035. By deploying our global multi-category portfolio we can actively encourage smokers to 'Switch to Better'.

To enable this, we have refined our Group strategy. To ensure a clear line of sight across the entire organisation, anchored on three strategic pillars: Quality Growth, Sustainable Future, and Dynamic Business that support the achievement of our goals.

My six areas of focus for sharper execution, that I outlined earlier, are already fully aligned to these broader strategic pillars. And our newly launched values are a key enabler for the entire business, forming the core of who we are as BAT. Our performance will be measured across each strategic pillar. We will continue to work on refining the measures and targets, and to further align our proposals in our remuneration policy review this year. I look forward to sharing more details at a later date.

I am confident in the progression of our financial performance. The drivers of our growth will evolve through time as New Categories become a greater percentage of our business. The ranges reflect expected CAGR growth through the period, rather than annual targets. Our adjusted profit from operations growth will be enabled by increasing scale benefits driving New Category contribution margin and combustibles cost efficiencies driving positive operational leverage. This will enable group margin to remain at a high level.

We will continue to provide guidance on an annual basis, as our transformation evolves. This growth algorithm supports our 50% Smokeless revenue ambition by 2035 and we expect Smokeless revenue to reach around one third of our Group revenue by 2030.

In conclusion, 2023 was a year of resilient financial performance in line with our guidance. There is no doubt there is more to do.

We are sharpening our execution to navigate our near-term market challenges and set the business up for a stronger future.

The targeted investment choices we are making in 2024 are building the foundations for long-term growth and value creation.

There is an exciting opportunity ahead with growing nicotine industry value driven by New Categories.

And we are now seeing the evidence that our multi-category strategy will deliver long-term profitable growth.

We are committed to rewarding shareholders throughout our transformation, driven by enhanced financial flexibility, disciplined capital allocation and strong shareholder returns.

We will now be joined on stage by Victoria for the question and answer session, and Javed and I will be very happy to take your questions.

Victoria Buxton, Group Head of Investor Relations

Thank you, Tadeu, and good morning everyone. If you joined us via the webcast, you can type your questions directly into the online question box. Or, if you've joined the call you can press *1 on your telephone keypad. We will first be taking questions from the telephone lines.

Telephone Operator

Thank you, we have Richard Felton of Goldman Sachs. Richard, please go ahead, your line is open.

Richard Felton, sell-side analyst, Goldman Sachs

Good morning, thank you very much. So, just two questions from me please. The first one is on the U.S. Vapour category. I appreciate it may be difficult to put a precise number on it, but can you share any colour on how quickly you think the overall U.S. Vapour category is growing? That's across both the illicit and the tracked channels please.

Then my second question is on U.S. combustibles. Thanks very much for sharing the encouraging data points on BAT's relative performance in the market, but overall the category does still remain under a bit of pressure and we're seeing larger volume declines than has been the case historically. I know there's lots of moving parts, there's illicit vapour, macros are tough and there's still some COVID unwind, but as you think about the combustible U.S. market from a medium-term perspective, what do you see as the normalized rate of volume declines and then given BAT's commercial strategy and your outlook on pricing in that market, do you still see U.S. combustibles as a source of EBIT growth? Thank you.

Tadeu Marroco, Chief Executive

Okay, so let me digest your questions. The first one in the vapour category. Vapour is growing substantially in the U.S. markets. We believe that we have now around 29 million adult vapers in the U.S. but most of growth, and I would say that we have grown something like 20% over the last year or so, is concentrated on the illegal modis products in the first place. We believe that there is currently a revenue pool in vapour of around £10 billion, in which 60% of that is related to these illegal products. So we have built over time a very strong vapour business in the U.S.

As you saw in our disclosure, we have reached more than a billion pounds in terms of revenue, our level of operating margin now is very similar to cigarettes, not even gross margin, I'm referring to the operating margin, so it's a big business in the U.S. that we have built and we are very proud of the efforts. For sure that we are frustrated with the fact that there is no current level playing

field in the U.S. We know that the FDA is acting to help, to improve enforcement, we believe that there is much more that needs to be done on that. When they finally finish the conclusion of the PMTA, it will be a first step because then we can see what are the legal products that shouldn't be in the market in the first place. But it's encouraging to see that some states are taking the matter in their own hands and passing bills to try to certificate PMTAs and linking that with products that they will be trying to enforce in their own local markets.

We are, as we disclose in the presentation, doing all we can to work together with authorities at federal level, state local level, and we involve the ITC to eventually come to a point where we see some enforcement, but at what level, that would be, I couldn't say. But there is still a lot to do. But that's where we stand today on the on the vapour in the U.S.

On the combustible side, you're right, there was a lot of change happening over the last I would say four years. What we came from, just as a reminder for all of us, is a decline around 4% to 5%, pretty much secular decline of the U.S. market and then all of a sudden in 2020 we saw an uptick of of 1% to 1.5% because consumers were in lockdowns and receiving a lot of support at federal level, state level, and this whole process has started to wind down in the following two years, and then on top of that we have this whole process has been exacerbated by the conflict that started between Russia, Ukraine, and inflation that came at the back of that as well, and with a lot of pressure on consumer purchasing power.

So what we are seeing today in the market is a situation where the macros are playing a heavy weight on that, despite the fact that we are seeing early green shoots around the levels of unemployment, gas pricing going in the right direction, even inflation now reducing, we still see a lot of pressure on consumer purchasing power coming from high levels of debt. The cost of debt is still very high, mortgages and we believe that will take some for this whole process to unwind. It is difficult to predict, we are not giving guidance for 2024. But it's easy to see that these macros is responsible for at least 2.5%-3% of the decline in the US market.

So my best guess, if you want, for example, after we see some normalisation of, and we will see that because economic cycles are always like that, in the past, we have seen ups and downs, this will not be different. We believe that the market could well be stabilising around the 5% to 6% decline, with a recognition that more and more smokers are migrating to poly user products, for sure. That's the unknown in this whole process is the level of enforcement that the FDA needs to do in terms of modis impact, not just in the vapour business that I just spoke about, but also in the combustible business.

Telephone Operator

Faham Baig from UBS. Faham, please go ahead, your line is open.

Faham Baig, sell-side analyst, UBS

Good morning Tadeu, Javed and Victoria. A couple from me as well, please. Can I begin with the stake in ITC? Could you please remind us where we are on the approvals to reduce the stake? The anticipated timeline? And importantly, what we should expect BAT to use the net proceeds for. In other words, could the proceeds be returned to shareholders through a buyback? And secondly, on Heated Tobacco, do you have any early readings on the market impact from the EU flavour ban? I think you mentioned that BAT was able to retain a share, and in the back I think you highlighted in Czech Republic your share has actually grown. So could you just maybe give us more colour on how is BAT's share faring as glo has historically been over-indexed to flavours? Thank you.

Tadeu Marroco, Chief Executive

Okay. Sure. Let me start with your question on ITC. We're going to use that just to give some background and because it's important for us to remind where we are coming from. BAT is a very highly cash generative company. Every single year we are able to generate more than 80 billion of free cash flow. So this means that when we consider our growing dividend approach, and without any major material, if you want, M&A, on a business as usual base we are able to the leverage the company around the 0.2-0.3 times, subject to the effects of the year end. We have just demonstrated that through 2023. And the reason why we have said that we want to at least reach the middle of the range is for basically two reasons. One is, the world has changed, and we have seen from 2022 an unprecedented increase in interest rates, and that culminate with very high levels of the cost of capital compared with where we have been over the last decade, if you want. And this has, you know, even if we expect the interest rates start coming down, we've probably never been to the point that we were before.

So the world has changed, the cost of capital is more expensive than it used to be. That one point is clear. The second point is very particular to BAT. We still have out there a headwind related to Canada, the CCAA, and I have been very clear and transparent about that. And we have currently something as 2.3 billion of cash trapped in Canada, and if we finally, and I cannot give much information around the process that is going through with the plaintiffs in Canada, but we will expect the cash to go if we finally come to an agreement with the plaintiffs.

And also eventually have some material headwind in terms of our earnings moving forward. So, just to illustrate the point in the most simplistic way, if you strip out kind of that completely from our numbers, we would be seeing an uptick in terms of the ratio between 0.2 to 0.3 times. So, that's why we need the buffer, and I think that we have a very good plan to organically continue to drive down the leverage of the company, and I have no concerns at all about that.

Now for sure that we are trying to find ways to create more flexibility in terms of our capital allocation decision. And the financial flexibility comes with the problem to try to divert some of the assets that we have in the group. One of the reasons why we have exited 30, more than 35 markets, mainly in the last few years, is also a consequence of that. We generate some proceeds on that, not really that material, has also the benefits that we are now refocused the group moving forward in terms of resource allocation for the really growth markets moving forward. And this was very good exercise. We'll continue doing that. But we cannot ignore the fact that the major assets that we have in the balance sheet is the association with ITC as an associate. So, that's the reason why we are talking about ITC in this release, today. We want today... We want to keep a level of influence in ITC, that is transforming itself based on local legislation. We need to have a minimum of 25% of shareholder to keep a veto rights, we would like to do in the first phase. And these means that given the fact that we have above 29% there is space for us to reduce our shareholding. Now, what we need to do, and we have been working for some time on that, with people on the ground, closer with the authorities, meaning the Central Bank is trying, and with the help of ITC, is trying to reconstruct all the history of the shareholder of BAT that dates back 100 years. And through this period of time, as you can imagine, ITC has grown inorganically, which is another complexity. We had, you know, bonus issues, we have share splits, we have subscriptions. So, we also have changed in the regulatory environment, mainly on the tobacco front. So, we had to reconstruct this old history. And that's where we are working for some time now, very difficult, very difficult for me to give you a timeline on that, other than to say that we are doing all we can to create this flexibility so the Board can make an assessment in terms of capital allocation decision moving forward.

Meanwhile, we are very supportive of our shareholding in ITC. It is a fantastic company, well-run, well-managed, a very fast-growing company in a very fast-growing market with the most populous country in the world. And contributing a creative for BAT in terms of earnings, also in terms of cash, because they have a very good policy in terms of dividend payout, and the share price actually has doubled in the last three years. So that's where we stand in terms of our ITC holding.

Javed Iqbal, Interim Finance Director

Say about the HP ban?

Tadeu Marroco, Chief Executive

Yeah. The EU flavour ban. Well, first of all, around 50% of the consumables in Heated Products in Europe is flavoured. In our case, we are over-indexed to that, it's more than 7% of our portfolio that we sell in Heated Products in Europe are flavoured. So that's why it was important to launch this new herbal product, that we did, the first in the market, and we are very pleased with the level of competitiveness of this product and it is resonating quite nicely with consumers. It's up to the European markets to set their own timing, we have seen some markets that hasn't done so, so Czech, like you quoted is one of them, Romania is one is another one. In those markets, that we have seen that the flavour ban is already happening in the market, we manage to hold and sometimes even grow our overall share with veo, which is very pleased to see. There are some other important markets like Poland, Italy, still to come, so this is a process that we expect to come to a conclusion in terms of introduction of this flavour bans, by mid of this year, and we are very well placed with that. Because not just veo is a greater alternative but also the same time we are rolling out this new device, which is the glo hyper pro, which has enhancement capabilities new to the world display, also the heating, it brings a higher temperature, hence more satisfaction. The timing of the session is longer as well, so we are progressing in the right direction.

Victoria Buxton, Group Head of Investor Relations

Another question from the telephone lines.

Telephone Operator

Thank you. The next question goes to Gaurav Jain of Barclays. Gaurav, please go ahead, your line is open.

Gaurav Jain, sell-side analyst, Barclays

Hi, good morning. Thank you. I have three questions. So, first question is on the Newport pricing trends. So clearly, you have a stabilised share and the share is growing, where it is coming at the expense of pricing, and there is a concern that what you are doing could lead to the breakdown of pricing discipline in the

U.S. cigarette market. So could you please comment on that? The second question I have is on new product launches. So you are highlighting the glo new product launch. Can you also talk of new product launches in the other two segments, i.e. modern oral and e-cigarettes? And the third question is on leverage. So your competitors are now, you know, they are all operating at less than 2x leverage and that's where PM is riding too? so is the right leverage for you also closer to 2x rather than the middle of 2x to 3x? Thank you.

Tadeu Marroco, Chief Executive

Okay Gaurav, on Newport, we are doing ... We are introducing laddering in the brand and, which is aligned with the commercial products that we are seeing the markets. So in that sense, we are not really doing something unique, is just a recognition that when we have an economic downturn, our consumers have absolutely no safeguard to continuing the brand. So we introduced a soft back, we pilot that in some states in 2023 very successfully as you could see, in the numbers that we have demonstrated, and we expect to roll out this practice for throughout 2024. And it's important, despite the fact that there is a mixed impact on that, should keep consumers in the family because we have seen from the past that when the economic cycle change, the consumer upgrades, and so it's important that we keep them in the family, and that's exactly what we want to achieve with the introduction of the laddering, Newport specifically. For sure, it's not just that that we are doing, we are also assessing some channels that we haven't been really present before as we should, like for example, deeper discount channels, \$1 channels, that consumers start migrating to and we are establishing some trade practices that can be competitive in those channels to support our brands as well. And on top of that, like I mentioned during the presentation, we are increasing our trade reps and all that has a positive consequence in the market.

So we are very thoughtful in the way we are doing that, very measured in the way we are doing that, that's why we said since day one that this is a process that will not take months, will take more than that, and we are carrying on doing what we need to do.

And for 2024 the early signs are very positive on that space. It's important, just to make the point around the combustible business, to see that the U.S. markets, the total nicotine in the U.S. markets in terms of volume and revenue, with all the issues that we faced in 2023, are going. I understand they focus on the combustible because it's quite a cash generative, but overall nicotine is a space in the U.S. is still very favourable, and now for sure that a big chunk of that is going into the illegal products and modern disposals, that we expect the enforcement to come through, and then once it comes through open up this

white space and we'll be better positioned better than anyone because we are the leading brand in Vapour as well.

And then just making a link with your second questions about all the products. We do have an improved product in Modern Oral in the U.S. We pilot these new, refreshed, I would say, offer to consumers in terms of campaign, in terms of communication, the feel and look of the product, and very positively in New York. And we want to roll it out throughout the year. We also have in Modern Oral all the plans, very exciting plans in terms of new SKUs that will be launched in different markets where we have the freedom not in the U.S. and that will be just supporting our leading position, because we have basically leaders everywhere else other than the U.S. In terms of vapour we have a strong pipeline coming from the second quarter of this year. On the disposable side, but also on the refillable side and with new technologies we'll be hitting the market very soon. And we are very positive around those innovations that are coming through. And in terms of the leverage, like I said, the starting point for us, the 2.5 times is basically for us to be considered as a starting point, to have a bit more flexibility than we have currently. We have been...it's not to say that we want to stick to and stay there in the 2.5, like I said, I don't have major concerns about the leverage, because we have this very cash generative company, we can make improvements at about point 2, point 3 in any given year, so I think that once we get to the 2.5 we can have more flexibility than we currently have today. That's my whole point about the middle of the target.

Victoria Buxton, Group Investor Relations

Another question from the lines.

Telephone Operator

Thank you. The next question goes to Rashad Kawan of Morgan Stanley. Rashad, please go ahead, your line is open.

Rashad Kawan, sell-side analyst, Morgan Stanley

Yep. Thank you. And good morning, Victoria today. And Javed, thanks for taking my questions. Just a couple from me. One, just to go back on heated tobacco, the settlement with PMI, can you just explain whether the legal disputes

impacted your ability to innovate and how you think this will change your prospects if at all, in the category going forward in the medium term?

And then my second question, just to drill down a bit more on U.S. combustibles, I know you don't want to give 2024 guidance on the U.S., but if I can ask things a bit differently. Given how you've preliminarily guided on 2025, do you expect the level of competitiveness in the marketplace and the downtrading that we're seeing to continue into next year? Thank you.

Tadeu Marroco, Chief Executive

Okay, on the on the IP, the IP deal with PMI was primarily related to settle all this pending cases that we have around the globe. And we did that, it's important to say without any compensation, monetary compensation. So, for us immediately, this reflects into the case that we had against Vuse Alto in Virginia in the U.S., also a number of litigations that were in dispute around glo in Europe, and also Vuse in Germany, to mention some. Now, this also gives us, for both companies actually to give peace of mind for us to be focused on developing and accelerating their tobacco harm reduction agenda. And the innovator call into to that. So we're going to have more freedom to do it in the future, and this will be very positive, not just for BAT, but also for the industry as a whole. Because I think that all the industry wants actually is to have a better prospect of with different stakeholders around the day, how important it is the tobacco harm reduction and gets accelerated in the many jurisdictions. So, this was a strong point, a step forward, I have to say.

The combustible business. Yeah, you're right, it's difficult for me. But at the end of the day, I'm trying to you know, and anyone can be doing this type of analogy, is a lot of the downsides we are seeing today is related to the macro-economics and the macro-economics, my expectation for next year is to improve compared with this year, because we are seeing discussions around the eventually interest rates start to reduce, we know that there is a correlation between consumer confidence and sales of cigarettes. And once we have seen the past that once the interest rates start coming down, the whole sentiment change, and eventually the confidence can recover back, and this will have a positive impact on cigarettes. So the assumptions is that next year will be better. And for sure, one thing that is a bigger unknown, like I said before, is the enforcement around modern disposal, which also impacts the combustible side. But from the macro point of view, we would expect the business to improve from 2025 onwards.

Victoria Buxton, Group Head of Investor Relations

I believe we've got another question from the line.

Telephone Operator

Yes, the next question goes to Jonathan Leinster of Société Générale. Jonathan, please go ahead, the line is open.

Jonathan Leinster, sell-side analyst, Société Générale

Okay, thank you. And good morning, gentlemen. Yeah, a few questions if I may. First of all the launch of the glow hyper pro. I mean, you mentioned that as a premium product. Does that mean it's actually going to be priced differently from previous iterations and are the consumables any different... So is this a sort of step up to try and avoid the sort of price discounting we've seen in some of the key markets in terms of the sort of mainline close glo hyper?

Tadeu Marroco, Chief Executive

Yeah, Jonathan the device is already being priced at a higher price compared with the previous one, clearly it is a much improved device, and we have space for that. So this is one. The consumables will be improved consumables and this question depends a lot on the circumstance of each market. It's very difficult to give a kind of one size fits all answer to that. We have something in our hands that we believe that is much improved compared, in terms of consumer compared with the past. And if we want to reassess always, there is a lot of activities in the below WAP(?) as we speak today in Tobacco Heating products. So it's not just a question of what we want to do, it is how we see the competitive landscape as usual, in this case.

Victoria Buxton, Group Head of Investor Relations

I'm afraid we're out of time. Oh, Jonathan, sorry. I'll let you finish your questions.

Tadeu Marroco, Chief Executive

Yes, there's another one.

Jonathan Leinster, sell-side analyst, Société Générale

Okay. Very quickly. Well, probably not that quick. On the vaping markets across internationally, there's been a number of countries that have sort of formalised the market having previously been sort of a bit of a grey area. Is that something that, you know, is that major markets out there? Would you expect to sort of formalise the vaping markets, which would represent a real opportunity to you?

Tadeu Marroco, Chief Executive

We are seeing, we are encouraging to see some markets, taking the tobacco harm reduction in a very permanent basis. We just saw, for example, New Zealand, very supportive of vaping, which is very favourable, even the UK, they want to regulate further, but they have all in mind that it is a very important tool to reduce the incidence of smokers in general. Canada is the same, it's a question of how you fine tune the regulation. We are seeing more recently countries like Chile, where we expect at any time them to open up the market for vapour. And we know that there are discussions in big markets like Brazil, for example, they have a public consultation running as we speak, in terms of if they will regulate or not vapour. Turkey is another big market. In our current assumptions, we are not expecting any of those big markets to make bigger moves in the short term. But we expect that these as we progress and to ... and this is one focused area, like I said they're sustainable futures about that. We expect to have more and more evidence-based science, fact-based points through which we engage with all those different authorities, governments, in order to be able to unlock the potential that would make a tremendous positive impact for the current smokers in those markets.

Jonathan Leinster, sell-side analyst, Société Générale

Okay, thanks. Thank you very much.

Victoria Buxton, Group Head of Investor Relations

So as I as I was saying, I'm afraid we've run over time, but I think we've got one more question on the line which we will take.

Telephone Operator

Thank you. The next question goes to Joffrey Bellicha Meller, Bank of America Merrill Lynch. Joffrey, please go ahead, your line is open.

Joffrey Bellicher Meller, sell-side analyst, Bank of America

Thank you very much. And thank you for taking the time. I have a couple questions. The first one is on ITC's hotel demerger. I was wondering how you were thinking about your future stake in that company and if you would be immediately disposing it, assuming that you get the regulatory approvals for it. And the second question is on the U.S. combustibles margins, when you discussed about the laddering of the products, are the introduction of the soft packs, for example, with Newport at the same level of margin as your regular Newport products? Thank you very much.

Tadeu Marroco, Chief Executive

Okay, so Joffrey, the first question what I have to say to you is that there is no strategic intent from BAT to be a minority shareholder of a hotel in the Indian market. Now, you have to bear in mind that they are floating 60% of the hotel business, it is floating 60% of the hotel business, early to know exactly the timing of that, we expect to know more towards the end of the year, and the decision around what to do with the stake will be taken on board by the Board when it comes to the time and so, we're going to leave there the question on the hotel.

The second one is the laddering in Newport, we cannot keep the same level of margins of the price at the very top. But more important when we consider the level of cannibalization that we have and more important the retention of consumers, with it that is a very positive move, and that's why we have pilots who have taken our conclusions and then we start to roll out throughout 2024.

Victoria Buxton, Group Head of Investor Relations

Thank you very much Tadeu and Javed, and many thanks to everybody for all your questions. I apologise that we haven't managed to get to the questions online but we, the IR team, will be responding to those later on today. And with that, I'll hand back to you Tadeu for closing remarks.

Tadeu Marroco, Chief Executive

Okay, thank you all for listening today. Thank you all for listening today. To close, while there is still more to do, I am confident the investment choices we are taking will drive sharper execution and build the foundations for long-term growth and value creation. Thank you again for joining us today - I look forward to keeping you updated on our progress as we Build a Smokeless World together.

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