British American Tobacco Half-Yearly Results 2013
Wednesday 31st July 2013

CORPORATE PARTICIPANTS

Nicandro Durante

British American Tobacco plc – Chief Executive

Ben Stevens

British American Tobacco plc - Finance Director & Chief Information Officer

CONFERENCE CALL PARTICIPANTS

David Hayes

Nomura- Analyst

Erik Bloomquist

Berenberg Bank - Analyst

Adam Spielman

Citi - Analyst

Henry Davies

Merrill Lynch - Analyst

Fulvio Cazzol

Goldman Sachs - Analyst

James Bushnell

Exane BNP Paribas - Analyst

Rogerio Fujimori

Credit Suisse - Analyst

PRESENTATION

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

I am Nicandro Durante, Chief Executive of British American Tobacco, and with me this morning is Finance Director, Ben Stevens. This morning we will be taking you through the half-yearly results. Like last year we would be doing our Q and A via conference call following this presentation when there will be the opportunity for you to ask questions. And now to the headlines.

I am pleased to report that we have delivered another good performance against a difficult backdrop of global economic uncertainty, more challenging industry volumes and a currency headwind. On a constant currency basis these are the strong numbers with growth in revenue and profit. We are continuing to deliver on our commitment to high single figure EPS growth.

Total tobacco volume in the first half was down 3.2% although this result was impacted by a number of one-off factors, including trade inventory movements in Brazil and the GCC, there's the impact of the leap year. Excluding these factors underlying volume was down around 2%. This is likely better than the industry, which now expect to be down 2.5% to 3% this year. The difficult economic conditions in a number of markets in Western Europe, softer volumes in Brazil and Russia, as a result of the excise driven price increases and ongoing instability in the Middle East and North Africa have resulted in lower overall industry volume.

The Global Drive Brands continue to perform well with cigarette volumes up over 2% or 3.5% excluding one-off factors against a declining overall market. This demonstrates the continued strength of the brands.

We have carried good share growth momentum from 2012 into the first half of this year. Overall market share in the top 40 market is up strongly and importantly our share of the premium segment is also growing strongly, up 0.7 percentage points. Our Fine Cut business in Western Europe continues to perform well and volume was up 7%.

Adjusted EPS rose 8% to 109.1 pence, but in constant terms it would have grown 10%. We continue to reward our shareholders with increased dividends, and I am pleased to announce an interim dividend per share of 45 pence, up 7%. Let us now look at the brands.

The Global Drive Brands continue to perform well with volumes up over 2% and market share up by 0.4 percentage points.

Dunhill growth share and volume was up 6%. There were good performances in a number of markets, including Indonesia, Brazil, Chile, Romania, Malaysia and the GCC. In addition the brand is performing well in South Korea and has increased its share over the last two quarters.

Kent share was stable. Volume was down 3% impacted by industry decline in some of its larger markets, such as Romania and Russia, which offset growth in other Eastern European markets.

Lucky Strike grew share. Volume was 7% lower mainly due to the markets contraction in Spain and instability in the Middle East. The brand continues to do well in Western Europe where share is up 0.2 percentage points. Lucky Strike Additive Free continues to grow strongly and remains a leader in this growing segment, including Fine Cut, volume was down 5%.

Pall Mall grew share and volume was up 8% with good growth from Asia Pacific and the Americas. The brand performed well in Pakistan, Chile and Romania partially offset by declines in Germany, Russia and in Spain. In addition Pall Mall continues to grow volume and share in the Fine Cut segment, consolidate its position as the number one brand in Western Europe. Including Fine Cut, volume was up over 9%.

Our other international brands rose 2% and together the GDBs now account for close to 60% of BAT volume. Rothmans was one of our fastest growing international brands with volume up over 20% driven by a strong performance in Russia.

Reported cigarette volume was down 3.4% during the period although this was affected by trade inventory movements in Brazil and in the GCC, and the impact of the leap year, underlying volume was down 2%. Revenue on a constant basis was up 4% due to good pricing and a price mix of more than 7%.

In the As-Pac region volumes were strong, up over 5%, driven by good performances from Bangladesh, Pakistan, Vietnam, South Korea and Indonesia. Revenue at constant rates grew 5%.

In the Americas volume was down 9%, heavily impacted by industry declines in Brazil, growth in illicit trade and prior inventory trade movements. This was partially offset by good performances from Canada and Mexico however good pricing helped revenue increase 2% in constant terms and price mix in the region was over 11%.

The difficult conditions in a number of markets in Western Europe resulted in an 8% fall in volume against an industry decline of 10%. Declines in volume was seen in Italy, Spain, Poland, Greece and Germany. Revenue however was up 4% at current rates and 1% on a constant basis.

EEMEA cigarette volume was down 4% or 3% excluding a one-off impact of trade inventory movements in the GCC last year. This was mainly due to industry declines in Turkey, the Ukraine, and instability in the Middle East, however revenue grew 7% at constant rate driven by strong price mix of more than 11%.

As-Pac delivered another good profit performance due mainly to Australia, Pakistan, Vietnam, Taiwan and Bangladesh, all which contributed to the 9% profit growth at constant rates.

Profit at constant rates in the Americas region grew 2% mainly due to Brazil, Mexico and Canada. However, the region was affected by adverse currency impact, mainly the Real.

In Western Europe profit in constant terms was flat. This was a good result in a region that has seen significant duty paid market contractions due to fragile economic conditions. Despite this, France, Switzerland, UK and Sweden all achieved good profit growth.

EEMEA delivered an excellent 13% growth in profit. This was mainly due to the GCC and South Africa, although exchange movements were negative for the region, profit at current rates grew 7%.

Turning now to the regions in more detail, in Asia-Pacific strong performances from a number of markets helped profit to grow 7% at current rates despite a favourable foreign exchange. At constant rates profit rose 9%. Volume increased over 5% driven by good performances in Bangladesh, Pakistan, Vietnam, South Korea and Indonesia, partially offset by declines in Japan and Malaysia.

The GDBs' performance is strongly across the whole region with volume up 14% during the period led by Pall Mall in Pakistan, Dunhill in Indonesia and Lucky Strike in the Philippines. In Japan volume declined but share was maintained despite strong competitor activities and aggressive trade inventory deals by other competitors.

In Australia volume declined however profit increased strongly due to higher pricing and cost saving initiatives. The GDBs performed well mainly driven by the growth of Pall Mall. Share was lower due to competitors' price activities and growth in the ultralow price segment. Although it remains a recent event there continues to be no change in market trends as a result of the plain packaging regulation.

In Indonesia we had a very good first half with increasing volume and a stabilisation of share, sharing the premium and as at ASU30 segments grew driven by Dunhill Mild Kretek increased marketing investment in the strategic portfolio together with higher input costs impacted profit.

In South Korea volume was up although share was stable with a growing trend over the last eight months. Profit was lower due to higher market investments partially offset by cost savings.

Pakistan, Vietnam and Bangladesh continue to deliver excellent results. All three grew volume, profit and share strongly.

In the Americas region, profit was down 1% at current rates, mainly due to exchange movements in Brazil. At constant rates profit grew 2% although this was held back by transactional forex effects in Venezuela. Regional volume declined, just over 9%, mainly due to Brazil where volume was down by 15% as a result of large excise driven price increases and associated one-off trade inventory movements. Excluding the distortions, underlying volume in Brazil was down 11%.

Share was strong across the region driven mainly by growth in Brazil, Canada, Mexico and Venezuela. Good performance from Lucky Strike, Pall Mall and Dunhill helped the global drive brands grow over 17%.

Brazil reported a strong constant currency profit growth driven by higher pricing and cost savings. Volume was lower due to the contraction in the overall market following significant excise driven price rises. Trade inventory increases in the Q4 2012 and growth in illicit trades, which is now 28% of the market. However market share continues to grow strongly and was up 2.3 percentage points to more than 77%, mainly driven by Dunhill and Free.

In Canada profit grew strongly and volume increased driven by the good performances of Pall Mall even more here, leading to market share growth. The illicit market remained relatively stable.

In Mexico, profit and volume grew strongly. Share increased by 1 percentage point mainly due to an outstanding performance by Pall Mall.
A good performance from Lucky Strike and the launch of Pall Mall in Argentina led to an increase in share however profit declined due to the lower volume and increased marketing investment.

In Western Europe, cigarette volume declined 8% mainly due to contractions in Spain, Italy, Holland, Germany, Greece and the Netherlands. However, Fine Cut volume continued to grow strongly and was up 7%. As a result total tobacco volume was down 6%. Despite the reduction in volume, profit at current rates was up 3% offset on a constant basis thanks to good performances from Switzerland, the UK, France and Romania.

Industry cigarette volume in the region continues to be impacted by the high unemployment levels, which are causing consumers to trade down to Fine Cut and illicit trade in a number of markets. E-Cigarettes are growing although on a very small base. I am pleased to say that we have now launched Vype, our first new e-cigarette, into limited internet distribution here in the UK and we have plans to do much more over the next few years.

In Italy both volume and profit were down as a result of the difficult economic environment. Share in cigarettes declined but share in profits in the Fine Cut segment continued to grow strongly.

In Germany good performances from both Lucky Strike and Pall Mall led to a stable market share. Profit declined mainly due to the reduction in industry volume. BAT remains the leader in the additive free category with continued good growth in the additive free variance of Lucky Strike and Pall Mall.

In France, volume was lower due to the market contraction but profit was higher as a result of exchange rate movements. Lucky Strike continued to perform well, growing overall market share.

In Spain, market share was stable. Volume was significantly lower due to the industry volume being down over 12%. Profit also declined.

In Romania, although volume was lower, share continued to grow, driven by good performances from Lucky Strike, Dunhill and Pall Mall. Share in the premium segment is now nearly 70%. A strong price drove an increase in profits.

Market share increased in the UK driven by the strong performances of Pall Mall and Rothmans. Although industry volumes declined good cost management and pricing led it to a strong growth in profit. Despite the difficult economic conditions in Western Europe we are growing share in a number of markets with good share growth in the GDBs and you have now the number one Fine Cut brand in the region.

Profit in the EEMEA region grew 7% and this was mainly due to good pricing, which was partially offset by the adverse impact of exchange and lower volume. At constant rates profit increased strongly by 13%. Volume was down 4%, impacted by trade inventory movements in the GCC in the prior year. Underlying volume was down 3% mainly as a result of decline in the industry volumes in Russia, Turkey, the Ukraine and the continuing instability in the Middle East.

In Russia, the overall market was down 7% as a result of the excise driven price increase and the first signs of some growth in illicit trades. Share in Russia grew driven by the performance of Rothmans in the value for money category. Kent held share, maintaining the leadership of the premium segment. Good growth in revenue was offset by increased marketing support behind the portfolio leading to flat profit.

In the Ukraine, good share growth was driven by strong performances from Kent and Rothmans however volume was down following a significant decline in the industry partly driven by a growth in illicit trades. This together with increased marketing investments impacted profits.

In South Africa, profit grew in local currency but adverse exchange rates impacted reported profits. Industry volume declined leading to lower BAT volume although this was affected by trade distorting.

In Turkey, profit increased due to the improved pricing and cost savings. Volume declined as the overall market contracted following the excise driven price increase at the end of 2012 and the growth of illicit trades. Market share was lower.

Continual political stability and a fragile economy affected volume in Egypt. This, together with adverse foreign exchange, resulted in lower profit.

The GCC market reported good market share growth to Dunhill's continued strong performance. Profit grew strongly, mainly driven by improved product mix and price increases in 2012. Industry and BAT volume was down due to a strong comparator, which was inflated by trade inventory increases ahead of an implementation of graphic health warnings.

In Nigeria, profit was up mainly due to cost savings however the continuing instability in the country resulted in lower volumes.

I will now hand you over to Ben who will go through the financials.

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

Thank you, Nicandro, and good morning everyone. Before I get into the detail I'd like to point out that the 2012 comparatives have been restated to take account of the revised IAS 19 employee benefit.

Profit for the six months to June 2012 is reduced by £21 million, earnings per share by 1.1 pence. The full year effect in 2012 was £46 million and 2.3 pence respectively. Obviously while this affects reported profit there's a compensatory entry in other comprehensive income and the balance sheet values do not change.

As you know, currency headwinds during the first half impacted both revenue and adjusted profit by 2%. The impact on EPS was also 2%. I wouldn't like to speculate on currency movements for the rest of the year given the recent volatility however if spot rates were to stay as they are for the balance of the year the impact on the full year EPS would be 1.6%.

Operating margin for the group grew by 100 basis points in the first six months of the year. At constant rates this was 80 basis points. All regions contributed to this improvement with the exception of Western Europe, Asia-Pacific, in particular Australia, and the EEMEA region once again performed well. This was mainly driven by higher pricing and lower costs. Americas also continued to improve despite already high margins in the region, although this benefited from foreign exchange. Western Europe margins were slightly down despite good cost management due to the impact of lower volume.

This is another good achievement on top of a significant improvement last year. We reiterate our objective of growing margins by 50 to 100 basis points a year.

Turning now to the income statement: adjusted profit from operations grew 4% to £2,944 million. At constant currencies growth was 6%. This reflects good pricing momentum combined with our continuing focus on cost management so that we achieve good flow through from our revenue growth.
Restructuring costs were higher than in the first six months of 2012. The main items were further costs associated with factory rationalisations in Australia and Russia, and charges relating to restructuring in Argentina and Canada together with the cost of initiatives directly related to the implementation of our new operating model. Un adjusted profit from operations grew 3% to £2,807 million. I will cover finance costs on the next slide.

Despite some weakness in the Indian rupee, associates were 26% higher at £425 million. For the purposes of the adjusted earnings per share calculation, the adjusted contribution from associates is £29 million or 9% higher at £368 million. The adjusted contribution from Reynolds American was 3% higher at £290 million. At constant rates the increase was 1%. This is lower than Reynolds American announced due to adjustments between US GAAP and IFRS, the IAS 19, and the accounting treatment of Medicare costs.

Once again ITC have performed extremely well with this adjusted contribution increasing by 18% to £144 million. At constant rates the growth was 22%. Profit before tax was 5% higher at just under £3 billion.

Net finance costs were 14% higher compared to the same period last year. This is mainly due to higher interest payable as a result of increased borrowings, a reduction in investment income on cash balances across the group and one-off tax case related interest income in 2012. This was partly offset by the net impact of fair value changes on derivatives and exchange differences.

Our underlying tax rate for the period was 30.5%. This is below the rate for the first six months of 2012 but broadly in line with the full year rate. The lower rate is mainly due to the geographic mix of profit. I would anticipate a similar rate for the full year.

Profit for the period rose 6% to £2,188 million and the non-controlling interest charge fell 6% to £148 million, but constant currencies, the adjusted non-controlling interest charge fell 2%.

The share buy-back programme reduced the average number of shares from £1,961 million to £1,922 million and this contributed to an adjusted earnings per share of 109.1 pence, an increase of 8% or 10% at constant rates.

The main driver of adjusted earnings per share growth was operating profit, which was up 6%. As mentioned earlier, we are now facing a currency headwind, and exchange rates have a 2% adverse impact on EPS growth. A strong performance by ITC, the lower tax rate and share buy-back programme all contributed to the 8% earnings per share growth.

Moving on to cash flow. Operating cash flow increased by £151 million. This was largely driven by the higher profits in the first half of 2013 and is consistent with the increase in the same period last year. The timing of working capital movements tends to absorb cash in the first half, as was the case last year. This is largely driven by the timing of leaf purchases. I expect the increase to partially unwind by the year end.

Net interest rose as a result of higher borrowing, and tax paid grew due to increased profit. Higher dividends to non-controlling interests reflect the payment of final dividends from 2012. Income from associates is in line with last year. Overall free cash flows £812 million, which is £91 million higher than last year.

Dividends paid increased by £32 million. The increase in the share buy-back programme to £1.5 billion in 2013 is reflected in the higher cash outflows. Net investment activities mainly relate to further payments in respect of the CN Creative acquisition. Investment activities in 2012 also included a small increase in our shareholding in the business in Bangladesh. Total net cash outflow for the period was £1.68 billion.

Finally, net debt has increased by £2 billion since the year end and is £1.2 billion above the same period last year. The difference in net debt is due to a higher opening balance and the exchange rate impact of non-sterling denominated debt. Net cash flow is in line with last year.

That's the end of the presentation and I'll hand back to Nicandro for the Q and A session.

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

Thank you, Ben. In summary, the underlying business continues to perform well despite the pressure on industry volume and the adverse impact of exchange rates. Our growth strategy continues to deliver. Constant revenue growth of 4% reflects continued good price mix of over 7% and a strong performance from the GDBs. At 109.1 pence EPS is up 8%, excluding the currency impact it would have grown 10%. These are good results at the apple end of our strategic matrix and I remain confident of another year of high single figure and its growth.

Now on a personal note, I'd like to mention that this would be John Daly's last half year results briefing. John has decided to retire and he will step down from the Management Board at the end of December, although he remains a member of the Main Board for the first quarter of next year. Over nearly 20 years at BAT John has played a very large role in the success of this company. The board and I wish John the very best for a well-earned retirement. We'll miss John's passion, commitment, energy and great humour. He really leaves behind him a true legacy, a true leadership legacy.

Finally, thank you for watching the webcast. We will be shortly starting our question but before asking your question please do not forget to state your name and firm. Thank you.

QUESTION AND ANSWER

Operator

If you are on the phones and you have a question please press 01 on your keypad now. Our first question is from the line of David Hayes at Nomura. Please go ahead with your question. Your line is now open.

David Hayes – Nomura - Analyst

Morning, gentlemen. Thank you. David Hays, from Nomura. Two areas if I can: just firstly on Russia, you talked about the increased marketing investment mainly in profits were flat. We've heard one of your competitors talk about increased spend in Russia. I just wondered whether you could talk about that marketing spend and whether that is a rise in competitiveness, whether that's just a phasing issue that will drop away a little bit in the second half. Then I guess just to confirm that you took a price rise in July and the quantum of that.

The second area of questioning was just on the cash flow. Obviously, as you say, seasonally, if you like, an outflow in the first half as expected but I notice that the inventory actually was an inflow. Is that the benefits of SAP coming through and work on the inventory side starting to benefit and is that something we can expect to see as a trend for the next couple of years? Thank you.

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

Well let me answer the first question, David, good morning, and Ben will take the second one. Regarding Russia, yes, we have a little more load on market investment in the first half. Nothing unusual. In our case it just supported the launch of Rothmans. We launched Rothmans the second half of last year and then with the continued support to scale the distribution of the brand across the country. By the way, the brand is doing extremely well with our market share now around 1.7 of the Russian market. On the back of the performance of Rothmans, on the back of the performance of Kent, we are growing market share big time in Russia and we are extremely confident in the performance of those brands.
As you know, Russia was declined 7% in the first half of the year, and in the case of BAT we declined just one because of the market share growth. So the market investment is working but I think that the load in the first half is pretty much on the back of the Rothmans launch in the second half of last year. So nothing I would say exceptional.

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

Hi, David, it's Ben here. Obviously we buy leaf stock at the half year so you'll see an increase in inventory in the half year, but the effect of stock builds also has an effect so sometimes stock builds appear in inventory but more often they appear as trade receivables, so you've got two offsetting effects there. So I think you've got to look at working capital as a whole. And that's been broadly similar to last year in terms of the shape of it. We do expect that to reverse slightly as obviously leaf stocks come down for the full year.

It's a little early for inventory reductions to be seen as a result of the SAP implementation. Remember, we're only live in Malaysia at the moment, but it is certainly one of the areas that we're looking at over the next couple of years to squeeze harder, partly because on the one hand you'll see excise credit coming under pressure from governments but also partly because we're going to have a reasonable period of higher CAPEX as we invest in next generation products, as we invest in innovations, and obviously as we spend the money on the SAP programme rolling out.

David Hayes – Nomura - Analyst

Okay, that's great. Thank you very much.

Operator

Our next question is from the line of Eric Bloomqvist of Berenberg. Please go head. Your line is now open.

Erik Bloomqvist – Berenberg - Analyst

Good morning, Eric Bloomqvist, Berenberg. Could you discuss the NGP initiatives and certainly with the launch of Vype yesterday, how that fits into the perspective regulatory environment proposed by the MHRA and kind of where the European Union seems to be going? And also the product that Kingsley mentioned earlier today, which I believe is the Nicoventures offset product, and then if you could expand as well as part of that on Nicandro's comment that e-cigs account for about 0.5% to 0.8% of the tobacco market.

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

We launched Vype two days ago in limited internet distribution, as I told you. We intend to expand it in the second half, during the next couple of months, in the UK and beyond. The market today is unregulated and I think there is a market out there, and we want to participate. That's why we've launched Vype. It doesn't mean that once we'll have the MHRA approval with the two products that are going through regulation now, we are now going to launch them. MHRA has said already that it's going to grow further, for around the two years the current products in the market; we didn't think that we should be out of this market, even if it's an unregulated one. When you have the approval we will launch regulated products according to the regulation that is going to be in place.

In terms of the size of the market. As I said, it's a market that is growing. We see consumer interest for e-cigarettes. Nowadays it's quite a small market. You can split the European market into categories. The developing market is in which the conception in terms of adult smokers that have had some loyalty to the categories are on 1%, and then markets such as France and markets such as Germany that you have a little more developing, which will have 3% or 4% of the smokers smoking e-cigarettes, so we thought that there is a market out there, we should participate. But the loyalty is very low because the product will not deliver. We believe that with Vype we'll have a better consumer acceptance. We think that's the better product, that's why we are there.

Erik Bloomqvist – Berenberg - Analyst

Okay, thank you. Then with respect to your comments on Australia, you noted that the low price segment was increasing and suggested this was due to competitor activity. Is that the whole reason for the down-trading or is it possible to just aggregate competitor activity from any plain packaging effect?

Then related to that, the Australian press is suggesting there's a tax increase coming in Australia. If you had any further detail on that, that would be helpful. Thank you.

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

Regarding the potential excise increase in Australia, I have no details to be honest with you. We heard something this morning that it may come but I have no -- probably have the same information that you have, same piece of information that you have, so I don't have anything to add on that.

Regarding Australia plain packaging: and then I'll go to the down-trading. To date we have not seen any change in consumer behaviour as a result of the plain packs legislation. What we have seen in Australian markets is some down-trading but this has been a feature of the market in the last couple of years, and this has been driven mainly by price increases and also some competitors have launched some brands in the low price segment. But this has been happening in Australia for the last four or five years, so we have seen some down-trade in Australia, as I said, for some time. So nothing unusual.

So far after eight months of implementation of plain packaging we have seen no influence. The size of the market is declining but it's declining more or less at the same level as it used to decline with the size of price increase that you have implemented. So nothing has changed.

David Hayes – Nomura - Analyst

Great, thank you.

Operator

Our next question is from the line of Adam Spielman of Citi. Please go ahead with your question. Your line is now open.

Adam Spielman – *Citi - Analyst*

Thank you very much. I've got two questions. One on Brazil and one on marketing. Can I ask the Brazil one first? And it's really to gauge the outlook, particularly for profitability in Brazil or profit in Brazil, profit growth in Brazil. Clearly we're past the anniversary of a big tax increase. My understanding is there's been no price increases in Brazil since January, in effect. In the statement that Souza Cruz put out yesterday, there was the statement that some costs increases might be higher in the second half than in the first half so I was just wondering on Brazil how we should think about the second half going forwards. Thank you. And then I'll come on to marketing.

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

Okay, regarding Brazil, first of all, Adam, as you know, we don't comment on pricing going forward so I cannot comment anything about how the price is going to evolve. What I can tell you is they have another excise increase in January next year, that's going to be lower than the previous ones, as I said before, because their excise increase will go down in the coming years. Their plan was a big excise two years ago, a smaller one last year, then a smaller one next year, and even a smaller one in two years, three years' time. So that's the situation with Brazil. We don't comment on pricing.

Regarding costs, I don't think the costs in the second half in Brazil are going to be significantly higher than in the first half, to be honest. I see no reason. We have bought the lease already so they leave that it to -- you are using the first half is the same one as the second half. So I don't see any big pressure in the costs base of the Brazilian market.

What we may have is that this phasing of market investments. Sometimes it's a little bit more load than in the first half, sometimes a little bit more load in the second half. I wouldn't be able now to talk about what's the load in Brazil in the first half or in the second half, but I wouldn't say that it's an additional investment. It's just a question of loading one half against another one. So that's the situation in Brazil.

Adam Spielman – *Citi - Analyst*

Thank you, and that's a good lead into the second half of the question. I noticed in a number of markets you're talking about increased marketing investment. You mention it in Russia, you mention it in Ukraine, Argentina, for example, and Korea, and I was just wondering whether you could give a global figure where the marketing investment has gone up as a percentage of sales, weather and how we should think about that. And I guess whether, also related to that, were there any big offsetting decreases you haven't mentioned, maybe in Australia or somewhere else? Thank you.

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

Adam, regarding market investments, of course I'm not going to give you the number, the figure, but what I can tell you is growing -- slower than net turnover, but I don't think that you have a huge surge in market investments. We are trying and we are doing as part of this strategy to invest this market, so we are investing in markets which needs a boost. For example, places that you just mention or South Korea, and those market investments are working quite well. You remember at the beginning of this year when you have the full year announcement we said that you're going to focus in some markets in 2013, that you're facing some problems, such as Indonesia and such as South Korea, and it's working quite well. South Korea we have 18 months of consecutive share growth, Indonesia we stabilised the share, we started to grow the last couple of months. Dunhill Kretek is growing fantastically well. So we are just investing in this market. So we are investing less in some markets and investing more in some others. I don't think that total market investment is a substantial change, and I think that market investment have to look at those things in three or four years' base. Three or four years' base we are not increasing dramatically.

Just refocusing the investments where what we call the high growth markets or priority markets.

Adam Spielman – Citi - Analyst

Just to be clear: the marketing investment is a percentage of turnover I think you said had fallen in this half relative to the first half of 2012?

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

It's very difficult to talk about half year because we have -- sometimes we have investments in one half against another one. You have launch of innovations, you have launches of brands. For me it's much easier to talk in a two to three years' perspective. Two to three years' perspective then that total is growing faster than the market investment, that's what I said. But in our six months' period it's very difficult to be precise because it depends on how we implement your pipeline of innovations, depends when you are launching your brands. As you said, in Brazil, the first question, the second half probably are going to spend a little bit more, probably because there is a load in terms of implementing innovations behind our brands in the second half. So if I give you a number, a figure, for you in the first half probably it's not going to be accurate. So what I'm saying is that in a two to three years' timeframe that's how we see these things, market investment is growing -- is lower than at the moment.

Adam Spielman – Citi - Analyst

OK, thank you very much.

Operator

Our next question is from the line of Henry Davis of Bank of America Merrill Lynch. Please go ahead. Your line is now open.

Henry Davis – *Bank of America Merrill Lynch – Analyst*

Hi, guys. Thank you. I've got four quick questions. First on current European volume. How much do you think is being driven by increases in illicit trade? Second, on your margin progression, I'm just interested to know what your margin progression would be without cost saves. And also just what timeframe should we be thinking for the mid-term 50 to 100 bits margin progression guidance? Is it another two, three, five years or even more than that?

Third, how much of your volumes at a group level are accounted for by slim cigarettes and menthol cigarettes including the capsule technology? Lastly, I was just interested reading the interview earlier. You talk about e-cigs being a potential opportunity. Now it looks to me like e-cigs would be much more competitive than traditional tobacco, which might run the risk of a lower price and margins, and of tobacco companies getting a smaller share of the overall pie.

So I was just interested to hear your thoughts on why that wouldn't be the case and why it is the potential opportunity. Thank you.

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

Okay, let me take three out of our questions and I'll pass to Ben to talk about margin progression. So let's go for the third question, volumes of slim menthol in a global base. To be honest, Henry, I'll get back to you. I don't have the numbers on the top of my head here. But I'll get back to you. I think that should be -- sorry, I'll get back to you to this question, if you don't mind. I ask one of my guys here to inform you later, okay?

Henry Davis – *Bank of America Merrill Lynch – Analyst*

Perfect.

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

Two questions. Can you talk about what's happening in Russia and, in particular, within premium how Kent is doing? That's one question. The second question is how should we think about the innovation programme? You're obviously rolling out natural around the world. Have you still got further to go on capsules and is there anything else coming up shortly that we should think about, even if you can't be specific as to what it is, that is meaningful, or could be?

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

Regarding the first question, European volumes. They are declining this year pretty much at the same rate of decline that we saw in 2012. But remember, at the beginning of the year, I had several questions about West European volumes, it seems that the market was a little bit more optimistic about this and we said that we saw no reason at that time to believe that 2013 looked better than 2012 because at the end of the day it's all about unemployment, it's all about the disposable income and those things are not changing, so I didn't see any motive to be optimistic about 2013, about the European volumes.

Regarding illicit trade, yes, illicit trade is an issue. It's growing in some European markets. We are working with the governments to see everything that can be done in order to break it down. In markets like Italy, for example, illicit trade this year has been stable, it's not been growing. On the other hand, in the UK, for example, it has been growing. So it's an issue for Europe but we work as close as possible to the government to inform them about the problems and find common solutions. In the case of Romania it has been declining. So you have some areas in Europe that have some successes and some areas that has got worse. But European volumes are declining more or less at the same rate as they declined last year.

The fourth question about e-cigarettes and margins. Let me start by saying it is a very small segment nowadays. It's 0.5, 0.8 of the market. It's almost -- it's minimal. We have some competition but I think that BAT is a unique position in terms of the quality of the brand that we are offering the product, the Vype product, and we believe, as well, that we have a certain understanding to be a front runner in this category.

In terms of margins, it's a category that's starting now. Our expectation, our projections, that the margins are going to be relevant. I don't think that they're going to be detrimental to the business. We have standing products we've had good margins and I think that it's going to be an important category, not only from the volume but from the profitability point of view. So we are not getting to the category because we have to, we think there is an opportunity there to make money, to be commercially successful.

I will pass to Ben to talk a little bit about margins.

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

Yes, margins, Henry, I mean the way I tend to think of it is that about 50% of the margin improvement tends to come through from pricing and 50% tends to come from cost savings. It's different in each period but that's a broad rule of thumb to go by.

On the guidance on margin improvement, and we're still confident of the 50 to 100 basis points, and we've done very well against that over the last few years, I've always said that when we get to 40% operating margin we'll pause and reconsider that guidance. That doesn't mean that we won't actually still grow margin after that because a lot of the work we're doing, things like the roll out of SAP, won't actually be complete until 2017 and so that will still be driving costs savings.

So the quest for cost savings never stops. But I think 50 to 100 basis points is a good guide until we cross 40%, then we'll pause and think again.

Henry Davis – *Bank of America Merrill Lynch – Analyst*

Perfect thank you very much.

Operator

Our next question is from the line of Fulvio Cazzol of Goldman Sachs. Please go ahead with your question. Your line is now open.

Fulvio Cazzol – *Goldman Sachs - Analyst*

Yes, good morning, gentlemen. It's a quick follow up on your comment, Ben, on the cost savings. I was just wondering on Western Europe specifically, I understand that obviously the economic environment has been poor but in recent years you've been able to deliver better operating profit growth than your competitors from cost savings. We didn't really see that in the first half. How should we think about the rest of the year and even in 2014 and beyond? Are we going to see a pause in terms of contribution from cost savings until the SAP programme is rolled out in Western Europe? I've got another question after that, but I'll just leave it there for now.

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

Hi, Fulvio. I mean I think you'll find that our profit increase in Western Europe was better than Philip Morris' entire profit increase, so I think that's not a bad performance by Western Europe.

We've taken some cost savings out of Europe over the past few years because, as we've said, it is a tough operating environment there. But we are really moving the SAP programme into Western Europe next so we start with Asia and then we move on to Western Europe, so you'll see in a tough operating environment the benefits of SAP coming through starting late next year.

Fulvio Cazzol – *Goldman Sachs - Analyst*

Okay. Then my second question was on Vype. I saw that you're selling the product at around £7. I was just wondering how does that compare to cigarettes on a stick equivalent basis and also how does that compare to other e-cigarettes in the marketplace? Also as a follow up question on that, could you give us some details of what your total production capacity is in the UK for that product?

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

Regarding pricing, Vype is being sold for the price that you just mentioned, which is equivalent a pack of cigarettes. A pack of cigarettes, Dunhill for example, in the UK is around £8.50 just to have an idea. If you go to value for money brand it's £2 cheaper than that. So that is a comparable basis.

In terms of capacity we are ramping up our capacity. That's why we started the internet sales last week, two days ago, and we are ramping up capacity. I don't think that capacity is going to be a problem for us in the second half of this year. In the next two or three months we will be able to expand distribution for the whole country and going for other channels and capacity is not going to be an issue. So we are ramping up capacity and we went to the internet first just to seek some reactions, in spite of the pilot that we went through, we thought to have a light launch was a good idea but capacity is not an issue at all.

Fulvio Cazzol - *Goldman Sachs - Analyst*

Thank you. Just as a quick follow up on the pricing, but on a stick equivalent basis how does that compare? I don't know how you would measure it, whether it's nicotine delivery, how does that compare to say a packet of cigarettes on that basis?

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

Fulvio, as I said, a stick is equivalent to around 20 sticks of cigarettes, so you can compare a stick of e-cigarette to a pack of cigarettes.

Fulvio Cazzol - *Goldman Sachs - Analyst*

Okay. Fine, so it's comparable.

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

It's equivalent.

Fulvio Cazzol - *Goldman Sachs - Analyst*

Okay, fine. Yes, thank you.

Operator

Our next question is from the line of James Bushnell from Exane. Please go ahead with your question. Your line is now open.

James Bushnell – *Exane - Analyst*

Hi, good morning, and thanks for taking my questions. I wonder if I could just dig into a couple of the regional dynamics. Firstly with Asia. Clearly your volumes are very strong but your price mix is effectively zero. I'm guessing there's some country mix in there but also given that your margins were up, and apologies if I missed your comment, Ben, on this, I just wondered how that tally is. Is there some SAP coming in there or what else was at play in the margins being up with pretty minimal price mix?

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

Sorry, you're talking about Asia here, I missed, because you came through on the phone not too clearly. Asia will always have a low price mix because quite a lot of the growth in Asia comes from places like Bangladesh and Pakistan, and that's been true for the last three or four years, not just this first half. So you'll see always a lower price mix from Asia.

The implementation of SAP, we've done Malaysia. The fourth quarter of this year will see the implementation in Australasia and then the first quarter of next year, if things go well, we'll see the implementation in South Asia. Then after that we'll carry on rolling out phases like Japan and Korea.
So the SAP related benefit you won't see until, certainly at the earliest, the back half of next year. However we are still seeing some benefits from the new operating model. We are still gathering back office cost together, putting it in shared service centres, taking advantage of labour arbitrage, that sort of thing. So it'll be a mixture for Asia but don't expect a high price mix from Asia because quite a lot of the growth is in lower margin markets and that's just the structural nature of Asia.

James Bushnell – *Exane - Analyst*

Okay, sure. Thank you. On Europe, your pricing was very strong and also at the same time I notice that of the nine markets you provide commentary on only three of those you mention had higher profits, and I just wondered where is that strong pricing coming from in terms of the price mix in Europe and can we assume that of those three markets that were growing profit that it must have been very significant to offset what was going on in your other markets to keep that region flat overall?

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

We have a very good pricing in Europe in several markets. I'm not that sure that I can give a list market by market now, where we had the pricing this year, but we had it in France, we had in Germany recently, we had Italy at the end of last year, we had in Switzerland, we had in Romania, we had in UK, we have everywhere. In terms of profitability in the first half, I usually, as I said before in another question, you have to take this on a yearly basis because the half year's result we always have a lot of investments one year against another year. But we have been growing profitability in a number of Western European markets, despite the market decline, the volume decline of 8%, we haven't been able to deliver product growth across the region, which I think that was a very good performance.

James Bushnell – *Exane - Analyst*

Okay, thanks very much for your help.

Operator

Our final question for today is from the line of Rogerio Fujimori of Credit Suisse. Please go ahead. Your line is now open.

Rogerio Fujimori – *Credit Suisse - Analyst*

Hi Nicandro. Rogerio Fujimori from Credit Suisse, two questions from me please. Nicandro, do you expect the big revenue growth differential between emerging and developed markets in the last five years to be perhaps a bit less significant in the future given the greater maturity of important emerging markets like Russia, Brazil and Turkey; if you agree with this statement?

Nicandro Durante - *British American Tobacco plc - CEO*

Yes, I think the margins -- Rogerio, you have to see these things from a perspective. You look at the last five years, the gap in terms of margins of developed markets and developing have been reduced. Not dramatically but have been reduced. I expected this to happen going forward. That's the whole part of this strategy, to be strong in the developing market, in which the potential to grow margins are much higher than in developed markets, in which the prices are already very high and the margins are high. So you take prices in developing markets and you end up with higher margins. So, yes, the gap is going to be reduced over time as it happened in the last years.

Rogerio Fujimori – *Credit Suisse - Analyst*

So you mean also the revenue growth, the French, should perhaps narrow as margins go up?

Nicandro Durante - *British American Tobacco plc - CEO*

There's no doubt about that.

Rogerio Fujimori – *Credit Suisse - Analyst*

My second question is do you think the industry profit pool in Western Europe can still grow in the medium to longer term?

Nicandro Durante - *British American Tobacco plc - CEO*

Let me put into perspective. When you ask this question in a moment that you are in the middle of the biggest economy in crisis in Europe, since the 30s, the obvious answer is going to be doom and gloom. I believe that the day that the market is stabilised, the day that disposable income will start growing again, unemployment going down, there is no doubt that the profit pool will go up. I think that is a question of market economy. It is a question of the situation which the markets face themselves to date. But do I have expectations that you go back and you start growing a profit pool, I have no doubt on that.

Rogerio Fujimori – *Credit Suisse - Analyst*

That's great. Thank you Nicandro, and all the best.

Operator

As that was the final question, Nicandro, can I please pass the call back to you to close.

Nicandro Durante - *British American Tobacco plc - CEO*

Thank you, guys. Thank you. I think that we see each other at the year end. I appreciate you joining us for this conference call. Thank you very much.

Operator

This now concludes our call. Thank you all very much for attending.