

2022 Half Year Results

Presentation Transcript

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Good morning everyone and welcome to our 2022 interim results presentation.

I am Jack Bowles, Chief Executive of BAT. With me this morning is Tadeu Marroco, Group Finance and Transformation Director.

Before I start the presentation, I take it that you have all seen the disclaimer on slide 2 and 3.

As usual, once Tadeu and I have taken you through the presentation, there will be an opportunity to ask questions.

I would like to take a few moments here to express our deep concern and sadness for everyone affected by the conflict in Ukraine.

While we continue to work towards the transfer of our local Russian business, we remain focused on the 2,500 people we employ in Russia and safeguarding their future employment.

This is an extremely complex undertaking, and we will provide an update on our progress as soon as we are able.

Thank you, turning now to our Interim results.

I am proud to say that, we are both Transforming our business and Delivering robust results, at the same time, we are successfully navigating an increasingly challenging macro environment in 2022, while delivering superior shareholder returns, with our growing dividend and £2 billion buyback

In the first half of this year we have built on the excellent momentum in 2021.

I am proud that we are making strong progress transforming the business from cigarettes, to lower risk alternatives for smokers, while at the same time driving our other ESG priorities.

We have now reached a milestone of over 20m consumers of our non-combustible products.

We grew New Category revenue by 45% in constant currency, and we have delivered more than a 50% reduction in New Category losses, alongside a continued increase in New Category investment to a total of £1.1 billion in the first half alone.

This strong performance has again been driven by all three New Categories, with new product launches in all three global drive brands.

This demonstrates the importance of a global multi-category strategy with strong brands, and great products, in the right markets.

We also continue to make good progress towards our ESG ambitions and targets, with 18 certified carbon neutral facilities, including two added in the first half, as we continue our work towards achieving carbon neutral operations by 2030 for Scope 1 and 2.

At the same time, we have delivered robust results in the first half with Group revenue up 3.7%, 90 basis points operating margin improvement, and adjusted EPS up 5.7% at constant rates.

While we recognise there may be challenges ahead, we are successfully navigating the current macro environment, driven by the resilience of our business.

This is underpinned by our pricing power*, with 90% of our full year planned pricing already achieved. We benefit from high gross margins, and, at present, low levels of input cost inflation, in addition, Quantum is delivering efficiencies and savings ahead of schedule.

These results have enabled us to return a total of £3.8billion in cash to shareholders so far this year, through the dividend and our buyback.

Since 2018, we have grown our Non-combustible consumer base by a compound rate of over 30%, reaching 20.4 million in June, with 4.3 million added in the last 12 months alone.

And excluding Russia, we reached 19 million consumers, adding 3.9 million.

We are confident in our 2030 target of 50 million consumers of non-combustible products.

Over the last 3 years we have grown New Category revenue by a CAGR of 31%.

In the first half of this year, we grew revenue by 45% this is on top of the 51% increase we delivered in 2021.

Non-combustibles now represent 14.6% of Group revenue, this is more than 2 percentage points higher than 2021.

We have real momentum in our New Category business and are well on track to deliver on our £5billion revenue target by 2025.

We drove more than a 50% reduction in New Category losses in the first half. This follows the 10% reduction we delivered last year.

Our three global brands, Vuse, glo and Velo, continued to strengthen, which enabled us to increase prices across the portfolio, in both devices and consumables.

Importantly, more than two-thirds of the profit improvement came from our increased scale and efficiencies.

At the half year, we already have a total of 9 profitable countries in New Categories.

While the route to profitability will not be linear, and we will continue to invest in new launches and geographic expansion this puts us in an excellent position to deliver New Category profitability by 2025.

At the same time, we are also continuing to invest in our transformation.

We have doubled our R&D spend since 2017, accelerating our pace of innovation.

In the first half, we opened an additional Global Device Development Centre, in Shenzhen.

Backed by science, we are developing technology and design that address consumer preferences.

Now let me take you through our latest innovations.

With our new glo platform, hyper X2, we have significantly improved all key aspects of our successful model, glo hyper.

X2 was developed with consumers at its heart a smaller, lighter device with induction heating, and a dedicated boost button delivering customisable heating options.

X2 was launched last week in Japan, our largest THP market, together with an upgraded range of consumables, to deliver maximum satisfaction.

We have ambitious roll out plans for glo hyper X2 in the second half.

In vapour, we launched Vuse Go, our new disposable product, in the UK in May.

Taking just 6 months, this is our fastest speed to market launch yet, and a great example of our increased speed and agility.

Vuse Go currently offers 6 flavours at a premium price.

Already available in over ten thousand stores, Vuse Go is fast approaching No.2 in the UK disposables category just 3 months after launch.

We have rapid market roll out plans in Europe for the second half.

In addition, we launched Vuse ePod 2-plus in May in Canada.

ePod 2-plus is our first-to-market Bluetooth connected device, with its own dedicated app, a device lock, to enhance Youth Access Prevention, Find my vape and direct subscription options.

While still early days, consumer feedback and performance to date have been very encouraging, and ePod2-plus is already more than half of all Vuse devices sold in Canada since launch.

With Velo, we have introduced new-to-world recyclable cans further demonstrating our commitment to embedding ESG in our New Category brands.

This complements the roll out of our recent launches of mini pouches and our Max range, which are driving higher trial and conversion, respectively.

Our accelerated innovation pipeline is fuelling our Faster Transformation and at the same time, we are delivering on our financial commitments.

Reported results were impacted by a number of one-off items, that Tadeu will cover in more detail later.

The most significant of these was a near £1billion impact, from the impairment of Russian assets.

Looking at our adjusted numbers we have delivered group revenue up nearly 4%, despite the current pressure on US industry volume, Profit from operations up 4.9%, Operating margin of almost 44%, EPS up 5.7% and strong cash generation

These are robust financial results that benefit from our strong performance in New Categories and the increasing energy in the organisation.

They demonstrate our ability to successfully navigate the current macro environment.

Through Quantum, we have achieved £1.5billion annualised cost savings 6 months early, and our progress continues.

We now expect to achieve in excess of £1.5billion by the year end.

With our pricing power* and no significant change in global elasticities, we are in a good position to successfully manage inflationary pressures and by leveraging our increased agility, we are ensuring continuity of end market supply.

This has driven a 90 basis point increase in our operating margin.

In summary, with our New Category growth momentum, and further reductions in New Category losses, we are transforming BAT at pace.

We have strong second half investment plans for both new product launches and further geographic expansion.

While we understand that there is more to do, these results demonstrate the strong progress that we are making in our transformation.

We are confident in delivering on our Full Year guidance.

I will now hand over to Tadeu.

Tadeu Marroco, Finance and Transformation Director

Thank you Jack.

I am delighted to share more detail, on how our first half performance demonstrates our faster transformation in action.

Our reported results were impacted by a number of one-off items, including:

- Close to a £1billion non-cash impairment of our Russian business, which is now classified as an asset held for sale.

- A provision of £450 million, recognised in respect of the DOJ and OFAC investigations into alleged historical breaches of sanctions.
- And restructuring charges driven by project Quantum. We expect these to reduce next year, following the completion of the current project.

Further detail on performance ex-Russia can be found in the appendix.

To better understand the key drivers of our performance, we will focus on constant currency adjusted results, unless otherwise stated.

In the first half, we delivered revenue growth of nearly 4% driven by:

- New Category growth of 45%
- And continued strong combustibles price / mix of 5%

Combustible volume was down 4.2%, impacted by a combination of

- the sale of our business in Iran in August last year and
- lower year on year industry volume in the US, reflecting macro pressures including high fuel prices and inventory movements.

With continued value share growth and robust pricing, our combustibles business delivered a resilient operational performance.

Profit from operations was up 4.9%, while absorbing a 1.5% headwind from transactional FX.

This drove adjusted EPS up 5.7%, or 8.6% on a current currency basis.

Our free cash flow before dividends of £2.3 billion was well ahead of last year, illustrating our continued focus on cash conversion.

I am particularly pleased, that for the first time, revenue growth in all three New Categories exceeded strong volume growth with the growing equity of our three global brands enabling us to take pricing in all three categories.

All this is supported by a clear ESG focus, and a substantial body of science for each of our New Category brands, which is actively contributing to our group sustainability targets.

Vuse won the Gold award at the Transform Awards Europe 2022 for “Best Use of Sustainable Packaging”.

We also have first of a kind clinical studies for glo and Vuse and based on over 135 of our own studies, and 3rd party data the science shows, that for Vuse and glo, harmful components are 90 to 99 percent less than cigarettes with toxicology between 95 to 99 percent less.

These strong innovation and scientific capabilities will be further enhanced by our new state-of-the-art Innovation Hub in Trieste, Italy where construction continues.

As Jack has already covered, we have reduced New Category losses by more than 50% in the first half whilst at the same time investing £1.1billion in the period.

Two-thirds of this profitability improvement was driven by our increasing scale and efficiencies, with one-third driven by pricing.

We continue to focus on the three profitability levers, Revenue Growth Management, COGS reduction and Marketing Spend Effectiveness and we have made strong progress in the first half.

We have further improved Vuse trade margins, building on the 30% reduction already achieved.

We delivered around £120m of productivity savings, driven by automation and increased scale.

Through our Market Spend Effectiveness tools, we have further reduced the cost of consumer acquisition** and retention across all three categories.

Having invested significantly in establishing our New Category business, we are now in the growth period, where we can continue to invest more and deliver improved profitability.

Our New Category algorithm is now starting to contribute meaningfully to our results

- With strong top line growth and increasing scale, our spend effectiveness is improving, reducing our incremental investment requirements.
- The growing strength of our three global brands has allowed us to increase prices on both devices and consumables.
- And, as we expected, all this is driving a marked improvement in New Category profitability.

Turning now to our New Category performance in detail.

In vapour, we continue to extend our value share leadership position, with Vuse achieving 34.7% value share in the Top 5 markets, up 1.2 percentage points, despite the rapid growth in disposables.

Growth in the vapour category has accelerated, driven by both disposables, which have expanded the vapour category and the continued growth of closed systems.

In Europe, our closed system value share, excluding disposables, grew strongly, and is now close to 50% across all three key vapour markets.

Disposables growth in the UK, France and Germany is reflected in our share of the total vapour market in these countries.

We have responded rapidly, with the launch of our new disposable offering, Vuse Go, in the UK with ambitious rollout plans for the second half.

In April, we were delighted to announce that Vuse had reached US vapour value share leadership in tracked channels.

In Canada, Vuse continued to extend leadership reaching 88% year to date value share, with the launch of ePod 2-plus.

More broadly across the other top 5 markets in Europe, we continued to build on the strong momentum from last year, with further value share gains in closed systems.

In the UK, Vuse Go is already fast approaching the number 2 position in the disposables segment, with premium price positioning and we are seeing very little cannibalisation of our existing Vuse portfolio.

Vuse Go is expected to drive margin accretion, once at scale.

Alongside Vuse Go, we are rolling out a take back scheme for devices in the UK.

In addition, we have strong Youth Access Prevention controls in place, including our retailer training and education programmes, embedding our full governance standards.

In THP, volume share in the Top 9 markets was up 1.6 percentage points to reach 19.6% driven by the continued success of glo hyper.

Excluding Russia, our share reached 18.9%, up 1.2 percentage points.

In Europe, which represents around half of global THP industry sales, hyper continues to drive strong momentum with glo revenue growth of nearly 90%.

glo gained year-to-date volume share of total cigarette and THP in all key markets.

In many countries, glo's share of the THP category now exceeds our share of cigarettes at a higher gross margin per stick, driving profit growth.

In Japan, glo's year to date share grew 60 basis points to 7.4%.

Both glo and our combustible business grew volume share with our total nicotine share in Japan reaching 20.7% up 60 basis points.

We are excited to have launched glo hyper X2 in Japan last week and we have rapid roll out plans for the second half

In Modern Oral, we have maintained our international leadership position outside the US, with 69% volume share of this fast growing category.

In the US, Velo volume share was down in a highly competitive environment as we continued our main investment focus on the much larger vapour opportunity.

The US Modern Oral category remains highly competitive, and still represents only around 2% of total nicotine industry value.

We have submitted a PMTA in the US for our superior, international Velo product range this will ensure we are well prepared for future opportunities in the world's largest New Category market.

In the more established markets of Sweden, Norway, Denmark and Switzerland we remain volume share leaders in the Modern Oral category.

In Sweden, our year to date Modern Oral category share was down 1.4 percentage points due to heavy competitor discounting.

However, our share of total oral continued to grow, reflecting the continued strong growth of the modern oral category.

We are also making strong progress with Velo in newer Modern Oral markets.

In the UK, Velo has reached volume share leadership, with close to 50% share and was awarded Product Of The Year.

We continue to see an attractive opportunity for Velo in emerging markets offering an affordable reduced risk alternative to cigarettes.

In South Africa, we launched a city test pilot in Johannesburg at the end of last year.

We have now entered the second phase of the test with guided trial and expansion to selected organised retail chains in Johannesburg. We are seeing encouraging early results.

Turning now to Combustibles.

Cigarette pricing was up nearly 9%, and while consumers are feeling the impact of inflation, we are currently seeing no significant change in global elasticities.

Pricing was partially offset by geographic mix driven mainly by volume growth in Brazil and Pakistan and lower US volume.

Combustible volume declined by 4.2%, mainly due to the sale of our business in Iran and lower industry volume in the US. This resulted in revenue up 0.6%.

With a well-balanced portfolio of brands across all key price tiers and the benefits of our Revenue Growth Management tool we believe we are well placed to navigate the inflationary pressures globally.

Turning now to the regions.

In Europe, New Category revenue was up 50%, driving total regional revenue up nearly 10%.

Europe is a true multi-category region and we are rapidly transforming our business. Non-combustible revenue already accounts for close to 20% of total regional revenue.

Combustible revenue grew 3.5%, as volume impacted by the conflict in Ukraine and a decline in Turkey was more than offset by strong pricing.

Value share was down 30 bps, mainly driven by Russia and Germany.

Profit was up close to 12%, driven by strong revenue growth and further cost saving initiatives as a result of Quantum.

In APME, New Category revenue was up 16%, mainly driven by THP, with total revenue in the region up 4.7%.

Combustible revenue grew over 4% and value share was up 40bps.

Strong performances in Pakistan, Japan and Bangladesh more than offset the impact from the sale of our Iranian business, in August last year.

Profit was down 5%, largely due to the change in excise terms in Australia in 2021, and the disposal of Iran.

Recovery in Duty Free continues at a very slow pace.

In AMSSA, New Category revenue was up over 70% driven by the excellent performance of Vuse in Canada and South Africa. This was a strong contributor to regional revenue growth of 6%.

Combustible revenue was up 4%, as markets, particularly South Africa and key markets in South America, began to normalise post COVID.

Combustible value share was down 40 bps, mainly driven by Canada, Mexico and Brazil.

Profit was up 6.5% driven by revenue growth, and the benefit of continued cost savings from Quantum.

Turning now to the US.

The business is performing well, with strong pricing and continued value share growth in combustibles, as well as an excellent New Category performance.

New Category revenue grew by 59%, driven by Vuse up 60%, and Velo up over 40%.

Significant vapour value share growth for Vuse, up 380bps to 36.3%, drove Vuse to the No.1 vapour brand position in the US.

This was delivered despite the continued growth of synthetic nicotine disposables.

We have grown monthly Combustible volume share sequentially, with a year-to-date increase of 40bps since January.

Overall year-to-date combustible volume share is still down 20bps versus full year 2021, following a decline in the second half of last year.

Combustible industry volume declined by 10%, reflecting the impact of macro factors including higher fuel prices and a return to more normal consumer consumption patterns post COVID.

Reynolds volume was down 13.4% in the first half.

This reflects the industry decline and the net effect of inventory movements in the period.

These included:

- the unwinding of the prior year stock build
- partially offset by additional inventory in June, ahead of the implementation of our global SAP platform

In the second half, we expect results to benefit from a softer comparator, offset by the reversal of the inventory phasing around our SAP roll out.

This means full year results will reflect the full unwinding of the prior year US inventory movements.

Value share in combustibles was up 30bps, supported by the strength of our premium brands Newport and Natural American Spirit.

Continued strong price/mix of around 10% was more than offset by the volume decline. Combustible revenue was down 3.4%.

Adjusted profit from operations was up 5.5%, driven by a material improvement in New Category profitability continued strong pricing, and efficiency gains from factory and salesforce rationalisations.

As a result, adjusted operating margin in the US was up 290 basis points to 52.6%.

Group operating margin also expanded strongly, and was up by 90bps on an adjusted current rate basis despite further incremental New Category investment.

We also absorbed a 1.5% transactional FX headwind on profit, or a 50 basis point headwind to margin, mainly due to the strength of the US dollar.

With the £281million reduction in New Category losses, New Categories supported margin expansion for the first time.

In addition, through Quantum, we have continued to drive further simplification and efficiency, delivering savings of £274million in the first half.

This brings total annualised Quantum savings to just over £1.5billion, with further productivity savings expected in the second half.

This resulted in Group operating margin reaching 43.9%.

Turning now to EPS, we delivered constant currency adjusted diluted EPS growth of 5.7%.

This reflects our robust operating performance, the benefit of the recovery in ITC post-COVID, and the share buyback.

While over 90% of our debt is at fixed rates, Net Finance costs increased driven by higher interest rates and the weakening of sterling against other major hard currencies.

As a result, we now expect full year net finance costs to be closer to £1.6 billion with an underlying tax rate of around 25%, based on current tax rates.

Finally, we expect a transactional FX headwind of around 2% for the full year and extrapolating current spot rates we expect currency translation to be a tailwind of around 6% on full year adjusted EPS growth.

We delivered strong cash flow conversion of 77%, and £2.3billion of free cash-flow, in the first half.

While cash flow is always weighted towards the second half due to the timing of leaf purchases and MSA payments this is ahead of prior years, driven by our continued focus on working capital across the business.

We continue to expect full year gross capex of £700million, broadly in-line with adjusted depreciation and amortisation.

Based on current FX rates, we continue to expect to deliver full year adjusted net debt to adjusted EBITDA within our 2-3x corridor.

We are well on track to deliver another year of operating cash conversion in excess of 90% and expect to generate £40billion of free cash-flow over the next five years.

Our strong cash generation has enabled us to return £3.8billion to shareholders, including £2.5billion from dividends, and £1.3billion through our share-buyback.

Overall, I am very pleased with our performance in the first half. While there may be further challenges ahead, we remain vigilant.

We are successfully navigating the current macro environment and irrespective of the timing of the transfer of our Russian business I am confident that we are on track to deliver our guidance of 2-4% revenue growth and Mid-Single Figure EPS growth.

Thank you, and with that I will hand back to Jack for his closing remarks.

Jack Bowles, Chief Executive

Thank you Tadeu.

So, in summary, we are making strong progress.

We are delivering on the operational priorities we set three years ago and we are continuing to deliver robust financial results, driven by:

- continued strong growth and improving profitability in New Categories,
- the resilience of our combustible business,
- continued savings driven by Quantum
- and strong cash generation.

At the same time we are successfully transforming our business at pace with great momentum in New Categories.

Our Faster Transformation is well underway, driven by our multi-category strategy.

We are delivering on our Purpose.

We are building A Better Tomorrow by transforming BAT to a

- High growth,
- Multi-category,
- Consumer led, CPG
- With a reduced impact on public health and ESG at its core.

I am confident this will create value for all our stakeholders.

Thank you for listening.

I will now open it up to questions.

Questions and Answers

Telephone Operator

If you would like to ask a question, please press star one on your telephone keypad. Please ensure your line is unmuted locally, as you will be advised when to ask your question. So, once again, that's star one if you would like to ask a question.

The first question comes from the line of Richard Felton, from Goldman Sachs. Please go ahead.

Richard Felton, Goldman Sachs

Yes, good morning. Thank you for taking my question. With the US volume down 13.4%, obviously you've highlighted the impact of inventory phasing. Are you able to quantify what the net impact of those various inventory phasing movements were for H1?

Then, if we think about the 10% industry volume declines, you're lapping a tough comp phase, gas prices are rising, that's obviously weighed on your performance this year. But, as you think about industry volumes for Combustibles in the US over the next few years, are there any reasons why you don't think it should return to the 3 to 4% volume declines that we're used to seeing historically? That's my first question, and I've got a follow-up on New Categories after.

Jack Bowles, Chief Executive

Okay, I'll take the second part. Tadeu will take the first part. The industry volume in the US as I always said, in the previous calls, you always have to consider a three-year average in order to see what's happening in the US.

Of course there have been some stock movements at the end of last year, due to potential taxation and a lot of things that happened in the end of last year. But if you look at the overall trend in terms of the US market on a three year basis, you see that of course there is the post-COVID impact, where the market was much stronger, especially in the two years that have passed, and now we're seeing a softer market in the first half of the year.

You see a bit of recovery in the July results, but I think that what you have to consider is, one, we have a very strong portfolio. Two, we are growing premium share. Three, our brands are extremely robust in all price points, and we don't see downtrading currently in our portfolio, or acceleration of downtrading in the industry.

So we have to go step by step. We have generated a profit increase of 5% in the US. The New Categories, especially e-cigarettes, is taking more consumers, and that's good, because we're making money in e-cigarettes. So I think that the comparator is softer in the second half of the year, but we have to be prudent. We have to consider the numbers as they come.

And, as we know, we have a very strong position in the US market. We'll continue to grow on that, both on Combustible, value share is growing by 30 bps, which is an extremely good number. And, at the same time, we are very strong in terms of New Categories in the US. Tadeu.

Tadeu Marroco, Finance and Transformation Director

Yes, in terms of the numbers of brands compared with the market, you have to remember that last year we delivered a number ahead of the market, and we made the point about the stocks that were built at the back of some uncertainties, in terms of tax increase, the price increase that happened at the end, at the beginning of the year, and so on and so forth. So we said that there would be some unwind happening this year.

This partially happened in the first half of the year, and I would say that, between 13 to 10% of the market, you would consider that half of that was some of the unwind that happened already H1. The other half is the fact that we have a decline, our market share, by 20 basis points, like we mentioned, although we have already increased month on month since January 40 basis points, and so we have been recovering that. But, if you take the average compared with a full year 2021, we have a market share down. So I think that half you could attribute to the difference.

Jack Bowles, Chief Executive

So we have, if you want, a 30 bps increase in terms of value share, and there is strong pricing also since the beginning of the year, from across the industry. I think that we're in a very good position to continue to perform very well in the US. As I said, we're growing profit by 5%.

Richard Felton, Goldman Sachs

Great, thank you. My second question is on your New Categories business and thank you for giving us a bit more disclosure on the contribution. Looks like you're making quick progress towards that break-even target. But my question is on gross margins for Vapour. Now, if I cast my mind back to your CMD at the start of 2020, you said that you were making about 40% gross margin on Vapour, which at that stage is quite a long way below THP or your Modern Oral business.

Now, since then, you've made good progress with trade margins. You're talking about cost efficiency. You're taking pricing. Is it possible to give us an update on where those gross margins for Vapour are today? Is it in line with your other New Category businesses yet? Thank you.

Jack Bowles, Chief Executive

Yes, first, before Tadeu gives you more details, I think what is important is, three years ago people thought that we would not be able to get a strong position in terms of New Categories. We have demonstrated that multi-category New Categories was the way to go, and we are demonstrating last year with the growth of 50%, 51% in revenue and 45% in the first half of the year, with a total number now of consumers of 20 million, with a growth of more than 2 million in the first half of the year, which is even better than last year, that we are absolutely capable of driving our growth, and that we have very strong brands.

And at the same time, we've reduced the losses by 50% in the first half of the year, £281m. So I think that this demonstrates that not only we're very effective in terms of our COGS, we're very effective in terms of our consumer acquisition costs, and we are very well able now to take pricing

across the board in the three categories, making sure that we deliver profitability at pace, and that we meet all our targets for 2025.

Tadeu Marroco, Finance and Transformation Director

Richard, we are really pleased with the progress in the New Categories as a whole. In terms of our holistic view on that, for the first time, like we highlighted in the presentation, we have been seeing revenue ahead of volume growth in all of the three categories. We have a 45% revenue growth at the back of 51% when we closed 2021, so the growth continued at a very accelerated pace.

In terms of gross margin overall, the increase in this half compared with the full year is on the likes of 7%. So, we have grown gross margin of the three categories ahead of the revenue growth as well, which is very pleasing.

So, in terms of Vapour, we have been doing strong progress. At the back of revenue growth management, we are taking price, we are reducing discounts on device, we are working hard on the COGS, the automation that we highlight in the presentation, the trade margins that we quoted. So, the 40% that you are quoting - strip out the discounts on device, on the consumer, both sides. Today we are more on the 50%, so we have progressed against that 40%.

And overall we have been progressing in all three categories, and we are now with a business that has already passed these levels of investment, creating the foundations, and we are now in terms of operating leverage and trying to get to a level of scale that will allow us to keep on track on those margin improvements, not just in Vapour but across the categories.

Jack Bowles, Chief Executive

And you saw also, if I may add, you saw also that not only we are taking pricing across those three categories, but on top of that we have a pipeline of innovation for the second half that is extremely strong and will put in place all these new launches in the months to come. And I think that pipeline is extremely strong, consumer-based, different categories, different objectives, and innovation across the board, with a speed in terms of development of innovation that has increased dramatically.

And, as Tadeu referred in his presentation, we have doubled the investment in the last few years in terms of R&D, and are really motoring through our development, and are getting a very, very strong position. So, the balancing act between the financials and the consumer acquisitions is working very well and will continue to accelerate in the second half of the year.

Richard Felton, Goldman Sachs

Thank you very much. That's very clear.

Telephone Operator

The next question comes from the line of Gaurav Jain from Barclays. Please go ahead.

Gaurav Jain, Barclays

Hi, good morning, Jack. Good morning, Tadeu.

Tadeu Marroco, Finance and Transformation Director

Good morning.

Gaurav Jain, Barclays

Three questions from me. Good morning. If I look at any of the companies which are thought of as NGP leaders in the industry, their EPS growth has been at low to mid-teens over the last two, three years. And if I look at your delivery today, NGPs are now 10% of overall revenue, and then you are also reducing losses. You have slight, Tadeu clearly points out the margin improvement which is happening. Why wouldn't your EPS growth, once share purchases are layered in, why wouldn't your EPS growth accelerate to low to mid-teens at some point of time in the next three years?

Tadeu Marroco, Finance and Transformation Director

Well.

Jack Bowles, Chief Executive

Well, first of all, thank you for recognising our strong performance in terms of New Categories, and I must say that our financials are very robust in terms of the profitability of the business going forward, and we have scaled up in the last three years. I think that we have a certain number of kickers, but yes, at the end of the day it will take a little bit more time. But the reality is, we have a very, very strong business, and we continue to move forward.

Tadeu Marroco, Finance and Transformation Director

Gaurav, look, we spoke about the capital allocation framework back in the year-end results in '21, at the beginning of the year. And we want to consider, on any given year, what are the circumstances that we see ourselves? We have clearly recognised the value of share buyback, and this is something we have done in the past. We have now restarted the programme.

But we also want to create some reserves, so, to do some M&A bolt ons, that would be important, mainly on the Beyond Nicotine space, that you know we have this ambition to grow in that space as well, to accelerate the transformation of the company. We also want to keep the dividend growth in sterling base and pay down debts so we can keep within the three-to-two times corridor.

So we have to consider all those effects on any given year, and we have to see how this translates. Because today, the reality is that the kickers of the Group are not as high as they used to be in the past, because Reynolds now is part of the subsidiary, so it's part of the operating profit of the Group. And so it's difficult to start to speculate for the future in terms of impact.

But we have a very sound business. This transformation that we are now calling faster transformation, this chapter that we are going through our

journey of the transformation, it means that the New Categories will be more relevant to the Group results. You're absolutely right. You're going to see, and we said that, exactly that, that you see our Group revenue more impacted by the progress we make in New Categories, our bottom line more impacted by the progress we make in New Categories.

So this is not new news. This is something that we have said before. And we will continue going ahead, and we see what happens on the kickers side, to consider the capital allocation decisions that we might have to do in the future.

Jack Bowles, Chief Executive

So, we have a very high level of cash conversion, and also, we're doing a £2bn share buyback as we speak, and we're at £1.3bn in the first half of the year. Step by step.

Gaurav Jain, Barclays

Sure, thank you. Now, my second question is on inner dynamics in the US e-cigarette market. You have given this number on slide 25, the disposables Industry value share of 22%. Is this all synthetic nicotine, and what percentage of this will be flavoured, and if we have this clamp down from the FDA on the synthetic nicotine market, could a big chunk of this move to you over the next six months to 12 months?

Jack Bowles, Chief Executive

The good thing, there are different elements in there. One is, yes, they are all synthetic nicotine, because you cannot do flavours without synthetic nicotine. That was the past. Now the FDA says that synthetic nicotine is in the remit of the FDA. So now they are starting to put in place all their activities, in terms of control and implementation. The trade in the US is extremely dynamic, and we'll also start to take some positions related to that.

So I think that what is important to consider is that there are more people that are coming to vaping, which is great. That we have a very strong brand with Vuse in the US. That we are leaders in more than 34 states in

the US. That everybody thought that we would not be successful with Vuse in the US. And we are the leaders now. We are the leaders, and the market continues to grow. There was the crisis, of course. The market has recovered. Now it's growing by 3, 4% since the beginning of the year. And we are continuing to take positions in there.

So I would say that the disposable is something that is addressed by the FDA, and that brings more people to the category, which is in turn, without flavours, will benefit to the category where we are a leader and we are continuing to increase our leadership, and we're taking a lot of pricing. And by the way, competition has started to follow us on pricing, which is very good news also.

So it's all an acceleration in terms of the potential of New Categories in the US. Remember that, in the US, New Categories already represents more than 21% of the market, yes? So it is already a market that is extremely strong in terms of New Categories.

Gaurav Jain, Barclays

My last question is again on the US market, and given the strength of Vuse, your cigarette price mixes plus 11% you have lost from shares. Now, if Vuse continues to execute so well, do you really need to take as high a pricing and lose volume share? Or would you rather take less pricing and gain volume share on cigarettes as well, and let Vuse growth, and the EBIT swing from Vuse, drive your overall US EBIT growth?

Jack Bowles, Chief Executive

First of all, thank you very much for recognising that we have a very strong position on Combustible business. And, as I always said, the three priorities for the company are: value in Combustible, step change in New Categories, and simplifying the business.

On the value of the Combustibles, we are growing in the US 30 bps in terms of value share, and we are losing a little bit of share, but I'm not concerned with that. We look always at the right balancing act in between the two. Where I'm very pleased is that our premium share is growing, and we have very strong brands at the upper end of the portfolio, and we have now also, with Lucky Strike at the bottom, a very

strong brand that is more than 2% of the market now. So we have good visibility.

But what we said always is that we have a pricing strategy, and pricing tools in the US, that allows us to grow extremely granular. So, when we look at e-cigarettes, and when we have the leadership, I'm always going to do the call between the pricing and the competitive situation. I think that the demonstration that we have made in the last 12 months, even, is that you can continue to grow your position in the US in terms of e-cigarettes and increase your profitability through pricing.

Our consumer acquisition, automation, reduce our COGS also, and the competition is following our pricing. So I think that we're in a very good situation, where you have to always adapt and analyse the market, but I think that the trends are extremely positive for us.

Gaurav Jain, Barclays

Thanks a lot, Jack.

Jack Bowles, Chief Executive

Thank you very much.

Telephone Operator

The next question comes from the line of Rey Wium from SBG Securities. Please go ahead.

Rey Wium, SBG Securities

Hello, Jack, Tadeu. I hope you are well. I basically have three questions. I've just been - I just want to address this improvement in the next generation product margin. If we look at the loss has been reduced about 55%, so I just want to know and in terms of, if we're going to talk about a glide slope, I think you said you aim to be profitable in aggregate by 2024, 2025. So to me it looks like, if this trend continues, it might be better earlier. And it might be just, in that, is there a risk that you need to

spend more as a result of the big growth in Vapour disposables? So that's my first question.

Jack Bowles, Chief Executive

Let's, sorry, let's start with the first question. Because you know, I'm French, and three questions is always difficult for me. So let's go step-by-step. Your first question is related to...

Rey Wium, SBG Securities

I just want to know...

Jack Bowles, Chief Executive

Ah, yes, yes. Thank you. On that one, you have always to consider that this is a very dynamic environment. These categories were not existing even a few years ago. So we have a very good performance related to our different categories. We are taking pricing. But at the same time, we are improving our COGS, we are automating, and we are doing much better in terms of consumer acquisition.

At the same time, the innovation pipeline costs money. And we're going to spend the money as we go, in order to continue to expand our positions. Two years ago, we were nowhere to be seen in THP. That is, 50% of the total market of THP worldwide is in Europe. We were nowhere, and now we have 18% in average in terms of share. So I will continue to invest the money, but, as the base is much stronger, the cost of acquisition of consumer is better.

But competition will not sleep. They will continue to do price discounting. They will continue to do launches. And I think that we are very well positioned. That gives me a bit more space to be able to operate, and the target is 2025, so we'll take it as we go. First is about consumer acquisition and the efficiency and the reduction of cost of consumer acquisition and getting more traction in terms of our positions in the three categories.

And I have innovations to launch in the three categories. But all together, you saw last year, we reduced our losses by £100m, and this year in the first half of the year we are accelerating quite nicely. This gives me the muscle, the space, and the blood in order to be able to grow fast in terms of New Categories.

Rey Wium, SBG Securities

Excellent.

Jack Bowles, Chief Executive

45% growth in the first half of the year, on the back of 51% for the full year last year. Unreal growth. I think that that's stellar. And 2.4 million consumers in the first half of the year, additional. So we're even breaking reserves and records of last year.

Rey Wium, SBG Securities

Excellent. Then, just on to the Combustibles, I'm just curious. It looks to me you have a little bit of share pressure in markets such as Australia, Brazil, and Mexico. How do you plan to address that?

Jack Bowles, Chief Executive

I think that, when you look at our position in terms of Combustibles, first of all, it's a very robust position. What you have on top of that is a portfolio that is extremely strong, and what you see is that the elasticities are playing in our favour. So, of course you will lose a little bit of share here and there and increase your value share.

Australia is a specific example whereby taxation was changed in the last year, that has created a bit of a vacuum, related to the Australian industry as such. And there were some skirmishes in terms of pricing. We fought back, we recovered market share, and we're in a very strong position in

Australia now. So I think that we have a very, very strong position in Australia, and we are the leaders there.

In terms of Brazil, our share is still stellar. We are more than 73% share in Brazil, and we have benefited from the COVID environment when the market was closed and a reduction of illicit. That's very normal. Now you are a little bit on the back of the post-pandemic, so there is a bit of rebalancing, but nothing to be concerned over.

The reality is, we have a very, very strong business in Australia, or, in Brazil, and we have rebalanced our portfolio with global drive brands, launches, and we have rearticulated our route to market in terms of sales force, and we have a lot of efficiencies that are coming through in that market.

Rey Wium, SBC Securities

And I just want to know, just want to clarify regarding the treatment of Russia and Belarus. You're treating it as discontinued operations. I just want to clarify that, for modelling purposes, we need to remove Russia and Belarus from the remaining - half of 2021 and the first half of 2022. Correct?

Tadeu Marroco, Finance and Transformation Director

No, this has not been treated as discontinued operations. We still have control of the operation in Russia. We are in the process of transferring the business, so it means that we are trying to execute options to find a new buyer, local buyer, there, and that can take over the business and carry on.

So, what's happening is, as we have the intention to transfer the business that was communicated, based on IFRS 5, we had to put assets held on sale. And as a consequence, you have to revalue the business, which we are now attributing a new value for that, giving the circumstance, the difficult, because as you know it's a very complex environment.

So, the impairment that you see is basically us reassessing the value of those assets that are now for sale. But there is no discontinued operation,

because we still keep control of the business until we transfer fully the business.

Rey Wium, SBG Securities

Okay, so, just to clarify, you will keep the Russian operations in the FY21 numbers, until it's been sold in 2022?

Tadeu Marroco, Finance and Transformation Director

Yes, until it's been sold in 2022. Once we sell the business, and then we start providing a kind of organic view where we strip from the base as well. But until we do that, it's part of the numbers.

Rey Wium, SBG Securities

Okay, excellent.

Jack Bowles, Chief Executive

It's a very fluid situation, and a very complex situation.

Tadeu Marroco, Finance and Transformation Director

By the way, if you see the appendix, in the appendix of the presentation you will see a kind of picture of how it looks on the Group numbers. If you have done that. If we had already transferred the business, hence there will be no Russia any more in the base of '21 and '22. You can see the underlying numbers on the appendix.

Rey Wium, SBG Securities

Yes, that's actually what triggered my question, whether we'd need to strip Russia out retrospectively.

Tadeu Marroco, Finance and Transformation Director

It's just a reference for you.

Rey Wium, SBG Securities

Okay, excellent.

Jack Bowles, Chief Executive

But, as you see in that table, the trends are absolutely similar, and this was to give more clarity to everybody in terms of understanding with and without.

Rey Wium, SBG Securities

Okay, thank you very much.

Jack Bowles, Chief Executive

Thank you very much.

Telephone Operator

The final question comes from the line of Jonathan Leinster from Société Générale. Please go ahead.

Jonathan Leinster, Société Générale

Hi, good morning, gentlemen. Yes, I've got a...

Jack Bowles, Chief Executive

Good morning.

Jonathan Leinster, Société Générale

Two or three questions as well, please.

Jack Bowles, Chief Executive

Everybody has three questions this morning.

Jonathan Leinster, Société Générale

It's standard.

Jack Bowles, Chief Executive

So go slowly one by one.

Jonathan Leinster, Société Générale

Analysts only do things in threes. Going back to a previous question, the vape price mix, plus 25 in the period, very strong number, is that driven, clearly there's been some price increases, but are we seeing a general decline in the level of device and product discount from everybody, including yourselves and competitors? Or is that driven a lot by the change in trade margins?

Jack Bowles, Chief Executive

It's a bit of both. I think that, when you have products that are more effective, efficient, and recognised by the consumer, your cost of

acquisition reduces, because then your brand is part of the repertoire of the consumers, and then certainly you're in a much better situation. Also, there is more pricing, which is good. And we're continuing to grow on all our different positions. Tadeu, you want to add something?

Tadeu Marroco, Finance and Transformation Director

Yes, look. The US in Vapour is a major weight for our numbers, and of course it's a massive market. And in the US, we are doing exactly what we said we were going to do, and we are in the phase now of scale. So we don't need all the discounts that we used to have in the past on the device, so there is much less discount on the device than we used to.

And we are also taking pricing, because now we have put in place all this revenue growth, these growth tools, that we have for cigarettes also in the New Categories in Vapour. So we can be very granular in terms of where we increase the pricing based on the competitor landscape, and we are, as we speak, at 125 index to the second play in the market. So we are taking clearly pricing in the US, and reducing discounts, and this all helps in the revenue that you are seeing.

When you go outside the US, the strength of our leadership position is allowing us to have a much stronger competitive power in terms of negotiations with key accounts.

Jack Bowles, Chief Executive

Yes.

Tadeu Marroco, Finance and Transformation Director

And this allows us to move, for example, from front margins to back margins, that translate into moving away from a specific percentage of revenue as a margin to pay for performance, and this all reflects in lower trade margins, and that's exactly what is happening at this point in time. It's a combination.

Jack Bowles, Chief Executive

Yes, lower consumer acquisition cost, better margins, and more efficiency in terms of COGS, plus more pricing and strong brands. That's the very good equation we are in at the moment, and we'll continue to move forward.

Jonathan Leinster, Société Générale

And, just out of interest, what sort of level of trade margins are you moving to, and how would that compare to other, particularly to cigarettes?

Jack Bowles, Chief Executive

Of course, the trade margins are much higher than on cigarettes, but what we see is that there are conversions in time that will happen, and that will take some time. But we see improvements on the regular basis related to that.

And you have to remember that, also, the other element that is very important is, you pay much more taxes on cigarettes than you pay on other categories, which is normal because these are reduced risk products. So that works also in the equation, in terms of the financial delivery.

What's very important is, we said three years ago that it's a multi-category approach, that there are different consumer moments, different geographies, and you need different portfolios. It was more complex for us at the beginning to establish three categories, but at the end of the day, when you look at it today, last year we grew 51%. This year, half year, we grew 45%.

We're having now 20 million consumers, which is extremely comparable to other companies out there, and we are planning through, and we're able to take pricing in the three categories and do efficiency in COGS and consumer acquisitions and taking pricing. So I think we have a well balanced portfolio that is responding to the consumers, and we can play in full all the tools that we have in Combustible pricing, to understand exactly how it works, and start to reduce discounting.

And that's extremely, extremely powerful for us moving forward, because we want to do a lot of additional innovation in the next periods. And we

showed you during the presentation that we have a lot of innovations coming through in the second half of the year. That costs more, yes, but nonetheless we have a reduction of 50% of our losses in New Categories, so that's going in really the right acceleration, where we have the momentum and we're accelerating on that momentum. Pivotal year last year, accelerating on the momentum in 2022, 2023.

Jonathan Leinster, Société Générale

Just to follow up on that, do you expect in the second half that the declining losses in NGP will be anywhere near the level of the first half, given that I think there's a considerable number of launches in the second half?

Jack Bowles, Chief Executive

Well, take it step by step. We're not going to give a guidance on that for the second half of the year. Where we give guidance, we will deliver, financial algorithm in the corridors that we spoke about, and we will make sure that we are actively supporting these new launches in a balanced way, in terms of the balancing act with the investment and financials.

Jonathan Leinster, Société Générale

Okay, and lastly, you clearly made a £450m charge for the US investigation. Presumably that will be a cash cost at some point.

Jack Bowles, Chief Executive

We're not, absolutely not in a position to be able to speak about that matter as it stands, for very obvious reasons. We decided that it was prudent to take a provision, and we'll take it from there.

Tadeu Marroco, Finance and Transformation Director

Yes, it is a no at this point in time, but the fact is that our corridor of 3 to 2 is kept independent of the impact that this might have.

Jonathan Leinster, Société Générale

Right, okay. Thank you very much.

Jack Bowles, Chief Executive

We have a prudent accounting approach. Thank you very much.

Telephone Operator

There are no further questions, so I'll hand the call back to your hosts for some closing remarks.

Concluding Remarks

Jack Bowles, Chief Executive

Well, thank you very much for taking the time with us today. I must say that what is extremely important is that these results show that we are transforming the business and delivering robust results.

I'm extremely confident in our full year guidance. With the great New Category momentum that we have, we are on track for our 2025 targets. And our transformation is well under way. It's led by the New Category growth, and our pathway to profitability, and also a very strong Combustible business.

We are migrating the consumers from Combustibles to New Categories. Last year we had 1 billion packs that were carrying advertising, promotions, or information for smokers to move to New Categories. This year it's going to be 2 billion, and I want to continue to migrate the consumers from one category to the other.

The profitability, the margins, and the cost of acquisition of new consumers, with the New Categories that we have, and we are the only

ones to be in three categories and established in there, demonstrates that BAT's changing rapidly.

And it's powered by our people, our ethos, and the determination that we have to make a very clear commitment to delivering for all our stakeholders, all our stakeholders. We take ESG extremely seriously. We take our business extremely seriously. We are growing at pace, and we will continue to do that.

So, in a nutshell, I'm extremely excited about the future of BAT, and that 2022 first half comes on the back of a very strong 2021, where we grew in all the different categories, including Combustible, and we will continue to do so.

So it's about value in Combustible. It's about step change in New Categories. It's about simplifying the business. So we are growing value share in the first one. As we said, we did in 2021, we do in 2022. Step change in New Category. 51% growth last year. 45% on the bigger base in 2022, and £1.5bn that was £1bn, then went to £1.5bn, and now we say that we will deliver more than that.

So, thank you very much for your patience with us in the last three years. I think we're getting into a very strong position of which, I would not even call it foundation. I will call it a springboard to move forward. So, thank you very much for listening.

* References to pricing power reflect our balanced portfolio across price tiers and low global elasticities for our combustible products. The terms are not intended to reflect any of the Group's future pricing intentions.

** Target market for consumer acquisition is existing adult smokers/nicotine users.

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