British American Tobacco plc | Barclays Global Consumer Conference, September 2021

Gaurav Jain:

Good morning, everyone. Thank you for joining 30th Barclays Global Staples Conference. I'm Gaurav Jain, Barclays Global Tobacco and Cannabis Analyst. Joining us today is Jack Bowles, the CEO of British American Tobacco. Thank you, Jack, for giving us the opportunity to host you.

Jack Bowles:

Thank you, Gaurav and good afternoon and good morning everyone. I'm delighted to be... Yes, Gaurav?

Gaurav Jain:

Sure. Sorry to interrupt you, Jack. I will turn it over to you first for your opening comments. And then I will ask some questions that are on top of investor's minds. So over to you Jack.

Jack Bowles:

Sure, thank you very much. So I'm delighted to be with you today. I hope that you all managed to get a break over the summer for some rest and recuperation. Before my discussion with Gaurav, I wanted to take a few minutes to provide a brief update on the strong progress we are making towards building a better tomorrow and creating the enterprise of the future. Our established multi-category strategy is working, and our transformation is accelerating. In fact, I'm delighted to announce that since our first half results, we have taken global value share leadership in the Vapor category and Vuse is now the number one brand globally. Our strong U.S. momentum was an important contributor. And we are now leaders in 22 states, up from 20 in the half year results. The Vapor Category is the largest of the three new categories, by both revenue and consumer numbers.

Jack Bowles:

And this is an important milestone in the transformation of our business. This builds on the strong momentum that we are generating. In the first half, we delivered 50% new category revenue growth, at constant rate. Building on our acceleration over 2020. And we've added 2.6 million new category good consumers, our highest ever increase. To reach 16.1 million consumers of our non-combustible products. This is powered by our strong global brands, Vuse, Glo and Velo, and is underpinned by strong innovation. Each brand drove its category share more than 280 bps higher and recorded volume growth of 70% or above. And we delivered strong financial results in the first half. Group revenue was up by over 8%, driven by the excellent new category revenue growth, together with volume and value share gains in combustibles, and the partial recovery of volume in emerging markets. We invested an incremental 350 million in new categories, while also delivering EPS growth of over 6%, which would have been up over 8% excluding transactional effects.

Jack Bowles:

We are building strong global brands of the future. With our record growth in consumer numbers, driven by significant additions across all three categories. Vuse, first half revenue was up 59% and this momentum has continued with the brand achieving global value share leadership in Vapor in July, as well as becoming the first global vape brand verified as carbon-neutral in June. Driven by the success of Hyper, Glo hit record category share across our top nine markets. With revenue up 38% and Velo revenue was up 63% with progress both in [inaudible] and in the U.S. With this strong momentum, we are well on track to achieve our 5 billion new category revenue target by 2025. Also, we are digitalizing BAT at speed. It is transforming our brand relationship with consumers. With more than 12 million contactable consumers, a more than doubling of our social media follower's year-on-year, and Vuse as the leading branded search in Vapor. Digital is also adding value throughout our operation.

Jack Bowles:

Our rapid e-commerce growth comes with much higher margins. And our average subscriber value is three times the traditional retail consumer. RGM now covers 75% of group revenue, enabling precision targeting, store level pricing and optimized trade investments. While MSE leverages data to maximize ROI, and now cover 75% of new category investments. Digitalization is just one part of our transformation. Our portfolio transformation is accelerating with 12% of the group revenue now in non-combustibles. While, of course, our focus remains on continued acceleration of our new category business. We continue to develop further opportunities beyond nicotine. Reducing the health impact of our business puts ESG at the core of our strategy and together with stretching targets across E S and G, builds on over 20 years of strong foundation. Quest, our organizational and business transformation program with five pillars, includes Quantum, which is simplifying the business and delivering ahead of plan. We have increased our overall Quantum target to 1.5 billion pounds of expected savings by 2022. So, through Quest, we are creating the enterprise of the future.

Jack Bowles:

As we have said, previously, 2021 is a pivotal year in our transformation. While delivering strong financial results, we also accelerating our new category revenue growth. Powered by share gains across all three categories and our fastest growth in consumer numbers to date. This momentum is giving us increasing scale. We're now well on track to reduce the negative impact on group margin from new categories for the full year, with a clear pathway to our 5 billion revenue target and to profitability by 2025. Lastly, we remain committed to deleveraging the balance sheet around three times, adjusted net debt to adjusted EBITDA, by the end of the year. At this point, we expect our capital allocation flexibility to increase. So our established multi-category strategy is working and we are rapidly transforming BAT into a high growth multi-category CPG led by the consumer. Growing new category volume, revenue, and value and reducing our impact on public health. We think ESG at the core of our strategy means that we're creating value for all our stakeholders. I am excited about the future for BAT. Thank you. And over to you, Gaurav.

Gaurav Jain:

Well, thanks a lot, Jack, for those comments. And if I could start, by just asking about the stock price performance of BAT. So it has been a difficult stock to own over the last three years. The stock is roughly flat, and it has significantly underperformed some of your competitors, such as Philip Morris and Swedish Match. So, for a long-term investor, what would change the narrative for BAT over the next three years?

Jack Bowles:

Well, I think that we have transformed the company in the last three years at speed. I think that we have a consolidated our combustible business. I think that we've made a very important inroads in terms of new categories. We are present now in three categories, and we are taking a very strong share momentum. Our revenue is growing by 50%. And I must say that also the transformation of the company with the savings in terms of the cost base of the company, the digitalization of the company. I don't think that all this is included in our share price at the moment, but yet, we still have to do a lot of investment in the business. We still have to demonstrate our capability to continue to grow from that very strong base. And it will take a bit of time, but I'm very confident in the future of BAT. I'm very confident in our acceleration and momentum in terms of new categories.

Gaurav Jain:

Brilliant. So, one thing that could clearly change for BAT over the next six months is share repurchases. And you did allude to it in your presentation. So by our math, you will still be levered at three X at the end of this year. And it will be slightly more if we exclude Canada, which

Gaurav Jain:

Which is, you know the industry is under protection, bankruptcy protection, there. So how should we think of sharing repurchases? Is the leverages still too high in an industry grappling with new product disruption and regulatory change?

Jack Bowles:

You know, what's important to consider is that the performance of the business is extremely good. As I said earlier, not reflected yet in the share price, but we continue to invest in the business. We continue to do the right thing for the business. And we said that by the end of the year, we'll be around three in terms of net debt to EBITDA.

Jack Bowles:

We're sticking very strongly to our 65% in terms of a dividend policy. And we have the cash. Our business is extremely cash generative, and we'll do the decisions towards the end of the year, the beginning of next year. I think that it is, we understand the logic and the attraction in terms of share buy back of course, and we're reviewing that. Let me assure you, we're reviewing that on a very regular basis. There are timings for things, and we will review a capital allocation towards the end of the year.

Gaurav Jain:

Sure. Now, your EPS growth has all turned over years has been high single figure EPS growth, which is about 7%. And this year you are growing at about 5%, but included in that is a 2% adverse headwind from FX transaction. So, if we say that from FY23, so not FY22 but FY23, you don't face adverse effects headwinds. So, your core EPS growth reverts back to 7%. And then we add in share repurchases. And then you're also spoken of NGP losses reducing between now and FY25. So, if I add all these up then your EPS growth should be high single digit, low double digit. So is that a plausible scenario for your company?

Jack Bowles:

Gaurav, we have to go step by step, okay. Two years ago when we had discussions, a lot of people told that we could not get the position in new categories, that we could not get the position in THP, that we could not get to a position in e-cigarettes, that we could not get a position in modern oral and that the combustible business was questionable. We've seen a lot of things happening in the last two years. We have a very strong business now. So I have had that for two years of very straight jacket, as I always said, and I want that straight jacket to have a bit more space so that I can do and continue to do the right thing for the business, which is to invest in the business and to make sure that we have the pathway. Look at what we've done and we've achieved in terms of the new categories.

Jack Bowles:

It's the fastest development that you can see in three categories. We're now having understanding in terms of the consumers, the route to market and all the intricacies of three categories. So let me have a bit of space and we'll speak about these things by the end of the year, but do not forget, we said it was also dependent, related to COVID. COVID is not over, we're present in 180 markets and you see a lot of different situations in a lot of different markets. You see a bit of a price skirmishes here and there, you see a regulatory framework that are moving, as you saw in Europe, the menthol ban, there's a lot of moving parts. So, I think that we have to go step by step and continue to develop and to deliver these very strong results that we have delivered on in the last two years in transforming the business.

Jack Bowles:

There's a still a long road to go in terms of transforming the business and to take positions. As we just said earlier, I mean, we're now global leaders in vapor. We have now in the markets where we're present, which are only half of the markets that are the markets of THP at the moment, we're having a 17% share. And in some markets more than 22% share in Japan, we have now 22% of the segment. So let's go step-by-step, we are highly cash generative. We're delivering the financials and we are growing our business according to what we said, step-by-step

Gaurav Jain:

Sure, Great. Now you're just touching on the chip shortage, which exists right now, that semiconductor industry and your key competitor just reduced their guidance for heat-not-burn volumes for this year, because they are saying that H and V device availability is an issue. So, is it something that you are also seeing and is it impacting your ability to acquire new customers this year?

Jack Bowles:

Well, I cannot comment on the competitors, but what I can say from our side is that we have digitalized all our supply chain end to end. And that has given during the COVID period, a lot of flexibility to move the products around and to do the things right. And we see exactly the same thing with the chips. So we didn't have any problems or shortage since the beginning of the year. We have always managed to keep all the needs that we had and to continue to deliver. So in a way, the fact of being a contender or a competitor that is growing fast and at pace gives us the space to manage all these things. So there will be some skirmishes, certainly, but I don't see any major definite problem related to that.

Gaurav Jain:

Sure. Now, on your targets for NGPs breakeven by FY25, and what you have said is that FY21, you know FY20 was a peak year of losses, FY21 should improve. And we have seen the marketing efficiency on

NGP is improved. So, is that now a continuous trend and a linear trend between now and FY25, or we will see up and downs and how that profitability of NGPs evolves?

Jack Bowles:

Yeah, I think what's very important to note is that, two years ago we had a weak portfolio and we had a weak presence in terms of new categories. Now, what we see sequence after sequence is that we're growing very fast. So, what I can say is that the 5 billion is well in reach, and we will make sure that we reached that 5 billion, but it's not only a 5 billion that I'm interested in because that's just a milestone. What I'm also very interested in is the profitability of these categories. And that's why I said, I could have said that for later, but I said 2021 will be the moment where we start to reduce our losses. And for me, it's very important as an organization and as a company that we continue to have the right balance in terms of the revenue growth, the consumer acquisition and the pricing. And we are taking pricing on a regular basis through these three categories in order to ensure that we have the right balance.

Gaurav Jain:

Sure. Now coming, we are just focusing still on the profitability question and let's go down category by category. So let's take heat-not-burn as a first category where it seems that you are pursuing a discount strategy, especially around the device side of things. And I think even in your H1 presentation, you highlighted that your stick pricing is 90% of your competitor.

Jack Bowles:

Right.

Gaurav Jain:

So does that imply that your terminal margins in heat-not-burn would be lower than what we are observing for IQOS, which is more-

Jack Bowles:

I'm not going to speak about IQOS, but what's important is that as we go along, we have economies of scale. We're innovating very fast in terms of induction heating. And what we see is that our revenue growth is going up very fast. So we are in consumer acquisition mode. We have now 30% of our volume that is coming from competitors and 70% is coming from FMC consumers. So as the right balance, we want to have of course, a more balanced into these two numbers. And we'll continue to invest in that category. As I said, in terms of a geographical spread, we are only in around 40, 45% of the markets that have THP at the moment. So as you said, rightly I'm investing the money in terms of brand building first, consumer acquisition, the devices, I do some discounting, but not on the consumables, which is where you make your money and where you will continue to deliver value in the future.

Jack Bowles:

We are at an index of 90% and some countries at an index of a hundred or even a 107. So we're having a right balance in terms of growing fast, but managing our growth. There is, for me, always a major difference between the rush and speed. So we go at pace, at speed and we expand in markets after markets and we continue to do so on a regular basis. What's very important to me is that we have the right product, the consumers appreciate our product. We have induction heating and the burner is solid.

Gaurav Jain:

Sure. And so just, there's in a bit more as best like, clearly you have gained volume share over the last year in heat-not-burn and as you highlighted,

Gaurav Jain:

[inaudible] now have 17% share. I think last year it was 11. So is there a point when these volume share gains start translating also into value share gains? IE, your pricing becomes bit more aggressive than actually what even competition is doing right now. What is that point?

Jack Bowles:

No, I think that there's not a specific point. What you have to see is the right balance, always between a value share and volume share and making sure that your pricing elasticity is at the right level so that you continue your consumer acquisition and you continue to grow. As I said, we still have a lot of space to cover, and we still have a lot of share to grow in each area of the geographies that we are in. And we're seeing that very clearly. So in all the markets that we are in, our market share gain is slower than the market share that we're getting out of the growth of the category. So we're growing faster than the segments everywhere. And that's a very good sign in terms of the health of our group moving forward. And we'll continue to invest in there because I think that we have very good products. We have innovation and we have a pipeline for the future.

Gaurav Jain:

Sure. Now, one more question on heat-not-burn, and that is in Japan, which is clearly the largest market. And, you have absorbed some of the excise tax hikes in recent years, and that's why your average selling price there has been pressured on heat-not-burn, and there has been another tax hike this year. So should we expect continued pressure on your ASPs because you will keep absorbing these excise tax hikes, not only in Japan, but you know, Ukraine also increased the CR, Germany's going to increase heat-not-burn taxes next year. So, how do we think about ASP's volume revenue in that context?

Jack Bowles:

Yeah. I think what you have to realize in Japan, by the way, in Japan, now we have 23% segment share and we have more than a 7% a share of nicotine. So I think that we're having a very good position there. I think what's important to consider in the future, in Japan is that we'll continue to develop the brands on a strong pace. And I think that the balance between pricing and consumer acquisition will always be something that is extremely important to me. I want to create value. Okay, it's a reduced risk product, and I want to continue to be able to offer these consumers in Japan and in the other places, in the different geographies, these products to the right point, because I think what's important is the sustainability of the category moving forward. And we have to make sure that we continue to manage that in the right way. So we do a lot of exercises in terms of pricing in order to make sure that we have the right position related to that. It's all about value creation on the midterm.

Gaurav Jain:

Sure. Now moving on to E-Cigarettes and that you highlighted that you are now the biggest company globally in E-Cigarettes by value and especially in the US, your pod share is now well over 30% and your device share is well over 50%. So where is the point when you could think about improving profitability? Like I think what you have done recently in Europe. And a question on European E-Cigarette market there as well, that as the European E-Cigarette business now approaching breakeven?

Jack Bowles:

Yeah. What you see across the board is we're starting to take more pricing related to e-cigarettes. And that's a good thing because our growth now is constant, and I would say very strong. What you see in the US is that even when we did the half year results where 20 states where we're leaders, now it's 22 states. You see that, as I said, two years ago, the open system category will blend into the closed system category, which is happening now, the closed system category is around 80% of the market. So I think that it has crystallized now our positions. There is a leader still in the market, but a few years ago it was 20% gap after it was 15, after that it was 10, and now it's five. And we are leaders in 22 states.

Jack Bowles:

So we continue because we think that we have the right product for the US market, for the age bracket of 25 and above. Our brand is not tainted by any under age usage. So the brand is strong. We have 2,500 sales reps in the US that are doing our business across the different categories. We have a very strong position in distribution. We can leverage in terms of scale, the automatization of manufacturing, of the products, which implies a reduction of 30% of the cogs. And we can continue to improve in terms of the efficiency of marketing footprint. We can do pricing to the level of the outlet, because all the tools that we have in combustible that you've seen have been very effective and efficient. We're growing value share very strongly in the US in terms of combustibles. Now that we have scale, we can implement them. And that's what we're doing since 12 months in the US. So we have a very strong position that we'll continue to grow from there.

Gaurav Jain:

Sure. And you know, now we are seeing, I think over the last two three weeks, a lot of press releases from the FDA denying a lot of marketing denial orders to some of the E-Cigarette companies, but they're all very tiny companies. So what are you expecting on the PMTA process? When do you think you will hear something from the FDA and what is the potential contestable space now that you have seen what the FDA is doing?

Jack Bowles:

Yeah. As I said before, I think that there's a strong contestable space because a lot of companies or product will not be granted the PMTA. We have to be fair to the FDA you know, I really support the fact of having a regulated environment in the US. I think that the regulated environment is good for the consumer, and it's also good for the different manufacturers. So that contestable space will come as we go along. It's going to be a long process, it's going to be a long road. But yet at the end of the day, the ball is rolling in the right direction. And that's why we invested so much in terms of building the brand that we have in the US and going for leadership in the US because then you can navigate that new environment of PMTA. So it will take a bit of time, but it's good to have an environment that is based on science. It is good to have an environment that is creating a level playing field between the competitors.

Gaurav Jain:

Sure. Now moving to Modern Oral so, you clearly have an outstanding business in Europe, but in the US Velo does seem to be struggling to gain a lot of traction, despite selling at a significant discount, almost 40% discount versus Zyn. And on a total oral tobacco basis in the US, it seems that Velo is cannibalizing your own oral tobacco business. So do you still need to adjust something around your smokeless portfolio in the US or the go to market strategy, and how long can you give these aggressive discounts going in the market because I remember that in your 1H results, your realization, per Velo can was 50 cent, which was pretty low.

Jack Bowles:

Okay. Let's start with the beginning. First, the Traditional Oral category in the US is around 10% of the total market. The margins are extremely good, and we have a big share in there, more than 30%, but we're not the leaders in there. So there's 70% of contestable space. Of course, there are some consumers that are coming to Modern Oral that are coming from Traditional Oral. But again, there is 70% that is not ours. And we have 30% that are coming from FMC. So 30% coming from FMC, everything is good. You have always to remember that Modern Oral is a quite difficult to ritual for the consumers. So, that category will take time to mature, and that category will have some, skirmishes in terms of development. Put it bluntly, one year ago, we had no position in Modern Oral in the US.

Jack Bowles:

We acquired the company that gave us the possibility to expand our portfolio in 60% of the market that we will not present in IE above four milligram in terms of nicotine. And we grew share. So now what I'm doing is I have an expansion in terms of geography that went from 20,000 outlets to 80,000 outlets. I still have room to grow in terms of a geographical expansion. I have products that are absolutely competitive in the market, and I'm doing some price promotions in order to balance the exercise. There's lots of price skirmishes at the moment in this category in the U.S and it will not stop very soon. Why? Because everybody is in the acquisition of space. Again, for me having 2,500 reps to be able to expand my distribution and to contact the consumers is a very good thing. So the brand is strong. It will take a bit of time and we're taking pricing when it is deemed necessary in the different geographies. Remember, we're not having a blanket approach in terms of pricing. We do it state by state. We do it city by city. We did do it cohort by cohort of consumers. So it's a small category, 1.6% of the total nicotine in the market. And it is a contestable space that is taking both from traditional oral, where we have only 30% of the segment and FMC, which is extremely good.

Gaurav Jain:

Sure. Now focusing on the U.S. Cigarette market. So you have taken pricing ahead of everybody else this year. And at the same time, you have introduced Lucky Strike and the discount segment. So can you just help us understand what you are doing and the U.S. cigarette market and how is this impacted your recent market share trends?

Jack Bowles:

Yes. I think that you have to consider the U.S. as you consider all the other markets. First off, you have to have the right portfolio, top to bottom. And we saw that we were growing share in premium, which is extremely good. And that we had a bit of a lag in terms of consumers 35 years old in terms of the low segment. So we noticed Lucky Strike, but Lucky Strike, we do it very surgically. We go state by state and we see what we need to do with that brand. So it's more of a compliment of the portfolio that we needed to do in the U.S. Now in terms of pricing, we developed a lot of tools in the last few years with digital and with bots in the last few years in the rest of the geographies of BAT. And what we saw is that there was a need in the U.S. Because one size does not fit all. You have in Texas, prices around five and in New York prices around 10. You have different cohort of consumers. We needed to do some geo pricing, and that's what we did. And it has enabled us to take more pricing than competition, but yet at the same time, not having a reduction in terms of total market share that was significant. And we continue to grow in terms of value share.

Jack Bowles:

We have a very good understanding in terms of the price elasticity in the U.S. As you know, the U.S. Market, you cannot look at it from a one year perspective. You have to look at multiple years and you see that the evolution of the market, when you take a three-year average, is very stable. So we continue to look at pricing and we look at what competition does, and we adapt related to that. I think that it's a market where the cigarettes are still extremely cheap compared to not only the income, but the available income for the consumers. I think that there are still some space pocket by pocket and will continue to do so.

Gaurav Jain:

Okay, brilliant.

Gaurav Jain:

And one last question, before we wrap this up, so you will have north of 2 billion pounds in free cash flow after dividends. Almost two and a half billion pounds. And you're clearly looking at some eminent opportunities. Some small eminent opportunities, whether they are in cannabis where you invested in OrganiGram. So how should we think about these potential investment opportunities? Could you be interested in looking at any U.S. multi-state operators? Could you be looking at something in beyond nicotine, like some pharma type of company? Could you just help us frame your thoughts around investing and emanate?

Jack Bowles:

Yeah, I mean, Tadeu and myself, when we started with our new jobs about two years ago or a bit more, the first thing that we did really in terms of that space was to create that corporate venture arm. And that allows us to buy what we need. I mean competencies. I mean science. I mean patents and I mean products where we need to compliment our portfolio. So M&A is something that we're looking at on a regular basis. And when I did the first Investor Day, two years and a half, I think that was in London, it was already in the presentation Beyond Nicotine. And I'm a strong believer in Beyond Nicotine, but you go step-by-step.

Jack Bowles:

I'm the only one to be in three categories. So I have more knowledge about the consumers at large than most. And it allows me to know in which spaces I want to go. And in the half year results, we spoke about the three consumer spaces that we were interested in. We have, as I said, more than 200 prototypes that we're working on. In different spaces, different products come. Speaking to these different consumer spaces. I think that there is a lot of opportunities, but we'll have to go step by step. It is something that we're building competencies in, and it is something where we have already invested and we will continue to invest in the future. Combustible business, as I said, three priorities very clear, combustible business go for value, 25% reduction of the SKU's, for instance. The new categories, step change and now we are growing by 50%. Very good. And we have the technology and we have the innovation that we need in there and we have the consumer access and then simplifying the organization.

Jack Bowles:

So I think that will continue because our finances are becoming cleaner. The cash available, as you said, is big. Tadeu spoke about 40 billion in terms of cash to 2025. So there's lots of space for the dividend and lots of space for capital allocation. And I think that we will continue to use that money to develop the company and to fulfill the strategy that we've put forward two years ago. So let's take it step by step. Two years ago, I remind you, nobody thought that we could take a position at THP. Okay. We did. Nobody knew, or nobody wanted to see that we could take a position in e-cigarette. Juul was taking the world by storm and they were going international. Now we're the leader in terms of that category. In terms of modern oral, we are having a very good position in the rest of the world leader. And in the U.S. we're making strong inroads.

Jack Bowles:

Beyond Nicotine, it's already been three years that we're working on that. Because I'm convinced that there is a part for combustible. And we have to transfer the consumers to the other categories. We have more than 45 million packs where we do advertising or information for the consumers to move to the other categories. THP, e-cigarette, modern oral and Beyond Nicotine. We'll go step-by-step. It is a question of doing the things at the right pace and with the right investments in order to support our development. We want to create a better tomorrow for the company. We want to transform that company. 2021 is the pivotal year where we have that position that we have now, in terms of new categories. Where we have the possibility to go to around three times and to have the possibility to do capital allocation towards the end of the year. On the ways of a strong business in terms of combustible, a strong business in terms of new categories. And we'll continue to develop.

Gaurav Jain:

Well, thanks a lot, Jack, for those comments and thanks a lot for coming to our conference. We will end the session now. Thank you.

Jack Bowles:

Thank you very much for the opportunity.