



British American Tobacco Preliminary Results 2011
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PRESENTATION

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

Good morning everyone. I'm Nicandro Durante, Chief Executive of British American Tobacco and, as usual, I'm joined by Finance Director, Ben Stevens. Also in the front row there are a number of my colleagues including Richard Burrows, Chairman, and John Daly, Chief Operating Officer.

Welcome to those of you who are listening on the conference call or watching via the webcast. After the presentation, as usual, there will be an opportunity for those of you in the audience to ask questions.

2012 was another very good year for BAT. We met all long term financial goals. In what was another year of financial uncertainty and rising unemployment with investors and consumers continuing to look for security the group delivered a strong financial performance across all regions.

Reported volume for the group was down 1.6% and organically 2%. This was principally as a result of industry volume declines in Western Europe, Brazil and Egypt together with volume losses in low margin brands in Indonesia and Turkey. We have grown our global drive brands by 3% with all brands contributing to the increase. Share is up in the majority of our top 40 markets with a strong performance in many markets including Brazil, Canada, Malaysia, France, Germany, the GCC and Pakistan offset by losses in Indonesia, South Korea, Italy and Turkey. However, following increased (inaudible) investments share in these four countries has stabilised in recent months and, as a result, overall share in the top 40 is up over the last six months of 2012. I am pleased to say that you had good share growth momentum entering 2013.

Currency was a major feature in 2012 with headwinds impacting revenue, operating profit and EPS growth by 5 percentage points. Reported revenue fell 1.4% but on organic constant basis grew nearly 4%, reflecting good price mix of 6%. Pricing remains strong and we have already achieved 80% of our planned pricing for 2013. Adjusted profit on a constant basis was 8% ahead. We continue to do excellent work in addressing our cost base with operating margin up 160 basis points. Adjusted EPS rose 7% to 207.5 pence and would have been 12% up excluding the effects of currencies. The Board is recommending a final dividend increase of 7% to 134.9 pence.

Now on to the brands. It was another good performance on the global drive brands excluding the impact of the one off in Japan in 2011 the GDBs were up 4% against a market down 1% to 1.5%. The GDBs now account for over a third of group volume.

Dunhill grew share and volume was up 2% with good performances across the globe including Indonesia, Taiwan, Malaysia, South Africa and Romania offset by a decline in South Korea as a result of price disadvantage. Excluding South Korea Dunhill volume was up 9%.

Kent grew 1% with increased volume in Russia, Vietnam, Ukraine and the Middle East. Adjusting for the Japan one off Kent would have been up 4%.

Lucky Strike continued to go from strength to strength with outstanding volume growth of 11%. The brand performed strongly in all regions with convertibles accounting for 80% of the growth in 2012. Our own natural version is showing significant growth.

Pall Mall continued to grow volume and share globally. Volume was up 3% during the year despite declines in two of its key European markets in Italy and Spain. With growth coming from Pakistan, where it reached a record share of 25% in December, as well as Russia, Romania, Canada and the UK.

All four brands maintained or grew market share and overall GDB share in the top 40 markets was up 0.3 percentage points or up 0.4 percentage points excluding the Japan one off.

Total international brands including GDBs grew 2% to £377 billion and now they account for 54% of group volume.

Now looking at volume and revenue. Group organic volume was down 2%. Excluding the one off in Japan it was down 1.7%. This was driven by industry declines in Western Europe, Egypt and in Brazil following the excise driven price increase, together with volume losses in low margin brands in Indonesia and Turkey.

Organic revenue at constant rates was up 4%. Driven by continued strong pricing all regions contributed to this performance although Asia Pacific was impacted by geographic mix and the high Japan comparator. Excluding Asia Pacific price mix across the three other regions was strong, averaging 8%.

Organically operating profit grew 8% in constant currency. Every region contributed to this good result with India in particular putting in an excellent performance, up 15% in constant currency terms. Western Europe delivered good organic profit growth of 3% despite the economic difficulties in the southern European countries.

Elsewhere the Americas region achieved a strong constant organic profit performance of 6% despite a 3% fall in organic volume, mainly as a result of Brazil excise driven price increases. Asia Pacific reported strong constant profit growth of 7% despite a 2% volume decline.

Overall these good profit performances were adversely impacted by exchange rate movements reducing the group's reported operating profit growth by 5% down to 3%.

Looking at the regions individually in Asia Pacific strong performances from a number of markets and favourable exchange rates helped profit grow 8% to £1.7 billion. At constant rates profit rose 7%. Good volume performances in Bangladesh, Pakistan, Taiwan and Malaysia were offset by declines in South Korea, Indonesia and the high Japan comparator. Excluding the Japan one off revenue and profit at constant rates would have been 2% and 9% higher respectively. Volumes would have been flat.

In Australia volume was lower, however profit rose as a result of higher pricing, cost saving initiatives and favourable exchange rates. As you know, plain packaging was implemented at the beginning of December and early indications are that it has had no impact on the market.

The change in excise structure in Indonesia and excise premium price increases adversely impacted volumes of the low margin local brands. These together, with increased market investments and high clove prices, resulted in a decline in profit. However, our investments in building a new portfolio are beginning to pay off with the launch of Dunhill Mild and the relaunch of Star Mild both performing ahead of our expectations. As a result market share stabilised in the final quarter of 2012.

Malaysia delivered an outstanding performance with growth in market share and profit. Dunhill continued its good performance achieving a record share of 47%.

In South Korea profit, volume and share were impacted by prices from competition, however market share has stabilised during the second half of the year.

In Japan profit was up but volume and market share were down following the high comparator last year. We have successfully retained an increase of more than a full share point of the 2010 exit share despite significant competitive activity. As a result market share is 12% - a record achievement excluding the one off distortions in 2011. This was driven by the success of the new innovations in Kent and Kool.

Bangladesh, Pakistan and Vietnam all grew profit, share and volume.

In the Americas region profit was down 2% on last year to £1.4 billion mainly driven by negative exchange rates and lower profits in Mexico.

The lightest shaded part of the graph on the slide represents the organic numbers at constant rates. As you can see, organic constant revenue was up 4% and profit 6%. Regional volumes were almost flat at £142 billion.

The decreases seen in Brazil through its excise driven price increase were almost full offset by the additional volume resulting from the Columbian acquisition. Stripping out this impact regional volume was down 3% on an organic basis. Brazil's profit was driven by an improving product mix and higher pricing. As I previously mentioned, industry volume was down following the excise driven price increase last year which fuelled the growth of illicit trades, despite the establishment of a minimum price. Our market share rose strongly, mainly driven by Dunhill and some key local brands.

In Canada volume increased driven by the good performances of Pall Mall and Du Maurier leading to good market share growth. The absence of significant price increases resulted in the illicit trade stabilising. Profit was flat.

In Mexico industry volumes continued to be impacted by the increase in illicit trade which now stands at 17%. Lower volumes and a tough comparator at the beginning of 2011 due to the excise refund resulted in lower profit. However, market share was up, mainly driven by Pall Mall.

Columbia saw good growth from the GDBs and Mustang, the main brand acquired in the purchase.

In Argentina overall volume was down and market share was flat but premium share improved to a record high of 29%, up over 3 share points versus 2011. With Lucky Strike the fastest growing brand in the market.

In Western Europe reported profit was down 3% but up 3% on a constant basis. Overall the region's good profit performances in France, Germany, Switzerland, Romania and the UK partially offset by a decline in Italy. The economic uncertainty in the southern part of the continent continues to put pressure on consumers' disposable income and to impact volume which declined by 5% mainly due to Spain, Italy, Poland and Hungary. The fine cut market grew with volumes up 8% versus 5% for the industry and Pall Mall strengthened its position as the leading brand in fine cut with an 18% uplift in volume.

In Italy both volume and profit were down as a result of the difficult economic environment. Share in cigarettes declined but profit and share grew strongly in fine cut.

In Germany volume and share were up, outperforming all other industry players and trade brands. Lucky Strike extended its leadership on the all natural segment and was the fastest growing brand in the market in 2012. Profit also grew, driven by higher pricing and good cost management.

In France profit and share grew, despite the market contracting. Lucky Strike convertibles and all natural offerings were key drivers of share growth.

In Spain operating profit increased strongly on the back of price increases and a lower cost base. Share declined despite the growth of Lucky Strike which is now one of the fastest growing cigarette brands in the market.

In Romania industry volume was slightly down. Nevertheless group volume increased, resulting in a higher market share, mainly driven by the strong performances of Dunhill and Pall Mall. This, together with good pricing, resulted in higher profit.

Market share increased in the UK driven by the strong performances of Pall Mall and Rothmans. Price increases and efficiency improvements led to a strong growth in profit.

Profit in the EEMEA region grew 8% to £1.4 billion mainly due to stable volume and good pricing which was partly offset by the adverse impact of exchange. At constant rates profit increased strongly by 15%.

Losses in low margin brands in Turkey continued.

Political instability in Nigeria and Egypt impacted regional volume which was marginally lower at £235 billion.

In Russia both profit and market share grew. Exit share at the end of 2012 was 0.5 points higher than the prior year. Rothmans, which was launched in the value for money segment during 2012, has performed well and has already achieved an exit share of over 1%. The group maintained leadership of the premium segment with another good performance from Kent.

Ukraine saw a strong increase in both volume and market share, also driven by Kent's good performance. However, a very competitive price environment coupled with increased market investment, resulted in lower profit.

In South Africa profit grew at constant rates but was flat at current. Despite the continued growth of illicit trade, volume was up although market share was slightly down.

Continued political instability in Egypt and poor law enforcement fuelled the growth of illicit trades resulting in sharp declines in volume and profits but growth in market share.

In Turkey Kent and Lucky Strike performed well. However, losses in the low price segment led to a decline in both volumes and market share, although shares showed some sign of stabilisation in the final quarter of 2012.

Lower volume, coupled with adverse exchange rate movements, resulted in lower profits. The GCC markets reported good market share growth due to Dunhill's continued good performance and a strong growth mainly driven by improving the products and price mix.

Ben now will take you through the financial statements.

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

Thank you, Nicandro, and good morning everyone. I'll start with operating margin. As you know, our medium term target is to grow operating margin by 50 to 100 basis points on average each year. Obviously some years will be below the average and others above but I'm delighted that we've comfortably beaten this target in 2012 with margins increasing by 160 basis points. In organic constant terms the margin increase was 140 basis points.

All the regions contributed to the improvement. Asia Pacific was well ahead, driven by higher pricing and tight cost management, particularly in Malaysia, Japan and South Asia. EEMEA also grew strongly with good improvements in the GCC, Russia and South Africa. The Americas continued to improve operating margin despite already being above 40% and Western Europe was also ahead of 2011 despite the challenging economic environment.

Turning now to the income statement adjusted profit from operations grew 3% to £5.7 billion. At constant rates this growth was 8%. Revenue growth at constant rates was 4% and, as you've just seen, our cost programme is continuing to improve margins leading to an 8% increase in operating profit at constant rates.

Restructuring costs were marginally higher than 2011 at £206 million. This mainly related to the introduction of our new operating model together with the continuation of factory closure and downsizing activities in Australia, the integration of Columbia, the closure of the Bremen factory in Germany and restructuring in Argentina. Amortisation of trademarks is slightly above 2011 due to the full year impact of Columbia.

Profit from operations increased by 15% aided by the absence of the one off charges seen last year.

Net finance costs were marginally below 2011 despite the higher closing net debt position. This was mainly due to the absence of a number of one off interest costs associated with tax cases and the advantage of low interest rates. These were partially offset by lower investment income.

Associates were 3% higher at £692 million. For the purposes of the adjusted earnings per share calculation the adjusted contribution from associates was £38 million, or 6% higher at £697 million. The contribution from associates was 10% higher at constant rates of exchange. The adjusted contribution from Reynolds American was 4% higher at £448 million. At constant rates the increase was 3%.

ITC delivered an excellent performance. The group's share of profit after tax increased to £237 million, a growth of 9% at current rates and an impressive 23% in constant currency. Profit before tax was 15% higher at £5.6 billion.

The underlying tax rate was 30.6% compared to 31.2% in 2011. The key drivers were geographic mix of profits and the positive resolution of some tax audits in Germany and New Zealand. Our guidance for 2013 is for a tax rate around the current level.

The non controlling interest charge was similar to 2011. At constant rates of exchange this charge would have increased 8% with the difference mainly due to the devaluation of the Brazilian Real. Profit for the period rose 22% to £4.1 billion.

The share buy back programme reduced the average number of shares from £1,982 million to £1,949 million and, as a result, the adjusted earnings per share is 207.5 pence, an increase of 7%.

Earnings per share growth at 7% was adversely affected by exchange rates. At constant rates the growth was an impressive 12%. This was driven primarily by the increase in profit from subsidiaries. A good performance from associates, the lower effective tax rate and the share buy back programme all contributed positively.

Moving on to cash flow operating cash flow was £240 million lower at £5.1 billion with the reduction driven by two main factors. Firstly capital expenditure was higher due to the funding of our innovations strategy, the One SAP bill and the purchase of Globe House. As a result net capital expenditure increased by £176 million over 2011.

Secondly you may recall at the half year announcement we had an increase of around £450 million in working capital and we anticipated that this would partially unwind. As you can see the increase at the year end has reduced to £141 million. This increase over 2011 was mainly due to stop bills in a number of markets. The lump sum payments on pension funds, primarily rates to UK schemes, is now shown separately to give greater transparency to cash flows of this nature.

Net interest paid was lower primarily due to one off payments relating to interest on tax cases in 2011 which do not recur and tax paid increased broadly in line with profit growth. The main driver of the higher income from associates was the Reynolds' share buy back programme. Overall free cash flow was £3.3 billion. Operating cash flow conversion was 90% with free cash flow as a percentage of adjusted earnings at 81%.

Dividends paid to shareholders rose 8% to £2.5 billion. Under the share buy back programme 38.9 million shares were repurchased at a cost of £1,258 million including transaction costs.

Net investment activities relate to the purchase of CM Creative Limited in December and a small increase in our shareholding in the business in Bangladesh. In 2011 the main investment was the Columbia acquisition. There was a net cash out flow of £637 million for the year.

Finally net debt which ended the year at £8.5 billion. The increase was limited to £545 million despite the outflows from the share buy back programme.

Given the strength of our balance sheet we have announced this morning that we'll reopen our share buy back programme to a value of £1.5 billion for 2013.

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

Nicandro Durante - British American Tobacco plc – Chief Executive

Thank you, Ben.

In summary, 2012 has been another very good year for British American Tobacco. We have met or exceeded all our financial targets. Despite facing a currency headwind and economic uncertainty we have once again delivered high single figure earnings growth of 7% at current rate and an excellent 12% at constant rates. The proposed dividend per share is 7% higher at 134.9 pence and we also increased our share buy back programme for 2013 from £1.25 billion to £1.5 billion.

I am confident in the business you continue to deliver. Price remains strong. We have a very good brand portfolio, a proven capability in innovation and marketing, good share growth momentum and a diverse geographic footprint.

We now open the meeting for questions. For the purpose of the webcast please remember to state your name and the firm you represent. So who'd like to start?

QUESTION AND ANSWER

David Hayes - Nomura- Analyst

David Hayes from Nomura. Just on the margin progression to your point about it being ahead of the target. Were there one offs in there that mean it's 150 it will certainly drop to 20 to have brought something forward, or would you say that it's a steady progression? Secondly, on Brazil, I wondered whether you could talk about the resilience of the market volume wise in the last couple of months following the additional price rise following the tax in January? Staying in Brazil, in terms of the limitation on ingredients that's coming in, I wonder whether you can talk about which to factor in, either volume or cost, associated with that change towards the end of the year? Thanks very much.

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

The guidance for operating margin is 50 to 100 basis points a year and we feel no reason to change that at the moment. If you strip out the operating margin increase from ASPAC actually the rest of the group was 0.9% so it's bang in line with the guidance we give. ASPAC did have one or two one offs in it. FX was quite a contributor so that was about 0.4%. The Japan volumes last year. Remember we were flying in product in jumbo jets and that hit the margin in 2011 so that's been an increase as well. We've got the closure of the Australian factory in as well so that's a one off in Australia because that's not going to come every year. Also you've got good pricing and tight cost management. So some one offs in Australasia and that's why I'm comfortable and holding to the 50 to 100 basis points.

Nicandro Durante - British American Tobacco plc – Chief Executive

Okay. Taking a Brazil question let's talk a little bit about the impact of the excise increase we had last year. As I remember well what happened in the first half of last year was a sizeable excise increase. It is a five year plan in Brazil and every year the excise increase will go down so the excise increase that we faced in January 2013 was lower than last year and in 2014 it's going to be lower than 2013 and 2015 is going to be even lower. So in 2015 the excise increase will be around 5%.

The impact of terms of the market. Because of the large excise increase the market was down from the duty paid point of view 6% last year. This was mainly driven by the growth of illicit trades, despite the minimum price that was introduced. Illicit trade went from 20% to 22%. What's happened in Brazil is that local companies abide by the illicit trades by the minimum price but the contraband of course not. So the national companies' share went down and the illicit trade went up.

The volume in Brazil from a consumption point of view was 3% down so the difference between 3% and 6% is the growth in illicit trade. If the question is how much is the market going to be down in 2013 with the new excise increase it's very difficult to predict. We'll have to wait and see.

But more importantly Brazil, despite the large excise increase and despite the fact that the competition usually lags increasing price against BAT, we grew market share big time in Brazil; 1.2%. So it was the highest market share growth that you have in a single year. It just shows that the portfolios work extremely well. We have a trader in the market. He was doing extremely well. So the company's in a very good shape.

Regarding the ingredients ban. That's the main impact to the ingredients ban was ban in menthol. Don't forget that menthol is a very small segment in Brazil accounting for less than 2% of the market. We don't foist the introduction of the products without some of the ingredients because some of them are still allowed such as sugar, of course. It will be September 2013 so we are ready to come to the market with the new products according to the new law. Some changes have been made already. We don't fully see big changes in terms of the costs for the company.

James Bushnell – Exane BNP Paribas - Analyst

James Bushnell from Exane BNP. Two questions on volume. Your volumes in the Asia region seem to tail off a little bit in Q4. I wondered if you could just talk moving parts and how we should think about that going into 2013? Then secondly on Western Europe, conversely your volumes seem to have got a little bit better in terms of the decline. We've obviously heard a few different things from your competitors about how they see Europe. What are you thinking about Europe? Are you seeing it as a stable volume decline situation or one with up or down cycle?

Nicandro Durante - British American Tobacco plc – Chief Executive

First of all it's very difficult to analyse volume trends when you look for quarter by quarter base because you have lows in one quarter compared to the other, as you saw in places like Brazil before the price excise increase, in the Philippines and things like that. So probably we will see the impact for example in our case in quarter one in Brazil that probably the funds are going to be lower than the quarter four. It doesn't mean that the underlying dynamics of the market have changed dramatically. That's the first point that I'd like to highlight.

The way that I see the market going for 2013, overall market, from the consumption point of view, is going to be pretty much similar to what we saw in 2012. That will be a stable to a slight growth. Of course the duty paid market we saw that decline around an average of 1% to 1.5% because fine cut grew strongly in Europe, for example, and the illicit trade in a global base was a little bit higher last year than has been in previous years.

So in terms of volume trends I don't see big changes in 2013 against 2012. But looking at the volumes on a quarter by quarter base it is very difficult.

In the case of Western Europe how I see the devolution of Western Europe - I think that was your question. It's a very large region and when you talk about a region in reality you're taking a temperature of someone that maybe cold at his head and very, very warm at his feet. I see that volumes, looked at quarter by quarter in Europe, mainly the Southern European countries, is not getting any worse but it's not getting any better. I see similar rates of decline that you saw in the first half of the year. You have in some places of course a slightly better trend and some other place a slightly worse trend. Our numbers in Europe. We declined less than the competition because we are growing share. We are doing very well in Western Europe, mainly driven by Lucky Strike's performance. That is why it is the strongest region for Lucky Strike in Western Europe. We grew Lucky Strike volume 11% in 2012 so that is the situation.

In terms of Asia Pacific, as I said, it's very difficult to analyse quarter by quarter. The region had an outstanding performance in 2012 in eight out of the ten top markets. The markets we faced some issues in were Indonesia, in which we had some volume losses because of the introduction of the new excise structure, but the share has stabilised in the last four months and also our restructured portfolio is much stronger. It's more than half of the volume now and 12 months ago it was 20% of the volume. Also we had the issue in Korea of a tough comparator against the previous year.

James Bushnell – Exane BNP Paribas - Analyst

What do you think of volume growth in Asia over the next couple of years? We've had Japan and other things going on in the last year or two. What do you think about that?

Nicandro Durante - British American Tobacco plc – Chief Executive

I think that Asia is one of the regions that should see volume growth. I'm talking about the region consumption point of view. Talking about BAT I think that we have a very strong portfolio, we have very good plans in place, a very good pipeline of innovation and we expect to grow faster than the market. Just a minute. Adam.

Rogério Fujimori – Credit Suisse - Analyst

Nicandro for you. Which markets among your top 15 are you most optimistic about for 2013? One question for Ben. You have a very good visibility I presume obviously on the savings that will come from the SAP roll out in Australia and the productivity plans in place. Would you say that the amount in costs savings for this year - £3 million is higher than last year? Thanks very much.

Nicandro Durante - British American Tobacco plc – Chief Executive

Your question about the top 15 markets, the biggest markets in BAT, and how do I see in terms of growth potential for 2013? I think that you're talking about not volume but profitability, volume and share. As I said in my statement this morning we think that we're in a very good position. In some of the markets I think that we have some good inroads in those markets such as Canada. We now see, for two years in a row, BAT growing share and property has been stable, so I see this with optimism next year. In places like Mexico we are back to growth. We've a very strong portfolio. Overall I'm optimistic about all big markets. Some others such as Indonesia we are making the right calls to start growing so I am optimistic about our top markets.

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

In terms of savings obviously the nature of savings in BAT is changing so we're ending the closure of factory type savings. We're going through the collection of back office overhead into shared service type savings. Once we've got SAP in we'll see further savings coming in working capital. I'm not going to split those savings out between SAP and non SAP savings or even within SAP but they all underpin the growth in operating margin so that's why we're comfortable signalling a continual growth in operating margin for the foreseeable future, because the things we need to do to deliver those savings we're already doing, which is putting in a consistent set of business processes backed up by a single system SAP around the group.

It's a steady pace, yes. Remember the programme will go on for four or five years so this is not a one hit wonder.

Nicandro Durante - British American Tobacco plc – Chief Executive

Can I have Adam now?

Adam Spielman - Citi - Analyst

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

Let's talk about Russia first of all. What we have seen in Russia is we had a large excise increase at the beginning of 2013, as you are aware, but more important than the excise increase is how it's changing the dynamics of the market because the excise increase is moving low price brands up faster than premium brands so it's compressing the price gaps. So we saw, for example, in the last 18 months, low price brands in Russia going up in terms of pricing 40% and premium brands 23%. If you look at January for example low price brands in Russia in December/January went up 20% and premium brands went up 11%.

This plays quite well with our portfolio. We have 46% of the share in the premium segment in Russia so this uptrading that you're seeing in Russia plays in our favour. Kent is doing well in Russia. We saw some growth of market share in Russia in Kent. I think that we left 2012 with a very strong position in terms of market share. As I said driven by Kent and the Rothmans launch that is doing extremely well in Russia. It's one of the best launches that we have seen in Russia in the last years. We have 0.5% market share in December 2012 against December 2011 so exit vs exit so we are doing very well.

I think that the change in excise structured in Russia plays in our favour. That's the first question.

Your second question, Adam?

Adam Spielman - Citi - Analyst

Innovation.

Nicandro Durante - British American Tobacco plc – Chief Executive

Innovation. You have to understand first of all that you have to sweat our assets. There are a lot of investment behind innovations, as I said last year. So I want to roll out innovation to the majority of our brands. Innovations account for 16% of BAT's volume and 45% of the GDB volume so there is a way to go. Our share of the capsule segment, for example - that is the advantage of being the first mover - is 53%. So it has a long way to go in the current pipeline with all natural. I can guarantee to you we have a very good pipeline of innovation for the coming two to three years. We just have to be careful to, as I said, to sweat innovation because bringing innovations to the market doesn't mean that the consumers understand the following morning. It takes one year. Eventually some of the markets take two years to get the awareness and the purchase that we all expect. That is the moment you come with a new innovation. It's not about bringing innovation every year to the same markets. We are trying to sweat what we have to roll out and we are being successful because 2011 volume of innovation against 2010 was 25% higher. 2012 against 2011 was 20% higher. In a market that's declining between 1% to 1.5%, I think that's the reason that the GDBs are growing faster than the markets; because the GDPs are the primary vehicle to drive innovation. Not only the brands that you drive innovations. We try to put in our premium portfolios. You have some very strong premium brands across the world.

I think that you have a question, Jon?

Jon Leinster - UBS - Analyst

Yes. Jon Leinster from UBS. Looking back at last year and going into 2013 can you give us some guidance in terms of cost outlook for the margins and give us an outlook on 2013, whether the innovation is probably a little bit less this year, whether the marketing costs are going to ...?

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

In terms of margin increase for last year you've got a number of impacts on the margins. You've got pricing obviously which works in our favour. You've got mix because more of our growth is in lower margin markets. That's what you get with developing markets. You've got costs of sales increases and then you've got productivity savings. So in terms of the overall margin improvement last year the pricing benefit offset the volume and mix and cost of sales decline and the true underlying margin increase really came through from the cost saving programme.

In terms of guidance for next year I couldn't possibly give you guidance on the breakdown of the margin increase next year. Remember in terms of the SAP programme we only put in SAP in Malaysia in Q4 of 2012. We're doing Australasia and South Asia in 2013. It's not until 2014 that the real industrialised roll out of SAP starts happening in BAT so more of those savings later on.

Jon Leinster - UBS - Analyst

Can you give us some idea in terms of leaf costs....

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

In terms of leaf costs leaf costs are going up about 5% so no real significant difference in leaf cost. Cured leaf, which is our major leaf, is slightly lower than Burley but they're all in the 5%/6% region so no real significant increase in costs.

Nicandro Durante - British American Tobacco plc – Chief Executive

Okay. Eric?

Fulvio Cazzol - Goldman Sachs

Fulvio from Goldman Sachs. I read in one of the interviews this morning that you had passed on already 80% of price increases that you were planning for this year. How does the absolute level of pricing compare with, say, last year? Are you seeing the same level in percentage terms? Then my second question was on Brazil. Minimum wage there is increasing 3.5% this year versus 7.5% last year. Do you think the pricing in that particular market is going to be a little bit more difficult in 2013?

Nicandro Durante - British American Tobacco plc – Chief Executive

Let me start with the second part of the question; the Brazil price increase. The price increase in 2013 is lower than the previous year but don't forget it's still a large price increase on top of another large price increase at the beginning of last year. As I said, the impact in the market is pretty much dependent on the economics and it's about unemployment and disposable income. If unemployment in Brazil improves this year - and I don't think that there is any indication that the situation is getting worse there - and disposable income stays as it is or improves, I think that it will be well absorbed, but it is very difficult to predict to be honest, because it's a large excise increase on top of another large excise increase so it's very difficult to predict what is going to be the market reaction.

The first question about the prices. As I said this morning, we have got already 80% of the pricing that you're expecting to have in 2013. It's just to highlight that we are in a very good pricing environment. When I was here last year I said that it was around 65% or even 70%. It's slightly better. I cannot, unfortunately, disclose the amount of pricing but, as I said, we make our projects and space in the financial targets that we have and we have already 80% so it's a very strong price environment.

John?

Jon Fell – Deutsche Bank

Two things. First of all on Des's new appointment. I'm wondering how we should interpret that. Does that represent a step up in your efforts on next generation products? Is that mostly a UK effort at the moment or it is going to be a global thing? Then quickly on the Philippines I'm wondering what your ambitions are there? What's a reasonable goal for the next five years and are you going to have to spend a lot of money there initially to get the position you want?

Nicandro Durante - British American Tobacco plc – Chief Executive

Let me start with NGP - next generation product. This is a natural development of our strategy. We have been working very hard in the last couple of years in the harm reduction. That is not a new thing in BAT. The acquisition of CN Creative at the end of last year is part of this programme. They are a small innovative company developing nicotine devices. We set up Nicoventures two years ago also as part of this strategy and in the hope that you can bring to the market some products in the next couple of years. That's the reality.

We thought that having a focus on all those developments under the same umbrella was the right thing to do so it's something that we thought through and we were discussing for the past one year. It came to fruition but, to be honest, it was already working in that way but going through one of our current Board Directors. We thought that we needed a special focus on that. That's why it deserved a management board position for that.

Regarding the Philippines we are extremely happy that now we have a level playing field in the Philippines. The Philippines is one of the top ten markets from the volume point of view so, of course, we are going to invest in the Philippines to grow. How successful we are going to be is very difficult to predict but are we going to invest in the Philippines and are we going to invest behind our brands and trade in order to get our market share there? The answer is yes. But, unfortunately, it's very difficult to give your targets of where do we want to be in five year's time? We want to be as high as possible

but we have a local strong competitor there that has the majority of the market share. It's going to be tough. They have strong brands as well but we are going to make the investment in order to grow there.

Erik?

Erik Bloomquist – Berenberg Bank - Analyst

With respect to Canada. Quite favourable development over the last two years. Does that outlook change since it sounds like a number of provinces are taking tax increases, or is it simply you're going to be able to price and offset the accompanying volume decline and increase in illicit? The second question is back to the regulatory outlook. If you could comment on what you see happening with the Tobacco Products Directive and also then the appetite of countries for plain packaging given what we know at this stage in the game? Thanks.

Nicandro Durante - British American Tobacco plc – Chief Executive

Okay. The first question's about Canada. Yes, I think that we are in a much better position in Canada than we were two years ago, or three years ago. I always came here and said it is one of the markets that we had to step up our game in. We have done so. We have been growing share and we are in a very good position. The profitability has been declining for three or four years in a row. We have stabilised that. I don't think that you'll see large excise increases in Canada this year. As far as we know those excise increases are more or less according to inflation. That's something that the industry can cope. Illicit trading in Canada, to be honest, is slightly down in 2012. 0.4 percentage points only but slightly down. Because we don't see huge excise increases and because the Government has been focusing on fighting illicit trade I think that we have good potential for growth in Canada in 2013 but we have to wait and see. It's still February. A long way to go. So far it seems that we haven't seen anything that could disrupt the trends.

Regarding regulation -- and I think that your question is about the TPD and plain packaging and I think that I start with the plain packaging. As you know we introduced the plain packaging implementation in Australia. It started in December and, as I said during my speech, we haven't seen any changes in the market. You have to consider that with the display ban then the consumers headed to us for the brand anyway so we haven't seen any change, but it's too early to call. We have to wait and see.

Regarding New Zealand, New Zealand have listened to the arguments for and against this measure and they have acknowledged the importance of their trade obligations and the WTO challenge that's going through against Australia so they have postponed the implementation until we have a resolution of the WTO challenge that you should see in 2014. We are glad that they made this call.

The third country which is analysing it is the UK, as you know. In the UK you have a consultation. We're having hundreds of thousands of submissions. We should see the results of the consultation in the coming months.

The fact of life is just three countries are moving to this direction. We have a lot of noise around the world but we haven't seen any consultation or haven't seen anything to progress so far. I'm not saying that it's not going to happen but the fact is just three countries are looking at that carefully.

In terms of the TPD we believe that the draft legislation contains provisions not based on science. We expect to see further amendments in the European Parliament. They are going to analyse this later in the year. You know that there are measures in packaging, ingredients and formats of packs and things like that. I don't think that any of those provisions are based on science and you are against it. I think that, at the end of the day, we will bring unintended consequences if those measures are implemented. We have to wait and see the European Parliament to debate it. It should happen at the end of this year but my expectation is that there will be some amendments, if you ask me the question, because it's just measures that are not based on science and are not going to meet any public health goals that they set by themselves.

Dirk van Laanderen – Jefferies - Analyst

Hi. Dirk van Laanderen from Jefferies. I wonder if you could give your thoughts on capex in 2013 and beyond? Then also maybe, just on working capital, is there a structural reason why it's an outflow and where do you see opportunities for improvement there and could SAP be the enabler?

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

Just on working capital the increase we faced this year was largely stock builds so that happens every year in a sense. We had stock builds in Brazil this year. We had stock builds in Russia. So you're just seeing the natural flow through of those stop bills. Nothing particularly unusual there and much better than the position at the half year reports.

In terms of net capex going forward we've got the roll out of SAP to do and of course, as you roll out the innovation strategy, you're buying machines to put that volume on to as well. So you'll see capex staying at or just marginally above the current levels for the next year or two before coming down again once the SAP programme is rolled out.

Nicandro Durante - British American Tobacco plc - CEO

May I have one more question? Yes.

Martin deBoo – Investec - Analyst

Ben, Tax rate. The Consumer sector as direct US\$ exposed, the question on looking forward is the whole value creation. Do you see an upside on that? Where is that on your to do list?

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

Our tax rate largely is a result of mix of profits so I don't see any substantial changes coming down to substantially reduce the tax rate, no. We do what we can. We're conservatively aggressive when it comes to tax planning. That's the way we like to describe it. We don't push the envelope in terms of tax planning but where there are established schemes then we tend to use them. I see the tax rates staying at around the current level going forward.

Nicandro Durante - *British American Tobacco plc - CEO*

Okay. One more question?

Henry Davies - *Merrill Lynch - Analyst*

Henry Davies, Merrill Lynch. Just on your reduce harm efforts... How do you view the long term opportunity in e-cigarettes versus modifying risk cigarettes versus some of the other mix delivery devices you have and are you seeing any signs of governments, or regulators, becoming more accepting of a reduced harm approach to reducing smoking? Thank you.

Nicandro Durante - *British American Tobacco plc - CEO*

There is a growing interest in terms of nicotine devices. The consumers are interested in that and that's why we are stepping up our efforts in this area. We think that it can be an important category in the long term. I don't think in the next five years you'll see big chains switching from combustible to non combustible but mid to long term it can be an important category. That's why we're stepping up our efforts with everything that I just said.

In terms of the regulatory bodies we have been in contact with them, mainly the MHRA in the UK, and I think that it's very difficult to predict how they react when they start having those products in the market. Nowadays excise is very low and I think that should be kept like that if you think of the harm and reduction strategy. The harm reduction concept should work. That is my expectation going forward. We intend to develop a range of products inside the risk continuum not only in cigarettes. That is why you are stepping up our efforts through Nico Ventures, CN Creative and some internal initiatives.

Thank you. This session is over. Thank you very much.