British American Tobacco p.l.c.
Half-Year Results 2017
Thursday 27 July 2017

CORPORATE PARTICIPANTS

Nicandro Durante
Chief Executive
Ben Stevens
Finance Director

CONFERENCE CALL PARTICIPANTS

Owen Bennett *– Jefferies - Analyst*
Adam Spielman *- Société Générale – Analyst*
Jonathan Leinster *– Berenberg Bank - Analyst*
David Hayes *- Bank of America Merrill Lynch – Analyst*
Michael Lavery *– Piper Jaffray – Analyst*
Fulvio Cazzol - *Goldman Sachs – Analyst*
Chas Manso *– Société Générale - Analyst*

Presentation

Operator

Ladies and gentlemen, welcome to the BAT Half Year's Results Call. I'll now be handing over to Nicandro Durante. Please begin your meeting.

Nicandro Durante, Chief Executive, British American Tobacco p.l.c.

Good morning everyone and welcome to British American Tobacco's 2017 interim results presentation. I'm Nicandro Durante, Chief Executive of British American Tobacco and with me this morning is Ben Stevens, Finance Director.

And, as always, a warm welcome to those of you who are listening on the conference call or watching via our website, bat.com.

As usual, after taking you through the results presentation, there will be an opportunity for those of you on the call to ask questions. Before I start the presentation, I will take it that you have all seen and read the disclaimer.

As you are no doubt aware, it's been a busy start to the year. I am pleased to say that we have delivered another good performance over the first half of this year, despite lapping a strong volume comparator.

During the first half of 2017, we continued to grow share, again driven by the outperformance of the Global Drive Brands. Although volume was down 5.6%, with strong price mix, adjusted revenue at constant rates was up 2.5% and adjusted profit grew 3.2%. Adjusted EPS was up over 6% at constant rates and up 21% at current rates.

In NGPs, Glo continues to go from strength to strength and has reached an estimated share of 8% in Sendai, with the rollout in Japan progressing well. In vapour, our business in the UK also reached a record share in retail of 41.5% with Vype reaching all-time highs. I will cover this in more detail later.

Perhaps more importantly, I am delighted that two days ago, we complete the acquisition of Reynolds American with overwhelming support from both sets of shareholders. This makes BAT one of the world's leading consumer products business. I'm very excited about the prospects for the enlarged group. We will now focus on integrating the two companies and delivering the expected synergies. I am pleased to welcome Debra who has joined the management board, another Reynolds Group employees for BAT. I will now hand over to Ben who will, as usual, take you through the detail of the first half results.

Ben Stevens, Finance Director, British American Tobacco p.l.c.

Thank you, Nicandro, and good morning everyone. As Nicandro mentioned, the Group performed well against the strong first half comparator last year when organic volumes was up over 2%. Reported volume was down 5.6% and organic volume was down 5.8%. This is mainly due to industry volume decline, in particular in Pakistan, following significant excise-driven price increases last year as well as the phasing of volume shipments, which we expect to unwind in the second half. Excluding Pakistan, volume would have been down only 2.6%.

This reflects our continuing corporate share growth of 30 base points, and another strong performance from the Global Drive Brands which grew share 50 basis points. Although reported Global Drive Brand volume is down 1.3%, excluding Pakistan, it would have been up 2.6%.

Adjusted revenue is up 2.5% at constant rates benefiting from strong price mix, growing NGP revenue and M&A. Adjusted revenue excludes the excise included in goods required under short term contract manufacturing arrangement mainly from Bulgartabac.

Adjusted profit grew 3.2% on a constant basis and operating margin was up 30 basis points despite the absorption of a 3% transactional currency headwind. Constant currency adjusted EPS grew 6% and was up 21% at current rate. Throughout the presentation this morning, we'll be referring to adjusted revenue, adjusted profits and adjusted EPS as revenue profit and EPS.

Turning now to operating margin. I'm pleased to say that after two years of reported decline, we have returned to operating margin growth. On an organic basis, the improvement was 50 basis points driven by good pricing and TaO efficiencies together with significant product cost savings and the benefits of factory footprint optimisation.

This was despite absorbing a 3% transactional FX headwind. Operating margin was up 30 basis points after the impact of acquisitions. If foreign exchange rates were to stay where they are today, the transactional currency impact would reduce in the second half, but we would still expect a full-year impact of around 2% on operating profit. Whilst we don't give guidance for any particular year, I remain confident in our long-term ability to grow operating margin between 50 and 100 basis points per year on average.

Moving on to the regions. Asia Pacific delivered another good performance in the challenging environment. Significant industry contraction and the timing of shipments mainly in Pakistan saw a reasonable volume down 9.8%. But excluding Pakistan regional volume would have been up 0.5%. Despite the volume decline, revenue at constant rates was down only 2.9% as a result of good pricing and Glo revenues. Constant currency operating profit grew 2.3% driven by Australia, Bangladesh, Vietnam and New Zealand. With a strong currency tailwind, profit grew 14.4% at current rates.

Share in the region was up 30 basis points underpinned by a good performance from the Global Drive Brands which grew share 40 basis points. In Australia, both revenue and profit were up. Share grew strongly driven by Rothmans, which remains the fastest growing brand in the markets, and Winfield, the number one capsule brand. In Malaysia, volume and profit declined as the significant excise-driven price increase in 2015 continued to drive market contraction, downtrading and growth in illicit. As a result, overall share was down. However, share has improved sequentially since the beginning of the year and is now up a 100 basis points driven by Dunhill, which is up 80 basis points since December.

Kent drove another strong share gain in Japan. In THP, Glo continues to exceed the expectations and Nicandro will cover this in more detail later.

Volume and profit in Pakistan was significantly lower. This was driven by industry volume decline and growth in illicit following the excise-led price increases as well as the phasing of shipments where trade loading in H1 2016 ahead of an excise increase was not repeated. In Indonesia, volume was down as excise-driven price increases resulted in industry decline and downtrading. Market share was slightly lower as Dunhill was impacted by the downtrading. However, Lucky Strike continues to perform well. Bangladesh posted an outstanding result with double-digit growth in volume, revenue and profit. Share also grew strongly and was up over 400 basis points.

In the Americas, volume was down 6.5% mainly due to industry decline in Brazil and Venezuela. However, good pricing led to strong constant currency revenue growth of 6.5%. Profit growth in Canada, Chile, Colombia and Mexico offset declined in Brazil and the Caribbean leading to regional profit growth of 2.3% at constant rates. At current rates, profit was up 14.8%. In Brazil, the excise and VAT-driven price increases together with a weak macroeconomic environment continue to drive downtrading and growth in illicit trade. Volume and profit declined as a result. Although market share was down, Minister grew share strongly.

In Canada, good pricing grow revenue and profit growth despite lower volume. Share was maintained and Pall Mall is the fastest growing brand in the market. Mexico posted another strong performance with an increase in volume driven by Pall Mall. This together with good pricing and cost savings led to higher profit. Regional share was down 10 basis points although the GDBs performed very well. Their volume is flat and share was up 60 basis points mainly due to a strong performance from Lucky Strike in Chile and Colombia and Kent in Chile.

Western Europe continued its good momentum from 2016. Profit at constant rates was up 4.8% with good performances in Germany, Romania and Denmark, partly offset by France and the UK. At current rates, profit was up 16.8%. Reported volume was up 0.7% and then only 0.4% on an organic basis with regional share growth of 20 basis points. Profit in Germany increased due to good pricing and lower costs. Share grew driven by Pall Mall and Lucky Strike both reaching record shares. Excellent performances from Pall Mall and Dunhill in Romania led to higher volume. This together with good pricing and improved mix and cost savings resulted in strong revenue and profit growth.

In France, profit was down due to the partial absorption of excise. Immediately following the capsule ban at the beginning of the year, market share and volume declined, however recent trends are more positive. In the UK, Rothmans and Pall Mall performed well driving a small increase in market share. However, volume declined as the overall market contracted. In Spain, volume and profit grew and share was up strongly, driven by the continued success of Rothmans and Lucky Strike. The Global Drive Brands posted an excellent performance with volume up 8.2% and share up 50 basis points mainly driven by Pall Mall and Rothmans.

In EEMEA, despite a significant transactional FX headwind and challenging trading conditions in Russia and South Africa, the region delivered a good performance. Strong price mix more than offset volume decline of 4.6% leading to revenue growth of 5.9% and profit up 3.5% with good results in Turkey, Iran, Ukraine and North Africa. Excluding the impact of transactional effects mainly in Nigeria, Russia and South Africa, profit would have been up around 12%. At current rates, profit was up 17.7%.

In Russia, volume was down due to the growth in illicit trade and market contraction. Profit was lower, driven by competitor-led price discounting and consumer downtrading. However, market share increased with Rothmans and Royals driving growth.

In South Africa, a continued weak macroeconomic environment and illicit trade growth resulted in a reduction in volume and profit. Benson & Hedges and Dunhill both grew share. Although overall market share remained lower, it has now been stable for the last nine months. Turkey had another excellent performance. Share increased driven by Rothmans and Kent, the fastest growing brand in the market. Good pricing led to an increase in revenue and profit despite the decline in volume. In the Ukraine, prices have started to recover following the price war. This led to a markedly improved financial performance. Volume was significantly lower mainly due to market contraction and short-term disruption to industry distribution. GDB volume was up 1.2% and net share was up 60 basis points mainly due to Rothmans and Kent. Regional share grew 40 basis points.

Adjusted earnings per share of a 134.4p at current rates was up 21% driven by growth in operating profit, good results from associates, both Reynolds American and ITC and a 15% translational currency tailwind. Net finance costs were flat, however the average cost of debt was marginally lower. Our effective tax rate was 28.4%, 150 basis points below last year. Non-controlling interests were marginally higher as profit growth in Algeria and Vietnam was offset by decline in Malaysia.

I usually give some guidance around the expected full-year tax rate. Following the inclusion of five months of Reynolds, we expect to maintain an effective tax rate of around 30% for 2017. A pro-forma full year tax rate would be around 32%.

On currencies, if rates were to stay where they are today, the translational tailwind including five months of Reynolds as a subsidiary, would moderate to a full-year benefit of around 9% on operating profit and 8% on earnings per share.

Now on to cash flow. Overall free cash flow was £1,083 million, which is £524 million higher than last year. This is mainly due to higher operating cash-flow conversion, lower tax outflows and higher dividends received from associates.

Depreciation is the main component of non-cash items. Working capital outflows of 899 million were lower than this time last year. This is primarily due to non-recurring stock builds in the prior year relating to the implementation of the Tobacco Products Directive. As always, I'd like to caution that the timing of working capital movements tends to absorb cash in the first half largely due to the timing of leaf purchases. Net capital expenditure of £187 million is higher than 2016 driven by investments in Next Generation Products.

Net interest paid was higher, at £326 million due to upfront costs relating to financing arrangements to the acquisition of Reynolds. Tax outflows of £547 million were lower than the same period last year as a result of timing differences in payments. Higher dividend payments to minorities were driven by Malaysia. Restructuring and settlement outflows were higher mainly as the result of translational FX movements on escrow payment linked to the Quebec Class Action lawsuit. Dividends from associates increased, driven by strong results from Reynolds. This delivers free cash flow of £1,083 million.

Turning now to financing and shareholder returns. Net debt increased £1.7 billion to £18.5 billion. Following the announcement of our recommended offer for the remaining 58% of Reynolds American, S&P and Moody's confirmed the Group's credit rating at BBB+/BAA2 stable. We're targeting Net Debt-to-EBITDA of around three times by the end of 2019 with further deleveraging thereafter, returning us to the higher end of a historic Net Debt-to-EBITDA target of 1.5 to 2.5 times. The cash component of the Reynolds acquisition has been financed through the drawdown of the $25 billion acquisition facility. The $20 billion bridge component will be refinanced in due course through capital market issuances.

We remain committed to rewarding shareholders with an increasing dividend and continue to see 65% that's a sustainable long term pay-out ratio. From 2018, BAT will pay full equal quarterly dividends, and, as part of the transition, an additional interim dividend will be paid in February 2018. This will be 25% of the total cash dividends paid in 2017 amounting to 43.6p.

Before I hand back to Nicandro, I'd like to make a few comments on the addition of Reynolds to our numbers. We will report the US as a separate division alongside the other regions. We understand from Reynolds' management that they had a good first half with good growth in revenue and adjusted profit. Cigarette market share was flat, however the premium brands, Newport and Natural American Spirit saw growth.

Moist snuff performed strongly with share gains, and in vapour, Vuse had an excellent first half with double-digit revenue growth.

As you know we're confident of delivering at least $400 million of annualised cost synergies by the end of the third full year following completion and the savings are expected to flow through from early next year. The one-off costs of delivering these synergies are expected to be around $350 million.
We will be treating the Purchase Price Allocation charge for inventory valuation uplift, the charge for amortisation of acquired trademarks and transaction fees as adjusted items. Note that the pro-forma of P&L published in the offer documentation is based on unadjusted figures and 2016 FX rates.

Finally, whilst the deal is accretive to EPS in its first full year, accretion in calendar 2017 will be limited given the short period post-completion and the phasing of the synergy benefits. Thank you and now I will hand you back to Nicandro.

Nicandro Durante, Chief Executive, British American Tobacco p.l.c.

Thank you, Ben. Looking at share, the business continues to perform well and we are now in our seventh consecutive year of share growth through an increased 200 basis points since 2010. The GDBs grew share another 50 basis points in the first half. Their consistent, strong growth remains the key driver of our corporate share performance. Look at the brands in a little bit of detail. Dunhill performed well in a number of its key markets including Romania and South Africa.

Volume was down 4.5% mainly due to industry decline and downtrading in Malaysia and Indonesia. Market share was down 10 basis points although it has recovered in the last quarter with an improving share in Malaysia, Brazil and South Africa. In Indonesia, Dunhill remains the largest international kretek brand in the market with a 4.7% share despite consumer downtrading. Dunhill continues to perform well in Romania with a strong volume growth. In South Africa, Dunhill also reached a record share of 15.1% in May 2017.

Kent share was up 15 basis points and volume was down only 1.6%. Volume and share grew strongly in Turkey, where Kent reached a record share of 6.3% driven by the continuous success of the Switch and Demi Slims range. In Brazil, the migration of Free to Kent is on track with 100% retention to date. Around 60% of the consumer volume has now been migrated. Kent's volume in the Middle East or Russia was down due to marked decline and downtrading. In Chile, Kent grew share for the second consecutive year reaching 23.7 % post the implementation of the Kent Spark a new brand imagery. The brand saw strong volume growth in its slimmer ranges with Kent demis performing well and Kent Superslims variants in Japan reaching a share of 3.5%.

Lucky Strike had a very strong first half with share up 20 basis points and volume up 12.4%, reaching new record shares in Germany, Spain and Chile. In Indonesia, Lucky Strike Mild, our second international Kretek brand continues to grow both volume and share following its launch in May 2016, and the successful migration of Club Mild. In Spain and Chile, share increased strongly up 70 to 90 basis points respectively, driven by the continuous success of the Black Series. In Croatia, Lucky Strike is the fastest growing brand in the market with a record 8.1% share year-to-date. A really great performance.

Pall Mall grew share 10 basis points driven by the good results in Pakistan, Poland, Canada, Chile and Germany. Volume was down 9.6% mainly driven by the market decline in Pakistan. This masks growth in Germany, Poland, Rumania and Mexico. Excluding Pakistan, Pall Mall volume would have been up 4%. The implementation of the new-brand imagery and packaging in Germany is showing encouraging early results. And in Poland, Pall Mall's share grew 170 basis points, and in Chile the brand was up 70 basis points. In Germany, the brand reached a record share of nearly 11% in May.

Finally, Rothmans continued its excellent performance, despite lapping a strong comparator, share grew 15 basis points and volume was at 6.2%. In Russia and Turkey, the success of Rothmans Demi Click capsule variants continues to drive good share growth. Rothmans tubes continued to perform very well in Italy, where the brand grew share 50 basis points. Volume grew strongly in Russian, Nigeria, Czech Republic and in Spain.

Turning now to the Next Generation Products. We have made significant progress building our Next Generation Products business investing over $1.5 billion over the last six years.

Consumers are not homogenous. They want different brands at different times and for different reasons. Our strategy of developing and marketing a range of THP and vapour products puts us in the best position to capture a significant share of this exciting and profitable market. It also has the potential to generate the greatest benefit to public health. We continue to believe that as products improve, vapour will -- achieve substantial consumer penetration. We are seeing an increasing use of flavours not related to tobacco with 10% of consumers not even using nicotine-containing liquids. This is clearly different consumer behaviour to both combustibles and THP.

In the UK, BAT now has a leading 41.5% retail share of vapour, based on Nielsen and Vype continues to perform very well reaching a new record retail share of nearly 11%. Vype is also the number-one brand in UK pharmacies. Good progress has also been made in France and Italy. And our vapour revenue grew strongly in the first half. Last year, the vapour category outside the US grew over 40% to an estimated consumer value of nearly £4 billion. We also estimate that the US market was worth about a $5 billion in 2006. With Vuse, we are now the largest vapour company in the world.

In tobacco heating, Glo's share in Sendai is around 8% and nearly one in three smokers have purchased a Glo device. The expansion of Tokyo, to Tokyo, Osaka and the Miyagi region at the beginning of July has got us to an excellent start. Glo has already achieved a share of 3.1% in a major convenience chain across the expanded geographies and device penetration is already at over 8%. After just three weeks shares in the chain is 3% in Tokyo, 2.4% in Osaka and 6.1% in Miyagi, which includes Sendai.

Share in Sendai itself is also holding up very well at around 8% and conversion rates have continued to grow as distribution is extended outside the city. These are great results. Glo and KENT neostiks are now available in more than 13,000 retail outlets in Japan, as well as flagship stores in Tokyo and Osaka with the distribution covering 25% of Japanese tobacco consumers. Consumer awareness of the brand is already at 25% nationally and we'll be rolling out across the rest of the country in the second half with full coverage expected by the end of December. Our recent launches in Canada and Switzerland are also showing encouraging early results. In Switzerland, repurchase rates for Glo have been steadily rising. In our city test in Vancouver, we have opened a flagship store with distribution in a further 300 outlets. Next month we will be launching Glo in South Korea.

So, in summary, the business is performing in line with our expectations in the first half of 2017 with good results against the backdrop of a strong prior year volume comparator. We continue to grow share.. grow share powered by the GDBs. Although volume was impacted by industry decline and the phasing of shipments, we anticipate a stronger volume performance in the first half.

As a result, we continue to expect profits to be weighted in the second half of the year. Although this is moderated by NGP rollout costs and lapping a stronger comparator in Ukraine. Reynolds is now a key part of the BAT Group and we are now focused on progressive integration delivering the synergy benefits. These are good first-half results and I'm confident of another good year of constant currency earnings growth. So, now we're going to open for the Q&A. Who would like to come with the first question?

Q&A

Operator
Thank you. Ladies and gentlemen, if you do wish to ask an audio question please press 0, 1 on your telephone keypad. If you wish to withdraw your question you may do so by pressing 0, 2 to cancel so that is 0, 1 to register for a question. Our first question comes from the line of Owen Bennett from Jefferies. Please go ahead.

Owen Bennett, Analyst, Jefferies
Good morning, guys. Three questions if I may, please. And the first one, so you mentioned how we spend on NGPs will be ramped up in the second half. I was just wondering if you could be a bit more specific in terms of how much it will increase versus the first half to get an idea of how margins may progress. Secondly is it possible at this stage to give a rough idea of how much NGPs are contributing to the revenue number? And then thirdly, obviously a very strong share performance of Glo in Sendai. I was just wondering if it's taking share of competition or is it all incremental to the overall category. And also you said conversion levels continue to grow. I was just wondering what they're actually at at the moment. Thanks very much.

Ben Stevens, Finance Director, British American Tobacco p.l.c.
Okay [inaudible] It's Ben here. Just struggling against the feedback. We're not going to give a separate figure on spend for NGP, but I can guide you towards Capex for the full year for BAT's excluding Reynolds. So, we're coming around 700 to 750 million Capex for the year, and that will include the extra spending on NGP. In

terms of contribution to revenue, again, I'll give you a bit of a clue on that in terms of our price mix figure. You will remember the price mix figure was pretty high at over 8% in the first half. About 0.6 of that came from NGP which is obviously a considerable amount of turnover at the moment as we grow. So, hopefully that's helpful. And I'll hand you back to Nicandro to talk about share.

Owen Bennett, Analyst, Jefferies

Cool. Thank you.

Nicandro Durante, Chief Executive, British American Tobacco p.l.c.

To answer your question about Glo, as I mentioned during the presentation, we are growing extremely well ahead of expectations in Japan. The share that we're experiencing in places like Tokyo, we've 3% in this retail chain. In Osaka 2.4 and the Miyagi region 6.1. They are above our expectations. And if you compare these with the numbers that you have reached in Sendai at the same period, three weeks, they're much stronger. So, we are very happy with the result so far.

Regarding your question, if -- is the Capex that is growing and you're taking share[?] on the competition, it's very difficult for me to say. I think it's best for you to ask the competition how they're doing, but we are growing very fast and we're very happy with that.

Owen Bennett, Analyst, Jefferies

Cool. Thanks very much.

Operator

Our next question comes from the line of Adam Spielman from Citi. Please go ahead.

Adam Spielman, Analyst, Citi

Hello. Thank you. Good morning. Some more questions on tobacco-heating products if I may. First of all, you say that Switzerland is going very well. In the past, you said that you thought that Japan was really the most, you know, the best market. I was wondering if you could just give your sort of personal guess as to a relative to market size between Japan, Korea and Europe. So, in other words, if share in Japan reaches, I don't know, X, in Europe, do you think it would be half X or quarter X? Second question, do you see any reason why in Korea you shouldn't have the same market share as iQos. The third question is do you think capacity will constrain your volumes at all this year and in 2018? In other words, can you give some colour on your capacity for Glo 6? Thank you.

Nicandro Durante, Chief Executive, British American Tobacco p.l.c.

Thank you Adam. All are very good questions. So, let me start with the first one about Switzerland. I reconfirm what I have been saying for a long time. I think that Japan is rather unique. The specific critical conditions come together in Japan, which is driving this exceptional performance of the category. For example, there is no vaping there. Consumers are exceptionally high on social consideration. It's is a very conformist consumer. Over index is 1 milligram of menthol and a love for technology of innovation. You're not going to repeat this in Europe. When I say this is ahead of expectations, it doesn't mean that there in Switzerland we are repeating the success in Japan.

Just to give you some data, after three weeks in Sendai -- after six months in Sendai, sorry -- after the same period of the largest Sendai that we are in Switzerland, which is around 15 weeks, in Sendai, the device penetration was 12.3%. Shenning Handlers[?] was 5.6%. In Switzerland, device penetration is 0.2; Shenning Handlers 0.2. So, they are -- when I say that the results are good according to our expectations, we are not expecting to have in Europe a Switzerland or in Vancouver which the results are similar, the same success in Japan for the unique characteristics of the consumers. So, I hope that answer your question. So, do not expect to have Switzerland having half of the success in Japan in the same period of time. This is not going to happen. The consumers are completely different so the potential is not the same. It doesn't mean that the category is not going to grow over time, but this is going to take much more time, and it's going to be much as lower. That's your first question.

Regarding Korea, you said do I expect to have in Korea the same results that the competition is having. Well, our objective is to lead the NGP category, to lead in vaping and to lead in tobacco-heating products. So, over time, I expect to have more than 50% of the category. That's our objective. That's why you are working. It is going to happen in the first six months, one year, two years I don't know. But this is our objective. So, I see no reason for not being successful in Korea as we are being successful in Japan.

The third question that you raised about capacity; our consumables capacity is going to increase four times between end of 2017 to 2018. And we have the ability today to supply more than double our current demand for 2017 and 2018. And by end of 2018, we want to be present in 20 markets. But the supply chain is complicated in this category. We have to use multiple partners and particularly on the device. However, the compatibility of Glo [inaudible] process in technology helps in flexibility and responsiveness. At the end of the day, the lead time for us to increase capacity to the category is around nine months. So, it's all about the successes that you're going to have going forward. It is going to be more than double that you're estimating. Yes, we may run into capacity issues, but that's a good problem to have.

Adam Spielman, Analyst, Citi

Can I -- thank you for this answers. I just want to come back on the on the capacity because you gave a lot of data which I didn't quite understand. You said it's going to be four times at the end of 2018 where it is at the end of 2017. And then you said in 2017, you can fully supply the current demand. Can you just expand on that last bit?

Nicandro Durante, Chief Executive, British American Tobacco p.l.c.

All I'm saying that we have launched plans for 2017 and 2018. And as I said, by the end of this year we expect to be in five markets. By the end of next year, we expect to be in 20 markets. What I'm saying is that according to our projections in terms of demand, we will be fully equipped to supply double that the demand that we're estimating for these five markets this year and the 20 markets next year. And as I said --

Adam Spielman, Analyst, Citi

So, what you are estimating?

Nicandro Durante, Chief Executive, British American Tobacco p.l.c.

Demand more than double than we estimate. We may run into problems of capacity, but it's a good problem to have; if you have more than double than the demand. And I said the lead time to create a new capacity is around nine months. So, you have early signs if the success is significant, then we can increase our capacity.

Adam Spielman, Analyst, Citi

Excellent. Well, that was good news. Are you able to say what you're expecting, what you're forecasting for demand?

Nicandro Durante, Chief Executive, British American Tobacco p.l.c.

No, we are not because we see that the markets that you're launching and the volumes that we intend to sell, no, we are not going to disclose this Adam.

Adam Spielman, Analyst, Citi

I'm not surprised. Thank you there.

Operator

Our next question comes from the line of Jon Leinster from Berenberg. Please go ahead.

Jon Leinster, Analyst, Berenberg

Thank you very much. Good morning. I'm afraid couple of questions still on the same subject. Just following up from Adam's, if you're going to be launching in the further 15 markets for Glo during 2018, does that imply a significant shift in the internal resources in terms of marketing and also sort of a big pickup in the sort of number of flagship stores around the world? So, is it going to be a big increase in marketing and does that reflect in a sort of reallocation away from the conventional business into next-generation products?

Nicandro Durante, Chief Executive, British American Tobacco p.l.c.

Jon, the reality there would be some resource allocation of course because if you are going to go for a big launch, for example in places like Korea, there will be conflicting priorities in terms of launches. You have the focus of the company. You need to be focused on one or two big launches during the year. There will be some reallocation, of course, but we expect to have an increase in marketing investment, not only in reallocation. We think that is a nascent category and that you demand some investments upfront, and not only in THP but in vaping as well. We're not talking about a lot about vaping here but we expect by the end of this year, beginning of the next year to launch two fantastic products Zip[?] and Three[?] that you have discussed this before, and Raptor[?]. And also there will be conflicting investments between the vaping and THP and combustible. But I think that we can manage it, but net-net there will be an increase in investment.

Jon Leinster, Analyst, Berenberg

Okay, thanks. Just quickly, on Russia, some of the other comments, again, a bit like yours been that there's been a big price-driven scenario then. On what stage are we? Has there been any price increases since say March in the marketplace and is there any sort of timeframe and that been resolved in itself or is this just a competitive situation we'll just have to see how it rolls out over the next year or so?

Nicandro Durante, Chief Executive, British American Tobacco p.l.c.

In Russia, these are very competitive markets. We are doing well there. I assume always we are growing share. Rothman is doing extremely well. But there was some absorption of excise at the beginning of this year. How the price is going to unfold, nobody knows. So we're happy to wait and see. These are very -- the only thing that I can see is a very competitive pricing environment nowadays. And the company is doing well in this competitive price environment.

Jon Leinster, Analyst, Berenberg

Right. And lastly perhaps in terms of the global market, I think earlier in the year you said the global market in volume terms you'd expect to be down by about 4%. I mean given that everybody's volume seem to be well below that in the first half, is that something which you feel still sticking to? Do you expect volumes in the second half on a global basis to show a significant improvement versus the first half?

Nicandro Durante, Chief Executive, British American Tobacco p.l.c.

I think that the volume declined for this year. We estimated to be around I said in the past 4 to 4.5. And I still think that's going to be around this. It's very difficult to be precise on those numbers as you can expect. So, I don't change my view for the year. We were a little bit higher the volume decline in the first half because you have this swing in Pakistan because of excise last year was at a different moment. We've had some loading -- it usually happens before an excise increase in the first half. But if you model this in a yearly basis, it should be around 4 something. I think that BAT is going to do much better than this because we're growing share.

We have a very strong share per performance, 30 basis points, 50 basis points in Global Drive Brands. Global Drive Brands now they are 50% of our portfolio, which is fantastic progress. If you go back to 2010 it was around 30%. So, we are doing very well. The Global Drive Brands is growing much bigger in our portfolio, make our life easier to drive growth. And so, I think that the second half is going to be stronger for us for the reasons that I highlighted. So, we haven't changed our views about the 4% and we haven't changed our views that they're going to perform better than this.

Jon Leinster, Analyst, Berenberg
Okay. Thank you very much.

Operator
As a reminder, if you do have a question for the speakers, then please press 0, 1 on your telephone keypad now. Our next question comes from the line of David Hayes from Bank of America Merrill Lynch. Please go ahead.

David Hayes, Analyst, Bank of America Merrill Lynch
Thank you, morning all. Three for me if I can. Just first I can just confirm the answer to [inaudible] the question. Do you say that the next-generation product contribution with 60 basis points to the pricing in the first half, so to make sure I understood that correctly. And I guess still NGPs, just trying to again get you to be a little bit more specific about the medium-term plans. I mean can you give us an idea when you think that you'll get breakeven based on current plans at least from that rollout of both vaping and heat not burn products?

Then secondly just on the cost savings and synergies at Reynolds, and even you had it for one day, so I'm not going to ask you to increase the $400 million expectation just yet, but you keep talking about being at least $400 million. I wondered if you can talk about whether you can sink in that point because there's specific areas that you think you can explore that aren't in that number or whether it's just you think potentially you can get deeper into the areas that you've already talked about? And then finally for me just on Saudi Arabia, I know it's relatively small. But we've had a big price rise there recently, I just wonder whether you can give us the quantum of your exposure to that and whether that will affect that number in terms of volume performance for the full year? Thanks so much.

Ben Stevens, Finance Director, British American Tobacco p.l.c.
Yeah, David, it's Ben here. So, yes, of the 8.1% price mix in the first half, 0.6 came from NGP. So, we can confirm that. In terms of the breakeven for NGP, I mean NGP is already profitable in a number of markets. Obviously as we roll out to new markets, then we invest in those markets. So, it's hard to give a sort of overall figure, but we expect NGP to be a positive contributor from next year. In terms of Reynolds, we've said at least $400 million of synergy benefit. We've only owned the company for 36 hours. So, it's going to take us some time to lift the hood on it and have a good look, and note the US referencing there rather than lift the bonnet, to take a good look at the 400 million and see what really is there and what time it will take to extract that. So, we'll stick to our at least $400 million of synergy benefits for the moment. And obviously, if we can achieve more we will do.

Nicandro Durante, Chief Executive, British American Tobacco p.l.c.
We had a GCC question. Yes, we have a significant excise increase recently. We expect the market to be down this year because of that around 11%. We expect as well some down trading. We think that obviously in previous segment and administration of premium and even value for money is going to be down to the low price benefiting from that. We have launched recently Pall Mall as a value-for-money brand and it's doing very well, and it's doing its role of absorbing the down traders. So, we are doing well, but the industry is going to be down at 11%.

I cannot be precise now how BAT is going to perform in the scenario because the changing pricing was significantly. I think that price is almost double, is we'll have some time for the consumers to get used to that and you'll see how this is going to work. But we estimate for the year around 11% decline. But that's a number that you have to wait and see. It can be 2% or 3% up or down, depends on how this is going to be received by the consumers because that's not an environment that we have seen many price increases in the past. So, it's very difficult to understand the elasticity there. So, we have to wait another two or three months to see how the market is going forward.

David Hayes, Analyst, Bank of America Merrill Lynch
Okay. Thank you very much.

Operator
Our next question comes from the line of Michael Lavery from Piper Jaffray. Please go ahead. Your line is open.

Michael Lavery, Analyst, Piper Jaffray
Good morning. Thank you. Just wanted to follow up on the capacity, a couple questions, you've talked about some of the limitations. Am I hearing you right that it's both on the device and the neo stick capacity side? And then related to that, as you look ahead with the expansion you expect for 2018, you've got Capex running this year about 100-150 higher. What should we expect for 2018 if you know we'll have 4x, the NGP capacity? Is it some order of magnitude of that incremental increase?

Nicandro Durante, Chief Executive, British American Tobacco p.l.c.
Your question Michael, the first one was about capacity in terms of device and consumables. If it is the question, then the numbers that I gave you in terms of four times more capacity next year in order to cope with our launch plans for 2017 and 2018. As I said, now we are present in three markets, we are going to be present in another two before the end of the year. One of those being South Korea, and you have another 15 for next year. So, all the numbers that I gave you for capacity they refer for both device and consumables. So, there's no difference.

For the second question, Ben would --

Michael Lavery, Analyst, Piper Jaffray
Sorry, if I just clarify something there. I guess what I'm curious is where is your bottleneck. Is the restriction that you're not able to make the devices as quickly or the consumables or are both of them constrained or at the moment is it simply a question of --are you saying you don't have capacity constraints at the moment and it's just a question of getting the demand to grow?

Nicandro Durante, Chief Executive, British American Tobacco p.l.c.
As I said, Michael, just going back to what I said before. We have capacity for these 20 markets. We have double the capacity for the demands that we estimate for the both markets. If the demand is going to be more than double that we estimated, may run into capacity problems. The lead time to build the new capacities either for device or consumables is around nine months. So, if you know early enough that we are selling more than double that we estimate, we can build capacity, but not less than nine months. So, the bottleneck is for both. If you sell more than double, then our forecast for the category.

Michael Lavery, Analyst, Piper Jaffray
Okay, sorry. That's very helpful. And then on the Capex side?

Ben Stevens, Finance Director, British American Tobacco p.l.c.
Yeah, I'm not going to give guidance for 2018 Capex, but obviously to the extent that our TPH product is successful, we'll be laying down capacity in line with what Nicandro has talked about. So, I would expect to see a growth in Capex in 2018, but we're not going to put a figure on that until we get a bit closer to understanding what the amount of capacity we need to, or the Capex we need to spend in 2018 because that will depend on our demand forecast for 2019.

Michael Lavery, Analyst, Piper Jaffray
No, that's very reasonable. And one last one, just when you look at the Vype flagship store in Milan and then some of the Glo stores like in Japan or Vancouver, do you imagine any opportunity to put both of those under one roof or do you feel like the message and the marketing is separate that you would want to keep those --

even if you're present with both products in a market, you would rather keep those separate or could that be a place that operates for both?

Ben Stevens, Finance Director, British American Tobacco p.l.c.

So, there's an opportunity to bring all of our marketing to NGP together. But you got to remember that individual markets that we're either driving ahead would say Glo, which should be a Japan flagship store or Italy, which should be more on Vype and Pebble and brands like that. Over time, we see opportunities to bring together, but at the moment we've got different stores in different markets.

Michael Lavery, Analyst, Piper Jaffray

Okay. Thank you very much.

Operator

Our next question comes from the line of Fulvio Cazzol from Goldman Sachs. Please go ahead.

Fulvio Cazzol, Analyst, Goldman Sachs

Yes, good morning, gentlemen. Thank you for taking my question. My first one was on the strong price mix of 8.1. You highlighted that 0.6 of that came from NGPs. Could you breakout the rest, i.e., how much was price and how much was mix? I presume that the decline in Pakistan would have had a significant benefit to the price mix line, please?

And then my second question is in Australia, you reported improving pricing and marginally lower volumes and market share gains. Do you think industry pricing power has now been restored in this market? And then my third question is just on Sendai. The data the chart that you provided on, I can't remember what slide this is, it's not numbered but, showing that in the first 10 weeks you went from basically 0% share for Glo to about 6%. And since then, over the past 20 weeks or so, it's only gained an additional 2%. Obviously, the overall 8% share improvement is quite interesting, but just wanted to know how you're thinking about future growth prospects in terms of share for that for the brand in Sendai. Thank you.

Ben Stevens, Finance Director, British American Tobacco p.l.c.

Yeah. Maybe I'll take the price mix question. Two of the big influences on price mix obviously one was Pakistan where, as Nicandro said, we had trade loading last year ahead of a big excise increase in the second half of the year. And then this year of course, you had the impact of that excise increase. Good news in Pakistan is that the excise structure has actually been changed by the government; so, expect a better performance in the second half. And then Ukraine, of course, where we are coming out of the price war with prices going up and volumes going down. So, if you put Ukraine and Pakistan together; you can probably take another 3% of that price mix. So, that takes us to an underlying price mix of around 4.5% in the first half of the year.

Nicandro Durante, Chief Executive, British American Tobacco p.l.c.

Yeah, question about Australia. Yeah, in terms of Australia, as I said before we had very good share growth of 70 basis points. The company is doing well. Winfield is doing excellently well. Rothman is as well. We have more price environment that was not as complex as last year that was very competitive. It's still very competitive, but we had excise increase and price followed. I don't know how this is going to unfold for the future because we don't make predictions about pricing. But nowadays is we are in a better situation that we were one year ago. That's the fact.

Regarding Sendai and regarding the potential for Glo, after three months in Sendai, we already had around 5% market share and you continually grow. The way that we measure this it's not only about the share, but the share has been growing week-after-week [inaudible]. It's difficult to grow market share in the first -- in the second three months as you grow in the first three months of course. But we look at device penetration, conversion rates, overall share. And in Sendai, week after week we are having a great performance. So, we're extremely happy with Sendai. And as I said before several times that when I launch the product in Sendai in December or six months ago, someone had told me that they will have 8% share after six months. Well, I would have said that I would be the happiest man in town, which is the case nowadays.

So, I'm very happy with that. What I said in the case of Tokyo is that you're having even a better performance there. And even more importantly is that awareness of the brand in the whole Japan outside Sendai is above 25% without any work done by the company, which helps, of course, the roll out. And one of the reasons that in Tokyo we're having even a bigger success.

And I think I'll take advantage here just to highlight the point that I made earlier about Switzerland Vancouver. And I said that don't expect the same results. And I like to highlight that the launch plan for these places, they are exactly the same ones that we implemented in Japan with exactly the same goal set, the flagship store. This is exactly the same amount of resource and the results are not similar because consumers are different. Places like in Europe in which Vype is available, social considerations are not so high, don't expect the same results. It's not for lack of investment, it is because consumers are different.

Fulvio Cazzol, Analyst, Goldman Sachs
Very clear. Thank you very much.

Operator
The final question comes from the line of Chas Manso from Société Générale. Please go ahead.

Chas Manso, Analyst, Société Générale
Yeah, good morning. I have a question on vapour and sort of the pricing outlook, the pricing strategy of vapour. This is fairly a lower unit price point than the heated tobacco. And I was wondering whether you see that price gap sort of narrowing over time and what your view is to get that up to -- you know, to get the revenue and the possibility up in that area where you have a global region.

And on combustible, previously you have sort of quantified how big your sort of top five tobacco markets were in terms of the percentage of profit. So, I was wondering whether you could do that again given that you've called out Brazil, Russia and South Africa as being a challenging market; and I think they're in the top five. And clearly, that's been offset by good performances elsewhere. So, maybe we should start to focus on how the top ten are doing maybe.

And the final question for me would be a Western-European pricing question. I think the price mix in Western Europe was less than 1%. And obviously there's been some absorption in France. And I was just wondering your view on the pricing momentum in Europe whether it's still in line with the traditional rates or whether you see sub-pricing[?] in Europe slowing down?

Nicandro Durante, Chief Executive, British American Tobacco p.l.c.
I'll try to answer your question. If I understood well the first about vaping, you were talking about market prices. So, let me take advantage to talk a little bit about vaping here. And let me start by saying why you believe in this category. If you look at 2016 against 2015, we have 60% more consumers in the category than one year ago. We had -- well, I'm talking about vaping in the top 40 markets outside United States. We had in 2016 24 million of users as compared back to 15 million of users in 2015. So, penetration clearly is not an issue because the penetration is much, much higher than tobacco-heating products, much, much higher.

The problem is the depth of usage. And the depth of usage is going to be solved by quality products. And we think that's what we have been working so hard. We made such a huge investment in the last six years to develop an outstanding set of products for consumers. And that's why I said we had good products already. We are leaders in more than 50% market share in Poland, 41 in UK. So, we have leadership in several markets in Europe. We are leaders already outside United States in the vaping category. And Vype is probably the biggest brand in the category already. But we think that with ePen III and Raptor coming at end of this year, first half of the next year, I think that we have a good chance of crack the product quality. And if you transform consumers from with this high penetration to conversion, and I think that the category is going to be a fantastic category and very profitable going forward.

Regarding your questions on the pricing, prices are moving up. But, as I said, you price up as soon as you have outstanding products that differentiate yourself against the consumers. Our products are already priced above the market with Pebble, ePen II and so and so forth. These new products that you come to the market, we'll have a good pricing, good margins. And the margins [inaudible] they are in markets between two, three, four times than combustible. So, I don't think that we have a problem with margin, we don't have a problem with penetration, we have a problem of conversion. And the quality of the products is going to define how we are going to do that, how we are going to do on that category.

The second question about combustible, you said in the top five markets. Can I ask you after the call have a chat with Mike because I don't know what has been released so far top five markets that you said. I'm not aware about that. If you don't mind, Mike, you talk to you about and check exactly what you need and then take from that.

And the third question is about Western Europe pricing. Obviously, we don't give any forward-looking for pricing. We have some absorption, as you know was a little bit tough in the past in Italy. We had some absorption this year in France. On the other hand, in some other markets, price is moving quite well in places like Romania and so on so forth. So, it's a mix situation. So, prices is a little bit -- if you talk about Western Europe as a whole, prices are not as strong as they were last year. That's what I can say. How this is going to unfold? As I said, we don't make predictions on pricing. There are so many elements that you have to take into account. Europe is extremely competitive market as you can expect. So, you have to see how the things will go.

Chas Manso, Analyst, Société Générale

Okay, thank you.

Operator

I'll now be handing over to Nicandro Durante for any closing comments.

Nicandro Durante, Chief Executive, British American Tobacco p.l.c.

Okay, guys, thank you very much for joining us in this conference call. If you have any further questions, please give Mike a call. Thank you very much.