Imperial Tobacco

Morocco Factory Visit
Americas Presentation
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Who's Presenting

Good morning ladies and gentlemen, my name is Jonathan Cox. I have been at Imperial for 17 years and, following the acquisition of Commonwealth Brands in April 2007, became the General Manager for our non-cigar US operations later that year.

Agenda

I'd like to spend the next 25 minutes or so giving you an overview of our Americas division. I will concentrate my comments on the USA and those sectors covered by Commonwealth Brands as this market is by far the largest contributor to the Americas division.

Fernando Dominguez, our cigar business unit Chief Operating Officer, will cover off our USA cigar position as part of tomorrow's roundtable discussions.

In terms of content, I will start by giving you an overview of the USA followed by an update on the status of the FDA Bill. I will then look at the tobacco market, including the impact of April's State Children's Health Insurance Program or "SCHIP" bill and our performance so far this financial year. I will also outline where we currently believe the market will be in the medium term and how we will ensure the sustainability of our business in that environment.

Overview – volume, share and profit growth

Before we go into the details, here are a few items that may be of interest and go some way towards setting the scene.

At around 300 million people, the USA has the third largest population in the World behind India and China, and in fact the combined populations of the three largest metropolitan areas - New York, Los Angeles and Chicago are roughly equivalent to the whole of Spain.

At 14 trillion dollars, it is easily the World's largest country in terms of GDP, more than Japan, Germany, the UK and France combined.

At around 47,000 dollars of GDP per head, the population is relatively wealthy – which, incidentally, makes tobacco products relatively cheap – but try telling that to the consumers.

In practice though, the USA is not a single country, but effectively a trading bloc made up of 50 individual states.

That said, like Scandinavia or the Balkans, some of these states tend to homogenise into groups, and in the US there are arguably 9 regions and 5 independent states. Each of these have fairly distinct cultures, different tax rates and, in some cases, different rules, some of them quite bizarre. For example in North Carolina, where we have our factory, it is illegal to use an elephant to plough cotton fields.

On the political front, for the first time in a long time, the process has alignment, in that Congress, the Senate and the President are all Democrats or hold a democratic majority that is "philibuster" proof.

Some would argue that this has, and will, make for some fairly radical legislation that may not be as well thought out as under bipartisan rule.

The current priorities of the Government fall into three areas. Firstly, Healthcare Reform, and we are now all familiar with the SCHIP legislation, which has had a significant effect on the tobacco market. There is also the "war on terror'", or more specifically the funding of it. Thirdly, is the economy, unemployment is at 9 per cent and growing, there is potential for deflation and there is a 730 billion dollar trade deficit. The focus is also on clearing the logjam in the credit markets and to some extent re-regulating the financial institutions.

From a tobacco perspective, the current and medium term environment will be dominated by the impact of April's SCHIP implementation coupled with the forthcoming FDA regulations.

From a company perspective, our priorities remain the same as they ever were, sustainable growth in volume, share and profit.

FDA Introduction and Context

Before going into the market dimensions and our business performance I want to update you on the current status of the FDA, the implementation of which is likely to shape the long term future of tobacco in the USA.

The Bill has been in discussion since 1996 and has changed little in terms of its underlying provisions since then.

Anthony Hemsley, Commonwealth's VP of Governmental Affairs, is here and a veritable expert on the machinations of the US Government, and he will be more than happy to answer your technical questions in the bar later.

FDA Bill – The Process

As you know the FDA has now passed through Congress and Senate and was signed into law last Monday by the President.

This slide describes its process through the legislative machinery with Congress passing the Bill in April and the Senate in June.

Whilst Imperial has always supported fair and reasonable regulations, the FDA Bill is not actually regulation per se but a loose framework for the FDA to create specific tobacco controls at will over time.

As such, Imperial did not and does not support the bill because it gives the FDA which is, some say, overburdened already, freedom to make sweeping changes to tobacco regulation without further consent of Congress, and little consultation with the industry.

For example, the FDA will not be able to ban nicotine but it could reduce the nicotine content to virtually nil without consent from its masters. Also, whilst the FDA will start with cigarettes, its remit allows it to expand its control over all other tobacco products including smokeless and cigars, at any time. We expect that within 24-36 months, the FDA will have all tobacco products under its direct control.

That said, we do know certain things – not least, how much it is going to cost. We also know some of the priority areas of focus.

FDA Bill – Post Enactment

In terms of post enactment key milestones, user fees shall be levied on all manufacturers from Day 1. These will be calculated quarterly and shall total 85 million dollars for 2009 (pro rata), 235 million for 2010, 450 million for 2011 – up to 712 million for 2019 and annually thereafter.

To put this into context: based on estimated annual cigarette market volumes of 320 billion, the 2010 levy will amount to between one and two cents per pack.

12 months after enactment, we shall have to comply with new marketing restrictions that will limit our point of sale activity to black and white text only and also introduce new, larger health warnings on our packs.

Two years after enactment we shall have to comply with new pesticide restrictions and 3 years post enactment our manufacturing facility will have to be GMP, or good manufacturing practice, compliant, that is once GMP has been defined for tobacco manufacture.

FDA – Our Position

So how are we positioned against this backdrop?

Although the changes brought about by the Bill will be significant for the USA and shall require the investment of time and resource for compliance purposes, we are confident that operating under the regulatory authority of the FDA will have a minimal impact upon our business.

If anything, we are at an advantage, given our experience of operating in darker markets, and markets that are even further advanced in terms of tobacco control regulation.

Our portfolio of brands across different product categories leaves us well placed compared to many of our competitors, some of which will find the hurdle of compliance just too steep, which may offer more opportunities for us.

Additionally, our network and ability to engage with congress and the various administrations will allow us to be involved in guiding the development of the various regulations at each stage.

So that's the regulatory side, I'd now like to take a look at the market, our business performance and our opportunities.

Market Dimensions – volumes

This slide shows three charts, together illustrating the consumer shifts within the US market, starting on the left.

The bar graph illustrates how the market was broken down in 2004. In total it amounted to around 438 billion stick equivalents and as you can see the vast majority or 90 per cent is made up of cigarettes, smokeless amounted to around 6 per cent, with fine cut tobacco and cigars being around 2 per cent each.

The middle chart illustrates the growth of each sector. Cigarettes – the red line, has declined by around 12 per cent whilst smokeless has grown by 22 per cent, cigars by 45 per cent and fine cut tobacco by nearly 60 per cent.

Given that smokeless, cigars and fine cut tobacco were relatively small in 2004, these growth rates coupled with cigarette decline has led to no real change in the overall market picture.

The chart on the right hand side illustrates the position in 2008. The market totals just over 400 billion units, which represents a total consumption decline of approximately 8 per cent, or roughly 2 per cent per annum.

At this point, cigarettes represent 85 per cent of the total, with smokeless amounting to nearly 9 per cent with cigars and fine cut tobacco accounting for 3 per cent each.

So, despite some of the hyperbole, cigarettes still represent the vast majority of the tobacco market, that said this sector will continue to decline whilst the others are expected to grow.

Market Dimensions – gross margin pool

Converting these volumes into relative values gives an idea of the total US manufacturers' margin pool. After discounts, which are significant in the US, we estimate that the total industry gross margin pool amounts to around 20 billion dollars, which makes it the largest in the world.

Of this 20 billion dollars, we estimate that cigarettes make up approximately 15.8 billion, around 80 per cent of the total. Smokeless, despite only being 9 per cent of volume, accounts for approximately 13 per cent of value, although the current price repositioning by UST will change this in 2009.

Otherwise cigars amount to approximately 6 per cent with the fine cut tobacco category making up the difference.

The market is serviced by a relatively large number of manufacturers, but nearly 90 per cent of all the margin streams are generated by just three.

Philip Morris USA, with a strong cigarette presence, combined with UST in the smokeless category and John Middleton in cigars together account for approximately 55 per cent of the total under the Altria banner.

Second is Reynolds which owns Conwood and has just under 30 per cent of the cigarette market and approximately 40 per cent of the smokeless category. In combination these amount to approximately 20 per cent of the total tobacco industry margin.

In third place is Lorillard, who operate solely in the cigarette category but enjoy around 15 per cent of the total industry margin pool.

Imperial with around 4 and a half per cent share in the cigarette market, 30 per cent of the cigar market and around 10 per cent of fine cut tobacco volumes is the fourth largest player with around 3 per cent of total industry margin.

Despite the size of the large players, and given that price increases are relatively assured in the short to medium term, even fairly small players, such as Imperial, generate a substantial profit and we anticipate that we will continue to build on our position with further share and margin gains.

SCHIP: Consumer Prices

Up until 2009, the market could be described as being fairly benign and therefore fairly predictable. You are all aware of the recent Federal tax increases off the back of the SCHIP bill in April, and you will also be aware of the trade destocking at that time.

In combination these formed what is probably the greatest "market shock" since the MSA introduction some 11 years earlier and so it is worth highlighting a couple of points.

From the start of 2009 until April 2nd, the average retail price of cigarettes rose by approximately 25 per cent. Most reports highlighted the impact of the Federal Excise Tax in isolation and overlooked the other component parts, which are highlighted on the chart such as the 90 cent MPIs in February and March, the State tax increases which have crept up throughout the period, and trade margins which have improved significantly.

I mention this because the consequences of the SCHIP bill still have some way to go, particularly from a State perspective.

Here, the State Governor's are looking at repairing their own balance sheets and see increasing the State Excise Tax on tobacco products as an "easy win".

To date there are an unprecedented amount of SET changes on the books, 24 in total, and these range from 32 cents per pack in Maryland, to 2 dollars and 1 cent per pack in Vermont.

If these are all passed, then a further 16 per cent would be added to consumer prices, making 41 per cent in total. However, we think that only around two thirds will in fact be passed, which would reduce this amount to around a further 10 per cent before the end of the year. That is before any further MPIs.

As such, consumer prices will have risen by approximately 35 per cent from the start of the year to the end of it and this will no doubt have a significant impact on market volumes.

Going forward into 2010 and 2011, as with other commentators, we expect that price inflation and market volumes will return to their underlying trends of 8 per cent consumer price inflation and 4 per cent volume decline respectively.

SCHIP: Volume and Margins

However, some of that volume impact has already been felt. The Maxwell report for the first quarter of calendar year 2009, indicated that total cigarette volumes were down 10.4 per cent by the end of March, more than double the decline of previous years.

You are also aware that there have been two price increases in the same January to March period which amounted to an average of 9 dollars per thousand, or 18 cents per pack, and were taken by virtually all brands either as a list price increase or changes to discounts in the market.

This slide illustrates the impact of both margin and price to the various price segments. For example if one had a brand in the Premium Sector, and it followed the sector change, then one would see a volume decline of almost exactly 10 per cent when compared to the same period last year. The 9 dollars per thousand increase represents a unit margin uplift of approximately 13 per cent. Taking the volume decline compounded by the unit margin gain gives a net dollar margin gain over the period of approximately 1.7 per cent.

In terms of sector volumes, as you can see the high price declined a little ahead of the market at nearly 11 per cent, the mid-price sector dropped by nearly 13 per cent, and the low price sector by nearly 7 per cent. At this point I should caution you that certain brands have moved price category over the two time periods being compared.

That said, and stripping out these movements, there is strong evidence of downtrading occurring in the market, which I will touch on later.

The second factor illustrated is unit margin. Obviously, the price increase effects the unit margins more strongly the lower down the price points one travels, so whilst this is worth a 13 per cent unit margin gain at the premium end, that same increase is worth around 45 per cent at the low end of the market.

The net dollar margin gain compounds the volume and price elements to give a view as to the overall net dollar margin one could expect for a brand when comparing it to the same period last year.

This data is all in aggregate form, and one can surmise that those manufacturers who have not been able to off-set their volume declines with sufficient margin increases may be pre-disposed to take further MPIs.

Market Dimensions – cigarette price tiers

As I mentioned earlier, there has been some evidence of downtrading in the market, and this slide compares the market data for the four months spanning the SCHIP introduction – in other words February through May.

The graph separates out the price categories in the market in terms of what a consumer would be likely to see, which because of various discounts at both wholesale and retail, may be very different from what one could surmise from a simple analysis of the manufacturers' list prices.

Here there are five segments running from premium to bottom with what we believe to be their respective margin ranges detailed across the bottom of the chart.

In terms of movements, one can see that the premium sector, mainly thanks to Newport has grown slightly in terms of share, and please bear in mind we are talking about market shares rather than volumes.

What we call the high price sector, which is essentially made up of two brands, Marlboro and Camel, has declined by around 2 percentage points over the four months.

Over the period the Pall Mall promotion moved it from a mid priced brand to a low price brand such that it distorts the numbers.

Nevertheless, and with Pall Mall stripped out, this sector also suffered as consumers moved to the low and bottom priced brands.

There has been some commentary that supposes that those consumers that have downtraded will, in the relative near-term, review their choice and revert back to their previous brands. We have yet to see any evidence of this and expect downtrading in the market to continue and it will be some time, and possibly not for another 12 months, before we see a new market equilibrium emerge. As such, I am not in a position, or at least not one of comfort, to be able to place any predictors on the future price segmentation at this time.

Our Cigarette Performance

Now looking at our cigarette performance, over the past few years our results have been robust and we have outperformed the market.

Despite the de-stocking in March, calendar Q1 volumes, the second quarter of our financial year, were down 6.4 per cent against last year, but still much better than the market. Additionally, our financial performance was bolstered by significant improvements in margins through the two MPIs in the period.

Our Portfolio Performance

From a brand perspective, our core portfolio has faired well with both USA Gold and Sonoma registering share gains from last year, despite the recent actions of both PMA and RAi.

In addition, and in terms of portfolio development, Davidoff, at the premium end, has started to gain some traction in urban areas which gave us enough confidence to launch the Slims variant in March.

Otherwise, over the second half of last year we ran market tests for Fortuna in both Texas and Florida. We have since released the brand to other areas, including New York, California and Chicago. I am pleased to say that this has gone well with volumes in the April to June period estimated to be well over 10 times that of the first calendar quarter.

That said it will take a long time before either of these offerings will reach the materiality of either USA Gold or Sonoma but they constitute investment in the medium to long term sustainability of the business.

Our Performance – FCT, papers & tubes

Outside of the cigarette sector, the fine cut tobacco and non-tobacco categories are performing very well.

This slide illustrates very strong year on year growth for fine cut tobacco which has more than doubled in volume terms. In addition, the papers and tubes business, in combination, has shown a 16 per cent uplift.

Market Dimensions – fine cut tobacco

In April, and given the relative rate of increase in taxation on fine cut tobacco when compared to cigarettes, one could reasonably expect that these categories would come under considerable pressure.

However, that does not appear to have been the case and all three have proved to be extremely resilient. This is because some manufacturers, most notably us and Republic, anticipated the issues and moved production to expanded tobacco.

This slide explains that transition.

Firstly, and for those that are not familiar with the terminology, 'expanded tobacco' takes raw tobacco and by a process of heat and pressure increases its physical volume. Obviously the trick is to do this without adversely affecting the product characteristics and I'm pleased to say we are probably the world's experts.

What this means for the US is that one can now offer a product that is optically the same as a non-expanded product but weighs roughly half as much – which is handy given that the taxation on fine cut tobacco is weight based.

The chart on the left hand side compares average fine cut prices with the cheapest freely available cigarettes, pre-SCHIP. Here a 1 pound bag of non-expanded fine cut tobacco cost the consumer around 19 dollars, whereas a carton of 200 factory made cigarettes would cost around 14 dollars.

I should explain that some people, and I'm not one of them, can make more that 200 cigarettes from a 1 pound of fine cut tobacco. At this point the difference is about 5 dollars and 3 cents or 36 per cent when comparing one product to the other.

The chart on the right hand side looks at the situation post-SCHIP and adds the change in Federal Tax, manufacturer's price and the relative increases in trade margins to both cigarettes and fine cut tobacco. As you can see the price of the same cheap, freely available factory made cigarettes has increased by 8 dollars to 22 dollars for 200.

The next column illustrates what has happened to the non-expanded product. Here the FET increase of over 23 dollars per pound coupled with trade margin increases has seen the product rise to a retail price in excess of 47 dollars.

No matter how good you are at rolling or tubing tobacco, at that price there are few if any consumers who rationally choose that option over cigarettes, and so those who sounded the 'death knell' for the category were reasonably justified.

With expanded tobacco however, much of the impact of taxation and consequently on trade margins, has been mitigated. In the far right column you can see that at a unit price of 26 dollars and 44 cents at retail, the new expanded products are only 5 dollars and 44 cents or 26 per cent more than the cigarettes.

All that leads me to two important points for Imperial, firstly, the category will continue to prosper and no doubt continue to grow at historical rates.

Secondly, because a number of manufacturers, who have chosen or are not able to expand their product, have left the market, one could suggest that our share in that category will also continue to grow.

Market View – Medium Term Market View - cigarettes

Now the dangerous slide, which looks at the cigarette market over the medium term, and by that I mean in the 24-36 month range, and I'll start by saying that, whilst there is a significant amount of analysis behind this slide, all the numbers will no doubt prove to be wrong, so don't quote me on them!

These numbers are however our best guess of how things will look once the current, somewhat capricious times are behind us.

By way of explaining what the slide says, let me take you across the top line. At the moment we estimate the cigarette volumes which are part of the Master Settlement Agreement or MSA to be around 334 billion sticks at an average net margin after discounts of 47 dollars and thirty cents per thousand. This generates a margin of 15.8 billion dollars in the year, which you will remember from my earlier slide.

Over the medium-term we expect this volume to have dropped to 273 billion, but the margin per thousand to have increased to 63 dollars giving an overall gross margin of 17.2 billion dollars. This movement represents a volume decline of 18 per cent against an industry total dollar margin increase of 9 per cent.

I'm not going to take you through each line of this analysis but instead point out some of the salient points.

I just talked about MSA cigarette volumes, but these are not representative of the total category. We do not expect the non-MSA cigarette volumes to grow as they are constrained by regulations but we do expect the illegal trade in cigarettes to increase significantly in volume terms. In combination we expect total cigarette volumes to decline over the period but total gross dollar margins to increase by 10 per cent.

As I said earlier, all these numbers are exactly wrong, but they are roughly right, and they give us a good indication of the medium term trends we are likely to encounter.

And it is against those trends that we constantly measure our current business model to see if there are any changes to be made.

Our Business Opportunities

With cigarettes at 80 per cent of the total profit pool and with our share of that segment being over 4 per cent, there is plenty of opportunity for growth. Put another way, 19 out of 20 consumers do not use one of Imperial's products on a regular basis and by converting an additional 1 out of 19 effectively doubles our share.

All of the above leads one to a fairly obvious strategy which involves concentrating on what we do, and doing it well. Tactically this has and will continue to involve investment into brand advertising and promotion as well as increasing the resources at the point of sale, whether that be in terms of sales-force or promotional activity.

On a brand basis, the core portfolio of USA Gold and Sonoma will continue to receive the emphasis of effort in a bid to improve their distribution, share and ultimately their volume positions. At the same time, work continues on expanding the Davidoff pockets as well as supporting the Fortuna growth.

And, I have spoken a lot about our fine cut tobacco position and the opportunities we have there.

In all, we believe that Commonwealth is in a strong position to continue its growth momentum and see no compelling reasons to divert from the current business model.

Thank you ladies and gentlemen. I will now take any questions that you might have.