Imperial Brands

Barclays Global Consumer Staples Conference, Boston

Fireside Chat with Stefan Bomhard CEO, Lukas Paravicini CFO and Gaurav Jain (Barclays)

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Gaurav Jain: Good afternoon, everyone. Thank you for being here. I'm Gaurav Jain, Barclays' Head of Global Tobacco. With me today, we have Imperial Brands management: Stefan Bomhard, CEO of Imperial Brands; and Lukas Paravicini, CFO of Imperial Brands. Thank you so much for giving us the opportunity for this fireside chat.

Now, when Stefan joined Imperial in July 2020, Imperial was what many investors thought as uninvestable, and the stock bottomed out at 4x P/E during the worst of COVID. And I used to think, how low can a stock go? And for me, Imperial was the test case. But yes, stocks can go to 4x P/E, is what I learned.

Since July 2020, including dividends, Imperial has returned 106% – all numbers through today – and it has outperformed every tobacco stock, bar Philip Morris, and also handedly outperformed MSCI World Staples Index, which has returned 42% since he joined the company.

Now, while this is interesting, what is even more interesting is that Imperial has actually outperformed S&P 500, which is up 92%, and NASDAQ. Now, this surprised me, but NASDAQ is up only 79% since Stefan became the CEO.

And despite all of this, Imperial only trades at 7x P/E.

So, Stefan, the first question is, can Imperial continue to outperform all the indices as we look out over the next few years?

Stefan Bomhard: I mean, Gaurav, first, it's exciting to sit here and with you quoting the facts as the reflection of the progress we've made.

Look, nobody can give you or anybody a guarantee about the future, but I think what for me is exciting is we are today a different company than we were four years ago. And I think the capabilities that we've built from a people perspective, process perspective, clarity about strategy will serve us well in the future as well. So, I can't give you a guarantee where the stock will sit in four years' time, but I think what I feel very good about as we go in the future, we're better placed to perform well in that context.

Gaurav Jain: Sure. And you know you launched your strategy now four years ago, the five-year strategy. So, since that time, what has surprised you? Where do you think you are ahead? Where do you think you are behind?

Stefan Bomhard: I think, number one, what's exciting – and you referred to the share price performance – I think what's exciting is that we're now year four of a five-year strategy. And if you look at it, the circumstances in which these results have been delivered – I mean, most notably, consumer; I mean, the inflation that we all have experienced – are noticeably different versus what we thought it would be like, and we've delivered exactly what we promised four years ago.

Now if you ask me about what has surprised positively, negatively, I think on the positive surprise side, Gaurav, what I'm truly excited about, it was clear that there were certain capabilities that Imperial did not have and it needed to have as a consumer goods company. And the ability for us as an organization with a quite mixed track record, as you said, to attract top talent into the organization – if you look at the executive team today, you can arguably say this is the most consumer goods-focused management team of any of the tobacco companies, with virtually everybody having background in consumer goods – I think has surprised me, the ability to attract. Because normally, people say it's hard to attract top talent in the industry. And I think I'm quite happy with the progress. I know it's a positive surprise.

I think the other positive surprise for me was the quality of people I found in Imperial, because there are many good people. And the ability of our organization and our people to embrace what has been a very meaningful change, and a clearly very different direction of where we're driving to, was a very positive surprise.

So, the two combined I think have set us well for the change agenda that we have gone through in the last four years.

If you look at the negative surprises, I have to admit when we shared at the Capital Markets Day in January 2021 our commitments, what numbers we wanted to achieve, we couldn't foresee that we would face the single biggest event on price inflation and that we would have to deal with a war in Europe, which led us to have to leave our Russian business and have significant knock-on effects on many of our European businesses. And logically, the effects of regulation and the lack of enforcement of some of the regulation, I couldn't have foreseen in January '21.

And therefore, from this perspective, I'm really happy that we've delivered what we promised now four years ago, despite some circumstances that clearly were more difficult.

Gaurav Jain: Sure. So, Lukas, you're now in the fourth year of the five-year plan, and the way the guidance was spoken of in 2021, that there will be accelerating growth through this period, it would imply that next year you are looking at 6% EBIT growth. Is that still the expectation?

Lukas Paravicini: Let me just go back to the five-year plan. As you pointed out properly, the five-year plan was always built in two phases. The second phase, in which we are now, was all about accelerating our adjusted operating profit closer to the mid-single digit. And I think if you could see back in '23, we have accelerated that adjusted operating profit nicely. This year will be another year where we accelerate further the operating profit.

So, well on track to what we have said to get close to that mid-single digit, and we will come back to you and the market in November to give guidance to the next year. We are focused on this year to deliver that acceleration, but we are well on track what we have said in our Capital Markets Day of accelerating to the mid-single digit.

Gaurav Jain: Sure. So, now that we are in this fourth year of the five-year plan, should we expect a new three-year or five-year plan sometime in FY25? Or would you like to move to an annual guidance kind of framework, given the significant changes which are happening in the industry?

Stefan Bomhard: Gaurav, the number one focus, as Lukas touched upon, is about right now, deliver this fiscal year and deliver the final year of our current strategy. And that is kind of where priority number one sits.

But it's very right to ask what happens after September 2025. So, in the background, Lukas, myself, the rest of the executive leadership team, and the extended organization is now carving out time to think what comes afterwards. At the same time, you will probably understand it's a bit premature to say, is that going to be another five-year program, is that going to be another – or is this going to be more an annual rhythm?

I think what I can give you the confidence on, some of the things that inspired the current five-year program are probably going to be the same, and I'm talking a bit more about the process. I think one thing I felt very strongly about when we developed the current strategy, it starts with the consumer. The consumer decides, because they're the people buying our products every day.

And it also starts with the facts. Because if you remember, the discussion was about it isn't what the industry wants, it isn't what some people want. What are the facts? What has been the growth of NGP? What has been the market size development?

So, these principles, I think it's very fair they're probably going to be the same as we develop our program, going forward.

Gaurav Jain: And just continuing on the topic of stock prices, clearly, the U.S. tobacco stocks, they are seeing a lot of interest. They are trading at much higher multiples than U.K.-listed tobacco stocks. So, do you think Imperial can move its listing from the U.K. to the U.S., like some other firms in the U.K. have done recently in other sectors?

Stefan Bomhard: I think it's very right, if you look at total multiples, the U.S. market has higher multiples than the U.K. No doubt about it. And also when you look at our industry peers, the US-listed ones have higher multiples than us.

At the same time, I think there are two things I think that are important. The one is the very practical nature. Today, as you will know, one of the requirements is about that the majority of your turnover would be in the U.S., which is not the case for us. The U.S. is a very important market, our single most important market, a single country, at around 35%, but it's well below the majority of our business.

And as you will know, also one of the big things is that any relisting of a company would require different reporting. But most importantly, it would require for today's shareholder base to actually approve and support a move to a listing to the U.S., which is quite a high hurdle rate.

So, I think what is right for us – and what we have worked very hard, and participating in your conference here is one of the examples – we have been more reaching out to U.S. investors, making sure that the Imperial story is present with them at events like this and in one-to-one meetings.

In principle, the focus of our philosophy very clearly is we're here to create value for our shareholders. And at this point in time, the focus for us is to deliver the program. And as the numbers that you shared before, I think we're making good progress. But that is, I think, how we see it, is priority number one to create value for our shareholders, irrespective of where we're listed.

Gaurav Jain: Sure. Lukas, so your key peers in the U.S. – Altria and BAT – are barely growing EBIT in the U.S. in FY24 and will also be growing U.S. EBIT in FY25, which will be likely below what we discussed as your real expectation. So, now, 6% EBIT growth, you don't talk about which would be the contributing factor, but assuming it is equally divided across the three segments that you have, neither Altria or BAT's U.S. business will be growing at 6%. That's our estimates.

So, do you think this creates risk for you long term, in that this can be interpreted as that your key competitors are investing more than you are?

Lukas Paravicini: I think when you look at that question, you have to probably go back and look at the differences that exist between us and the peers. Imperial has the broadest portfolio. We can reach all consumers at each of the price points, which is a defining feature of Imperial in the U.S. It's a key feature, especially in a market where you also have down trading, which is another feature of the industry in itself.

Whereas our peers, their margin pressure comes probably more from the fact that their portfolio is more biased to the premium segment. And so, their margin pressure comes from that, on top of the volume pressure that they have. So, that's quite different from where we are.

We are well positioned in this market. And so, your fears of other people investing more is probably not relevant. We are in the right segments, with the right price points, and investing behind our brands sufficiently. And I think that's probably the biggest difference.

Gaurav Jain: Sure. So, Stefan, just now let's talk about the U.S. cigarette market, which is still the largest in terms of profit pool, if not volumes. And the volumes in U.S. cigarette markets have remained pretty weak, on comps which were already weak. So, is minus 9% the new normal in U.S. cigarettes? And if that's the new normal, how confident are you in continued growth in your U.S. tobacco business?

Stefan Bomhard: Sure. Nobody can give you a definite answer, but I think from my perspective I don't think the 9% volume decline in the U.S. is the new normal. Because what doesn't change? If you look at the average price of a pack of cigarettes in where U.S. consumers buy it – probably not here in Boston, but more in the South, in the Midwest – it's still one of the more affordable pack prices versus other markets. So, the ability to continue to price in this market is absolutely intact.

I think what we're looking at right now, there are two special effects that increase the market size decline, and they're well covered and our more U.S.-focused competitors have published quite some information about it, which we agree with. Fundamentally, you have two effects. Macroeconomically, the U.S. consumer is under pressure; especially, the lower-income consumer is more under pressure. That means their disposable income is more squeezed than before. Which we think, because as inflation levels are still at elevated levels in the U.S., if this becomes the more normal level, we should see some of that pressure ease. And that should help market size also for combustible cigarettes.

Number two, the reality is you are seeing in the last 18 months a significant amount of cigarette smokers or duelists who have used vapes use disposable vapes. And fundamentally, because these are all illicit products, as you well know – none of them approved by the FDA, nobody knows what's in it because they've not been tested according to U.S. regulations – per puff, they are significantly cheaper. And therefore, as consumers economize at this point in time, as long as this offer is illegally in the marketplace, you will have consumers use these products. So, that is impacting the market.

Now, the reality is I'm a big believer that the U.S. government is still one of the best governments, in the sense of having clear regulation around a category and also enforcing it. So, I can't tell you about what time, how much longer it will take for the U.S. government to enforce these rules that is written in a highly regulated industry, if I may say, more consistently. But I have to believe there is going to be a tailwind from increasingly a more consistent enforcement of the rules that the U.S. government has written to protect its consumers.

Gaurav Jain: Sure. Now, just remaining still on the U.S. cigarette market – and just as a reminder, the U.S. cigarette business is about 80% of your overall U.S. profits – we have had an acquisition recently. Japan Tobacco is entering the market; they are acquiring Vector Group. They have said that the combined market share of the two companies will be 8%, and your market share in U.S. cigarettes is about 9.5%. And they will also be playing in the discount cigarette segment. So, how does that change the competitive landscape for you?

Stefan Bomhard: I mean, logically, I can't tell you, because I'm not Japan Tobacco. I mean, they will define what strategy they will have once there is approval on the acquisition.

What I can tell you is that Japan Tobacco is a very well-known competitor to Imperial. We compete in many markets across 120 countries in the world with Japan Tobacco. So, it's a very well-known competitor to ourselves.

The other thing I would look at is the acquisition, the potential acquisition, of Vector by Japan Tobacco will give, as you rightly point out, Japan Tobacco a much bigger presence in what is the deep discount segment. That is where one-third of our business sits. Two-thirds of our business does not compete against that. That's an important distinction.

And I think, therefore, we feel – today's assessment of us, I don't think it will dramatically change the dynamics of the marketplace.

And there are probably two important points I would add. Because of the unique regulatory nature of the U.S., that you cannot launch new brands into the U.S. market, that does mean that Japan Tobacco will compete only in one segment.

And finally, I wanted to build the bridge back to one of the other questions. I think one thing not well understood and not well talked about, I think we need to look at it in the perspective this is a company that has a very long-term point of view. And they've just placed – this is the single biggest acquisition they would have done in many, many years. And the way we look at it, they've just put a big investment into the U.S. market, in what I would see as a signal of confidence that the U.S. combustible market will continue to be a very attractive market for many years to come. Otherwise, you wouldn't have invested shareholders' money into the U.S. market.

Gaurav Jain: Sure. Lukas, a couple of questions for you, because some of your peers have commented on these topics. So, one is – and this is focused on the U.S. cigarette market – that there is the end of the MSA legal settlement bill, which happens in December 2024. And that amount total is at $500 million capped for the industry, and everybody has some share in it. And

Altria has disclosures on this in their 10K. So, the question is, how much did you pay in FY24? And then, will that go away for you also in FY25? And how much is the benefit from that?

Lukas Paravicini: So, as a smaller player, we actually never had to pay any MSA legal settlement bill; so, the legal bills. We pay obviously the fees, but not the legal bills. So, there is no change for us, going forward.

Gaurav Jain: Okay. And secondly, also, on the tobacco leaf costs, which were inflationary for the industry over the last couple of years. And then we have had one of your peers say that tobacco leaf costs have peaked and they might be deflationary in the second half of this year, their calendar year, and then in FY25, it might completely unwind the tobacco leaf inflation. So, how are you thinking about your tobacco leaf costs?

Lukas Paravicini: Again, for us, the good thing on leaf is given our margins, our COGS is only 30% of our revenue. Leaf is only 30% of that 30%. So, you have to see that proportion of the cost, first.

The other thing is, like most of us, we buy the leaf a year in advance. So, we have very good visibility of what costs will do. There is a lagging effect. That's why we also have quite a significant inflation this year still on leaf. So, it's roughly 14%, 15% that will hit our P&L this year.

And indeed, we do see that coming down. Some of that inflation is also driven by the U.S. dollar currency fluctuation. But as I said, we see that inflation coming down. In our case, given also the U.S. dollar, given also some of the events we have seen in one of the largest tobacco leaf markets, which is Brazil, there's a difference between coming down and being a deflation. We don't see that. We still will have inflation next year, but less than we have this year, for sure.

Gaurav Jain: Sure. Now, talking about the other 20% of the U.S. business is cigars. So, it had done pretty well during COVID. In the last two years, there has been a massive unwind. So, can you just tell us where we are with your cigar business? And one of your key competitors, they have made comments that they are looking at a strategic review of the business; that's Philip Morris. So, how do you see the evolution of the U.S. cigar market?

Stefan Bomhard: Sure. Gaurav, I think overall what is exciting right now is you now see the mass market cigar market, the market returning again to more normal circumstances. In the run-up to COVID, you saw some very significant market size growth of that market, which then exploded even more in COVID as consumers had very few opportunities to spend their money. And then in the last two years, we saw a very abrupt decline of the market as consumers spend their money again on other categories, including the hospitality industry.

And at the same time, as you asked Lukas about leaf inflation, mass market cigars, the cost of goods of leaf is significantly higher than in cigarettes. And there, we saw – because you're looking at some very premium leaves – you saw even more of inflation. So, the industry had to take some hefty pricing to reflect the increased cost of goods.

So, you have the double whammy of consumers kind of coming out of the category because they were spending their money in other categories again and, on top, us increasing prices of the industry to pass on the cost of goods inflation.

What I think is exciting to see and reassuring I think for us, if you look at the last 12 months now, you see the industry returning to a much more normal pattern. You still see some volume declines, to be clear, but that's normal. I think some of the big growth of the mass market cigar sector is pretty over. But what you can still see, a significantly more attractive market size development versus combustible cigarettes.

And why is that exciting for us at Imperial? Because our market share in mass market cigars is well above our market share in cigarettes. And on top, we own the most desirable and the most premium brand in the entire sector, with Backwoods. And this year, specifically, if you look at our market share development, also helped by great innovation that we have in the marketplace, and despite this being quite an expensive product, a very premium product. So, in a world where consumers are counting their pennies, we're seeing the Backwoods brand gaining share.

So, I feel very good about being in this segment. I think it's an exciting segment. It's going to be one that will be a growth driver for Imperial for many years to come. And we have a great brand portfolio there.

Gaurav Jain: Sure. So, now moving to Europe. And Lukas, maybe a question for you. We are seeing very strong growth in European volumes this year, which is on top of strong volumes which happened last year and which were very strong the year before that. So, what do you think is driving this exceptional growth in the European cigarette market?

Lukas Paravicini: It's a very good point. And we focus a lot on the U.S., and the U.S. has a very specific connotation. But after the volatility of COVID, what we are seeing actually at group level is volumes declining again, much more in line with a long-term trend. And that is true also in Europe.

And that's good. I mean, that's really what you see the nor. The U.S. is the outlier. And you see also from our big markets, like Germany and Spain, that volumes have recuperated really well. The reason behind that is often that in those markets the affordability of cigarettes is still very good, especially compared to NGP. There is no big differentiation in pricing to NGP. Hence, there is not much of an incentive.

And the other part is probably what we call stigmatization of smoking. In Spain and Germany, you still have a lot of freedom to smoke. Hence, the predominance of NGP is less, the penetration is much less. Hence, your volumes in cigarettes maintain very well.

Gaurav Jain: Sure. So, Stefan, when you had arrived, Imperial used to lose market share consistently into a number of countries, and one of the key targets was to improve market share performance. And it has turned around in most countries, almost all the key markets, except for Germany. But even there, the trend of market share losses has improved; so, you're losing less share than what used to be the case. So, can you just help us understand what's happening in the German market and why has it been so hard to turn that around?

Stefan Bomhard: Absolutely. I mean, Gaurav, first, you touched upon it. I think what's very important, if you look at our strategy that we've been delivering against, on day one when we launched in January 2021, we said we want the aggregate market share of these five markets together, weighted by their respective size, to be flat. We didn't want to be the number 1 share donor in these top five markets combined that we had been before. And every single year since we launched the strategy, we've held our share or gained share. So, right now, if you look at the whole period we are up 40 basis points.

But I think we made it clear that that doesn't mean we're going to gain share in all five, every year. Because this is a highly competitive industry. And our top five includes some of the most competitive markets, like the U.S. or Germany, or markets like the U.K. and Spain.

Therefore – and it's funny, because I don't know who asked the question. It might have been you, Gaurav. I mean, I was asked when we launched the Capital Markets Day in January 2021, saying, "Stefan, which market do you think is going to take the longest to turn around, when in reality all five had lost market share?" And I said then, "Germany." Because from the knowledge and the data we had, it had been the one where we had lost market share for the longest period of time. And one factor that's probably not that well understood, it's a market where your A&P spending is still quite high because you have less restrictions. You can still do a lot of brand building towards adult smokers. And we had under-invested for quite a number of years. And our competitors, given how attractive the market is, had continued to invest.

So, to turn around what has been a decade of underinvestment we knew would take longer, and it's taken longer. But the great news, as you touched upon, what is exciting now is this fiscal year, when every year before we had lost 70, 80 basis points, at the half-year we lost around 25 basis points. So, still losing share – let's be very clear – but materially less than in the prior years. So, this year we can really see the green shoots. And it's the same playbook that was used in the other markets, but we knew this playbook would take longer.

So, I'm excited. I can't tell you when the German market will report a green number, but I have to believe at one point in time it will also report a green number. But then I immediately will tell you, therefore, another market in the top five will struggle.

But I think what's important from an investor perspective, you get the sense Imperial does manage this as a portfolio, and the underlying assumption that we're not going to shed share to our competitors in our top five markets is the underlying principle.

Gaurav Jain: Sure. And now, quickly turning to NGPs. So, you are present in all the NGP categories: heated tobacco, e-cigarettes, as well as modern oral. So, do you think you are at a point where prioritizing one or two of those categories would make more sense, given the strong growth we are seeing, especially in modern oral?

Stefan Bomhard: Let me take you back, Gaurav. The reality is when we started this strategy, it's pretty fair to say we weren't terribly successful. And the big category we had invested in was vaping. At one point in time, that was the only category Imperial was present in.

And when we worked on the strategy – and we did a lot; I mean, I looked at a lot of the data with the team – it became very clear. The consumers, depending on the market, have made different choices. If you go to the Nordic countries, it's all about oral nicotine, modern oral nicotine. If you go to a market like Italy, it's all heated tobacco as the primary preferred category. But then you travel to France, and just across the border, and it's all a vaping category. So, I think – and also what I observed – and four years later, it's even clearer – consumer preferences can switch very quickly.

But the reality is, we fundamentally believe if we want to serve our consumers where there's a sizable NGP market, given where the market is today, you have to be in all three. So, I think what's exciting, we have that capability now. We have offers that are competing well in the marketplace, despite our smaller scale, in all three categories. So, wherever the market switches, we have that agility to operate in.

So, I wouldn't want to prioritize today one, because if there's a lesson learned from the last five to ten years of development of NGP, it's still a very dynamic field. And it's about the ability to be present in all three categories. Unless there's a clear picture emerging what consumers prefer across the portfolio markets, I think having competitive offers in all three categories is one of the recipes of success for Imperial.

Gaurav Jain: Sure. So, Lukas, now turning to capital returns, which has been a very exciting part of the Imperial narrative over the last few years. So, in the first – two years ago, you did £1 billion of share repurchase. Last year, or this year, you're doing £1.1 billion. And the obvious question becomes, where does it head to next? So, can you just help us or remind us what's your philosophy on buybacks versus dividends and how we should expect the growth in this?

Lukas Paravicini: Very pleased to do so. I think, as I mentioned in the past already, for us, the capital allocation policy is a key value driver. It goes hand in hand with our strategy. Our strategy will deliver the cash we need. And this is fundamental. Without cash, there is no point in having a capital allocation policy. Having cash or a good strategy without capital allocation doesn't work either. So, capital allocation remains fundamental for us.

And after having invested sufficiently in our business, maintaining our strong balance sheet with our leverage where it is right now, it then comes to the point, as you pointed out, Gaurav, in terms of how do we balance properly a progressive dividend policy based probably on the underlying performance in terms of adjusted operating profit with the share buyback. And we are an "and" company. We want to do both. And we have the resources to do both.

And I think what you have seen in the past is that we have continued to do a progressive dividend policy, and we have meaningfully increased the share buyback over the last two years. And I think that's really important. For us, the share buyback is a fundamental part of the capital allocation. We have been very clear that it is a multiyear share buyback program. Our cash flow gives you confidence that we can sustain that.

What the exact value will be will always be defined at the end of the year when we discuss that with the Board and come to the market to define exactly the value. But what I want you to be confident about is that there is a multiyear share buyback and the share buyback has always been meaningful. I mean, every year, the last two years, we have retired more than 5% of our share capital. So, that should give you confidence also going forward into the next year.

Gaurav Jain: Now, if your leverage target is 2x and if it does go in mid-single digit and next year the expectation, let's say, is mid-single digit, then your leverage will keep coming down if you're returning only 100% of free cash flow to shareholders. So, is there an opportunity to return more than 100% of free cash flow to shareholders?

Lukas Paravicini: Again, probably the problem you are describing is a nice problem to have for a CFO, I have to tell you. And I think what we are trying to do is very consistent. What you have seen is we decide every year what is the best way to serve the shareholders in terms of excess cash returns. You're right that over the next two, three years, not necessarily in the short term, if everything goes as planned, there will be more opportunities for that. But right now, we're focusing on this year and next year.

And we will always be very reasonable in those share buybacks. It's going to be meaningful, but we're also maintaining some headroom for us to be sure that we weather all the unexpected events. So, that's where we're heading. When we come to that point, we'll have that discussion.

Gaurav Jain: Sure. And we are almost out of time here, but we have a breakout session in the next room as well.

Thank you so much, Lukas, thank you so much, Stefan, for giving us the opportunity.

Lukas Paravicini: Thank you very much, Gaurav.

Stefan Bomhard: Thank you, Gaurav.