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SWMA.ST - Q4 2017 Swedish Match AB Earnings Call

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## PRESENTATION

### Operator

Good afternoon, ladies and gentlemen, and thank you for standing by. Welcome to today's Swedish Match Full Year Report 2017 Conference Call. (Operator Instructions) I must advise you that this conference is being recorded today, 14th of February, 2018.

I would now like to hand the conference over to your speaker today, Emmett Harrison. Please go ahead, sir.

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**Emmett Harrison** - *Swedish Match AB (publ) - SVP of IR & Corporate Sustainability*

This is the Swedish Match Fourth Quarter 2017 Telephone Conference. And with me today are Lars Dahlgren, our President and CEO; Marlene Forsell, our CFO.

In the Investor section of our [swedishmatch.com](http://swedishmatch.com) website, you will find the presentation for today's call, which is intended to be viewed in conjunction with our prepared commentary. So we encourage you to follow along with that presentation.

In that same Investor section, you will find copies of the interim report. After our prepared commentary, we will be taking questions.

During today's call, there may be certain comments that constitute forward-looking statements and are subject to risks and uncertainty. Management believes that these statements are based on reasonable assumptions, but can give no assurance that expectations will be achieved. Risk factors are outlined in the latest interim report and annual report, which are available on our website. Swedish Match assumes no obligation to update information concerning its expectations. A recording of this call will be made available on the Swedish Match website.

I will now turn the conference call over to Lars.

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**Lars Dahlgren** - *Swedish Match AB (publ) - CEO & President*

Thank you, Emmett. And good afternoon, everybody. We're very pleased with our performance in the fourth quarter where we delivered strong growth in sales and operating profit from product areas. And further refined our business portfolio by complementing a divestment of our remaining interest in STG.

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Slides 3 and 4 reiterate the headline bullets from our interim report released this morning, and I'd refer you to the report rather than repeating them at the call. And instead start on Slide 5, where we have summarized some of the financial and nonfinancial highlights of the fourth quarter.

Every product area delivered sales growth in local currencies, and operating profits were up for all product areas except other operations. Net financial performance for snus and moist snuff product area reflected the geographic breadth within this product area with sales growth from all geographies.

Profits were up in local currencies for snus in Scandinavia and moist snuff in the U.S. And the net operating loss relating to our snus and ZYN business outside Scandinavia once again improved. We have now decided to scale up our investment in U.S. production capacity by another \$25 million, bringing the total investments for ZYN capacity in the U.S. to about \$60 million.

Our other tobacco products business had another great quarter for cigars. And for the full year, our cigar volumes hit a new record where we shipped over 1.6 billion sticks.

And our U.S. chewing tobacco business continues to be challenging in sales decline. Our market share is between both the premium and the value segments of the U.S. chewing tobacco market growth.

With the V2 acquisition, chew bag sales helped to offset both the sales decline for U.S. chewing tobacco and negative currency translation for chew as a whole.

And while volumes were softer for lighters and matches, operating profits were aligned with product area growth with good contribution from our complementary products business.

On the regulatory and legal front, there has been a lot of activity, especially after the close of the year, with our ECJ hearing and new proposed regulations for sales and marketing of snus in Sweden, which we will expand upon a little later in the presentation.

Marlene will now provide a brief overview of the financial performance for our largest product area, snus and moist snuff.

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### **Marlene Forsell** - Swedish Match AB (publ) - CFO & Senior VP of Group Finance

Thank you. Moving to Slide 6, you can note that for snus and moist snuff product area, operating profit in the quarter increased at a more robust pace than for the full year. Also for sales, the fourth quarter grew more strongly than the year-to-date period when measured in local currencies, up 7%.

In Scandinavia, Swedish Match's volumes grew slightly less than the market, mainly attributable to some of the lower market shares in Sweden.

Pricing was up in local currencies in both Sweden and Norway. But in Sweden, mixed effects partially offset the effects of price increases. And the weakened Norwegian krona burdened the reported average price per can.

For moist snuff in the U.S., Swedish Match shipment volumes were up in the fourth quarter following a relatively soft third quarter. Once again, volume growth was driven by our pouch products and tubs. Quarterly fluctuations in sales, volumes and profits are normal due to promotional phasing.

With higher level of promotions, sales for moist snuff grew less than volumes, but operating profits still increased, as costs were lower in the quarter.

The net operating loss for snus and ZYN outside Scandinavia improved by SEK 36 million versus the prior year and amounted to SEK 23 million. Much of our efforts in this business are directed toward the U.S. market where we continue to experience growth for both snus and ZYN in volume terms as well as higher realized pricing.

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ZYN growth has been particularly robust. During the fourth quarter, we expanded distribution and ZYN is now available in close to 9,000 shops, roughly half the number of shops where the General Snus is available.

We are increasing production levels for ZYN in the current Swedish production facility. This is expected to cover demand until we have our U.S. ZYN production setup completed, an investment project that now is estimated to add more than USD 60 million to capital expenditures, mainly in 2018.

Slide 7 provides some more details to the top line drivers in our Scandinavian snus business on a quarterly trended basis. The estimated industry volume growth and Swedish Match's underlying volume growth were both stronger than in each of the previous quarters of 2017, while our own price mix effect was weaker. The weaker price mix effect was heavily influenced by the declining value of the Norwegian krone versus the Swedish krone, 6% weaker than the fourth quarter of the prior year, but also reflects the launch of One, which is, like XR, a product that has a somewhat lower selling price than traditional premium products.

### Lars Dahlgren - Swedish Match AB (publ) - CEO & President

This is Lars, again. And on the next slide, our snus and moist snuff markets remain intensely competitive and demand a keen focus on innovation and new product development. And on this slide, you can see some of our new Scandinavian product initiatives over the past several months, many of which we spoke to you about during the third quarter conference call. Since then, we have expanded distribution of One, which now represents about 2.5% of the Swedish market. And we're also gradually expanding the distribution of ZYN in Sweden, which over time is filling in for Omni and other worldwide product, but tobacco-containing. It can be noted that the Swedish government has now proposed to implement the rate-based tax regime as of July of this year with the tax being about half of the tax for snus. Small Batch and General Hernö Gin are examples of specialty premium products, which uniquely featured flavored profiles for the Swedish market.

In Norway, G.3 Wire is a product with similar positioning and strength as our very successful G.3 VOLT product, but available in different flavor. Our G.4 Blizzard, a strong worldwide product with a mint favor is also showing progress in the Norwegian market.

On Slide 9, if we look at estimates for the Swedish market growth according to Nielsen, our assessment is that Nielsen underestimates market growth due to the exclusion of e-commerce. Still, from Nielsen I can get a good feel for market growth trends, both on a volume and a value basis. And as you can see, price increases from May onwards have provided support to the total retail value growth of the market.

Slide 10 provides Swedish Nielsen measures on a quarterly basis with a split into price segments according to Swedish Match's definitions. The value segment share has been stable over the past year. Market share losses in both the value and the premium segment have resulted in an overall market share being down 0.1 percentage points on a sequential basis from the third quarter and down 1.6 share points from the same quarter of the previous year. The share loss within the value segment has been impacting by our divesting of the Mustang pouch products.

On slide 11, you see the development in size of the different price segments in Sweden over time. After several years of decline, the premium segment has been relatively stable over the past 2 years as a share of the total market. The more traditional higher-price varieties of premium pouch and loose product, what we call the Premium 1 segment, continued to decline. Since the launch of XR, we have faced increased competition in the popular price premium segment, which we refer to as the Premium 2 segment, and this segment has grown as a share of the total market. Our launches of General One and GR One support our position within this fast-growing segment.

On Slide 12, we have summarized the year-on-year growth in Norway in both volume and retail value terms according to Nielsen data. While the category growth has come down some the past year, it remained very healthy at around 5% in volume terms.

And on the theme of healthy and as a side comment, a milestone was reached in Norway during 2017.

According to the Norwegian Directorate of Health, the number of snus users in Norway now exceeds the number of smokers. The volume growth in Norway is attributable to the product segment while loose snus continued to decline consistent with historical levels.



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As in previous years, the growth in retail value has outpaced volume growth as a consequence of excise tax increases and manufacturers' price changes.

Slide 13 shows that we continue to show very good progress in our performance in Norway. Although we still had a slight year-on-year share decline in the fourth quarter, the decline was solely attributable to the decline of the loose segment as a share of the total market.

And Slide 14 depicts the market share development in Norway since the beginning of 2015. As you can see the continued growth of the third largest player in the market has not had any material negative impact on our share trajectory.

Shifting gears to moist snuff in the U.S. on Slide 15. The U.S. moist snuff market has demonstrated continued but slowing growth in terms of overall volume shipments to wholesalers. Industry price increases have become more meaningful, so the development in retail value growth is more favorable. Our estimate is that the standard loose segment has remained relatively stable over the past few years, while especially pouches and, to some extent, tubs have contributed to category growth.

And Slide 16 provides more detail on the pouch segment. Over the past 5 years, the moist snuff pouch segment, as according to our data, grown by 11.5% in volume terms and Swedish Match has grown at a faster pace at 15.5% on average, helping us to offset our volume declines in the traditional loose format.

And on Slide 17, these mix shifts in our own portfolio are evident with the largest share of our business coming from the faster-growing segments of pouches and tubs.

With Slide 18, we move to snus and nicotine pouches outside Scandinavia. This is primarily our U.S. business for General Snus and ZYN, but it also includes certain other brands and markets outside the U.S., including exports from V2 that was acquired on August 31 last year.

In the U.S., we continued to see good growth for snus and outstanding performance for ZYN. The growth of ZYN has been robust, as they have both added distribution points and have seen faster rotation of product in stores. Our new production in the U.S., which should start to come online early next year, will support further growth for this attractive brand. Consumer acceptance and demand from retail was in -- have exceeded our initial expectations, and this is why we have now decided to further scale up the investment in capacity for the U.S. market.

Now over to Slide 19 and regulatory developments. In January of this year, the Swedish government announced that it intends to propose new legislation on tobacco and similar products to the Parliament on February 20. This proposal would, if passed, be effective on January 1, 2019. The measure that received most headlines was the proposed outdoor smoking ban in several places.

For the snus category, we consider the most important changes in the proposal to be the ban on commercial messages on in-store signage and the ban on self-service at retail. Leading up to this proposal, there were voices that advocated that the proposals include plain packaging, a complete display ban as well as restrictions of -- on adding favors to snus, none of which were included in this final proposal.

In November, we have appealed the Norwegian lower court's decision that standardized packaging for snus is consistent with proportionality principle of EU law. And we expect a ruling on the appeal during the first half of the year, and if there are no changes following the verdict, all snus and cigar products sold (inaudible) through sale from July 1 of this year must be presented in plain packaging.

A hearing took place before the European Court of Justice on January 25 with regard to the ban on snus within the EU. This ban is clearly disproportionate in view of the solid scientific fact base in support of snus, and similar to Norway, it's discriminatory. The Advocate General is expected to publish his opinion on April 12 at the latest and we expect the court's ruling a few months after that.

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### **Marlene Forsell** - Swedish Match AB (publ) - CFO & Senior VP of Group Finance

And this is Marlene, again. And we are on Slide 20. Within our tobacco products, sales and profits were higher than in the fourth quarter of 2016 in both reported and local currencies due to the continued strong performance by our cigar business and further supported by the positive

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contributions from chew bags following our acquisition of V2. The weakening dollar versus Swedish krona has had a major impact on reported performance. In local currencies, sales were up by 12% while operating profit was up by 15%.

For cigars, the portfolio mix was favorable this quarter with regard to sales. And there was a strong growth from our natural leaf portfolio.

For chewing tobacco, volume declines were consistent with long-term declines of sales, and profits were negatively impacted by the shift in our portfolio toward more value-priced products. Both sales and operating profit were positively impacted by the first full quarter of reporting of V2's chew bags.

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### **Lars Dahlgren** - *Swedish Match AB (publ) - CEO & President*

Slide 21 depicts our volume development on a 12 months rolling basis by quarter. And as I mentioned, we hit a new record level of shipments exceeding 1.6 billion sticks for the year. And as the picture illustrates, we have successfully grown the share of natural leaf varieties in our portfolio, and we have had particularly strong growth within the relatively small, but attractive rolled leaf segment.

Slide 22 illustrates the split of our portfolio relative to the split of the market segments where we materially participate. In other words, we have excluded little cigars and pipe tobacco cigars from the chart. As you can see, we overskew relative the market in both natural leaf small cigars and the rolled leaf segment. Both of these segments are currently growing faster than the overall market and the selling prices are also more attractive.

For rolled leaf, the cost of goods is higher than for natural leaf small cigars and we recently announced a price increase in our rolled leaf assortment.

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### **Marlene Forsell** - *Swedish Match AB (publ) - CFO & Senior VP of Group Finance*

And for chewing tobacco, you can see on Slide 23 that our volume declines were in line with long-term trends in 2017, following a very weak 2016. Both total market and Swedish Match decline rates tend to move from quarter to quarter and year to year.

Slide 24 shows the market portfolio shift toward lower-priced products and big bags. This is also true for Swedish Match. Swedish Match has gained share in both the premium and value price segments over the past year. And our mix in shifting -- is shifting, putting pressure in both sales and profits per unit sold.

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### **Lars Dahlgren** - *Swedish Match AB (publ) - CEO & President*

And staying with chewing tobacco and shifting over to chew bags on Slide 25. We've been very pleased with the performance of the 2 since the acquisition.

Our chew bag volumes are growing at a healthy pace and the business is profitable. And as you know, we are in a number of markets in Europe and our products are sold via the e-com channel in several more, and these markets are growing. A good example is in Denmark where both Swedish Match and other competitors offer products. The Danish market has grown nearly 40% this year and we estimate the size of the market to be around 2 million cans, a testament to the strong demand and acceptance of this convenient format for chewing tobacco.

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### **Marlene Forsell** - *Swedish Match AB (publ) - CFO & Senior VP of Group Finance*

And this is Marlene, again. Turning to lights on Slide 26. Sales and volumes for both matches and lighters were lower with positive price mix effects, not fully offsetting the volume declines and the negative currency effects. Sales for complementary products grew, as they continued the success in the Brazilian markets.



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For operating profit, performance was better due to good sales from complementary products and lower overhead costs for matches and lighters. Some of these lower overhead costs were of a temporary nature.

In the lights product area, it is often better to look at longer periods than isolated quarters, as quarter fluctuations are often notable.

We are now on Slide 27. And as you note from the graph, the net finance cost was low in the quarter, while net interest expense continues to be relatively stable. The low net finance cost for the quarter is the result of a dividend received from STG of SEK 42 million, just prior to our final divestment of the remaining holding.

During most of 2017, the average interest-bearing debt has been higher than in 2016. The impact on net interest expense from higher debt has been largely compensated by lower average interest rates. Going into 2018, following a bond issuance [and some] repayments during the year, the average interest rate is just below 2.70%, which is about 70 basis points lower than when we went into 2017.

On slide 28, I will give you some background to the lower average interest rates on the bond portfolio. As I've talked about before, we repaid maturities of EUR 200 million in November 2017. These bonds ran with an interest rate of about 5%. Also during the fourth quarter, we issued new public bonds of EUR 200 million. The new bond loans have a tenure of 8 years with an effective rate of just below 2.3%. In the graph, the new bonds are shown as maturities in November 2025. As you also see in the graph, we have maturities of SEK 1,250,000,000 falling due over the course of 2018. The bonds with fixed rate falling due in 2018 run with interest rates of approximately 4 (inaudible). The size of our bond portfolio during 2019 will depend on what issuances are made.

We are now on Slide 29. As we have highlighted in the interim report, the reporting of group sales will change in future periods. The changed reporting is a consequence of the implementation of IFRS 15, a new standard for revenue recognition. Under IFRS 15, the Swedish distribution functions will report the distribution fee charged for their logistics services as revenue. Under IAS 18 supplied until the end of 2017, the revenue reported has equaled the gross invoice amount of goods delivered to retail.

I would like to draw your attention to Notes 1 and 2 of the interim report that further explains this change and provides restated 2017 numbers for reference. The graph on this slide shows the actual reporting 2014 to 2017, as well as what the reporting would have looked like had we applied the new standard during the historical periods. The new reporting better reflects the growth [and model] of Swedish Match's main business. Going forward, only our producing and selling businesses will be reported as segments.

Moving over to the next slide, during 2017 or -- 2017 has been another year of strong distributions to shareholders. Share repurchases during the fourth quarter amounted to SEK 509 million, and for the full year, that means that the total share repurchases aggregated SEK 2.6 billion at an average share price of SEK 295.60. Together with the ordinary and special dividends paid, the total shareholder distributions during the year have amounted to SEK 5.5 billion. For the 2018 Annual General Meeting, the board of directors are proposing an ordinary dividend of SEK 9.10 representing an increase of 8% and special dividend of SEK 7.40 payable shortly after the dividends are approved.

Finally, on Slide 31, with regards to outlook statement for 2018. It is good to note that CapEx for 2018 will be impacted by our plant investments in ZYN production in the U.S. With the new U.S. tax law, we expect a lowering in the group income tax rate going forward. For 2018, the tax rate is expected to be around 21.5%. Our 2018 tax payments will also benefit from the immediately -- immediate deductible investment in plant and machinery, considering our relatively large plant investments in the U.S. In 2017, tax payments were positively impacted by the tax cash effect from the large pension contributions that were made in 2016, and which were deductible at the 38% tax rate. Somewhat lower than normal pension and other post-retiree benefit contributions were also made in 2017, again, deductible assets at 8% tax rate, which will have a tax cash impact in 2018. Currency developments are another area to keep in mind. At the current spot rate of relevant currencies versus the Swedish krona, we expect the currency translation effect to be negative over the next several quarters.

Okay, operator, we can now open the floor to questions and answers.



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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) The first question comes from Adam from the Spielman (sic) [Citi] company.

### Jemima Benstead

It's actually Jemima Benstead from Citi in for Adam. My first question is on the tax rate as you just mentioned. So the guidance for 21.5% was better than we had expected. So the question is, do you intend to let this benefit fully drop through to bottom line? Or should we expect some level of reinvestment into the business?

### Marlene Forsell - Swedish Match AB (publ) - CFO & Senior VP of Group Finance

Well, when it comes to -- we have talked about reinvestment in the business during the conference call, so I mean, of course we are investing in the business. However, I mean, this tax rate reduction, I would expect, I mean, to flow through to our cash flow. So you would -- you could see the full benefit of this in the future in the cash flow statement.

### Jemima Benstead

And then I just have one more question on ZYN and on international snus. So this year, your loss decreased by SEK 55 million in snus outside of Scandinavia. Do you think that each year the loss will decrease by a similar amount? Or should the reduction accelerate? Just trying to think -- see how we should think about the curve going forward.

### Lars Dahlgren - Swedish Match AB (publ) - CEO & President

Yes. And we have been on that trajectory of reducing losses quite noticeably for a couple of years now. And that's our clear ambition, to continue on that trajectory. So it should be a meaningful reduction as we see it, in operating loss for 2018.

### Operator

The next question comes from the line of Stellan Hellström from Nordea.

### Stellan Hellström - Nordea Markets, Research Division - Senior Analyst of Retail and Consumer Goods

I'd like to start also with asking about the reduction that you see in costs for snus and ZYN outside of Scandi. And is this that you see this year driven primarily by volume increase? Or is it also that you expect gains from the production plant in the U.S.?

### Lars Dahlgren - Swedish Match AB (publ) - CEO & President

The production plant will not be operational during 2018, but the investments will take place during 2018. So a little bit into 2019, they expect to be that one up and running. So the improvement that we forecast in terms of operating profit is coming from good cost control on the marketing side and even slight reductions there, but primarily from increased gross profits in the business.





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**Marlene Forsell** - Swedish Match AB (publ) - CFO & Senior VP of Group Finance

So that it can also be noted that the improvements during the course of 2017 have been mainly driven by gross profit improvements.

**Stellan Hellström** - Nordea Markets, Research Division - Senior Analyst of Retail and Consumer Goods

Yes. And the -- on the plant expansion there and also ZYN production, is that to any extent in 2018 a limit on your volume growth?

**Lars Dahlgren** - Swedish Match AB (publ) - CEO & President

To some extent, but at the same time, we are gradually ramping up capacity in Sweden. So I would say that it is well-aligned with our plants, but we do need to think in how much -- many stores and so forth, we offer the product.

**Stellan Hellström** - Nordea Markets, Research Division - Senior Analyst of Retail and Consumer Goods

Very well. Just also question on the price increase that you made in -- on natural leaf in the U.S. To what extent is that only to offset raw material cost increases or -- and also if there's something that competition is doing, or are you somehow now prioritizing profits before volume?

**Lars Dahlgren** - Swedish Match AB (publ) - CEO & President

It is more than raw material cost increases between '18 and '17. When it comes to competition, we'll have to wait and see, but we are very competitively priced already in this segment to the consumer. And we just announced it, so -- and there will be -- it will take some time before it's effective, maybe 1 or 2 months as we sell through inventory at the previous price points.

**Stellan Hellström** - Nordea Markets, Research Division - Senior Analyst of Retail and Consumer Goods

Very well. Then just also a question on the Swedish tax potential claim here for SEK 300 million. Can you just help us understand how -- what are the risks here? How many years does this pertain to? And also is this a practice that would -- if you hypothetically would lose this case, would that affect your tax rate going forward?

**Marlene Forsell** - Swedish Match AB (publ) - CFO & Senior VP of Group Finance

This is Marlene. I would -- I mean, in case then, that we would lose these cases, they would be reported as tax expenses. So in the year of that potential loss then, it would affect the tax rate, but it wouldn't be an effect on the tax rate on a running basis. When it comes to sort of the risk involved, I would say the fact that we haven't recognized them as provisions means that we believe that it's more likely than not and that we'll win such an appeal. But it's very likely that it can be a case that can drag on in court for more than a year and more than 2 years.

**Stellan Hellström** - Nordea Markets, Research Division - Senior Analyst of Retail and Consumer Goods

Very well. And then just noting the relatively high costs reported under the other segment here, is there anything of a one-off nature or a higher cost level, just...

**Marlene Forsell** - Swedish Match AB (publ) - CFO & Senior VP of Group Finance

Yes. I mean, there are things of one-time nature in there, but I spoke to Emmett about this (inaudible) before. And I don't want to overemphasize that either because, I mean, in other operations, there are various functions and those functions drive different types of projects every now and



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then. So the cost level tend to fluctuate. So I would rather look more at the full year cost level than -- which was more or less on parity with prior year level.

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**Stellan Hellström** - *Nordea Markets, Research Division - Senior Analyst of Retail and Consumer Goods*

Okay. And then just finally on Swedish news here. I know you don't want to comment very much about pricing, but maybe you could announce then also what would you do with the Swedish excise tax increase in the beginning of the year.

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**Lars Dahlgren** - *Swedish Match AB (publ) - CEO & President*

We have not adjusted for -- it was a very minor Swedish excise tax increase and we have not adjusted prices as of January 1.

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**Marlene Forsell** - *Swedish Match AB (publ) - CFO & Senior VP of Group Finance*

May I add to, Stellan, also to your question on the tax. I mentioned that it would have a tax effect for the tax rate in the year in case that we lost, but of course, in that period we'd also have a cash impact.

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**Operator**

The next question comes from the line of Gustav Sandström from SEB.

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**Gustav Sandström** - *SEB, Research Division - Research Analyst*

My first question relates to ZYN in the States. I appreciate that you say that the turnover in stores for ZYN is larger than in the same-stores where -- if you sell snus, but could you perhaps put in a broader perspective how -- comparing ZYN to sort of the full category of snus in the existing stores, where they compete head-to-head, so your brands and others?

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**Lars Dahlgren** - *Swedish Match AB (publ) - CEO & President*

Yes, that's a metric that we follow. And we are in about 9,000 stores now, and then we've been gradually adding stores. So when we look at 3,500 stores that were the first stores where we've been since 2016, there ZYN is outperforming in the entire snus category, including competitors, roughly 120% of the snus category. So while that's not -- it's not necessarily an exact indication of the potential for ZYN on a national basis, it's at least an indicator, and as you know, the U.S. snus market is, as we estimated, just shy of 60 million cans.

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**Gustav Sandström** - *SEB, Research Division - Research Analyst*

Right. And could you shed some light on perhaps a little bit more how your rollout plan looks in terms of which states you're currently looking at to roll out ZYN or intend -- increase the density of ZYN stores [seen] primarily, say, next 6 months and where you see ZYN stores to snus stores ratio on a perhaps 1- to 2-year basis in the States.

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**Lars Dahlgren** - *Swedish Match AB (publ) - CEO & President*

One of the big benefits with the ZYN model is that it's a non-refrigerated product. So it's significantly less expensive to increase distribution. And it's also highly demanded by the retail. And so based on the current trend, it's naturally our ambition to make the product significantly more



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available across the U.S. down the road, but we do need to monitor capacity. And right now, we are in the western region, but we're also in the Chicago area.

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**Gustav Sandström** - *SEB, Research Division - Research Analyst*

And on that note, could you quantify the effect of your capacity for delivering ZYN in the States following the completion of the investments you announced in the States?

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**Lars Dahlgren** - *Swedish Match AB (publ) - CEO & President*

I think a good lead there is, when I said that we do follow this or comparison to other categories and if we compare it to the snus category, we see that ZYN has the potential to be at least that size. So that's kind of a ballpark number that we are investing for at this stage. And we don't give exactly how much the capacity will be.

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**Operator**

(Operator Instructions) The next question comes from the line of Chas Manso from Societe Generale.

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**Charles Manso de Zuniga** - *Societe Generale Cross Asset Research - Director of Consumer Equity Research*

Could we just kick off with a housekeeping question. Your V2 contribution in the quarter, could you just break out sort of in percentage terms, how much of V2 goes into the snus and snuff and how much of it goes into OTP, that would be helpful. What I'm trying to do is bridge the gap between the constant currency sales in snus and snuff for the quarter, which I think is 7%, versus the Scandinavian organic sales growth from Slide 7, which seems to be 3.5%. I'm just wondering whether V2 covers all that gap and how much of it is the uptick in international snus and nicotine pouches?

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**Marlene Forsell** - *Swedish Match AB (publ) - CFO & Senior VP of Group Finance*

If we start with -- there are more or less 2 questions then, because 1 question is related to volumes for snus and nicotine pouches and the impact of V2. And the other one was more related then to sort of sales impact and OTP and snus for that acquisition. And first of all, I'd like to point to our note -- which I don't currently recall the number of -- but it's in the back of the interim report where we actually state the exact now -- the contribution from V2 during the quarter then for the total group. Having that said, we don't give an exact split between snus and chewing, but chewing is a larger part than snus in that -- those sales numbers and profit numbers. When it comes to volumes, we have so far not specified details, these are still relatively small numbers. But of course, looking at the snus and nicotine pouches outside Scandinavia, the contribution from V2 is material. And I would say that it's...

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**Lars Dahlgren** - *Swedish Match AB (publ) - CEO & President*

I don't have that number in my head.

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**Marlene Forsell** - *Swedish Match AB (publ) - CFO & Senior VP of Group Finance*

But it's material in that increase, but so it's assumed.



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**Charles Manso de Zuniga** - *Societe Generale Cross Asset Research - Director of Consumer Equity Research*

Okay. And sorry, another question, if I may, is on your operating costs, which fell year-on-year, Q4 to Q4 quite substantially, by something like 320 basis points, something like that. But in your release, there are various mentions of costs being down for a temporary nature. And I'm just wondering how much of that cost reduction, i.e., margin improvement is of a temporary nature and how much is kind of a structural long-lasting cost improvement?

**Marlene Forsell** - *Swedish Match AB (publ) - CFO & Senior VP of Group Finance*

Yes, and first of all, I mean, if we're looking at -- I haven't done this exact math now. But looking at the P&L, one should be aware the U.S. dollar then have an impact on those numbers. So a weaker U.S. dollar make the operating costs look lower than reported in Swedish kronas. Having that said and looking at our product areas, it is so that snus and moist snuff in the fourth quarter of prior year, we had some costs of a more temporary nature and the costs have been relatively low for the quarter and all this year, so on a comparison basis, that has an impact on margin. And -- but I would again say, and I talked about (inaudible) for snus and moist snuff in the second quarter also pointing out that the cost level was often low in the third quarter in general, but I would say that overall the full year numbers are maybe more meaningful to look at due to the fact that there are fluctuations in numbers. Having that said, when it comes to the margin improvement in the fourth quarter now coming from snus and ZYN, we actually have noted that there is an acceleration in the lower -- loss coming from that area. And that, of course, has a greater impact on margin in the fourth quarter.

**Charles Manso de Zuniga** - *Societe Generale Cross Asset Research - Director of Consumer Equity Research*

Okay. I know other people have tried. But, I mean, on the accelerating loss reductions, I mean, is a maximum loss now the fourth quarter annualized x 4?

**Marlene Forsell** - *Swedish Match AB (publ) - CFO & Senior VP of Group Finance*

We don't see that exact guidance. I mean, we were mentioning that it's going to be a noticeable lower than in outlook for next year. It depends, of course, also on what the investments [are doing] behind growth next year and so on, but it's going to be noticeable, it's lower. And yes, this year, we've talked about -- beginning of the year, we've talked about actually being on par and then the same sales being lower versus the mid part of the year then.

**Charles Manso de Zuniga** - *Societe Generale Cross Asset Research - Director of Consumer Equity Research*

Okay. And the final one from me on the proposed Swedish regulations. Could you just let us know what percentage of the cans that you sell in Sweden have less than 20 pouches in them and....

**Lars Dahlgren** - *Swedish Match AB (publ) - CEO & President*

(inaudible) and we see no issue to add there. I think it's 2 pouches or something like that, but it should be considered as a nonissue.

**Charles Manso de Zuniga** - *Societe Generale Cross Asset Research - Director of Consumer Equity Research*

It's a nonissue. And on the self-service point, I mean how much of the market is self-service? How much is behind the counter?



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**Lars Dahlgren** - *Swedish Match AB (publ) - CEO & President*

In the free trade, I think, it is around 30% that is self-service. So it's -- in the numbers towards -- it's not insignificant. But -- I mean, what they have to do is to move the snus cooler behind the counter, basically. They don't have to cover it up or anything.

**Operator**

The next question comes from the line of Karri Rinta for -- from Handelsbanken.

**Karri Rinta** - *Handelsbanken Capital Markets AB, Research Division - Research Analyst*

Firstly, I just wanted to better understand the accounting treatment of this ZYN investment. You mentioned that the tax reform in the U.S. gives you some flexibility in how you will sort of book that as CapEx or maybe expense as you go along. So is there -- how should I sort of pencil in this USD 60 million? Is it all CapEx or will some of it just be sort of expensed along the way? And will that be seen in 2018 or 2019?

**Marlene Forsell** - *Swedish Match AB (publ) - CFO & Senior VP of Group Finance*

It's a good question. I would say that it will be capitalized more or less on a cash basis. So the asset will be recognized in the balance sheet along with it sort of being unpaid, but -- and of course, put in place. But what I meant when talking about the impact on a tax cash basis is that with the new tax regulation in the U.S., you are allowed to make deductions, [depreciate] both deductions let's say, immediately. Normally, you're allowed to do that over time so that when you depreciate an asset, that depreciation becomes tax-deductible. But now then we are going to be allowed to do that on an immediate basis, which of course means then that has a positive impact to cash flow when it's being paid. Whether or not all of that is coming in '18 or partly in '19 as well, that I don't want to be too exact about, but over the course of '18 and '19, we will be able to get them.

**Karri Rinta** - *Handelsbanken Capital Markets AB, Research Division - Research Analyst*

All right, that's helpful. And then I just wanted to clarify the -- or follow up on the earlier question and answer, the -- about the ZYN volumes enabled by the new capacity. You mentioned that the snus market is SEK 60 million and you have seen outperforming the whole snus categories in some of the stores. So I relate -- so would this capacity give you a delivery capacity of 60 million cans of ZYN when up and running?

**Lars Dahlgren** - *Swedish Match AB (publ) - CEO & President*

A little bit more.

**Karri Rinta** - *Handelsbanken Capital Markets AB, Research Division - Research Analyst*

Okay, all right. That's good. Then finally, a little bit of a broader question on the Swedish snus market. Given that these new regulations do not include a complete display ban and no ban on flavors, do you expect any impact on sort of competitive behavior in 2018? And then maybe related question, what is your own commercial agenda in 2018 in Sweden in sort of a -- in broad terms in snus?

**Lars Dahlgren** - *Swedish Match AB (publ) - CEO & President*

I don't see -- I mean, this is the same for everybody in terms of the regulations. And I don't see that this would cause any particular competitive behavior. But you never know what the competition do. And in terms of Swedish Match, we'll continue to deliver our existing portfolio of very high quality, but also bring interesting innovations to the markets. So we feel good about our own pipeline of products for the Swedish market this year.



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**Operator**

Thank you. Dear speakers, there are no further questions at this time. Please continue.

**Lars Dahlgren - Swedish Match AB (publ) - CEO & President**

Okay. Thank you, everybody. We would just like to finish off by informing you that the release of our first quarter 2018 report will be on May 4. Thank you.

**Operator**

That does conclude our conference for today. Thank you for participating. You may all disconnect. Have a lovely day.

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