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SWMA.ST - Q2 2019 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 Q2 report conference call. (Operator Instructions) I must advise you that this conference is being recorded today, Thursday, 18 of July 2019.

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

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

Hello. This is the Swedish Match Second Quarter 2019 Telephone Conference. And with me today are Lars Dahlgren, our President and CEO; and Tom Hayes, our CFO. In the Investors section of our 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. 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 uncertainties. Management believes 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.

And with that, I would like -- Slide 3 of this presentation reiterates the headline bullets from our interim report released this morning, and we refer you to the report rather than repeating them on this call.

And with that, I'd like to turn the conference call over to Lars Dahlgren, who will begin on Slide 4.

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

Thank you, Emmett, and good afternoon, everyone. Let me start off with a few summary comments from the quarter, where Swedish Match delivered solid financial results on both a reported and local currency basis and a record quarter for our snus and moist snuff product segment.



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It can be noted that in addition to currency translation effects, there were a number of factors that influenced our financial performance during the quarter. Calendar effects in Scandinavia, principally resulting from the timing of Easter, as well as pipeline volumes for our national launch of ZYN in the U.S. had a positive impact on volume, sales and operating profit growth. It can be noted though, that the national expansion for ZYN in the U.S. also implied meaningful cost for the establishment of new distribution.

In addition, the acquisition of Gotlandssnus in 2018 and the implementation of the new retail and merchandising program in the U.S. at the first of the year also affected the comparability of reported results.

The largest contributor to our sales and operating profit growth on both a reported and local currency basis came from our snus and nicotine pouches outside Scandinavia, predominantly ZYN in the U.S. As part of our national rollout plan for ZYN in the U.S., we have rapidly expanded distribution, adding approximately 36,000 stores, bringing us to a total of slightly more than 51,000 stores at the end of the quarter.

While this store build generated an estimated 2.5 million cans of pipeline shipments, the majority of sales and operating profit growth came from further increases in average sales per store in previously existing stores and volumes that were sold through to consumers in new stores.

While the store build over the coming quarters will be at a more modest pace relative to second quarter, we remain confident that we will reach our estimated 60,000 store distribution level by year-end with plans to add more stores in 2020 as capacity permits.

The reception from the trade and consumers has been very positive. And while it is still early, the national launch markets appear to be trending consistently with how our early installs in the Western region developed.

In Scandinavia, overall market growth has remained strong with volume growth at more than 6% led by nicotine pouches, and also in Sweden for pouches in the somewhat lower-priced premium 2 segment. Through pricing and segment mix shift, the overall value of both the Norwegian and Swedish markets continue to outpace volume growth in the markets.

For Swedish Match, shipment volumes were up by 5% and up a bit less than 1% when adjusting for calendar and acquisition effect as a result of segment mix shift and share declines in certain segments. While we have been participating in the volume growth in the rapidly-growing nicotine pouch segment in Sweden and Norway, our market share in those segments are lower than our overall share of the market.

For Other tobacco products, or OTP, the U.S. mass market cigar category remains soft in the quarter, with category volume continuing to decline. The decline was driven by the HTL segment while the natural leaf segment continued to demonstrate growth.

We had anticipated a difficult year-on-year comparison for cigars in Q2 owing to high levels of promotional activity for our HTL and gaining natural small cigars in the prior year. While our overall cigar shipments in the quarter declined by 5% on a constant trading day basis compared to the second quarter of 2018, we were pleased to note that our rolled leaf volumes have continued to improve and in the second quarter were on par with the prior year level.

Our Lights business had a very weak quarter with volume declines for both matches and lighters. While we saw sales growth for lighters, sales and operating profits declined significantly for matches and complementary products. In addition to market conditions, which will be -- which we will touch on later, the financial performance for Lights in the quarter was burdened by restructuring cost of approximately SEK 12 million, with the bulk of that related to Brazil.

Thomas Hayes - Swedish Match AB (publ) - Senior VP & CFO

On Slide 5, we have summarized some of the quarterly highlights of the snus and moist snuff segment. Even when adjusting for the positive impact of volumes due to Easter timing, our Scandinavian snus business delivered improved sales and operating profit in the quarter compared to the prior year. From a combination of favorable price/mix, higher underlying volumes, the impact of the Gotlandssnus acquisition and a slightly stronger NOK versus the SEK.

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In the U.S., as we noted earlier, ZYN was a major contributor to sales and operating growth within the snus and moist snuff product segment. Shipment volumes for ZYN in the U.S. approximated 11.5 million cans in Q2, up roughly 5.5 million cans sequentially compared to shipments in the first quarter of 2019. Our U.S. moist snuff business reported sales and operating profit growth in the quarter on increased shipment volumes and improved underlying pricing. Our volume growth was once again led by pouches, while our loose products and aggregate also grew.

And finally, just a reminder of the change in our U.S. cost allocation methodology earlier this year for shared operating expenses for our U.S. businesses. This has impacted operating profit and EBIT margins for our snus and moist snuff as well as our OTP segments. When comparing versus Q2 2018 reported results, the effect was negative for the snus and moist snuff product segment by SEK 15 million and positive for the OTP segment by that same amount.

On Slide 6, we have provided our estimates of trended total market and Swedish Match volume growth in Scandinavia adjusted for hoarding and calendar effects as well as Swedish Match underlying currency adjusted price/mix effects by quarter. From time to time, we make adjustments for certain periods as more information becomes available. And you may note that there was an upward adjustment made to our estimates for total category and Swedish Match underlying volume growth for Q1 2019. The market growth in Scandinavia remains robust at well over 6% and with pricing and some portfolio mix shifts, Swedish Match underlying currency-adjusted price/mix remains positive.

Scandinavian market growth is being sourced from both Sweden and Norway. Particularly in Sweden, we have, over the last couple of years, noted an increased consumer interest in the snus category, a development we believe has been influenced by the increased number of product offerings in the attractive premium 2 segment and the introduction of nicotine pouches. Also in Norway, the consumption growth remains healthy, but we see a trend with more and more of the products being bought in Swedish border trade shops, tax-free channels and on e-com.

Our underlying volume development relative to the overall market reflects the segment market share challenges we face. Our underperformance to the market has been worsened in recent quarters, a result of relatively sharp increases in market segments where our segment shares significantly under-skews our category share as well as market share losses in the attractive premium 2 segment in Sweden.

On Slide 7 and looking specifically at Sweden and Nielsen reported measures, the strong market trend is clear. Taking into account the underrepresentation in Nielsen measure, the true trend is even stronger than the picture to the left depicts. Since 2017, the retail value of the market has grown at a somewhat faster pace than market volumes. This is a result of tax and pricing changes supported by a stable premium segment versus the value segment as well as growth of nicotine pouches where products are premium priced.

Our sequential market share losses of 0.7 percentage points from Q1 2019 largely results from further market share losses in the premium 2 segment. Our new product introduction initiatives more recently have been targeted at mitigating this adverse trend. Segment shifts resulting from our lower share position in the rapidly-growing nicotine pouch segment also contributed to the sequential market share loss.

Supported by strong competitive activity in terms of product launches and in-store visibility, the nicotine pouch segment has doubled in size over the past year and now represents 3.6% of the Swedish market according to Nielsen. We believe that nicotine pouches have an even larger share of the market as e-commerce and certain high-volume independents are not taken into account in the Nielsen figures. While our market share in this attractive segment improved slightly from Q1 2019 levels, we need to capture a higher percentage of growth within the segment to markedly stem overall market share losses in Sweden.

Now looking at Slide 8 and Norway, where our market share declined 0.9 percentage points sequentially compared to Q1 2019 according to the Nielsen measure. This decline is almost exclusively attributable to the segment shifts in the overall market, with loose snus declining in importance and the nicotine pouch segment rapidly growing. The nicotine pouch segment in Norway has grown dramatically over the past 2 years and now represents 15% of the total market.

Our shares are relatively stable in both the loose segment and the regular tobacco portion segment. But in the nicotine pouch segment, our share progression has been disappointing and our Q2 2019 share within this segment remains far below our aggregate market share. Addressing our market share development in this segment is a key focus area of our Scandinavian business, but quick solutions to this challenge are particularly difficult given the regulatory landscape in Norway.



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

Turning to Slide 9, where you can see some of our more recent new product launches for snus and nicotine pouches in Scandinavia and in some markets outside Scandinavia. During the first half of 2019, we have stepped up our new product activity compared to the second half of 2018 levels and a number of products which we have introduced which are aimed at the nicotine pouch and premium 2 segments.

In Sweden, we have added a new ZYN Mini Dry variety, Spearmint. And for our G.4, or white assortment, we have introduced 2 new varieties, which are pictured on this slide. We have launched a number of product in the premium 2 segment, including a repositioned general Onyx and an additional XR variety, and on a limited basis, Wisby, 2 new products manufactured on Gotland.

Outside Scandinavia, we are now marketing ZYN in a number of varieties in both Slim and Mini Dry format in the Czech Republic and Denmark. ZYN has also been made available online in Switzerland and the U.K. and we are currently making the product available in select stores in the U.K.

Turning to U.S. moist snuff and Slide 10. Swedish Match shipment volumes rebounded following a soft first quarter. Our reported shipments tend to fluctuate based on promotional phasing and were up by 3% reported or 5% on a constant trading day basis compared to the second quarter of the prior year.

Based on distributor shipment to retail, we estimate that volume growth within the U.S. moist snuff category has been slightly negative for more than a year now. Based on this same measure, the value growth of the market has been more robust and during the second quarter was more than 5% compared to the prior year, with Swedish Match value growth increasing at a somewhat faster pace.

The pouch segment in the U.S. continues to grow as a share of the overall market and Swedish Match has been gaining share within this attractive segment. Based on our measure of distributor shipments to retail, the pouch segment grew almost 2% in the 6 months versus the prior year. Based on this same measure, Swedish Match experienced year-on-year moist snuff pouch volume growth of more than 10% during the first 6 months.

On Slide 11, the 2 charts illustrate the very strong growth for snus and nicotine pouches outside Scandinavia. ZYN volume in the U.S. accounts for substantially all of this growth. The shipment volume for ZYN in the U.S. was around 11.5 million cans during the second quarter, almost doubling the first quarter 2019 shipment levels.

And while today, we are in more than 52,000 stores, the chart on the right-hand side of the slide represents average store count and velocity rates measured on cans per store per week by quarter in markets in which we were present prior to the national rollout. We added a bit more than 1,500 stores in our initial launch markets.

Despite this build in distribution, in-store velocity rates have continued to increase and more of the volume growth over the periods presented has resulted from increased velocities rather than distribution gains.

In the second quarter, with a more rapid store distribution plan, a portion of volume included pipeline volumes in the new stores. And based on our estimates, approximately 2.5 million cans of the 11.5 million cans shipped in the second quarter was pipeline volume. We anticipate that by year-end, we will be in approximately 60,000 stores, which means that the impact of pipeline volumes relative to consumption-based shipments will be well below Q2 levels for the remainder of the year.

Thomas Hayes - *Swedish Match AB (publ) - Senior VP & CFO*

Moving on to Slide 12 and our Other tobacco products or OTP segment. Within OTP, we had highlighted in our communications around the Q1 interim report that Q2 would represent the most challenging quarter for our cigar business from a year-on-year volume comparison perspective, but that comps would get easier in the second half of the year and especially in Q4.

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As such, a decline in cigar shipment volumes of 7% on a reported basis and 5% on a constant trading day basis in the quarter was not altogether surprising. Our volume declines were most notable for our HTL or homogenized tobacco leaf cigars. While our shipment declines were due in part to high levels of limited time offering promotional shipments in the prior year, the HTL segment has been experiencing softness over the last several quarters.

The second quarter of the prior year also included high promotional activity for some of our small natural leaf varieties, but our shipment volume declines in that segment were more modest, owing to the relative market strength of that segment. For rolled leaf cigars, where we were faced with shortage of cigar leaf for a number of months, our volumes have rebounded to prior year Q2 levels.

In local currency, sales for our chewing tobacco businesses declined marginally in the quarter versus the prior year but operating profit improved. In local currencies, operating profit for chewing tobacco in the U.S. was in line with the prior year and was up for chewing tobacco outside the U.S.

On Slide 13, we have presented our estimate of the overall U.S. market cigar category and segment development based on distributor shipments to retail. The category rate of decline accelerated in the quarter and as you can see, the overall category decline is fully attributable to HTL cigars. Based on the same measure, Swedish Match volumes declined at a more modest pace in the overall market despite a more pronounced decline by Swedish Match in the HTL segment.

Ignoring pipe tobacco cigars, a segment where we have a very nominal participation, natural leaf cigars comprised approximately 60% of our portfolio compared to about 40% of the category as a whole. Our strong performance relative to the natural leaf segment in the second quarter is largely attributable to a much-improved position for rolled leaf cigars, where our reported rolled leaf shipments in the quarter were very close to what was an all-time record for Swedish Match in the second quarter of the prior year.

Turning to U.S. chewing tobacco on Slide 14, Swedish Match is well positioned in both the premium segment and the value segment. And based on our measure of distributor shipments to retail, we once again outperformed the overall category in both segments. The shift in the portfolio toward more value-priced products places added pressure on average selling prices and margin.

Shipment volumes of Swedish Match brands declined notably in both the first and second quarters compared to the prior year. Shipment volumes can experience quarterly volatility due to promotional phasing, and for the 12-month period ended June 30, shipment volumes were down for Swedish Match brands by 6%, while price/mix effect was plus 4%.

Moving on to Slide 15 and our Lights product segment. While this product segment is susceptible to fluctuations in quarterly performance, the second quarter financial performance was unusually weak. The poor performance was pronounced within our matches and complementary products businesses, where trade destocking and restructuring charges in Brazil adversely impacted financial results.

Operating profit for our lighter business also declined in the quarter when compared to the prior year, impacted by continued nylon cost pressures. However, lighter sales improved despite volume declines on improved pricing and mix. While conditions with regard to raw material cost, currency transaction cost for complementary products and overall match volumes remain challenging, we expect an improved performance in coming quarters.

On Slide 16, looking at the regulatory landscape, we touched on both the MRTP application and the FDA's proposed guidance on flavored cigars in the first quarter interim report and conference call. The comment periods for both items have closed and we await the FDA's final decisions.

In Switzerland, the Federal Supreme Court ruled on June 11 that the ban on snus is illegal and unconstitutional, making particular note of the fact that snus is less hazardous than other tobacco-based products allowed on the Swiss market today. With this decision was with immediate effect, this now means that Swedish Match will be allowed to sell snus on the Swiss market. Up until this decision, snus was only allowed to be purchased and brought into Switzerland for personal use, either from other markets or via e-commerce.



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And finally, on June -- excuse me, July 11, in a case brought against the FDA by various public health groups, the Federal District Court in Maryland issued its final order regarding the constitutionality of the FDA's previous extension of path to market filing deadlines for cigars and ENDS products to 2021 and 2022, respectively.

In the final order, the Maryland court ruled that manufacturers of ENDS products and cigars must file a path to market application within the 10-month period following the order date, which would mean by May 11, 2020. Once applications have been submitted, products may continue to be sold for up to 1 year while the FDA considers the application. And the order granted the FDA discretion in pursuing enforcement actions against noncompliant products and in exempting products from filing requirements for good cause on a case-by-case basis.

But we should note that there may be further challenges and possible delays to the new time lines. We would like to point out that our work on PMTAs for ZYN is in an advanced stage, and for cigars, we have already started to work on FDA applications.

On Slide 17, we've summarized relative metrics from our interim report relating to finance costs, our financial position and earnings per share. Net finance costs during the quarter were in line with the levels that we experienced during the past few quarters. The weighted average interest rate of our loan portfolio at June 30 was 2.08% compared to 2.18% at the end of 2018.

On April 3, 2019, we repaid SEK 892 million in bond debt and no further debt is due for repayment in 2019. Our net debt to EBITA for the 12-month period ending June 30 was 2.3. And as of June 30, Swedish Match had SEK 12.882 billion of interest-bearing debt, excluding retirement benefit obligations but including the recognition of lease liabilities of SEK 262 million from the adoption of IFRS 16.

The capital duration was 4.2 years with 98% of our portfolio subject to fixed interest rates. The EPS bridge illustrates the components of our 20% growth in EPS for the 6-month period ended June 30. And apart from the after-tax effects of our increased operating profit, the reduced number of shares benefited EPS.

During the first 6 months of the year, we made share repurchases in the amount of SEK 849 million. And on April 16, a total of SEK 1.770 billion was paid out to our shareholders in dividends at SEK 10.5 per share.

And on Slide 18, we presented our updated outlook for 2019, which reflects the change regarding our expectation for U.S. cigar market growth for the year, given recent softness for HTL cigars. Given that weakness, we can no longer confidently state that the U.S. cigar market will record volume growth in 2019. All other points from our Q1 outlook remain unchanged.

And as always, fluctuations in currency rates will impact our future reported results. And you may want to take note of some of the more important average exchange rates versus the SEK. The average exchange rate in the third quarter of 2018 for the U.S. dollar was SEK 8.97; for NOK, SEK 1.09; and the Brazilian real, SEK 2.26.

And with that, operator, please open up the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And the first question is coming from the line of Niklas Ekman.

Niklas Ekman - *Carnegie Investment Bank AB, Research Division - Head of Consumer Discretionary & Staples and Financial Analyst*

It's Niklas Ekman from Carnegie. A couple of questions. Firstly, if I could ask on the snus margin and the reason for the -- such a strong development in this quarter. I mean, in the past, you've had quite significant rollout cost, certainly margin dilution from ZYN and that does not appear to have

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been the case in this quarter despite that you've significantly increased your rollout. Can you explain a bit the dynamics here why margins were so strong in this quarter?

Thomas Hayes - *Swedish Match AB (publ) - Senior VP & CFO*

Yes. No, I would say that there were effects of marketing efforts around the placement of stores with our national distribution build. However, the cost associated with that store build was not overly dilutive to the benefit that we were getting with respect to volumes with the national build. So the ZYN U.S. volumes are premium-priced products, so on balance, those are much more margin accretive than our traditional U.S. moist snuff volumes in the U.S.

Niklas Ekman - *Carnegie Investment Bank AB, Research Division - Head of Consumer Discretionary & Staples and Financial Analyst*

Right. But can you explain how this -- how the profitability here is booked? I mean, you talked, for instance, about 2.5 million cans in pipeline volume. Doesn't that imply that you have costs, but you haven't really sold those product yet or at least you haven't charged the full price, so that would be margin dilutive?

Thomas Hayes - *Swedish Match AB (publ) - Senior VP & CFO*

Yes. Yes, so for the majority or vast majority of volumes that were sold, obviously both in our established markets and in our national expansion markets in Q2, the volumes that were sold went out at full revenue. So retailers had options relative to take free fill, so non-revenue volumes, or receiving a kind of a trade marketing stipend for that placement, and the vast majority selected the trade marketing stipend rather than the free fill of volume. So in that regard, when you look at our sales development and volume development, those volumes were full revenue cans.

Niklas Ekman - *Carnegie Investment Bank AB, Research Division - Head of Consumer Discretionary & Staples and Financial Analyst*

Okay. But doesn't that stipend then imply a cost for you?

Thomas Hayes - *Swedish Match AB (publ) - Senior VP & CFO*

Yes. Yes, and you'd see if you -- kind of on a trended basis, if you look at our development of SG&A, it was up relatively sharply sequentially -- year-on-year and sequentially. And I would say roughly 3/4 of that increase that you could see on a trended basis is a consequence of initial placement cost, whether it's that stipend or other cost of distribution, be it point-of-sale or merchandisers for those 35,000 stores.

Niklas Ekman - *Carnegie Investment Bank AB, Research Division - Head of Consumer Discretionary & Staples and Financial Analyst*

Okay. And secondly, this 2.5 million cans in pipeline volume, is that something you anticipate that could burden the -- or hamper the volumes recorded in Q3? Is it -- are we likely to see, if not a decline, then at least much lower volume growth going from Q2 to Q3 for ZYN?

Thomas Hayes - *Swedish Match AB (publ) - Senior VP & CFO*

No. I think you will have -- you will not have the benefit of that 2.5 million obviously in Q3, so you'll have, in essence, the reversal. Obviously, we continue to expect to expand our distribution over the second half of 2019. So there will be pipeline volume in connection with those -- with that distribution build but not to the degree that we saw in Q2. So on balance, we would expect Q3 volumes not to be at Q2 levels.



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Niklas Ekman - *Carnegie Investment Bank AB, Research Division - Head of Consumer Discretionary & Staples and Financial Analyst*

Okay. And just switching to cigars also, I'm curious if you could elaborate a bit on the -- your thoughts on the reason for the decline in the market. Because in the past, I mean, you've had supply-related issue on natural wrap but it -- that doesn't appear to be the case here at all. This is a decline in HTL that is not mitigated by strong growth in natural wrap basically. Why suddenly this decline in demand for cigars?

Thomas Hayes - *Swedish Match AB (publ) - Senior VP & CFO*

Yes. So -- and if we talk firstly about the general market dynamics, I mean, I think we've said quite clearly that our volume declines have more to do with our specific promotional activities in Q2 last year, and as we've mentioned, Q2 was our all-time record of cigar volumes. But more generally about the market, what we are seeing are sharp declines in HTL and in certain regards, that's even more so isolated within HTL value.

Within HTL value, you're not having as many new product introductions with -- given FDA regulations on new products. So I think in certain respects, there could be some aspect of that influencing overall category growth. The other dynamic that is taking place is kind of dual users from either cigarettes and cigars. You have instances where cigarette smokers may have converted or moved to mass market cigars, given more favorable tax -- excise taxes on cigars. Whereas now, certain of those cigarette smokers may be migrating to other alternatives, be it e-cigs or vape. So I think there is a general decline in growth within the cigar category. However, what we're seeing is still very solid growth within the natural leaf varieties and most particularly within the rolled leaf varieties.

Operator

The next question is coming from the line of Stellan Hellström.

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

Yes. Maybe just coming back to the rolled leaf discussion, how can you be certain that you are seeing growth there? Is it sequentially you're seeing that or [given] the weak volumes that you have had lately due to the shortage of leaves?

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

We know that the demand on our product has been quite a bit stronger than what we've been able to deliver. So in that sense, we feel relatively confident that we should be able to show growth there in the second half, particularly given the severe shortages we had in the fourth quarter. There is a very strong underlying demand for rolled leaf, and if more supply constraints that dictate the development.

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

Okay. And those supply restraints, they are not there anymore at all?

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

On our side, we have made significant progress, which means that we still have an element of restrictions but we have made very good progress, and that's why we could increase our volume sequentially in the second quarter compared to the first and even up to second, we -- the same level as last year. Q3 last year was also relatively high, but Q4 was particularly weak when it comes to rolled leaf cigars, and also Q1 this year was weak.



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

If demand is really strong, is there a point where you -- that you have visibility into where you see that you will -- would be able to supply sort of double-digit volumes growth if demand is there, of course?

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

I mean, we should remember that this is a subsegment of the cigar category, and in such, you do see relatively steep swings in growth rates in that segment.

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

Okay. I was just thinking if you have the capacity, if demand is there for double-digit growth, would you be able to supply it in the near future?

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

It's a bit of a hypothetical question. But yes, the demand is very strong on these type of varieties.

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

Right. Okay. Yes, then I realize your price/mix effect in Scandi snus is roughly half of what it was in the previous quarter year-over-year. Is this due to some mix effects? Or is it just that you have not increased prices to the extent that you did last year?

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

We made price adjustments in May of a similar magnitude as last year. And then there are a few moving pieces in this equation, one of which is that in the quarter, the Norwegian market was a little bit soft on delivered volumes compared to last year. And then there were certain select discounting that specifically changed in Sweden in -- during the quarter and our value volumes did relatively well. So -- but these are more, I would say, normal fluctuations.

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

All right. Good. Then just finally also, if you have any initial take on ZYN in the parts of the U.S. outside of the West? I guess it's early stage, but is there anything that you can comment on any different patterns than what you've seen before?

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

It's very early. But when we look at this on an aggregated basis, it's quite encouraging to see that the trends in terms of reordering patterns and those stores that have started turning reordered volume, they actually look very similar to the early -- to the installs that we have done in the Western region and the kind of levels we've seen there in the beginning, so that's certainly very encouraging.

Operator

We're taking the next question. It's coming from the line of Anna Frontani.



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Adam Justin Spielman - Citigroup Inc, Research Division - MD and European Tobacco and Beverage Analyst

It's actually from Adam Spielman here. And I just wanted to build on the answer or at least delve more into the answer you gave to that last question. I mean, you've obviously said it's similar to the Western region, but I was just wondering if you could be a little bit more specific. I mean, can you sort of talk about what flavors or strength is the strongest, whether you notice any difference by geography? And my understanding is perhaps at the beginning you saw offtake of, let's say, 10 cans per store per week when you opened stores. Is that the sort of run rate you're seeing? I was just wondering if you could be a little bit more detailed than saying it's roughly similar on average.

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

I mean, with the caveat that there are, obviously, it takes some time before new stores have started to normalize their reordering patterns and so forth, can give you a little bit more. First of all, in terms of strength, we see a very, very similar pattern, where I think the number is roughly 70-30 in advantage of the 6-milligram versus the 3-milligram. I don't have in front of me the details on the flavors but I haven't heard anything that it should deviate from what we've seen in the West.

Adam Justin Spielman - Citigroup Inc, Research Division - MD and European Tobacco and Beverage Analyst

Which is -- can you just outline very roughly what that is? I mean, is there a particular flavor? I'm guessing it's cinnamon that's particularly strong, or is it evenly spread?

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

Yes, I can. It certainly skews mint. And wintergreen is strong and cool mint is strong. And it's a fairly nice spread across the flavors. But wintergreen and cool mint and also spearmint and cinnamon is more 15% of the portfolio, roughly.

Adam Justin Spielman - Citigroup Inc, Research Division - MD and European Tobacco and Beverage Analyst

Yes, okay. That's fine. And then I was wondering, as for the real question, do you have any consumer offtake? I know you were talking about reorders, but do you get data for consumer offtake? I hate to mention the world Nielsen, but anything like that, that gives you a sense of the makeup, is there a sense of what consumers are really consuming?

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

In select chains, we do, and they are in line with the, say, these numbers that we are providing and which are based on shipments. But turning to your question on initial turns, 10 is a bit high. We have actually seen very consistent -- as you know, we track our store universe based on quarterly installs and it's a fairly consistent pattern across the Western region. And now, as I said, also early indications for the rest of the country. And that is more towards around 5, 6, where you're approaching a level of 10. So after 3 months, you're more 6 or slightly north of 6 on average. And what's very encouraging is also that some of the later installs have actually had a -- now I'm talking the Western region where we have longest [years] and actually more impressive performance than some of the earlier installs in the initial phases, really suggesting that product has gotten so established and that the word-of-mouth effect is fairly strong.

Operator

The next question is coming from the line of Mandeep Sangha.



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Gaurav Jain - Barclays Bank PLC, Research Division - Research Analyst

This is Gaurav Jain from Barclays. So I have a few questions. So first is on the modern oral category as it's being called. So your 2 key competitors in the U.S. have both announced plans on expanding in this category in a big way over the next few months. So how should we think of entrants in the face of these big launches which are happening and are going to happen?

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

Well, first of all, I think you should see -- I assume that you refer to BAT's launch of Velo, which is happening right now, and then the announcement by Altria about its acquisition of the ON business, which is a transaction that hasn't closed. But first of all, you should see both those moves as a testament to the strong developments that we have seen with ZYN, which is clear from the kind of investment levels that they're putting into this category. I mean, that -- in that respect, I definitely think that it -- more investments and more variety into -- with the products similar to ours will help growing consumer and retail demand for these type of products. So in that sense, the cake will be bigger. And then, of course, how market shares will play out over time remains to be seen and depending on consumer preferences and competitive activities and so forth. That is very difficult for us to comment on without knowing more details of their plans.

But what's very clear to us from the type of consumer feedback that we are getting on ZYN is that we have created a very strong franchise with consumers. And quite frankly, I haven't seen anything like this in my career in terms of consumer response. And from that -- in that respect, it's also very encouraging that we've been able to follow our plans completely when it comes to capacity buildup and therefore also the expansion on a national basis that -- where we are now in more than 50,000 stores, which means that our products, as we see it, will be well-established across the country in the minds of the consumers.

Gaurav Jain - Barclays Bank PLC, Research Division - Research Analyst

Sure. Now in response to a previous question around margins on ZYN, you mentioned that this quarter had a buildup of distribution costs. So as they normalize through the rest of this year, does it mean that your margins can actually step up further in ZYN from where they are already, which seems are already at a pretty good level?

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

We -- while we anticipate that we will have lower distribution or installation expenses in the form of incentive payments and racks in retail and so forth, given that we will not have the same pace of store installations, now that the product is more -- made more available, we will step up other type of marketing cost in lieu of the ones that you've seen on the distribution business.

Gaurav Jain - Barclays Bank PLC, Research Division - Research Analyst

Okay. And then if I could have a couple of questions on cigars. So can you remind us what percentage of your U.S. flavored cigar business will be in grandfathered cigars? And you mentioned that you're filing SE applications, so what percentage of your current cigar portfolio will get covered by the SE applications?

Thomas Hayes - Swedish Match AB (publ) - Senior VP & CFO

Yes. I'd say that the vast majority of our product portfolio as well as that of our competitors will have to go through the SE application process. So there have been -- the application process for cigars is referencing a date 2007, when the original Tobacco Control Act was put forth. So the changes that have taken place in the industry around foil fresh packaging and cigar filler, virtually every mass market cigar and market has changed in certain respects. So there is this process of substantial equivalence filing that all of us will need to go through.

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Gaurav Jain - Barclays Bank PLC, Research Division - Research Analyst

Okay. And on the current change which has happened in the U.S. cigar industry, is there any difference in cigar volumes in the states where adult-use marijuana has been legalized versus the states where it hasn't been legalized?

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

No. We haven't been able to see any correlation to cannabis states, so to say.

Operator

The next question is coming from the line of Gustav Sandström.

Gustav Sandström - SEB, Research Division - Research Analyst

Gustav Sandström with SEB here. A few questions on distribution for ZYN in the States. What's the rough overlap now in terms of stores selling your cigars versus selling ZYN? Is it one-to-one? Or are there a lot of stores that are not selling your cigars but are selling ZYN?

Thomas Hayes - Swedish Match AB (publ) - Senior VP & CFO

Yes. So -- I mean, we're, as we mentioned, in a little over 50,000 stores with ZYN at the end of Q2. And if you look at our kind of cigar and/or moist snuff portfolio, you're in or around 90,000 plus, so we have a lot of runway left in terms of distribution build that would mirror the balance of our portfolio. And we made the point also in the prepared comments that our distribution build in Q2 also reflected further store expansion even in the West region. So we are not even fully represented in the West region.

Gustav Sandström - SEB, Research Division - Research Analyst

Great. And if you look at those 50,000 stores selling ZYN, are all of them also represented by you with these other products? Or are there stores today selling ZYN that do not sell other Swedish Match products?

Thomas Hayes - Swedish Match AB (publ) - Senior VP & CFO

There may be. I haven't visited all 50,000, but I would say, largely, that we are present with ZYN where we're present with the other portfolio products of our U.S. business.

Gustav Sandström - SEB, Research Division - Research Analyst

And do you think that has been sort of a key selling point in order to get into those stores, to have been able to offering also cigars? Or how does the discussion work out with a typical store owner for them to accept selling ZYN?

Thomas Hayes - Swedish Match AB (publ) - Senior VP & CFO

Yes. And understand that our national expansion plans and the timing of our national expansion plans is more a function of capacity than it was in and around our understanding as to whether or not this product would be successful in the Western region. So we've had, for a number of



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quarters, retailers in the rest of the U.S. wanting ZYN, and we have held back until we felt that we had capacity in place to supply those retailers. So it's a relatively simple sell when you sit down with a retailer and demonstrate what ZYN has been able to do in the Western region.

Gustav Sandström - SEB, Research Division - Research Analyst

And so looking at those addressable stores then, of some -- up to 90,000 stores combining moist snuff and cigars, what's the total -- are there a lot of stores outside of that sphere that you could potentially go after a little bit longer term as this continues to develop?

Thomas Hayes - Swedish Match AB (publ) - Senior VP & CFO

Yes. I mean, I think we're -- if you use our number of roughly 90,000 stores, the leading brands within moist snuff are in more than those 90,000. So there's the opportunity there, and there could be opportunities in channels even outside of convenience, where we've historically not participated that largely.

Gustav Sandström - SEB, Research Division - Research Analyst

So I guess modeling-wise, one thing that sort of caps the potential is sort of your announced expansion production, now maybe you'll have a run rate capacity of say, 135 million cans, including with the Scandinavian capacity when this is fully up and running. In that scenario where you would feel there's more capacity warranted, what's the lead time from your sort of taking that investment decision to having new volumes out in the market?

Thomas Hayes - Swedish Match AB (publ) - Senior VP & CFO

We took the decision, let me get this right, in July 2018 and brought capacity online in the first quarter of 2019. There was some kind of building construction in our Owensboro facility to accommodate the new ZYN lines. But it's, I would say, 12 months at the earliest, but you're probably looking more 12 to 15 months of capacity expansion.

Gustav Sandström - SEB, Research Division - Research Analyst

Great. And then lastly, you mentioned here that the -- highlighted that there were 20 years ago since you offed your cigarette business and obviously, the European cigars are out now from the company. But at what point does it make strategically sense to perhaps start looking at your final smoked tobacco in your portfolio and look for alternatives there instead of holding it within the company?

Thomas Hayes - Swedish Match AB (publ) - Senior VP & CFO

No. I think -- I mean, our view and one of the reasons that we did not divest our U.S. mass market cigar business back in 2010 when we did the STG transaction was quite clearly, we view ourselves as being the best owner of that business. And I would say we still, even today, view ourselves as the best owner of that business. There are challenges in the U.S. cigar market in front of us with the softening HTL volumes. But I think given our position within natural leaf and given our experience and history with regulations, with what we've done within our U.S. General Snus products and the MRTP and PMTAs there, that I think we're best positioned to navigate regulatory challenges in the U.S. for our cigar business.

Operator

The next question is coming from the line of [Charles LaRosa].



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Unidentified Analyst

Is there any comments that you guys have, just with regards to the impact of cannabis in general? Will you enter and will that have an impact on demand, do you think, going forward?

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

This is something -- we see that some of our competitors have made investments in this space and we follow the development. But we don't comment specifically on new product or category initiatives before we've decided to do so.

Operator

The next question is coming from the line of Sanath Sudarsan.

Sanath Sudarsan - *Morgan Stanley, Research Division - Research Associate*

Just a couple of questions from me. First off, on ZYN, I know you are entering new markets in Europe. You obviously need to also provide increased supply in Scandi while also increasing up your ramp in U.S. Could you just tell us what is your priority first in terms of the limited capacity you have? How do you rank it? Is it U.S. first, then Europe you roll out and then Scandi? Or how do you see that? So that's the first question.

And secondly, besides the general mix issue you have in Scandi with snus, how do you kind of come out of this market share -- address the market share loss that you're seeing, especially in the premium category? Can you just step-up more of the initiatives you've done? And what do you expect to see over the next 6 months?

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

Yes. In terms of priorities here, first of all, there are -- in the Scandinavian and European markets, there are 2 different types of ZYN products, the Dry one and the Slim one, which is more of a moist product. And for the moist one, we are not selling in the U.S. at this point in time. So it's -- when we're talking in relationship with the U.S. market, it's more only on -- or it's only on the Dry product. And there, as you know, we have built up significant capacity on the U.S. market with an aim to basically have the U.S. self-sufficient. And then in terms of priorities, we look at a combination of factors in terms of what we believe in consumer response and future potential and so forth.

And as regards these mix issues and the pressure on market share in Scandinavia, I think, first of all, one has to see this from -- it's a coin that has 2 sides, so to say, because what we're seeing is a very dynamic category with an inflow of new consumers into the market. And there, it's difficult for us to sustain our -- the market share we have in the rest of the portfolio given the competitive environment. And -- but it's quite a bit of incremental growth in the category which is very positive, but it does put pressure on our overall market shares. And there, we are focusing on making sure that we fine-tune and come up with new relevant offers in these attractive segments that appeal to this kind of modern consumers. But it does take time to do so.

But we made, for example, now in the premium 2 segment in the Swedish market, as we sort of commented on at the beginning of the call, we made certain product introductions and the repositioning also of a very small, what was essentially a super-premium brand in the Swedish market, where early consumer response is very favorable. And we will be focusing on the nicotine pouch segment also, where the ease of capacity constraints in the U.S. is definitely creating more flexibility.



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Sanath Sudarsan - *Morgan Stanley, Research Division - Research Associate*

Sorry, just to kind of clarify on this. Am I right in assuming that the first priority after U.S. is addressing the Scandinavian supply issue and then look into new markets in Europe. And just to follow up on the second bit you said, you did say that the market is very robust in the sense it's growing 4% to 6%. But given that Swedish Match is only growing very low end of that, actually losing 400 bps of that growth, that's a big problem if the category growth slows down and you see the new consumers coming down. So it's very important to see the market share evolution from Swedish Match. So is that just driven by the new product? Or you do think there is more scope in the traditional products as well?

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

I say it's driven by -- it's a little bit semantics also what you mean by where you draw an exact line between traditional products and new products or more modern products here. And -- but the clearest example is, of course, loose versus pouches. And then you have the scale with the most extreme growth when it comes to nicotine pouches. And we agree with you that it's concerning that we are not taking a higher proportion of the growth in the market. But I think you also have to factor in that, as this growth is driven by new consumers and incremental growth, the consumption of the traditional products, while in a state of decline, are -- doesn't move as fast. So if there is a slowdown of the overall category, it's also likely that, that coincides with a slowdown in the segment shift. That's not a given, but that's the likely development.

Operator

(Operator Instructions) There are no further questions at this time. Please continue.

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

Okay. Then we would like to thank everybody for having participated today, and inform you that our Q3 report will be published on October 25. Thank you.

Operator

That does conclude our conference for today. Thank you for participating. You may all disconnect.

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