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SWMA.ST - Q1 2018 Swedish Match AB Earnings Call

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MAY 04, 2018 / 12:00PM, SWMA.ST - Q1 2018 Swedish Match AB Earnings Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen. Thank you for standing by, and welcome to today's Swedish Match Interim Report January to March 2018. (Operator Instructions) I must advise you, this conference is being recorded today, Friday, the 4th of May 2018.

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

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

Thank you. This is Emmett Harrison with the Swedish Match First Quarter 2018 Telephone Conference. And with me today are Lars Dahlgren, our President and CEO; and Tom Hayes, our CFO.

In the Investor 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.

In that same Investors 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 uncertainties. 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.

On 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.

So with that, I will now turn the conference call over to Lars, who will begin on Slide 4 of the presentation.



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

Thank you, Emmett, and good afternoon, everybody. Q1 marks a strong start to the year for Swedish Match. Our operating profit performance was aided by some calendar effects but this was more than offset by negative currency translation.

In that respect, we're pleased with the reported revenue and operating profit growth. Within snus and moist snuff, the key contributors to growth were the strong performance of our snus business in Scandinavia, both as reported and on an underlying basis and the continued impressive growth of snus and ZYN outside Scandinavia.

For OTP, cigars continued its growth trajectory with volumes up by 11% on a constant trading day basis. Cigar sales also grow due to higher average prices as a consequence of mix effects.

The acquisition of V2 in August 2017 strengthened our position in the niche European chewing tobacco market, further contributing to sales growth in our OTP segments. And the decline in sales for chewing tobacco in the U.S. was mainly driven by negative currency translation.

We're also very pleased to have acquired a relatively small but iconic Oliver Twist chewing tobacco business in Denmark, transaction that occurred after the close of the quarter.

With the strong sales performance within snus and moist snuff and a significant reduction of operating losses from our investment in snus and ZYN outside Scandinavia, the operating margin for snus and moist snuff notably improved.

For OTP, the results improvements in local currencies were broad-based. While V2 contributed favorably to our chewing tobacco performance, our organic chewing tobacco business also demonstrated profit growth in local currencies despite the margin of declining sales.

For cigars, the profit growth in local currency underperformed revenue growth due to negative mix effects on the cost of goods as well as FDA-related costs. And as a result, we experienced a decline in the operating margin for OTP.

The 1 product segment that had a disappointing quarter was like with declines in both sales and operating performance. The weak performance of our Lights segment was principally due to volume declines but unfavorably -- unfavorable currency effects and restructuring cost in the quarter also adversely affected reported result.

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

On Slide 5, we have summarized some of the quarterly highlights of the snus and moist snuff product segment. Both sales and operating profit grew sharply on a local currency basis due in part to strong volume development of our Scandinavian snus business.

Our own shipment volumes in Scandinavia were notably stronger than last year's first quarter, up 9% on a reported basis, reflecting the benefits of both positive quarter-on-quarter calendar importing effects and the acquisition of V2 Tobacco in August of 2017.

Match estimates that its underlying organic volumes were up by more than 2%. Pricing was also up in both Sweden and Norway, but in Sweden, mixed effects partially offset the effect of price increases.

For moist snuff in the U.S., Swedish Match shipment volumes were down slightly in the first quarter but were up on a constant trading day basis. Volume growth from our pouch products substantially offset declines from our loose portfolio.

Sales were flat while operating profit increased modestly. Quarterly fluctuations in volumes, sales and profits for our U.S. moist snuff business are normal with promotional phasing.



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The net operating loss for snus and ZYN outside of Scandinavia improved by SEK 39 million versus the prior year and amounted to a loss of SEK 3 million. ZYN growth in the U.S. has been particularly robust, sourced for both distribution gains and increased velocities at retail.

During the first quarter, we expanded distribution and ZYN is now available in more than 10,000 retail stores.

On Slide 6, we have provided estimates of trended total market and Swedish Match volume growth in Scandinavia, adjusted for hoarding and calendar effects as well as Swedish Match organic price volume effects by quarter. Market growth over the past 4 quarters has remained relatively stable at around 4% with our own volume growth in the late -- latest quarter up a bit more than 2%.

Adjusted for fluctuations in the exchange rate of the NOK, the underlying price/mix effect for Swedish Match has been at a similar level for the past 3 quarters.

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

Slide 7 presents Swedish market growth trends in volume and value terms according to Nielsen on an unadjusted basis.

Our assessment is that Nielsen often underestimates market growth due to the exclusion of e-commerce volumes. Price increases since May 2017 have provided support to the total retail value growth of the Swedish snus markets, as have some mix shifts among segments.

While Nielsen estimates that the category growth close to 3% year-on-year in the first quarter when our definitions of segments, the value of products segment grow by 1% and the premium products segment grow by 7%.

This is a function of the rapid development of premium brands at price points somewhat lower than traditional premium pouch products.

Next week, on May 7, we will be making upward price adjustments in Sweden, largely in line with the price adjustment taken in the prior year.

On Slide 8, you can see our share performance in Sweden within the premium and value segments according to Nielsen. Our share decline in the premium segment is due to competitor gains in pouches, but also due to the continued category decline rate of the premium loose segment, where our share is estimated to more than 95%.

Our innovative product offerings in the premium segment, XR and One, now have more than 9% of the overall market on a combined basis compared to about 7% of the market prior to the launch of One in the fall of 2017.

Nielsen reports that our premium volumes grow year-on-year for the past 2 quarters but not quite as fast as the overall market. Both XR and One fits specific consumer needs and with the launch of One, we have not experienced notable cannibalization of XR.

Within the value segments, what we have been growing with our higher-priced Kronan brand than mid-2017 delisting of Mustang pouch products capital with share losses for Kaliber resulted in an overall decline of our share within that segment.

Moving to Slide 9. In Norway, the category growth for the first quarter remained at very healthy rate at around 5% in volume terms, very much in line with the full year of 2017. And as in previous years, the growth in retail value has outpaced volume growth as a consequence of excise tax increases and manufacturers price changes. Our price increase during the first quarter was in line with prior years at a bit more than 2%.

Transitioning to plain packaging, in July at the latest, may be a factor that could influence both quarterly market growth rates and shipment volumes during Q2 and Q3, primarily.

We continued to show very good progress in our performance in Norway share-wise, as you can see on Slide 10. The year-on-year share decline in the first quarter was negligible with a drop entirely due to loose products. Our share in the pouch segment was up from Q1 2017 levels.



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A continued growth of the third largest player in the market with its focus on the all white segment makes Norway more competitive from a market dynamic perspective. Despite these challenges, we are making progress in our strategy of having quality innovative products available in the most desirable growth segments.

To our G.3 products, our share in Q1 remained stable at about 13% total market following marked growth during 2017. G.3 skews more heavily towards young adults, especially men, but also does well among young adult women.

The relatively new all white segment is especially appealing to younger adult women. Swedish Match was hardly present in the segment until the middle of 2016. Following the launch of our products within the G.4 range, we have been able to gain market share, and we now hold about 15% of this attractive segment.

On Slide 11, you can see some of our more recent new product introductions. In addition to a national rollout of a G.4 variety in Norway, we also launched a new strong product under the G.3 umbrella, Load. Load Super Strong was introduced in stores in early March and is the first Swedish Match product available in plain packaging. Next, to the plain packaging can, you can see the version of the same product as it looks on the Swedish side of the border.

ZYN in Sweden now has 3 new varieties under ZYN Slim. These all white products contain nicotine, but no tobacco, like the rest of our ZYN assortments. The difference is that the ZYN Slim products are a bit fuller in the pouch and moist, which should be interesting to current snus consumers. From July 1, ZYN will be packed at SEK 200 per kilogram, which is significantly less than the weight they packed for snus.

Turning to the U.S. and moist snuff. The moist snuff category has demonstrated minimal volume growth during recent periods. Despite the absence of volume growth, the moist snuff category has demonstrated healthy growth in value terms in the range of 6% to 7% as the result of price increases and some increased excise taxes.

One segment that is growing at a much faster rate in volume terms is moist snuff pouches. The pouch segment now makes up about 16% of the total category, and we have been gaining share within this attractive segment. This performance in the pouch segment has helped offset much of the share declines we have experienced from our traditional loose products.

On Slide 13, you can see the rolling 4 quarter volume trajectory for snus and nicotine pouches in markets outside Scandinavia with the bulk of this volume being in the U.S. ZYN has achieved rapid growth in the U.S. market but you can also see solid growth development for snus. While part of this is attributable to the V2 acquisition, our U.S. snus offerings are also experiencing healthy volume growth. In the 9,000 stores, where both snus and ZYN are available, ZYN has grown to the point where ZYN volumes outsell the entire snus category and the combined category of snus and ZYN has demonstrated strong growth. While this may not be the case when ZYN is in full national distribution due to regional preferences, there is no doubt that this is a positive testament to the consumer appeal of this all white nontobacco nicotine pouch product.

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

Turning to the OTP segment and Slide 14. For cigars, the strong volume growth continued and while fewer shipping days in 2018 negatively affected the revenue comparison, strong volume growth from our natural leaf cigars, particularly rolled leaf, resulted in a positive mix effect from the revenue side. Rolled leaf cigars are more expensive to produce, and as such, these mix effects adversely affected our cost of goods sold, which had a negative impact on operating profits. We have now implemented a price increase on our rolled leaf assortment but it is too early to draw any conclusions on how this will affect volume growth for our rolled leaf assortment. The increase in FDA-related cost results from changes to packaging and point-of-sale material that need to be up -- that need updated warning labels in August of this year.

U.S. chewing tobacco had a good quarter with modest volume declines on a constant trading day basis. Swedish Match grew market share in both the premium and value segments, but negative mix effects within the portfolio more than offset price increases. Reported sales and operating profit for our overall chewing tobacco business increased due in part to the inclusion of V2 Tobacco, where we also experienced profit growth from our U.S. business in local currencies.



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On Slide 15, you can see our volume trend for cigars. These trends reflect our concerted effort to actively pursue the faster-growing segments within the category. Our success has increased competitive activities within the natural leaf small and rolled leaf segments. And with the natural leaf small, we lost a little bit of share in the quarter year-on-year. But with the attractive positioning of our portfolio, we still outpaced the overall category growth during the quarter.

As the graph depicts, there tend to be some quarterly fluctuations on shipment patterns between segments due to, for example, limited-time offerings. As you can see in Q1, we had relatively tough comparisons for HTL but rather easy comparisons for natural leaf.

Turning to Lights in Slide 16. Sales and volumes for both matches and lighters were lower with volumes for lighters being especially weak. Demand has been adversely affected by declining cigarette consumption in certain of our key markets, but part of the decline in shipments relate to factors that have temporary nature, and we had also stopped supplying a lighter model manufactured by a third party. While there were some positive price and mix effects, they were not enough to offset the volume declines. The weak Brazilian real also contributed to the poor result as it caused, relating to a restructuring in Brazil, of approximately SEK 12 million.

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

Slide 17 contains a summary of regulatory developments. We are clearly disappointed with the recommendation by the Advocate General in the ECJ case on the legality of the snus ban. Given the ideological influence on tobacco control issues, we considered it -- consider it particularly important that there is a proper judicial review of political rule and policymaking decisions. The final verdict of the ECJ is expected in a few months, and while we realize that the recommendation of the Advocate General is very negative for our chances to prevail, we still hope that the court will arrive at a different conclusion.

In the U.S., we view the publications of the [ANPRs] (sic) [ANPRMs] as a sign that the FDA is prepared to move forward with its policy making ambitions spelled out in its July 2017 announcement, where the benefits of harm reduction in tobacco were more clearly recognized. Overall, the desire by the FDA that consumers should move to less harmful products is very well aligned with our strategy.

With regards to regulation of flavors and the potential impact on the cigar market, it is too early to assess the outcome of potential regulation, and our assessment is that we are well positioned relative competition when it comes to the use of flavors in the faster-growing segments of the market.

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

On Slide 18, we've summarized relevant metrics from our interim report relating to finance cost, our financial position and our earnings per share. The finance net improved versus the prior year due to lower average interest rates, partially offset by increased average debt levels. The weighted average interest rate of our portfolio at March 31 was 2.5% and that compares to 2.64% at the end of 2017. The capital duration of our portfolio was 4.8 years with 96% of the portfolio subject to fixed interest rates.

During Q1, we paid back borrowings of SEK 500 million and have SEK 750 million of future maturities for the remainder of 2018 that have an average interest rate of 4.1%. For modeling purposes, please note the low net interest cost in Q2 and Q4 of the prior year that were impacted by dividends received from STG.

On a reported basis, our net debt trailing 12-month EBITA at March 31 was 1.7, but factoring in the ordinary and special dividends paid in April of this year, that measure would have been 2.4.

The EPS bridge on this page illustrates the components of our 15% growth in adjusted EPS. Apart from the aftertax effect of our increased operating profit, both the lower tax rate and reduced number of shares had a meaningfully positive impact.

The lowering of the tax rate principally resulted from the U.S. income tax reform. The last page of the presentation simply repeats the outlook statement from the interim report. We have not made any changes to the outlook statement this quarter.



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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 in Q2 of the prior year.

The average exchange rate for the U.S. dollar was SEK 8.8; the NOK, SEK 1.03; and the Brazilian real, SEK 2.74. For the full year of 2017, those same average exchange rates were SEK 8.54, SEK 1.03 and SEK 2.68.

Finally, before opening up the floor to questions, I would like to point out that our first quarter represented our first reporting period under the new IFRS revenue recognition standard. The adoption of IFRS 15 resulted in what I consider to be a more appropriate reflection of revenue and margin developments for the group. The interim report contains a table reflecting reclassifications effects of this standard on a quarterly basis for 2017. And just as a reminder, the release of our Q2 report will be on July 19.

With that, operator, please open up the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And your first question comes from the line of Stellan Hellström.

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

Yes, I'd like to start with the price increase that you will take in Sweden. To start with the level here around 2%, that would be reflecting the expected consumer price increase, I would imagine. And also is this sort of evenly distributed price increase among the different price brackets?

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

This is Lars here. Stellan, it is, of course, the retailers that dictate the final price to consumers. But based on history and today's taxes, there's typically not that big difference between manufacturers take and what ends up being the increase to consumers. So you would expect to see something similar to that. And with that, it's around 2% and then of course, people have to be reminded that we do expect some continued mix effects, particularly within premium, I would say, where the fastest-growing segment of the entire market actually is this Premium 2 segment with a little bit lower price than the traditional premium segment 1.

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

Sure. Also, the question on the sort of distribution of the price increase at (inaudible) and -- yes, sure.

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

It's across most products, but the difference, a little bit. And then not on all, like for example, One, that one is relatively new. That doesn't mean that, that adjusts prices during the year. That's a question we'll have to revisit but it's fairly similar to the prior year.

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

Is there anything in particular that you would see that would make you change this in any way? For example, raising prices more on the lower end of this on the market?



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

Well, I'll take it back to any future pricing decisions in the future.

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

Sure. I'd like to ask also on the calendar effects here in Q2. There are some other effects also lifting your volumes in Swedish -- or in Scandinavian snus. Are we to assume that the calendar effect is about 5% and that would be reversed in the coming 2 quarters? Or...

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

That sounds a little bit high. I mean there is a positive Easter effect in Q1 of this year. But part of the very strong shipment comparison is attributable to relatively weak volumes in Norway in Q1 of prior year, following year-end hoarding in 2016, it must be, if I get the years correct. So it's not only an Easter effect that you see in here.

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

Okay, okay. Then on the neutral packaging in Norway, are these effects material in any way for you in the results? I mean, quarters? What do you expect...

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

Nothing, it's -- I mean, not in this quarter. And then what we point to is that, naturally, it's a little bit hard to predict exactly how it will affect shipment patterns and so forth around the transitioning date. So it's more to remind people that this is happening and it could distort shipment volumes.

Operator

(Operator Instructions) And your next question comes from the line of Adam Spielman.

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

I have 2 questions. The first one is around Norway. Obviously, you lost a little bit of share sequentially quarter-on-quarter. And now is that entirely due to the growth of all white or is there other factors? Has a #2 player got its act together? Could you give just a little bit of comment around that? Would be lovely.

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

I'm looking a little -- Emmett, do you have the details? Definitely, the main effect is that a [port] has taken market share in the Norwegian market. In terms of Imperial, it's my recollection it's relatively flat right now.

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

That's right. I mean our overall share decline was all due to loose if you looked at it on an annual basis.



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

And is -- and you said you had 15% share, if I remember rightly, of the all white segment. Or should I go back...

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

That's correct.

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

Yes. Okay. And then can I just ask a little bit, is there any more color you can give on the progress of ZYN sort of by regions? Or we think about it quite a lot, but is there a little bit more you can give about, so which regions are doing best or worst? Or which factors are causing it to do best or worst?

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

Well, region-wise, we are almost exclusively in the Western region. We have entered the Chicago market but that's relatively recent and it's much, much fewer stores. And when you look across the Western region, it does, I'd say, well across the region. It's -- some people live with the impression that California has the strongest state. That is not the case. We see, relatively speaking, we see good progression in California as well, but we see even stronger counts per store per week in some of the more inland states in the Western region.

Operator

Your next question comes from the line of Fulvio Cazzol.

Fulvio Cazzol - Goldman Sachs Group Inc., Research Division - Equity Analyst

I've got two related to ZYN. Firstly, could you give us some color on your expectation about how this product could develop in Scandinavia versus the U.S.? Maybe if you can just highlight some of the differences in terms of consumer and where the consumer's coming from between the 2 regions, please. And then my next question is on ZYN, outside of Scandinavia and outside of the U.S., basically in Europe.

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

On the last question, it is clearly not the tobacco product and did not -- therefore, not fall under the snus (inaudible) but what is the case, though, is, as you think about it similar to when e-cigarettes came into the market, it was sort of nonexistent product and category. So I think it's fair to say that this is something that needs to be worked out in the future, but we definitely see that there could be potential for ZYN or similar products to ZYN in your main European marketplace. In terms of the sourcing of consumers in the U.S. versus Scandinavia, I definitely think that there are some differences. And if you look at the white segment in Scandinavia, it is very much young adult females. That is true for Sweden, that is true for Norway. In the U.S., we see much more of a sort of broader tobacco user population. So we see that it's pulling from cigarette smokers. We are seeing that it's -- it was from some more snuff users and even some chewing tobacco users and probably on the margin of snus users as well. And it over skews quite strongly in male, but a little bit less according to information we have than compared to traditional smokers, which could be expected. With that said, just to be clear, as part of the PMK application, we go through a very extensive consumer research but it also follows very strict protocols whereby we don't look at the data until it's fully analyzed and complete according to the protocol. So if this would have been a non-PMK market launch for today, we would have done much more specific consumer research and store intercept and so forth than we currently have done. So part of the U.S. information is based on anecdotal information and information to our call center, et cetera.



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Operator

(Operator Instructions) And the next question comes from the line of Chas Manso.

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

Yes, so my questions. On ZYN, you're saying you're now 10,000 outlets. I was wondering whether you could share with us what your target is for the year-end. I mean from a small base, obviously, very fast growth here, almost 100% in the quarter in volume terms. Just wondering whether it was more in value terms and whether that kind of rate is a good indication for the full year. Those will be the ZYN questions. And on the OTP, clearly, a big drop in margins in Q1, quite a few moving parts. Just wondering what the new normal is, really, in the OTP margin developments going forward. And finally, on currency, you did point out currency. I was just wondering given recent dollar strength, whether the FX headwinds that you had in Q1 really now turns into a positive for the rest of the year.

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

So if I take the first question on it. Tom, answer on the OTP margin and the currency. When it comes to ZYN, for the remainder of this year, we plan for some additional stores and there are some change and so forth that express a strong desire. But this is all something we need to manage closely as we bid some capacity here in Sweden. And quite frankly, we will not ramp up distribution in too much before we have the capacity onboard in the U.S. So we should expect some distribution gain for the remainder of this year but nowhere near doubling, so to where we are now compared to the end of the year, for example. And we did build gradually also during last year, so on balance, we will probably have -- now I'm looking at Tom, about twice the distribution on average in '18 versus '17, I would say. But a very meaningful part of the growth that you've seen has come from increased velocity. So if you take the latest, about 1,500 stores that we added during this quarter, they had a significantly lower velocity than the bulk of the stores, but similar to where the other stores started also when we introduced them.

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

And on the OTP margin point, I would say that Q1 was a unique quarter with respect to OTP margin. Both a function of the portfolio mix that we saw, much heavier rolled leaf volumes in anticipation of the price increase that was affected. But also cost that would not be repeated to the extent in the remaining quarter of the year related to the FDA packaging change, both on the packaging itself but also to include point-of-sale materials. So that I would not characterize it as a new normal in OTP margin. And then currency effect, it's interesting that if you ask me that question 1.5 weeks ago, I'd probably give you a different answer. But I would say on balance with where the rates have increased of late, we're effectively on parity with Q2 of the prior year. You may recall Q3 and Q4, we had significantly lower U.S. dollar to SEK rates. So we were anticipating even before this latest ramp up some currency tailwind in Q3 and Q4.

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

And on (inaudible) it looks fairly certain that we'll get the positive effects already next quarter.

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

Okay. But would it be tough to replicate last year's margin in OTP?

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

That's something we'll have to see where we may end up. I think it's important thing to keep in mind now that there are some factors that depresses the Q1 margin based on what we see as the underlying capability of that business.



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Operator

And your next question comes from the line of Niklas Ekman.

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

Yes. First, a question about plain packaging in Norway. I was curious, first of all, have you started converting the existing portfolio into plain packaging? And I was also curious if you anticipate any significant costs relating to -- I suppose if you were late in your transition, you might have to actually buy back and maybe cancel previous orders if you anticipate costs related to this or is this just a marginal issue?

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

We are -- right now, we only have 1 product out in plain packaging. But as we speak, if it's about to happen very soon that you'll see a gradual implementation on shipments. We can't rule out, of course, that there will be some costs associated with this, but we don't expect any material impact. We've had some cash flow impacts already whereby it, for example, has to rebuild some lines to move away from the paper counts and the loose assortment to plastic counts to comply with the new legislations. There are some overall negative financial effects.

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

Okay. And a second question is on the price hikes here in Sweden in May. I was just -- if you could clarify because when you talk about manufacturers take, I assume that it's manufacturers take, including tobacco tax, so in excluding tobacco tax, you're talking about a little bit more than 2% price hike. Is that fair to assume?

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

I'd say it's excluding tobacco tax. We're talking in that magnitude of 2, maybe slightly above. And -- but if you look at -- as to say it's largely similar to last year. If anything, slightly, slightly less if you look on some of the various products and -- but similar magnitude. And if you take Q3 last year versus Q3 the year before, that was a net pricing effect on the Swedish market of plus 1.5% so that's -- that was your residual at that quarter after mix effects.

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

Very good. And then I was also wondering about the new tobacco law that will be voted for now in May, when will this be implemented? And do you see any tangible effects coming from this with the self-service ban and can not allowed to carry less than 20 pouches. If there's anything that will affect you maybe negatively or maybe even positively?

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

On the latter point there of the minimum requirement of 20 pouches, it's very, very small impact. It's minor SKUs that had to increase a couple of pouches or so. When it comes to the ban on self-service, I think it's fair to say that it's -- most of the impact will be at the retailers themselves because, obviously, some of the smaller retailers, it will be kind of a challenge to rebuild. And so far, how that potentially will impact category, I think, it's hard to say. Not dramatically in my opinion, but may be some people who otherwise would have tried something else will ask for the calendar used yesterday instead, but we're talking small effect here in my opinion.



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

Okay, fine. And then finally, just on ZYN and the potential expansion to other European countries. Is it fair to assume that you're now waiting with launching in additional countries maybe -- mainly because of production constraints? And once you have your full production up and running in mid-2019, you will be willing to test additional European markets, is that a fair assumption?

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

I would say that when it comes to the dry product of ZYN, that is the can that we're selling in the U.S., that is definitely at least the consideration. When it comes to ZYN Slim product, we don't have the same type of internal competitions, that is to say, between U.S. cans and European cans. So we'll be evaluating potential opportunities outside Canada, but this is something we need to get back to. As I said, it is -- the regulatory landscape is unclear given that it's a nonexistent category, and we want to do this in a prudent way and in dialogue with the relevant authorities.

Operator

(Operator Instructions) And the next question comes from the line of Fulvio Cazzol.

Fulvio Cazzol - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Sorry for another question. I was just wondering if you can give us your thoughts on how the rest of the year could shape out for the cigar business. I guess when you think about volumes in Q1, the -- on an underlying basis, they seem to be quite solid and the comparables become a little bit easier for you. I know that the second half last year, you were (inaudible) particularly tougher comparables. How should we think about the shape for the rest of the year? And is 11% underlying kind of sustainable given your innovation pipeline, please?

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

Historically, the cigar category, it can vary in terms of shipments from quarter-to-quarter, but we have a very strong portfolio of attractive offerings in the fastest-growing segment of the market. So we feel good about the cigar market overall, and I think it's fair to say that we feel particularly good about the segments where we have strong position. And take, for example, the rolled leaf segment was -- is a relatively small part of the market. It's 8% of the market, excluding the cigars, but it was substantially growth in that segment. We feel good about that. The one caveat that we need to throw in there is that we did, as Tom pointed out, announce price increase on our rolled leaf assortment and that probably even helped our volumes a little bit in Q1 as it will come by in ahead of the price increase. And it remains to be seen for the consumer and trade reactions to that price increase and throughout the year. But even after the price increase, we feel that our offering is -- will (inaudible) leaf is competitively priced in the marketplace.

Fulvio Cazzol - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Can you disclose roughly what the price increase is?

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

What I would say is on a packaging format, we went from 2 for \$0.99 to 2 for \$1.29.

Operator

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



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

Okay. Then we thank everybody for listening today and asking good questions, and we hope to hear back from you in conjunction with our call after the release of our Q2 results.

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

On July 19.

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

Thank you.

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

Thank you.

Operator

Thank you very much, ladies and gentlemen. That does conclude our conference for today. Thank you for participating. You may now all disconnect. Speakers, please standby.

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