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SWMA.ST - Q3 2018 Swedish Match AB Earnings Call

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## PRESENTATION

### Operator

Good afternoon, ladies and gentlemen, and thank you for standing by. Welcome to today's Swedish Match Interim Report January to September 2018 Conference Call. (Operator Instructions) I must also advise you that the conference is being recorded today, Friday, the 26th of October 2018.

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

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

Thank you. This is the Swedish Match Third Quarter 2018 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](http://swedishmatch.com) website, you will find the presentation for today's call, which is intended to be viewed in conjunction with our prepared commentary, so we encourage you to follow along with that presentation. In that same Investors section, you will find 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 expectations. A recording of this call will be made available on the Swedish Match website.

Slide 3 of this presentation reiterates the bullet points from our interim report released this morning, and we refer you to the report rather than repeating them on this call.

I will now turn the conference call over to Lars, who will begin on Slide 4.

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## OCTOBER 26, 2018 / 12:00PM, SWMA.ST - Q3 2018 Swedish Match AB Earnings Call

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

Thank you, Emmett, and good afternoon, everybody. Q3 was another strong financial quarter for Swedish Match. The increase in sales and operating profit in local currencies was driven by our 2 largest product segments, snus and moist snuff and other tobacco products. The sharpest increase in operating profit was seen in the snus and moist snuff segment, stemming from very good development for snus in Scandinavia, coupled with the significantly better results for snus and nicotine pouches outside Scandinavia.

The impressive results in Scandinavia was achieved by strong top line development. Already good overall category development further improved in the quarter as we saw an acceleration of volume growth in the Swedish snus markets. While there can be quarterly fluctuations, we attribute the acceleration in Sweden to the dynamic competitive situation in Sweden, particularly within the premium segment, as well as very good summer weather that most certainly increased snus consumption.

Despite losses in market share in both Sweden and Norway, Swedish Match generated very healthy volume growth, and on top of that, improved price/mix.

Snus and nicotine pouches outside Scandinavia once again reported operating profit compared with operating losses in the prior year. As planned, distribution build in the U.S. for ZYN, our nicotine pouch product without tobacco, slowed somewhat during the quarter due to manufacturing capacity constraints. We remain very enthusiastic about the longer-term market opportunities for ZYN, and we note that increased volumes and velocity rates during the third quarter, both on a year-on-year and a sequential basis. Further efficiencies in marketing support for our U.S. snus offerings also contributed to the favorable financial performance during the quarter.

We also made an acquisition within our snus and moist snuff products segment during the quarter, Gotlandssnus, a boutique manufacturer of high-quality snus and pouches without tobacco or nicotine, which is a terrific complement to the Swedish Match snus portfolio. It is worth noting that both V2, which we acquired last year, and Gotlandssnus have products within their portfolios which existed in the U.S. market prior to certain important cutoff dates under FDA regulations, enabling us to explore interesting growth opportunities not only in Scandinavia but in the U.S. as well.

Within the Other tobacco products segment, Swedish Match once again reported year-on-year cigar shipment growth during the quarter. Cigar shipment growth continued to be driven by our rolled leaf assortment despite the price increases taken earlier this year.

While the growth rate of cigar shipments during the quarter slowed relative to recent year levels, we're pleased to see that our financial performance of this business now reflects a contribution from not only volume growth but also from favorable price/mix developments within our portfolio.

For chewing tobacco in the U.S., we continue to experience the financial effects of the market trends toward increased demand for value-priced products. We have effectively responded to these market dynamics, and we outperformed the category, measured in shipments from distributor to retail in both the premium and the price-value segments during the quarter.

Despite the market challenges that we faced in the U.S. chewing tobacco business, sales and operating profit for chewing tobacco as a whole increased due to our recent acquisitions.

For Lights, despite challenging conditions in several markets and some pressure on raw material costs, operating profit held up well versus prior year as relatively strong shipments volumes for matches and favorable price/mix for lighters were the contributing factors.

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

On Slide 5, we have summarized some of the quarterly highlights of the snus and moist snuff products segment.

Reported sales and operating profit were up sharply in the quarter, up 16% and 21%, respectively. While currency effects positively contributed to the performance, our underlying financial performance was also quite strong, with sales up by 12% in local currencies. As Lars mentioned, snus

## OCTOBER 26, 2018 / 12:00PM, SWMA.ST - Q3 2018 Swedish Match AB Earnings Call

and nicotine pouches outside Scandinavia reported a net profit in the quarter and meaningfully contributed to the profit improvement within the snus and moist snuff products segment.

For the Scandinavian snus business, sales and operating profit growth resulted from increased volumes, positive pricing and stronger NOK versus the SEK. Swedish Match shipment volumes, including volumes from V2 Tobacco acquired in 2017, were up by more than 7%.

For moist snuff in the U.S., Swedish Match shipment volumes declined at a somewhat more pronounced level than during the first half of the year due to overall category softness, market share losses and our loose assortment and promotional facing. Volume declines from our loose products, including tubs, more than offset continued growth from our core pouch portfolio.

On Slide 6, we have provided estimates of the trended total market in Swedish Match volume growth in Scandinavia, adjusted for hoarding and calendar effects, as well as Swedish Match organic currency-adjusted price/mix effects by quarter. The increasing trend in the market growth rate during the first half of 2018 was influenced largely by Norway's increased relative share of the total Scandinavian market as the Norwegian market has historically grown at a quicker pace than the more mature Swedish snus market.

In the third quarter, however, competitive activity within the Swedish premium segments at both the full price and popular price premium levels, fueled category growth in Sweden, resulting in a year-on-year Scandinavian volume growth approaching 7%, whilst Swedish Match's volume -- underlying volumes were quite strong based on historical norms at slightly more than 4%. Our growth rate underperformed the market, and we lost market share in both Sweden and Norway.

Currencies also provided a nice tailwind during the quarter as the SEK weakened year-on-year relative to the NOK. While the price/mix effects were up 2.1% on a constant-currency basis, realized price/mix effects across our Scandinavian portfolio were up by more than 3% when not adjusted for currency effects.

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

Slide 7 presents Swedish market growth trends in volume and value terms according to Nielsen on an adjusted and year-to-date basis.

While we believe that Nielsen underestimates market growth due to the exclusion of e-commerce volumes reflects no trend is likely fairly representative.

The graph clearly depicts the strength of the Swedish snus category this year. For the year-to-date period, the reported growth in retail value is well above the growth in volumes, but it should be noted that during the third quarter, the growth rate and volume and value terms were more similar. While there have been price increases in the category, the fast growth of the premium snus segments has resulted in negative mix effects within the premium segments.

On Slide 8, we can see our share performance in Sweden within the premium and value segment as well as total share according to Nielsen. Our year-on-year share performance has declined, most notably, within the premium segment. In part, this is due to the category decline of loose products, where we have a very strong share, but also due to gains by competitors in the premium pouch segment.

For premium pouches, we see a correlation between the increased competitive activity and category growth. According to Nielsen, premium pouches grow by close to 10% versus the prior year in volume terms. The premium segment is also usually strong during the summer, so in that respect, the warm weather has been particularly helpful for the development of this segment. This impressive growth is primarily driven by products in the premium 2 segments, with pricing below the price points of really more traditional premium products. But we've also seen strong growth in the evolving all white nicotine pouch category, including good growth for our own product, ZYN.

Within the value segment, a segment that grow by less than the overall category rate, Kaliber plus, a range of products within the Kaliber family that was introduced at the beginning of 2017, has not lived up to our expectations. The slightly higher-priced brand, Kronan, has held up better.



## OCTOBER 26, 2018 / 12:00PM, SWMA.ST - Q3 2018 Swedish Match AB Earnings Call

Moving to Slide 9, which shows the volume and retail value growth in Norway, also according to Nielsen. In Norway, we consider the Nielsen coverage to be more complete.

As you can see in this graph, the strong category dynamics for the year-to-date period are very similar to the full year of 2017. Plain packaging is fully enforced since July 1. The change over to plain packaging in Norway has gone smoothly for Swedish Match with only limited out-of-stock situation, but it's still too early to assess if there will be any longer-term category implications.

For the third quarter, Nielsen reports unusually steep declines for the loose segments. But on the other hand, the loose segment held up better than historic trends for the first 6 months of this year.

Slide 10 depicts our market share development within different segments in Norway. During the third quarter, we experienced market share losses both versus the second quarter and versus the prior year. As is the case in Sweden, one should note the continued decline of the loose segment, where we have a very strong share position. We also lost share within the power segment, but much of which can be attributed to the rapid shift toward all white nicotine pouch products, which is becoming an increasingly crowded part of the market in terms of competition.

Recently, our largest competitor in Norway has entered this segment.

The all white nicotine pouch segment now has over 10% of the total Norwegian market according to Nielsen. And our market share within this segment is currently close to 19%, up slightly compared to our share at the close of the second quarter.

Slide 11 simply provides some further detail to our year-on-year share development in Norway and decomposes the share performance into the effects coming from pouches and loose, respectively. The loose segment now accounts for less than 8% of the total market, and our market share within that segment is above 90%.

Turning to Slide 12, where you can see some of our more recent new product introductions in Scandinavian. In Sweden, we introduced the new variety to our XR assortment, a strong version of Göteborgs Rapé slim. The initial response to this line extension has been very positive. At the end of the quarter, we overhauled our portfolio of our Kaliber value price brand, with both new packaging and improved product formulation. Our series of rotating Small Batch products within the premium segment in Sweden is only sold in limited quantities, but this initiative has been very appreciated by consumers.

In Norway, we had no new product offerings during the third quarter. One should note that we had a heavy portfolio of new product introductions in Norway, and the quarter is preceding the move to plain packaging.

Turning to the U.S. and moist snuff in Slide 13. In volume terms, the U.S. moist snuff category has been flat to slightly down for both the third quarter and year-to-date due to volume declines in loose, which were only partially offset by volume gains in the pouch segment. In value terms, the category has, according to our estimates, grown by close to 5% year-to-date as a result of price increases and some increased excise taxes.

Moist snuff pouches are growing at a much more pronounced rate than the overall market in both volume and value terms. Year-to-date, Swedish Match pouch growth in volume terms is up by more than 9% according to our data of distributor shipments to retail. In value terms, our pouch portfolio grow at twice the rate of the overall pouch segment.

Our growth in both volume and value terms for pouches is driven by distribution gains as well as more rapid store velocity.

Turning to Slide 14. You can see the rolling 4-quarter volume trajectory for snus and nicotine pouches in markets outside of Scandinavia, with the bulk of this volume being in the U.S. During the past few quarters, we showed you a similar slide that included volumes from the V2 acquisition. And if you were to include V2 snus outside Scandinavia, the number on the farthest column would will be about 4 million cans higher. By stripping out V2, you can see a clear picture of the volume trajectory for snus, mainly in the U.S., which lately has been rather stable.

## OCTOBER 26, 2018 / 12:00PM, SWMA.ST - Q3 2018 Swedish Match AB Earnings Call

For ZYN, we have worked hard to increase installed capacity to keep up with the growing market demand. We ended the quarter with ZYN distribution in around 13,000 outlets, mostly in the western region of the U.S. During the quarter, we shipped well above 3 million cans. The velocity in stores selling the product has been steadily improving even as we have added new stores.

As we noted in the second quarter's presentation, we plan to add some additional stores during the remainder of the year, but our current capacity situation puts a limit to how fast we can make the product more widely available. Our factory expansion project in the U.S. follows plan, and we expect a significant increase in available capacity over the course of 2019.

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

Switching gears to the OTP segment in Slide 15.

Reported sales and operating profit in the quarter were up sharply compared to the prior year, benefiting from favorable currency translation effects. The financial performance of the OTP segment improved as well in local currencies but at a slower rate than has been experienced in the first half of the year.

Swedish Match cigar shipments were up by 5% in the quarter, driven primarily by growth from our rolled leaf varieties, but we also saw shipment growth from both our natural leaf small varieties and our White Owl HTL cigars.

Also during the quarter, Swedish Match grew faster than the market in both the natural rolled leaf and natural leaf small segments, while losing some share within the HTL segment, resulting in an overall market share gain according to our estimate of distributor shipments to retail. U.S. chewing tobacco, which tends to experience quarterly fluctuations due to promotional phasing, had a relatively soft quarter with Swedish Match owned volumes down 7%.

Swedish Match grew market share in both the premium and value segments. The negative mix effects within our portfolio resulted in sales declines at a somewhat faster pace than volume declines. Chew bags and tobacco dips sold primarily in Europe contributed positively to both sales and operating profit.

On Slide 16, you can see our quarterly volume trends for cigars differentiated by segment. In the second quarter's presentation, we noted that our shipment growth in the second quarter of 7% on a constant trading day basis was in comparison to what was our highest shipment quarter of 2017. During the third quarter, shipments declined from the record Q2 level but were still notably higher than the third quarter of the prior year and continued to reflect an overall shift of our portfolio to the more attractive natural rolled leaf and natural leaf small segments.

On Slide 17, we provide a breakdown of our shipment volumes split between natural leaf small, natural rolled leaf and HTL varieties, compared with the overall market, in each case, excluding pipe tobacco cigars.

As you will note, Swedish Match, with a heavy skew towards natural leaf varieties, benefits from the rapid growth in the natural leaf small and natural rolled leaf segments. During the third quarter, more than 60% of our shipment volume came from natural leaf offerings. While the rolled leaf segment, marked in orange, is smaller than the other 2 segments pictured is by far the fastest-growing segment.

Slide 18 depicts our estimate based on distributor shipment data of total market and Swedish Match volume growth for the total cigar category as well as the HTL, natural leaf small and natural rolled leaf segments on a year-to-date basis.

As I noted earlier, during this quarter, we gained share in the 2 natural leaf segments. For the year-to-date period, despite underperforming in the market in both the HTL and natural leaf small segments, our share gains in rolled leaf and the more rapid growth for the natural leaf segment, overall, allowed us to continue to gain share in the total cigar category.

On Slide 19, we look at the U.S. chewing tobacco market split between the premium segment, which includes our Red Man brand, and the price value segment, where we participate with brands such as Big Duke and J.D.'s Blend. During the third quarter, we increased our market share in



## OCTOBER 26, 2018 / 12:00PM, SWMA.ST - Q3 2018 Swedish Match AB Earnings Call

both the premium and price value segments. The overall U.S. chewing tobacco market continues to decline at a rate of 5% in volume terms, with the premium segment declining at a rate of approximately 10%.

Like the overall market, our portfolio is shifting more and more toward price value products, and it is difficult to fully offset the volume declines and the portfolio shift with higher pricing in order to maintain sales and profits.

Turning to Lights in Slide 20. During the third quarter, sales and operating profit were very similar to last year's third quarter, and operating margins were broadly in line. Operating profits were up for both matches and lighters but declined for complementary products. We are currently facing cost pressures from one of our main input materials for lighters. Nylon pricing has gone up, and this will likely continue to increase in the 2019, putting pressure on our operating margin.

In terms of events, during the quarter, on Slide 21, you'll see the sign of the facility in Gotlands, which is now part of the Swedish Match family. Gotlandssnus is the manufacturer of high-quality snus, with a well-appreciated boutique brand, Jakobsson, among others. Gotlandssnus also adds another brand to our nontobacco non-nicotine pouch portfolio with Qvitt, a nice complement to our Onico brand. Like V2, Gotlandssnus provides opportunities to offer a broader range under Swedish Match in our Scandinavia's snus market, but also provides us with more opportunities outside Sweden.

For example, very recently, we began offering a new range of stronger snus products in the U.S. called Thunder Xtreme, which draws on the V2 portfolio, with products that existed before the FDA's cutoff date. Both V2's snus products and Gotlandssnus products are especially well known in e-commerce class trade.

Moving to Slide 22. You can see some of the other corporate activity and regulatory events during the quarter in addition to the Gotlandssnus acquisitions and the other new item, with the selection of our nominating committee.

On Slide 23, before ending with a brief comment on some financial indicators, I would like to address the recent development from the ECJ. On October 17, the ECJ provided clarification to the Bavarian Administrative court in Germany regarding the definition of chewing tobacco, covering a number of points, including the meaning and definition of the phrase, "intended to be chewed." Based on the ECJ ruling, the Bavarian Administrative Court will now assess the V2 tobacco Thunder Chew bag and loose chew products sold in Germany will be regarded as chewing tobacco. At this point in time, it is difficult to predict the eventual outcome of the German cases and their implications to other EU markets.

As a point of reference, Swedish Match sales and operating profit from chew bags for the 9 months ended September 30, represented 1.4% of total company sales and operating profit from product segments.

About half of the chew bag -- about half of chew bag sales were in Germany. We would also like to point out that ECJ has announced a date for its ruling on the legality of the ban on snus.

On Slide 24, we have summarized relevant metrics from our interim report relating to finance costs or financial position and earnings per share. Net finance costs during the quarter were comparable to the levels that we experienced during the first 2 quarters of 2018 and was significantly improve compared to the third quarter of 2017 due to lower average interest rates, partially offset by increased average debt levels.

As you look to the fourth quarter of 2018, you should note that the fourth quarter of last year, much like the second quarter of 2017, included dividend income from STG, with a net finance cost, which will impact the year-on-year comparability of finance costs during the fourth quarter.

Weighted average interest rate of our portfolio at September 30 was 2.19% compared to 2.64% at the end of 2017. The capital duration was 4.4 years with 96% of the portfolio subject to fixed interest rates.

During Q1, we paid back SEK 500 million in bond maturities, and during the third quarter, paid back the remaining SEK 750 million of maturities due in 2018 at an average interest rate of 4.1%. The debt that falls due in 2019 at SEK 1.1 billion has an average interest rate of 3.9%.





## OCTOBER 26, 2018 / 12:00PM, SWMA.ST - Q3 2018 Swedish Match AB Earnings Call

On a reported basis, our net debt trailing 12 months EBITDA at September 30 was 2.3. The EPS bridge illustrates the components of our 25% growth in adjusted EPS for the first 9 months of 2018. Apart from the after-tax effect of the increased operating profits, both the lower tax rate and reduced number of shares had a meaningfully positive impact. The lowering of the tax rate principally resulted in the U.S. income tax reform.

Finally, the last page of the presentation simply repeats the outlook statement of the interim report. As always, currency fluctuations 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 fourth quarter of 2017 for the U.S. dollar was 8.31. For the NOK, it was 1.02. And for the Brazilian real, it was 2.56.

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

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

Operator, you can open up the line for questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) We now have your first question from the line of Stellan Hellström.

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

Yes, I will -- first, I'd like to hear you -- your review on how the price increase on rolled leaf has affected the volumes. I think you said it's been going well. And maybe if there's any indication to how you view potential price increases on the natural leaf side in broader terms.

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

I think the price increase that was put in place tail end of Q1, early part of Q2, has worked out nicely. And we really have not seen any appreciable affect of decline on volumes. If anything, that's in part, when we talk about some of the challenges of tobacco supplies for continued growth within rolled leaf, we're actually growing at a pace that exceeded our expectations following the price increase. If we think about the price increases that may be available in other segments of the cigar market, that's a little more challenging. Rolled leaf, there's principally 2 competitors, ourselves and one competitor, and there's a broader-based competition within natural leaf small as well as HTL. And then within HTL, you obviously have challenges with an alternative product with HTL value. So I think, at this stage, while price increases -- I wouldn't roll them out within the cigar category over time. We're quite pleased with what we're seeing with the price increase within our rolled leaf varieties.

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

I was just curious to understand also why you mentioned here that the higher price on nylon should potentially lower your volumes on lighters. And then why do think you will not be able to pass that on to consumers? Ultimately, do you have any competitive disadvantage, or is it the challenge actually?

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

Yes. I think the comment was more about placing pressure on operating margins, not necessarily expectation of volume developed within the lighter category. And it's somewhat of a mixed bag when you look at nylon use within the industry. There are -- there is a competitor out there that





## OCTOBER 26, 2018 / 12:00PM, SWMA.ST - Q3 2018 Swedish Match AB Earnings Call

does not use nylon, and you may note that, that competitor is similarly experiencing cost pressures on their input. So -- and then there's a range of market positions in different geographic markets as to who likely would take a lead on pricing changes to reflect the increased input costs.

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

Okay, good. Then, finally, also on ZYN here. Now the new production lines in the U.S., how -- is it -- do you still expect those to be able to deliver volumes in Q1 already? And does that mean that you should then be able to increase the number of distribution points also or selling points in -- from that time?

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

I think it's fair to say that it's more the beginning of Q2 that is in our planning. And so far, the project follows plan. And everything has gone relatively smoothly. But it's, of course, big construction projects, and there can always be complexities. As (inaudible) is on board, naturally, you should expect that we don't have full capacity from day 1. But it will be a significant lift in capacity with the new plant becoming fully operational.

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

Sure. Is there anything to think about there in terms of operational costs that you may not have full capacity utilization, et cetera, beyond stock?

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

I mean, right now, we produce the products in Sweden in a smaller scale operation. So in that respect, as we reach the expected volumes and the expectation in the new plant, we should see a benefit.

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**Operator**

The next question is from the line of Niklas Ekman.

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

Yes, I have a couple of questions. Firstly, the national snus and nicotine pouches here, the earnings improvement, I'm curious, it looks like the majority of the year-over-year increase here comes from reduced losses or reversal to minor profits in snus, but the sequential improvement from the minor losses in Q1 to SEK 18 million in profits in Q3 is driven mainly by ZYN. Is that right to assume? And does that mean that ZYN is currently operating at a profit and EBIT margin of double digits at the moment?

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

Yes, we're not providing specificity on the operating margin of ZYN stand-alone in the U.S. And if I heard the first part of your question correctly, you were saying -- were you saying that the majority of the improvement quarter-on-quarter versus the prior year was principally due to reduced snus losses?

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

Yes, exactly. The year-over-year effect is mainly because U.S. snus losses have reversed.



## OCTOBER 26, 2018 / 12:00PM, SWMA.ST - Q3 2018 Swedish Match AB Earnings Call

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

Yes. I would not characterize that as being the key contributor to the improvement in our operating performance of snus and nicotine pouches outside of Scandinavia. So I mean -- I think a clear contributor to the operating performance within the quarter had to do with not only ZYN, but also increased trading profits from snus in the U.S.

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

Yes, that was kind of my point, that snus was the main driver -- snus not ZYN, was the main driver behind the year-over-year improvement. And I'm curious, because you saw -- you showed the volume development for snus, and it's kind of flattish in the last couple of quarters. So I was curious what had been the main reasons behind the significant earnings improvement for Scandinavian snus in -- or for snus outside of Scandinavia.

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

Yes. I would say, the principal driver for the improvement is the profitability of ZYN, increased volumes within ZYN.

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

And year-to-date, snus outside Scandinavia is still at a loss, but it's a much reduced loss compared to prior year.

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

Okay. Excellent. And also, just to clarify, when you -- the graph that you have on ZYN volumes with 10 million cans on a trailing 12-month basis, that's only for the U.S. business. So on top of that, you have a business in Sweden as well, which is another 2 million to 3 million cans. Is that correct?

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

It's correct that we have a business in Sweden. And if you look at the nicotine pouch category in Sweden, that we, for measurement reason, included in the snus market, is 2% according to Nielsen. Our estimate is actually that category is slightly bigger than that, probably between 2% and 3%, and maybe even closer to 3%. And according to Nielsen, we have 1/4 of that category.

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

Okay. Fair enough. We'll do calculations from there. And I was curious, this shortage of supply of tobacco in natural wrap -- natural rolled leaf, sorry, was that a key reason why growth slowed a little bit already here in Q3? And is it likely to be a lot worse in the coming 2 or 3 quarters?

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

Yes, I think that was a contributor to the slowing rate of growth. What I would say more broadly is it's not uncommon. You can -- in one of the slides where we had a quarterly volumes by format, you can see that fluctuations in quarterly volumes are not that unusual, given not so much price promotions, but we do have limited time offerings within the format that can flow into shipment volumes in any given quarter. But the availability of tobacco supplies for our rolled leaf format have definitely come into play there.



## OCTOBER 26, 2018 / 12:00PM, SWMA.ST - Q3 2018 Swedish Match AB Earnings Call

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

And if you look at the CMPP data, which illustrates shipments from the distributors to retail, as Tom pointed out in his commentary, we have very good growth for small natural leaf. But this quarter, that growth number was quite a bit higher than our shipment number. But then on the other hand, you have quarters where you see the opposite picture.

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

Okay. So more quarterly fluctuations rather than any constraints on supply?

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

Constraints on supply within our rolled leaf portfolio. And those constraints will likely continue into the first half 2019, so there are limitations on the actual tobacco leaf itself. And in that respect, you're somewhat dependent upon harvest. So we will continue to experience some level of volume pressure within our rolled leaf portfolio at similar levels that we experienced within -- in Q3.

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

And finally, just as a reminder, Q4 is typically a softer shipment quarter on a sequential basis, if you look here with the history, given the fewer numbers of shippings days.

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

Okay. And finally, just a question on chew bags. You talked about a potential write-down if there will be a negative ruling in the Bavarian court. And I was curious, is it really black or white? Because I think in the past, you have talked about that a negative ruling could maybe result in you making alterations to the products to fit with the regulatory environment. Or would a negative ruling here imply that you would have to basically scrap those products?

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

I think you're correct in saying that situation is very far from black and white. It's -- at this point, it's difficult to predict exactly what rulings in the German courts will be. But it could, of course, be that 1 or 2 of the products that we have they will use the pouches, that we're not allowed to continue selling that. And then as part of the regular impairment testing, that could influence what -- the book value of those intangible assets. But with that said, to your point, I think it's on the product alterations. In that sense, the verdict from this day has been positive that it provided some clarity and guidance on the type of alterations that may need to be put into that product. Because it's -- the court was clear on the point that it's not only the traditional chewing tobacco products that existed in the market that should be allowed within the Union, so one can launch a new type of chewing tobacco products in Europe.

**Operator**

And we have your next question from the line of Sanath Sudarsan.

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

On ZYN, you've seen a couple of large players come into this nicotine pouches space. And I wonder if you could expand a little bit how you're seeing that impact the category. And then, part 2 of the ZYN question is, what capacity or scope do you have for third-party manufacturing in the U.S., which could potentially accelerate your distribution there?

## OCTOBER 26, 2018 / 12:00PM, SWMA.ST - Q3 2018 Swedish Match AB Earnings Call

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

On your first question, I assume you mean -- I mean, BAT is present in Scandinavia and Switzerland and maybe other markets that I'm not aware of, but that's what's in the communication. And then Imperial has launched their Super White in Scandinavia and some other geographies. So it's not -- you're referring to -- I think it's fair to say that this increased competitive activity in the nicotine pouch category is part of the contribution to the strong market growth in Scandinavia. And Imperial is also present in Norway with a variety. So that is, I'd say, positive from category growth. In terms of the U.S. market, there have been comments about potential plans, but people also need to remember that products that weren't in the market before the FDA cutoff date would need to undergo PMTA application before they can be launched in the market.

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

And just on the point on third-party manufacturing, is that an option?

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

I didn't exactly understand that question, sorry.

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

So if you were looking to accelerate manufacturing, could you look at third-party contracting?

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

Our focus is to produce for ourselves. But I never say never.

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

Okay. And just one last one on cigars in U.S. So the FDA is reviewing its position when it comes to flavors for the likes of the vapor players, like Juul what -- how resilient do you think the cigar market would be if there was a total ban on flavors in cigars?

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

It's, of course, difficult to predict. But the cigar markets contains a lot of varieties and the non-flavored or non-characterizing flavors part of the business is a very substantial part of the market. So our assessment is that, by far, the majority of existing consumers that today predominantly smoke a variety of that characterized flavor would move to some of the non-flavored varieties.

**Operator**

We will now take our next question. The next question is from the line of Karri Rinta.

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

Karri Rinta, Handelsbanken. Follow-up on the FDA questions, maybe on the PMTA process. Just last week or earlier this week, FDA was out with some comments that were a little bit difficult to interpret what they meant when it comes to, especially the PMTA process. So what is your best guess at this point, whether we will see something that will sort of make the whole PMTA process easier for the products that they seem to favor,



## OCTOBER 26, 2018 / 12:00PM, SWMA.ST - Q3 2018 Swedish Match AB Earnings Call

i.e., smokeless product? Or are we still looking at sort of a -- if not a total, no to all new products, but de facto barrier to entry until maybe 2021, 2022 -- so what's happening on the PMTA front?

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

I mean, it's, of course, a question that should be asked to the FDA, but I think the FDA is sincere in their policies, or they see the value of consumers moving to less hazardous alternatives, and that would include some clearer guidelines on the application and processes. But meanwhile, I mean, we have PMTA applications approved for our general snus range in the U.S. So I'd say we have very good experience or good understanding of at least the type of information that this asks for. So we are in good shape when it comes to our own product. ZYN, which is where we have defined the PMTA before the deadline. But they will be positive for the industry and for the consumers and for public health. I believe, there were further clarifications from the FDA in that respect.

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

All right. And then, ZYN question. The number of stores and your volumes, and of course, if you look at the number of stores and then your delivery volumes, you see that you sell more per store. And so the question is that, the new stores that you're adding now, are they selling significantly more than the new stores that you added the year ago? Or is this more that the existing stores because of the increased velocity, are selling significantly more than what they did when they initially introduced ZYN?

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

That is actually a very positive part of our experience in expanding ZYN in the Western region that with some variations, of course, but to a large extent, we have seen, I would say, a very similar trajectory as we have added incremental new stores. Naturally, the newer stores start at a lower rate, but growth and trajectory promote in stores that we look at, we divide them into quarterly installs, were actually very similar.

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**Operator**

(Operator Instructions) We have your next question from the line of Adam Spielman.

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

I'd like to ask a little bit more about what happened in Sweden and Norway. You've said several times that increased competition in snus has driven the increase in demand beyond the weather effect. I was just wondering if you can really say in more detail what it is. Are we talking about the growth of all white as being the driver of increased demand. And is that? Or have sort of more aggressive promotion of other types of snus also affected it? And then on top of that, can you see where demand is coming from? Is it just increasing demand, or are we seeing an accelerated reduction in cigarettes?

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

Yes. I think it's a combination. First of all, as you point out, the weather definitely played a role, in our opinion, during the third quarter. But the nicotine pouch category alone doesn't account for the category growth, as you would see in the numbers, but it's one element that is positive. But then we've seen -- I mean, we have come out -- we talked in the recent couple of years, as you know, we have come out with new premium offerings and there have been other relatively successful premium offerings from competition. So when we say increased competitive activity, I wouldn't say that we refer to promotional activity. We more refer to many new type of products that typically can attract new users into the category. If you look at -- that comment is particularly relevant, and then maybe more so future potential when it comes to the nicotine pouches because there,



## OCTOBER 26, 2018 / 12:00PM, SWMA.ST - Q3 2018 Swedish Match AB Earnings Call

we see very limited data, but we have some data that clearly suggests that, that category expands and attracts, for example, cigarette smokers into the snus category.

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

Do you think that's also true in the U.S. as well? In other words, do you have a sense of where the ZYN users are coming from? I mean, snus smokeless cigarette users?

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

Yes. We have some information, and we get feedback from stores, et cetera. And it is clear and clear to us that ZYN actually resonates very well with the smokeless users. And if we look at it also on a little bit state-by-state basis, you start to see a pattern where moist snuff within the Western region has a higher penetration, typically, ZYN does better as well. And the positive thing is that when we look at the moist snuff category within the Western region, we don't see any negative impact on the development. And so that suggests to us that the ZYN volume has the same incremental type of contribution to the category -- or the combined category on nicotine pouches and other smokeless product. And that is still against the background. If you look now within the western region, our estimate is that despite we being relatively widely available within the Western region, but we are of course available in far fewer stores than what moist snuff is. Our estimate is that our volumes respond to about 4% of the moist snuff category in the Western region and without the negative impact on the overall category. But of course, not everybody is coming from moist snuff. We also see strong interest for ZYN among snus consumers. But when we look at their own year-to-date data, Western region does not underperform in the snus portfolio relative to the rest of the U.S. So that is very positive, I would say.

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

And the implications from that is that it's coming from, I guess, some cigarette users or from Juul use.

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

It's coming...

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

In addition to, maybe from some other...

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

One thing you have to remember that in the U.S. market also, the frequency of the Juul use is quite high. I think it's fair to say that its pulling from a lot of different sources, but the consumers that have experience with smokeless products tend to get appealed by the ZYN offering.

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

Okay. And moving on to cigars, this is a similar question from rolled leaf. Why do you think that's so successful now? And equally, we've been through a period -- I mean, over the last few years, we saw really good growth in natural leaf, and that seems to have tailed off. So I'm just curious as to why natural leaf has tailed off. And I'm even more curious as to why the rolled leaf has done so well? Or is it so well?



OCTOBER 26, 2018 / 12:00PM, SWMA.ST - Q3 2018 Swedish Match AB Earnings Call

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

Yes, I guess, to comment to your second point, firstly, I wouldn't necessarily say that natural leaf small as a category, or even within our performance based on distributorship in data has trailed off. I mean, it's still a very healthy segment, and it's growing quicker than the overall category. So I think there still remains levels of interest in natural leaf small. The other thing I want to say around natural leaf small and rolled leaf, part of it is general availability of those formats in markets, where the HTL segment has a much broader distribution, nationally. And it used to be that the natural leaf segments, generally, were more isolated geographically. They are gaining in distribution. And I think with the gains in distribution by both us and our competitors, consumers are getting exposed to what that smoking experience is like. So it's -- I would say, it has more to do with distribution than an absolute conversion within the category of HTL to natural leaf.

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

And you said, just an answer to my question, that the natural leaf small. I said it wouldn't stop growing. You said that's not true. I mean, it used to be growing double digits. I assume if it's growing, it's growing low single-digit now.

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

No. I mean, if you look at the distributor data, CMPP data...

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

Natural leaf small, year-to-date, is growing at 12%, and so effectively double-digit.

**Operator**

Thank you. There are no further questions -- we now have your next question. It's from the line of Chaz Manso.

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

A housekeeping one, first. On your group, snus and snuff and OTP figures, could you give us what the organic sales growth was without the M&A contribution? That would be helpful. And could you just clarify what the operating margin movement was in snus and snuff, excluding snus and nicotine pouches, was it -- excluding that, was it down?

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

Tom, if you'll look -- take the snus margin one, let's try to find some indication on the OTT segment there for you.

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

Yes. So on a reported basis, the snus -- and I'm talking now more specifically about Q3, the snus and moist snuff margin was up 1.8% to 47%, and the contribution from snus and nicotine pouch outside Scandinavia was more than that increase. So some of that has to do with levels of country mix, where we have obviously varying operating margins, depending upon the countries where those products are sold. And we also have higher OpEx in both Scandinavia and the U.S. during the quarter.





## OCTOBER 26, 2018 / 12:00PM, SWMA.ST - Q3 2018 Swedish Match AB Earnings Call

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

And to give you a feeling for it, you have to take the year-to-date period, organic growth is roughly 10%, so adjusted for currency translation.

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

And M&A. Okay, great. On the Scandinavian snus, maybe specifically Swedish snus, clearly, there's a lot of activity in the all white segment. Again, is that driving all the growth, i.e., excluding the white -- rest of the snus category is in decline? And you've been talking about 2 growth drivers, the weather and increased activity by everybody. Could you break those 2 down? How -- do you know -- if you have a feeling what the contribution was of each? And on pricing in Sweden, your main price increase, what percentage of the market now follow that? What's the implication so pricing opportunities come January?

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

If you take the growth, the white segment alone is not enough to account for the strong category, so it's generally -- I mean, increase -- there is increased snus consumption in Scandinavia for a long period of time. We have seen an inflow of consumers into the category. And if you take the Swedish market this year, particularly, we see good -- extra good development within the premium segment. And that is several kind of new or relatively new offerings that has helped increase the attractiveness of that segment. But also if you look at it within the value segment, while its share of the total market is slightly down versus the prior year period the -- at least the value segment pouches post growth. And in terms of breaking this down, it is, of course, very difficult. We haven't run the analysis for the last 10 years looking at summer temperatures and trying to correlate it with volume growth. But it is a factor. And in terms of pricing, it's -- it is when we look at Nielsen data, typically, happens is that it seems not all manufacturers for the past couple of years have taken pricing at the same time. There seems to be one competitor that has gone up a little bit in pricing lately. But then as I also pointed out, if you look at the kind of relative growth of the value versus the -- in volume according to Nielsen, we see more of a flat development in Q3 given the growth in premium 2.

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

Okay. My final question on U.S. snus. Sims little bit ex growth with all the focus on ZYN maybe. I was just wondering what your views were on those long-term opportunities in snus. You are launching some new brands. Obviously, you've got some applications with the FDA. What impact could did they have?

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

No, we continue to view the prospects for snus in the U.S. market as positive. I mean, I think it's fair to say that the category growth rates have come down a little bit from the past couple of years. But as you know, from the overall moist snuff category, that seems to be the case for our smokeless tobacco in general. And part of the explanation in our portfolio is likely also there's reduction. But we consider to be more efficient than marketing spend with less price promotions. And so in that sense, I would say, that our volume growth is positive to see that despite less marketing spending, including pure price promotions. And we continue to have volume growth. So we believe that there are continued growth prospects, but I think it's fair to say that, for the foreseeable future, the snus category is more likely to be a little bit more of a meaningful but a niche category of the U.S. markets, while at least the initial experience with ZYN in the Western U.S. is that has -- that product has the possibility of appealing more broadly in a quicker sense.

**Operator**

Thank you. There are no further questions, sir.



OCTOBER 26, 2018 / 12:00PM, SWMA.ST - Q3 2018 Swedish Match AB Earnings Call

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

Okay. Let me thank everybody for listening and asking good questions and remind you that the Q4 report -- the full year report will be published on February 13 next year. Thank you.

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**Operator**

Thank you very much, and that does conclude our conference for today. Thank you for participating. You may all disconnect.

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