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SWMA.ST - Q4 2019 Swedish Match AB Earnings Call

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## PRESENTATION

### Operator

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Ladies and gentlemen, thank you for standing by. And welcome to the Q4 report 2019 conference call. (Operator Instructions) I must advise that this conference is being recorded today. I would now like to hand the conference over to your speaker today, Emmett Harrison. Please go ahead.

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

Hello. This is the Swedish Match Full Year 2019 Telephone Conference. And with me today are Lars Dahlgren, our President and CEO; and Tom Hayes, our CFO.

In the Investors section of our [swedishmatch.com](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. 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.

Slides 3 and 4 of this presentation reiterate the headline bullets 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 5.

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

Thank you, Emmett, and good afternoon, everyone. Let me start off with a few summary comments from the fourth quarter where Swedish Match reported double-digit growth in sales and operating profit from product segments.

In the U.S., ZYN continued to demonstrate impressive growth. As of the end of the year, our tobacco-free nicotine pouches were in distribution in approximately 67,000 stores nationwide, and weekly volumes on a per-store basis grow from Q3 levels, not only in our 2019 expansion stores but also in established distribution within the Western region.

Our U.S.-based production capacity for ZYN is running smoothly and accounted for substantially all of our ZYN shipments during the quarter and with plans well underway to double that capacity by early 2021, but we intend to further increase distribution during 2020. We will balance new store distribution with ensuring that our existing store base has access to ZYN to support future growth in those stores. Given the market success for ZYN, we have recently decided to once again expand capacity and projects that had been run through 2022.

In Scandinavia, overall market growth for the combined snus and nicotine pouch markets has remained very strong, with underlying volume growth at more than 8% in the fourth quarter.

For Swedish Match, shipment volumes were up by more than 2% on an underlying basis. The negative share trend that we have been experiencing in the popular price Premium 2 segment in Sweden stabilized in the quarter on a sequential basis, and we also grow share in the conventional snus segment in Norway.

Outside the U.S. and Scandinavia, we have invested behind ZYN distribution into a number of new markets. And as of today, we are in 10 markets with ZYN on a limited scale, mostly in Europe.

For other tobacco products, or the OTP segment, the U.S. mass market cigar category remained soft in the quarter as the HTL segment continued to experience volume decline.

For Swedish Match in the fourth quarter, our shipment volumes were above the relatively soft prior year level, with growth coming from our natural leaf varieties, and both sales and operating profit in local currencies improved compared to the prior year.

Chewing tobacco had a comparatively weak quarter with lower volumes and higher cost per unit in both the U.S. and for chew bags in Europe. As you may have noted in our Q4 report, given the regulatory situation for chew bags as well as changed market dynamics, we have recorded a noncash impairment charge related to our European chewing tobacco business.

For our Lights businesses, sales and operating profit for matches were up on positive portfolio mix despite volume declines, while weakness persisted for lighters and especially complementary products on lower volumes.

In addition to an improved underlying result for matches, we also benefited from a decision regarding an indirect tax dispute in Brazil, adding about SEK 37 million to operating profit for this segment during the quarter.

Now turning to Slide 6. And before moving on to the individual product segments, we wanted to highlight a note from our interim report that beginning in 2020, we will be changing our product segment reporting. These pie charts provide a snapshot of our businesses under the 2020 reporting structure and clearly illustrate the growing importance of both our smokefree segment as well as the rapid development of the U.S. business.

In the fourth quarter, the U.S. accounted for nearly half of our smokefree sales, up from less than 40% in the fourth quarter of 2018. While currencies have played a role in this shift, ZYN in the U.S. has been the key driver.

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

On Slide 7, and returning to the 2019 segment reporting structure, we've summarized some of the quarterly highlights of the snus and moist snuff product segment. As noted earlier, ZYN in the U.S. was a major contributor to sales and operating profit growth within the snus and moist snuff

comparability of operating margin for the snus and moist snuff products segment reflects scale benefits from U.S. ZYN growth as well as manufacturing savings from U.S.-based manufacturing.

With regard to our Scandinavian business, Swedish Match's underlying volumes are estimated to be up by more than 2% in the quarter. The increased volumes, coupled with favorable pricing and mix shifts, resulted in improved sales and operating profit for our Scandinavian business compared to the prior year quarter. For moist snuff in the U.S., our shipment volumes improved despite continued category softness, and we once again gained market share in the faster-growing pouch segment of the market.

During the fourth quarter, we implemented changes to simplify our moist snuff pricing and promotional model, which required somewhat higher spending during this transition period. As the new promotional and pricing program becomes more fully reflected into the trade, we expect to see less quarterly volatility in our moist snuff shipments, reducing the strain on our supply chain, distributors and the trade.

Outside of the U.S. and Scandinavia, we have further expanded our geographic reach of ZYN in the European Union as well as New Zealand and the U.K. While we plan to continue to invest behind adding more markets during the course of 2020, one should consider these to be long-term investments with relatively limited levels of volume and distribution points initially in most markets.

On Slide 8, we have provided our estimates of trended total market and Swedish Match volume growth in Scandinavia adjusted for hoarding and calendar effects as well as Swedish Match's underlying price mix effects by quarter, in each case, reflecting the combined snus and nicotine pouch markets. The market growth in Scandinavia remained robust, even accelerating to over 8% in the fourth quarter, bringing full year growth to more than 7%. It is not unusual for market growth rates to fluctuate from 1 quarter to the next, but we are encouraged by the continued rate of growth, and that this volume growth has occurred with stability in the relative share of the premium versus value segments of the Swedish market.

It can be noted that nicotine pouches in Denmark are now included in the Scandinavian market as depicted above, which added about 1 percentage point of market growth in the fourth quarter and about 0.5 percentage point for the full year.

Our underlying volume development relative to the overall market reflects the market share challenges we face. When looking at the conventional snus category in isolation, Swedish Match has been losing market share in Sweden and gaining market share on the Norwegian market.

On Slide 9, we provide further details as to the source of growth in the Scandinavian snus and nicotine pouch market. Scandinavian market growth is being sourced from all 3 countries in recent quarters. And roughly 3/4 of the growth has come from nicotine pouches.

In Sweden, the contribution to year-to-date market growth is split relatively equally between snus and nicotine pouches, with snus growth largely attributable to the rapidly growing Premium 2 segment.

In Norway, all of the growth is coming from its version of nicotine pouches, which by Norwegian law, must contain at least trace amounts of tobacco, while the snus market is experiencing volume declines. In Denmark, snus is not allowed and growth is, therefore, exclusively attributable to nicotine pouches.

On Slide 10, we've presented Swedish snus volume and value growth and market share dynamics, excluding nicotine pouches, according to Nielsen. Despite declines in some segments, the Swedish snus market is growing in both volume and value terms, with a stable mix between value and premium-priced products. Over the past year, price and tax changes have partially been offset by mix effects, with strong growth in the Premium 2 segment being partly offset by declines for Premium 1. Our year-on-year share declines is, to some extent, attributable to mix shifts, but most notably, due to market share losses in the Premium 2 segment. Some of our new product initiatives more recently have been targeted at mitigating this adverse trend. It is notable that our share decline within the Premium segment improved slightly on a sequential basis, and our overall snus market share was essentially flat in Q4 compared to Q3.

On Slide 11, we've presented the market trend and market shares for nicotine pouch category in Sweden according to Nielsen. Supported by strong competitive activity in terms of product launches and in-store visibility, the nicotine pouch category has more than doubled in size over the past year, and that was roughly 6% relative to the snus category according to Nielsen. We believe the nicotine pouches has an even larger share relative

to the snus category as e-commerce and certain high-volume independents are not taken into account in the Nielsen figures. The snus pouch category is intensely competitive with numerous marketing activities and ongoing new product introductions. Our market share in the nicotine pouch category has been relatively stable. But recently, our continued objective is to capture a higher percentage of growth within this attractive category.

In terms of pricing during nonpromotional period, nicotine pouches are typically priced in line with or above Premium 1 snus products. And the dramatic growth of nicotine pouches has, therefore, contributed to a positive price/mix effect in the combined category.

Now turning to Slide 12. To the left, we have provided an overview of our estimates of the underlying market development in Norway, where we continue to see market growth for the combined snus and nicotine pouch market. For snus, Swedish Match has been holding its share in the rapidly declining loose segment and growing share in the pouch snus segment, helping Swedish Match to record overall market share gains in the snus category. However, all of the growth in Norwegian market has been on the nicotine pouch category, and there, we have been underperforming.

Even as we've noted a slowdown in Norwegian market growth in traditional channels according to Nielsen, consumption growth by Norwegians has remained healthy, supported by a trend of more and more of the products being bought at Swedish border trade shops, tax-free channels and on e-comm.

On Slide 13, you can see that the nicotine pouch category in Norway has grown dramatically over the past 2 years and is now nearly 1/4 of the size of the Norwegian snus category. Within this category, even with our own strong volume growth, our share progression remains challenging, and addressing our market share development is a key focus area of our Scandinavian business.

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

On Slide 14, you can see some of our more recent new product launches for snus and nicotine pouches in Scandinavia and in some markets outside of Scandinavia but outside the U.S.

In Sweden, we just recently added a new ZYN variety, ZYN Deep Freeze Slim. We believe that this product as well as its Norwegian sister, G.4 Deep Freeze, and the reformulated CRYO G.4 for the Norwegian market are well positioned for the consumer wanting a nicotine pouch with a more intense flavor release.

We also continue with our small batch offers in Sweden, which are full price offerings that help to provide interest and excitement for the specialty consumer.

Outside Scandinavia, we are now marketing ZYN in a number of varieties and countries, and recent launch markets include New Zealand, Estonia and Slovakia.

In 2020, we began producing ZYN Slim in – at both the Gotlandssnus manufacturing facility on the island of Gotland in Sweden and at the V2 facility in Silkeborg, Denmark. This expanded manufacturing footprint provides us with increased flexibility and production capabilities and helps to support new product development and new market expansion plans.

Turning to Slide 15 and moist snuff. Swedish Match shipment volumes were up by 3%, as higher deliveries of our pouch and tub offerings more than offset declines for our loose varieties. Based on distributor shipments to retail, we estimate that volume growth within the U.S. moist snuff category has been slightly negative for more than a year now due in large part to more aggressive price increases taken by manufacturers within the category as well as the rapid growth of nicotine pouches.

The moist snuff pouch segment in the U.S. continues to grow as a share of the overall category. And based on our measure of distributor shipments to retail, the pouch segment grew about 3% during 2019, while Swedish Match growth was more than 12%.

On Slide 16, the 2 charts illustrate the dramatic growth of snus and nicotine pouches outside of Scandinavia, with ZYN volume in the U.S. accounting for virtually all of this growth. ZYN is now available nationally in the U.S. And despite being in fewer stores than another nicotine pouch competitor, ZYN is the clear market leader. While we are currently available in approximately 67,000 stores, the chart to the right-hand side of the slide presents average store count and velocity rates by quarter in the markets in which we were present prior to the national launch. In these markets, despite further increases in distribution, in-store velocity rates have continued to increase at a faster rate than the store count.

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

Moving on to Slide 17 and our OTP segment. Within OTP, Swedish Match cigar shipment volumes were up 7% compared to a relatively soft Q4 2018, led by growth from our natural leaf varieties. During the latter part of 2018 and first half of 2019, a shortage of raw tobacco leaf limited our ability to produce rolled leaf cigars. The leaf shortage issue has been resolved, and we are working to reestablish our market position in the rolled leaf segment. Based on distributor shipments to retail, Swedish Match was one of only a few manufacturers to record volume growth during the fourth quarter, as a result of market share gains in natural leaf and our own portfolio skewed towards the growing natural leaf segments.

Sales and operating profits were down for our U.S. chewing tobacco business on lower volumes following a relatively strong year-on-year performance in the third quarter. These quarterly year-on-year fluctuations are fairly normal in the chewing tobacco business, in part due to trade and promotional activities. Outside the U.S., our sales grew for Oliver Twist chew bits but declined on lower volumes for chew bags.

Fourth quarter operating margin for the OTP segment was unusually weak. Beyond the market challenges for chew bags in Europe, the fourth quarter included costs of a temporary nature related to manufacturing asset impairments in Denmark and amendments to our U.S. benefit plans.

On Slide 18, we've presented a quarterly trend of Swedish Match cigar shipment volumes as well as our estimate of overall U.S. mass market cigar category and segment development based on distributor shipments to retail. Similar to the trend in our shipments, the cigar category slowed in late 2018.

For both the full year and fourth quarter of 2019, we estimate that the category declined slightly less than 1% as compared to growth in the natural Leaf segment, as growth in the natural leaf segment could not fully offset for declines in the larger HTL segment. Based on this same measure, Swedish Match cigars outpaced the category during the fourth quarter as a result of our portfolio positioning, with 65% of our portfolio in natural leaf varieties and a strong relative performance for our natural leaf brands. Our full year performance within the natural leaf statement was adversely affected by leaf shortages for our rolled leaf varieties and competitive promotional activities within the natural leaf small segment.

Turning to the U.S. chewing tobacco on Slide 19, where we once again outperformed the overall category in both the premium and value segments. The shift in the portfolio toward more value-priced products places added pressure on average selling prices and margin. For both the fourth quarter and full year, Swedish Match volumes were down about 7%. This volume decline, combined with a negative portfolio mix toward value products, could not be fully offset by increased pricing.

Moving on to Slide 20 and our Lights product segment. This product segment is susceptible to fluctuations in quarterly performance, and it is often better to look at longer-term results than 1 isolated quarter. For the full year, sales were down 4%, while operating profit, excluding asset sales as well as the benefit from a positive outcome from a dispute related to indirect taxes in Brazil, was down by 12%, owing to a number of factors, including a weak performance for complementary products, poor volume development as well as higher nylon pricing.

In the isolated quarter, volumes were lower for matches, lighters, complementary products, but a strong portfolio mix for matches offset the effects of volume declines, and operating profit for matches, excluding the tax benefit, was higher. Our volume decline for lighters in the quarter was partly attributable to a relatively challenging comp in the prior year quarter, and while still a burden, higher nylon pricing is having a less significant impact on year-on-year cost comparisons.

Moving on to regulatory topics on Slide 21, I'd like to highlight a few noteworthy developments with regard to the MRTP for General snus in the U.S. The FDA has received our marketing program plans for snus. And now that the 30-day period has passed, we were able to begin communicating with consumers about the fact that General snus has MRTP status.

In Germany, the Federal Administrative Court is expected to decide by mid-2020 whether to allow appeals to the Bavarian Administrative Court's November rulings in these cases that were adverse to our ability to continue to sell chew bags in their current form in Germany. While waiting for the appeal decision, the products are still sold in the market, but distribution has been adversely affected.

In the U.S., Congress has now passed legislation raising the minimum age of purchase for all tobacco products to age 21. This legislation includes products such as nicotine pouches with nicotine derived from tobacco.

In other developments on Slide 22. In Denmark, there has been a political agreement on an action plan with regard to the government's efforts to combat usage of tobacco and nonpharmaceutical nicotine products by youth. Included in the proposal are display bans, standardized packaging and flavor restrictions. Chewing tobacco would be subject to a flavor ban for flavors other than menthol and tobacco. The provision for flavors and standardized packaging would not apply to nicotine pouches containing no tobacco. Adoption of these provisions are expected this year with implementation in 2021.

And in the U.S., the FDA has chosen to focus its enforcement actions for the time being on e-cigarettes and vaping products, while deferring regulatory action on cigars until May 2020, which is the month given for substantial equivalents in PMTA applications. The FDA stated that it still intends to issue a regulation at some point that bans the use of characterizing flavors in cigars.

On Slide 23, we've summarized some relevant metrics from our annual report relating to finance costs, our financial position and earnings per share. Net finance costs during the quarter were in line with the level that we experienced during the past few quarters. The weighted average interest rate of our loan portfolio at December 31 was 2.08% compared to 2.18% at the end of 2018. Our net debt-to-EBITDA for the 12-month period ended December 31 was 2.1. And as of December 31, 2019, Swedish Match had SEK 12.935 billion of interest-bearing debt, excluding retirement benefit obligations, but including the recognition of lease liabilities of SEK 253 million from the adoption of IFRS 16. Of this amount, SEK 1.3 billion comes due in 2020. The capital duration was 3.7 years, with 98% of the portfolio subject to fixed interest rates.

The EPS bridge illustrates the components of our 23% growth in adjusted EPS for the year ended December 31. Apart from the after-tax effect of our increased operating profit, the reduced number of shares had a meaningfully positive impact. During 2019, we made share repurchases in the amount of SEK 2.989 billion, which means that during the year, SEK 4.766 billion has been returned to our shareholders via either share repurchases or dividends.

Finally, as always, fluctuations in currency rates will impact our future reported results, and you may want to take note of some of the more important average exchange rates versus the SEK. The average exchange rate in the first quarter of 2019 for the U.S. dollar was SEK 9.17; the NOK, SEK 1.07; the Brazilian real was SEK 2.44.

And before opening up the lines for questions, I would like you to take note of the last 2 pages of the presentation. Slide 24 provides you with a summary of reporting under the new 2020 reporting segments, providing specifications on sales, operating profit and operating margin by quarter for each of the past 5 quarters. In comparing this summary to historical segment results, you should note that certain central costs previously reported under other operations, related to smokefree initiatives, have been allocated to the smokefree segment under this new segment structure.

And finally, Slide 25 simply restates our 2020 outlook from the interim report. Global nicotine markets remain dynamic, and we are excited that consumers, regulators and the trade increasingly recognize the shift in consumption away from combustible cigarettes. We firmly believe that our products currently play and will continue to play an active role in this shift, and Swedish Match is prepared to invest in this effort toward our vision of a world without cigarettes.

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

## QUESTIONS AND ANSWERS

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### Operator

(Operator Instructions) The first question is coming from the line of Owen Bennett from Jefferies.

### Owen Michael Bennett - Jefferies LLC, Research Division - Equity Analyst

A couple of questions, please. First one, Mr. Dahlgren, one, could you give Swedish Match total share in Norway and Sweden in 4Q rather than the split between snus and nic pouches?

And then a couple of questions related to the inclusion of Denmark in Scandi now. First of all, I know that much of the chew bag growth in Denmark previously came from people shifting from snus, snus after it was banned. And would it be fair to say much of the nicotine pouch growth in Denmark now is sourcing from your chew bags? And then somewhat linked to that, what was the Scandi industry volume growth in 4Q at Denmark?

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

Yes, Owen, I mean, if you – some of these details may take some time for us to look at. But I mean if you were to combine the markets for snus and the nicotine pouches, our Q4 market share in Sweden according to Nielsen is 59.4%, and that's down sequentially with 0.4 percentage points from the third quarter and down 0.1% on – for snus, but an increase of 0.4 percentage points on nicotine pouches. But with the growth then on nicotine pouches, you get that resulting slight decline in sequential share.

And if you take the Norwegian market, it's a similar pattern on the aggregated level with 48.4% according to Nielsen and down from 48.9% in the third quarter. So up on snus from 55.7% to 56.3%, but a slight decline on 51 – or 15.1% to 14.4%.

And then you need to bear in mind that the Deep Freeze variants in Norway and Sweden are not included in these numbers, as they were launched after year-end. And then on the combined growth...

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

I guess he had questioned as to Scandinavian fourth quarter growth combined snus and nicotine pouches ex Denmark. Was that one of the questions?

### Owen Michael Bennett - Jefferies LLC, Research Division - Equity Analyst

Yes. Just because – I mean, I'm assuming some of the – some of that growth in Denmark from nicotine pouches is sourcing from chew bags. So actually, like it's taken from one going to the other. So I just wanted to get an idea of the Scandi volume growth ex Denmark in 4Q. And then also, would my assumption be right there that a lot of that nicotine growth is sourcing from chew bags in Denmark?

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

Yes, that growth level was 7.6% Scandi ex – for Q4, Scandi ex Denmark.

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

I mean if you look at the Norwegian market – or sorry, Danish market according to Nielsen, it is true that the growth of the chew bag market has slowed down to even slight decline on a sequential basis, but it's relatively choppy between the periods. But it's – I'd say if you take a couple of

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years' perspective, it's relatively flat, but you have exponential growth of the category. So if— I mean, it's equally fair to say that the nicotine pouches in Denmark have added significant acceleration to the smokefree category in the Danish market.

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**Operator**

The next question is coming from the line of Gaurav Jain from Barclays.

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

I have three questions. First is that why are you separating out the segments? Is it because your visibility into cigars is low? Or is that a precursor to a strategic action?

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

We'll, I guess, respond to these questions as you ask them. But the decision in and around the changed segment mix was really probably more reflective of kind of what we're seeing in regulatory and also ESG areas where we wanted to be more transparent. It is more reflective in the sense of how we're— how the smokeless business compared to the cigar business operates with respect to tobacco procurement, manufacturing. So we believe it provides, I think, a better view to the reader of the financial statements and ourselves internally as management to separate— or to reframe our product segments.

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

Sure. My next question is on the margins in ZYN. So early last year, we used to think that 40% is sort of the terminal margin in ZYN because the Scandi margins were in low 50s, and that's a market where you are the market share leader. So theoretically, your margins couldn't reach there. But now it seems that your margin in ZYN are already at 40%, and the revenue per can should keep going up in line with the U.S. smokeless category and the cost per can should continue to go down as you scale up. So is it incorrect to think that your ZYN margins could approach your Scandi snus margin?

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

I think the guidance that we've provided historically as to operating margin by business within our snus and moist snuff or smokeless segment, however you want to define it, usually reflected that within the U.S., we have greater opportunities to market, therefore, it would have a lower margin than within Sweden where there are limited opportunities to market your products.

And as we mentioned in the kind of prepared commentary that in 2019, there were scale benefits on the increased volumes of ZYN that are difficult to replicate once you anniversary a national launch. There will—we fully anticipate increased volumes not only within the category, but within our own shipment volumes. But it is more challenging. Also competitors have made moves to put in place more manufacturing capacity, so we expect the nicotine pouch market in the U.S. to become more competitive prospectively.

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

Sure. And my last question is on the cigar side of things. Like how are you approaching the PMTA deadline? Have you filed any PMTAs or SE applications? Have you refiled any stand-alone grandfather determinations? Would you be building up inventory ahead of the PMTA deadline? How do you approach this?

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

Yes. No, the filing of a grandfathered product, I'd say that the vast majority of all product on market today is not the same product that was sold in 2007. So it – while a company may file a grandfather product filing, it is simply to provide a cigar, which could then be used for substantial equivalent filings. We are in good shape with our substantial equivalence filing process and expect to file SEs for a vast majority of our portfolio by the May 2020 deadline.

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**Operator**

The next question is coming from the line of Fredrik Ivarsson from ABG.

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**Fredrik Ivarsson** - ABG Sundal Collier Holding ASA, Research Division - Research Analyst

A few questions from me as well, if I may. First one on the Scandi business. You say that EBIT was up in the quarter, but can you say anything about the margin here? Was it stronger or weaker than Q4 last year?

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

It's fairly comparable.

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

Yes. It was relatively comparable with the fourth quarter of last year. And do understand that the – our fourth quarter margins, generally speaking, decline relative to Q3 margins. And that's not simply what we see in Scandinavia. We have the same phenomena within our U.S. smokeless businesses as well, but the Scandinavian snus margin Q4 of this year was up slightly relative to Q4 of the prior year, largely doing to – or owing to price/mix.

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**Fredrik Ivarsson** - ABG Sundal Collier Holding ASA, Research Division - Research Analyst

Next one is on ZYN. You added quite a few markets in Q3 and also a few in Q4. Can you say anything about the initial learnings here from those markets, any one that's working especially well and vice versa? And also maybe if you can say anything about the potential capacity ramp-up for ZYN in Europe?

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

I mean it's relatively early days. And as Tom pointed out, it's – typically, we're talking hundreds of stores in these initial markets rather than thousands. But it's clear that in several markets, there's interest for these type of products. And as you're well aware, we're not the only competitor seeing this opportunity. And then it varies a little bit market-to-market as discussed earlier on the call. For example, Denmark has been a very fast consumer adoption on the – of the category, similar in Switzerland and you have other markets like Czech Republic and Slovenia. There, you're talking more kind of 10% or slightly south of 10% of the combined categories if you include chew bags.

As regards the capacity, in addition to the decision to further expand the U.S. facility for ZYN, we've also taken decisions to expand the ZYN manufacturing in Europe, including the dry variant. And we are busy there installing basically around 40 million cans of capacity that will start coming online with – during the summer, but with some of the steps outsourced and then fully up and running internally, some 12 months later than that or so. And so that volume also is – can be thought of as a little bit of extra margin if we need to support the U.S. market initially here before the third phase of the U.S. manufacturing setup comes online at the beginning of 2021.

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**Fredrik Ivarsson** - ABG Sundal Collier Holding ASA, Research Division - Research Analyst

And last one is on the CapEx guidance. Can you say anything more on this? You say it's significantly higher. Can you give a broad figure on what we're looking for?

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

What we said there on earlier questions on this topic is we have our outlook where we say that it's significantly higher, and then we wouldn't say significantly if we were talking 10 million crowns. It's more in 100 million crowns or hundreds of million crowns. But it is also difficult to estimate the kind of year on – year-end cutoffs and timing of – on the capital expenditures, but it will be notably higher than 2019 level.

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**Operator**

Next question is coming from the line of Adam Spielman from Citi.

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

So just a couple of questions about ZYN in the U.S. and then I want to return back to what you were just saying. So can you just talk about the velocity, cans per store per week in the Western region, and how that compares to the 3 other regions in 4Q?

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

I don't have that data in front of me. I mean we can compare the early – we have a slide that we usually show – that shows the traction on the expansion markets relative how the Western region looks like in the beginning, and that still holds true that all expansion markets and actually, including new stores that we have added in the West, trend above but with a similar slope of the curve as what we saw initially in the West.

And then in the Western region, the average velocity across all stores in the Western region is well above 30 cans per store per week.

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

And there's no sign of that slowing down when you look at...

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

If you look at the sequential development between Q4 and Q3 and even preceding quarters to that, it's a very similar pattern. So we grow the store count in the markets where we had been prior to the national launch from Q4 to Q3 by 8%, but the velocity in those markets grow by 13%.

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

Sequentially?

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

Yes.

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

Can I come back to – so first of all, thank you...

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

Yes. Adam, if I could just kind of add one comment that I believe the one chart is in the material that is presented, that shows the staples of velocity with the distribution build in our initial markets prelaunch. But even when we look within that market, we're not seeing really declined levels in the Western region by year of installation. So those earliest installations were not – we have not yet kind of seen a plateauing of their growth, in velocity. So the number that Lars mentioned that is considerably above 30 cans per store per week, you have some of those stores that were put in place in the very early stages of the Western region that are considerably higher than that number. So...

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

Good. Okay. Can I come back to the answer to the – that you were talking about before? So I'm a little bit confused, first of all, about Denmark, whether that's considered as part of the – because at the moment, I suppose you're talking about Scandinavia, you were talking about the U.S. and you're talking about other markets. And it's not quite clear to me where Denmark fits because I think that sometimes you sort of refer to it as part of Scandinavia. And I'm not sort of really talking about the legalistics, I'm talking about how you talk about it. And sometimes, it seems to be in that sort of new market bucket. So that's one question.

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And also you just mentioned 40 million of capacity. I mean is that capacity for Scandinavia and other markets? Or is that capacity for other markets? Sorry, I just wanted a little bit more clarity on that.

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

Yes. First on the geography part. I mean the Danish market is a relatively new smokeless market, as you know. And traditionally, we've been talking about Sweden and Norway when we say Scandinavia because that's where we had our volumes in there, of course, we still have the majority of our volumes in Scandinavia.

But given the development of the Danish market, we think it's appropriate to recognize it as a proper smokefree market and the – since it actually does belong to Scandinavia. From now on, we will try to be clear that when we talk about Scandinavia, we talk about Sweden, Norway and Denmark and then we talk about the U.S. and then we talk about markets outside of the U.S. and Scandinavia, then it's Europe and the rest of the world as well.

And it's also logical with the recent acquisitions in Denmark and the setup of our own organization, including our own sales force, which is part of the extra cost that we incurred in 2019, actually related to the setting up of that sales force, including termination of some prior distribution agreements.

When we – the 40 million cans I referred to, that is for the dry variety. And if we look at all markets in Scandinavia, the majority of the volume sits with the moist variety or our Slim varieties. And so – but the capacity there is intended on the dry one and the 40 million cans is intended both for Scandinavia but also expansion markets.

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And as I indicated also, it's also an extra reserve should we need to put in some extra volumes to support the U.S. market in the building-up phase of the further capacity there.

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

And when you're in, I don't know, Switzerland or the U.K. or Czech Republic, that's mostly dry or it's mostly moist?



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

It varies from market to market, and I don't have the exact split in my head. To my recollection, the U.K., I believe it's mostly dry. If you take Denmark, it's mostly moist. If you take Switzerland, it's mostly moist, same in Slovenia, I think, but – where we started with the moist, but the dry one has been added. So it varies a little bit market-to-market.

And then generally, just to provide our perspective on that, we think that the moist variety is very popular in markets where there is a niche consumption and existing in chew bag markets, there is a clear interest from existing chew bags consumers to try tobacco-free pouches as well. While as we see that the barriers to trial and usage typically are lower with the dry product for consumers not acquainted to the category, including cigarette smokers. So in that sense, it could well be that the potential for the dry variety on a global scale is larger, long-term. But on the other hand, the build may be a little bit slower as well.

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**Operator**

Next question is coming from the line of Karri Rinta from SHB.

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

Karri Rinta, Handelsbanken. I wanted to ask specifically about the U.S. capacity that you have right now, either on a monthly basis or on a quarterly basis. Just sort of looking ahead for the rest of 2020 and especially the second quarter because last year, you had the big expansion in in-store footprint in the second quarter and since – now that's being annualized and the velocity comments that you have made, so there could possibly be a very large step-up in the second quarter requirement from your customers. So what kind of capacity do you have right now? And how will that evolve in – during the rest of 2020 in the U.S.?

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

Yes. So as we commented on – in our prepared commentary, we did note that substantially, all of our shipments in the fourth quarter were sourced from U.S.-based manufacturing. So that's – we've sold 19.4 million cans. That will give you a feel and flavor of the size of our existing manufacturing capacity.

We continue to learn as we – as we work with this technology and these machines. So our ability and our yields via the process are – have improved. You're not going to get substantial increases because we are running kind of at scale, given the wave 2 of our capacity expansion in the U.S. and the ability to bring on new capacity is really more so towards the end of 2020, very kind of earlier parts of 2021.

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

All right. Very helpful. Then about the increased competition. I think Altria was out saying that they would start to manufacture ON! locally in the U.S. in the first quarter. So how would you expect the fact that you would get another large competitor to the market at some point in the first half? How does that – how would you expect that to sort of alter the competitive dynamics in the marketplace? Is it typically that the #2 is the one that loses most? Or is it the market leader? Because if I look at what's happened in Norway, well, it seems to be rather the #2 that has lost market share when #3 has entered the market. So how do you prepare? What do you expect from Altria's sort of step-up in the nicotine pouch market in the U.S.?

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

Yes. I mean naturally, we expect them to invest quite heavily behind the – or into this category. And in that sense, we expect increased competition. And I think one of the areas where we will see more of the – of the ON! product is, of course, at the retail level, where we can expect to see some investments on shelf presence and so forth. So I mean, there are positives and negatives, so to say, from a Swedish Match perspective here, where we definitely see that in this exciting and growing category, the further investments by competition will further drive consumer interest and not the least help accelerating the conversion of the cigarette smokers into the category.

But on the other hand, I think one should have realistic expectations when it comes to our market share given how high it has been. One should count that it will be negative for our market share, and where this balances of incremental category growth and the lower share, it remains to be seen. But when we look in markets where – there are markets where we have been side-by-side with relatively similar distribution, it is clear that the ZYN product and franchise resonates very well with consumers.

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

Very well. And then finally, is there any metric that you could share with us when it comes to Europe and your presence or your footprint in Europe when it comes to ZYN and nicotine pouches? I.e., I don't know, number of stores or something that we could start to track or that would give us a sense of the magnitude, your footprint in Europe compared to, for example, the U.S.

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

I mean it's – for now, we mostly indicate which markets we are in. And quite frankly, I don't have the exact store count in my head. But to give you a kind of feeling, I believe the number in the U.K. is around 700 stores. So that's a relatively niche distribution. If you go to Denmark, you would see us more widely available in – especially the convenience and gas stations and so forth. And if – pick a small country like Slovenia, I think it's fair to say that we almost have full distribution. In Switzerland, you will see us at the convenience chains like kiosk and so forth. So it varies a little bit market to market. Germany, a very big market, again, more selective on our parts, but very clear ambitions to increase that during the coming year.

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**Operator**

Next question is coming from the line of Robert Rampton from UBS.

**Robert Amos Rampton** - UBS Investment Bank, Research Division - Associate Analyst

The first is can you help us understand how much of your cigar portfolio you'll be submitting SEs or PMTAs for? Do you expect to get approval for the flavored portion? That's the first question.

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

Yes. So if you look at our cigar portfolio on a broader scale, we have a number of SKUs. But if you look at it, I mean those are more so packaging-related SKUs, different packaging formats. But the plan is that we would be able to file substantial equivalents for well over 95% of our volume by the May 2020 deadline.

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

And then when it comes to how the FDA will look upon flavors and how to bring that into – how big difference is a substantially equivalent product is allowed to – you had to note, I think, remains to be seen, but we can only see what you can see, as much as we can do in terms of how the FDA

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communicates around flavors in the cigar category. And I think it's fair to say that over time, it seems to be the agency's clear ambition to, at the minimum, get rid of characterizing flavors in the category.

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**Robert Amos Rampton** - UBS Investment Bank, Research Division - Associate Analyst

Very clear. And then just in terms of U.S. ZYN, can you share with us your estimate of sell-outs? And how that changed versus Q3? I'm trying to understand if the sequential growth there was as large as it was for ship.

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

It's – all indications we have is that, yes, we, of course, have a little bit of pipeline as we add the distribution. But we've been adding distribution less so between Q4 and Q3 compared to at least in Q2.

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And so for the sell-in to the trade, we believe it's a very good indication also of the sell-outs. There can be minor timing issues there, but the limited Nielsen dataset that we have at our disposal also indicates a very strong velocity at the – from the cashier.

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**Robert Amos Rampton** - UBS Investment Bank, Research Division - Associate Analyst

That's very helpful. And then, sorry, my final question, just in terms of the capacity of your U.S. facilities in the U.S., I mean over the course of 2020. I mean what is the most that it can – what are your current expectations for maximum production over the course of the totality of the year, taking into account how you expect it to change over the year?

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

Yes. We had a similar question earlier in that – and the point was that substantially all of the product that was sold in the fourth quarter was sourced from U.S. manufacturing. There will be opportunities to improve upon that. But that is really at a level that reflects the second phase of our production being fully at scale. And the third phase will begin to come online in parts, late 2020, but for the most part, in the first couple of months of 2021.

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**Operator**

There are no further questions at this time. Please continue.

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

Okay...

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**Operator**

Sorry. Excuse me. We have a final question, I'm so sorry. From the line of Sanath Sudarsan from Morgan Stanley.

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

Two questions from me, please. First on ZYN and your growth in the U.S. Could you just provide us more clarity on what the growth in volume numbers is? Is this more usage? Or actually adding more consumers? And if you have a rough estimate of how that's actually split? And would also be interesting to hear your thoughts if there has been any impact from the flavor restrictions on e-cigarettes.

And then this other bit is you highlighted some headwinds from the chew bag sales in Denmark. Can you possibly also give us some sense or your thoughts on Tobacco 21? How that can kind of affect your portfolio? And do you see this as a big opportunity to recruit more consumers in nicotine pouches?

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

Yes. I mean if we take the first – the last question first. The consumer research that we have indicates that we have a more mature audience when it comes to ZYN. So we don't see – if anything, we see it as reinforcing the positioning of our brand in the marketplace.

And then the – your other questions there, it's a little bit hard to get in this period of fast growth, it's a little bit hard to get exact data. But since we have expanded during the year here, to a large extent, obviously, a large part of the growth is by pulling in new consumers into the category. And we typically see that if you take a straight average in consumer poll the consumption, number of cans per week that a consumer consumes on the ZYN, it's relatively low compared to other categories. I think if anything, that speaks more for future potential as people – once they start using the product, they tend to like it more and more. And it's very clear to us that consumption is coming from adult tobacco users and is pulling, to a large extent, from smokeless categories but also cigarettes given that, that category is so much bigger to start with. That inflow is – seems to be relatively meaningful.

And to give you a kind of a high-level illustration of this, if you look at the Western region, where we've been the longest, and you compare our ZYN shipments to shipments into retail of moist snuff, we have seen for several quarters now that the weakness of the moist snuff category is most prominent in the Western region as ZYN has affected the category there. But if you add ZYN to moist snuff sales and compare fourth quarter to the fourth quarter of prior year and you look at that as kind of 1 category, we actually see a growth of around 10% of the total category, indicating that there is a clear inflow of cigarette smokers as well.

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

And can you just remind us of your portfolio, what's the potential...

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

And yes, sorry, just on your flavor there and on e-cigarettes, just a very quick answer. Very hard to read. But for sure, we see, not the least among in the trade, that they're, so to say, extra eager to secure space for ZYN in view of the – let's call it, the uncertainty of the vape category.

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

And just to clarify, on the Tobacco 21, do you have any sense of what percentage of your user base of sales is within the 18- to 21-year-olds in the U.S.?

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

I don't have an exact number. That should be very low. Given that our gravity point is well above that level.

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**Operator**

There are no further questions at this time. Please continue.

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

Okay. Then let me say thank you to everybody for listening and remind you that the release of our first quarter 2020 will be on April 27. Thank you.

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**Operator**

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

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