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SWMA.ST - Q1 2020 Swedish Match AB Earnings Call

EVENT DATE/TIME: APRIL 27, 2020 / 12:00PM GMT



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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Swedish Match Q1 2020 Conference Call. (Operator Instructions) I must advise you that this conference is being recorded today, Monday, 27th of April 2020.

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

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

Thank you. This is the Swedish Match First Quarter 2020 Telephone Conference. And with me today are Lars Dahlgren, our President and CEO; and Tom Hayes, our CFO. In the Investors section of our swedishmatch.com website, you will find the presentation for today's call, which is intended to be viewed in conjunction with our prepared commentary. So we encourage you to follow along with that presentation. After our prepared commentary, we will be taking questions.

During today's call, there may be certain comments that constitute forward-looking statements and are subject to risks and uncertainties. Management believes 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.

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

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



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

Thank you, Emmett, and good afternoon, everyone. Before providing you with commentary and highlights for the quarter, I'd like to remind you that as of the beginning of this year, we have revised our product segment reporting structure. We provided some historic details in our Q4 presentation in February. But on Slide 4, you can see the product categories, which are included within each segment.

(technical difficulty)

Operator

This is the operator. I apologize, but there is slight delay on today's conference. Please hold, and the conference will resume shortly. Thank you for your patience.

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

Harrison speaking. There was a technical problem, so the phone cut off. So Lars will restart with the prepared text for the Q1 2020 interim report conference call.

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

So sorry about that. Thank you, Emmett. I will go back to Slide 4, and good afternoon, everyone.

Before providing you with commentary and highlights for the quarter, I would like to remind you that as of the beginning of the year, we have revised our product segment reporting structure. We provided some historic details in our Q4 presentation in February. But on Slide 4, you can see the product categories, which are included within each product segment. The new segment structure brings together all of the group's smokefree operations under the new Smokefree segment, which we believe assists in communicating the financial performance, key priorities and investments directed to our vision of a world without cigarettes.

On Slide 5, we have the sales and EBIT split for the first quarter as well as for 2019 by product segments. For both sales and EBIT, primarily as a result of the rapid growth of smokefree volumes in the U.S., smokefree is growing its proportion of group results, despite sales and operating profit growth for both cigars and lights during Q1 2020.

On Slide 6, you can see our sales split by geography as well as the geographical split for each of our product segments. The U.S. has grown to about 2/3 of Swedish Match total sales reflecting, in particular, the strong growth for ZYN, but also solid performances for our remaining U.S. businesses, as well as the impact of a stronger U.S. dollar. Within the Smokefree segment, you will note that the U.S. has now surpassed Scandinavia as our largest contributor. For Lights, a substantial portion of sales come from markets outside of Scandinavia and the U.S., most notably countries in Asia and Europe, including Russia as well as Brazil.

Moving to Slide 7, let me start by stating that COVID-19 has had profound social and financial impact throughout the world. And we, at Swedish Match, are taking what we believe to be prudent and necessary steps to help reduce the negative consequences of COVID-19 on society and to ensure the well-being of our employees. For Swedish Match, the net financial impact from COVID-19 to-date have been positive, due principally to trade and consumer hoarding in the U.S. Shipments to the travel retail and border classes of trade in Scandinavia on the other hand virtually ceased during March due to travel restrictions. To-date, our manufacturing facilities have been relatively resilient. While we have experienced some temporary suspensions of production, most notably in the Dominican Republic, where natural leaf cigars are produced, we've been able to address trading consumer demand from existing inventory.

The COVID-19 crisis and related travel and social distancing restrictions have required that we reassess certain sales and marketing activities and how we best service our customers and engage with consumers during this difficult period, which resulted in delays to certain market the new



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product launch activities. As a company, Swedish Match entered the COVID-19 crisis on a firm financial footing due in part to a EUR 300 million debt offering in February of this year. The strong first quarter results further strengthened our financial position. And keeping with our financial strategy, our shareholders at our Annual General Meeting approved an increased dividend to SEK 12.50 per share. Our financial position also allows us to continue to invest in strategic growth initiatives, including the expansion of ZYN capacity in the U.S. and Scandinavia as well as new product and market efforts during this otherwise uncertain period.

Slide 8 highlights a few key points from the quarter regarding our product segments. The strong performance for Smokefree was the key contributor to the impressive sales and earnings growth in the first quarter. In the U.S. while ZYN continued to stand out as a major driver to the growth, moist snuff also performed very well on an underlying basis, and chewing tobacco had a solid quarter, albeit impacted by COVID-19-related hoarding effects. In Scandinavia, as mentioned, shipments suffered from COVID-19 effects, but we're encouraged by the continued very strong performance of the smokefree category on an underlying basis, as well as healthy growth for Swedish Match on that same measure.

It is evident that the nicotine pouch category helps expanding the consumer base. And as an example, in Scandinavia, we see an increased inflow of human cigarette smokers into the category. While hoarding effects positively impacted our cigar business, our focus on natural leaf varieties puts us in a strong position to capture future growth opportunities within the U.S. mass market cigar category. And for our lights business, the first quarter marked a good start to the year with operating profit growth also when stripping out the favorable impact of the Brazilian indirect tax dispute.

By that, I will hand over to Tom, who will provide some more color to the performance within each of our segments.

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

Thank you, Lars. On Slide 9, we have summarized some of the quarterly highlights of the Smokefree product segment, which includes snus, nicotine pouches, moist snuff and chewing tobacco. As in previous quarters, ZYN in the U.S. was a major contributor to sales and operating profit growth for the Smokefree segment. Shipment volumes during the quarter for ZYN in the U.S. were nearly 25 million cans. While difficult to determine with absolute precision, we estimate that 2 million cans of the Q1 ZYN shipments were attributable to distributor COVID-19 hoarding and an incremental 1 million cans were pipeline volumes, as we added approximately 13,000 stores to our ZYN store count during the quarter. The year-on-year expansion of operating margin for the Smokefree segment predominantly reflects scale benefits associated with ZYN growth in the U.S.

With regard to our Scandinavian business, Swedish Match's underlying volumes are estimated to be up by more than 3% in the quarter when adjusted for the COVID-19 effects on the travel retail and border classes of trade as well as for inventory adjustments. Outside of Scandinavia, we added 5 countries to our growing list of geographies where ZYN and nicotine pouches are available at points of trade. However, due to lockdowns, travel restrictions and store closures in a number of markets, we had to modify and, in some cases, defer our sales and marketing activities in new markets.

Turning to Slide 10 and moist snuff in the U.S., where we reported improved shipment volumes, sales and operating profits. Shipment volumes during the quarter increased sharply, which were partly affected by COVID-19 hoarding, but more so a result of changes to our moist snuff pricing and promotion model implemented in the fourth quarter of 2019. We've been pleased with the trade and consumer response to this change in support of our Longhorn brand. And we also once again gained market share in the faster-growing pouch segment of the market.

For U.S. chewing tobacco, like for moist snuff, we noted increased orders from wholesalers and retailers likely tied to the COVID-19 pandemic. Aided by hoarding volumes, shipments during the quarter for our own brands were flat compared to the prior year, and sales and operating profits grew in U.S. dollar terms. While quarterly shipments are volatile for this business, there's a long-term downward trend for chewing tobacco, so flat or increasing volumes are the exception rather than the norm. For chewing tobacco outside the U.S., our chew bags and chew bits shipment volumes for the quarter declined compared to the prior year in a number of our markets.

On Slide 11, we've presented Swedish snus trended volume and value growth, the market share dynamics, excluding nicotine pouches, according to Nielsen. The Swedish snus market is growing in both volume and value terms with a stable mix between value and premium-priced products. Our year-on-year share decline is attributable to market share losses in the faster-growing Premium 2 segment to premium branded products at



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a more popular price point, as well as mix shifts between the segments. Our snus market share development in Sweden was stable on a sequential basis. And while competitive launch activities within this attractive segment remain intense, our market share losses within the Premium 2 segment have been moderate over the past 2 quarters.

On Slide 12, we presented the market trend and market shares for the nicotine pouch category in Sweden according to Nielsen. Supported by strong competitive activity in terms of new product launches and in-store visibility, the nicotine pouch category has more than doubled in size over the past year and is now roughly 7% relative to the snus category, according to Nielsen. We believe that nicotine pouches have 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.

We should also note that due to channel shifts and shopping pattern changes brought on by COVID-19, the variability of the data may be more pronounced than would otherwise be the case. So any recent short-term fluctuations may not be fully reflective of consumer demand. The nicotine 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 over the past year, but our continued objective is to capture a higher percentage of growth within this attractive category. In terms of pricing during nonpromotion periods, nicotine pouches are typically priced in line with or above the Premium 1 snus products. And the dramatic growth of nicotine pouches have, therefore, contributed to a positive price/mix effect in the combined category.

Now turning to Slide 13. 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 maintaining its very strong position 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 the Norwegian market has been in the nicotine pouch category, and here, we have been underperforming. As you can see on the left side of the slide, after a reported dip of growth in the middle of 2019, influenced by the growth of e-com, the Norwegian smokefree category at brick-and-mortar retail, which is what Nielsen captures, has reverted to good growth in volume terms and even better growth in value terms.

On Slide 14, you can see the nicotine pouch segment in Norway has grown dramatically over the past 2 years and is now more than 1/4 of the size of the Norwegian snus category. In the nicotine pouch category, even with our own strong volume growth, our share progression remains a challenge.

On Slide 15, the chart illustrates the dramatic growth of ZYN nicotine pouch shipments in the U.S. on a trailing 12-month basis. It is always good to remember that shipment volumes do not always fully align in timing or magnitude with consumption volumes due to inventory stocking or destocking effects at the wholesaler or retailer level. As noted, shipment volumes during the first quarter benefited from both pipeline volume to the 13,000 stores added and estimated COVID-19 effects related hoarding and that collectively approximated 3 million cans. We expect to see some of the incremental Q1 volume and particularly the COVID-19 hoarding to unwind in coming quarters.

We're now on Slide 16. And while we are currently available in approximately 80,000 stores, this slide presents average store count and velocity rates by quarter in the markets in which we were present prior to the national launch in April of 2019. In these markets, despite further increases in distribution, in-store velocity rates have continued to increase.

On Slide 17, we've summarized trended volume and market shares by brand within the nicotine pouch category in the U.S. based on distributor shipments to retail. 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. Also, it is natural to assume that as competition increases and the market expands, our ability to maintain market share at these levels will be challenging. However, as you will note from the chart, despite losing market share over the past year, our volume growth in absolute terms has far exceeded that of any other competitor.

On Slide 18, you can see the size of our ZYN brand in the U.S. relative to a number of benchmarks in the established Western region as well as for all national launch markets on a trended basis based on distributor shipments to retail. In the Western region, where ZYN has been available for a number of years, ZYN is about 1/4 of the size of the moist snuff market and larger than the entire moist snuff pouch segment. It is also worth noting that ZYN's performance within the April 2019 launch markets has generally outperformed the Western region based on comparable time and



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market, and we believe that the development highlighted on this slide amplifies the nicotine pouch opportunity in the U.S. While this slide is interesting from a reference perspective, it's important to note that nicotine pouches draw consumers not only from moist snuff, but also from other adjacent categories, including cigarettes and vape.

On Slide 19, we list the countries where ZYN nicotine pouches and G.4 nicotine pouches, which is similar to ZYN, but with small amounts of tobacco, are available. Activities in some of these markets as well as expansion into other new markets are currently impacted by restrictions brought on by the corona pandemic.

Now moving over to the U.S., moist snuff on Slide 20, where we have summarized trended quarterly and Swedish Match growth rates based on distributor shipments to retail. While it's reasonable to assume that Q1 2020 growth rates have been favorably influenced by COVID-19 hoarding, it is also important to see that Swedish Match has demonstrated volume growth and outperformed the category for 2 successive quarters, which has resulted in an uptick in our overall moist snuff market share. Swedish Match shipment volumes were up by 15%, with higher deliveries not only for pouches and tubs, but also for traditional 1.2 ounce loose formats. This growth is attributable to a number of factors, including the EDLP strategy recently put in place for our Longhorn brand, our relative strong performance within the growing pouch segment, as well as the aforementioned trade hoarding tied to COVID-19.

Looking at the U.S. chewing tobacco on Slide 21, where we once again outperformed the overall category in both the premium and value segments. Shipments in the quarter for our own brands were essentially unchanged versus the prior year. As noted earlier, these higher-than-normal delivery trends were due to phased timing activities and notably to some COVID-19 related hoarding. Over longer periods, there have generally been a mid-single-digit volume declines annually for both the market and for Swedish Match, with a shift from premium products more toward value-priced brands.

Moving to Slide 22, in cigars, Swedish Match cigar volumes increased 7%, led by the growth for our natural leaf varieties and benefiting from COVID-19 trade hoarding in March. When adjusted for COVID-19 related hoarding, volumes are estimated to have been flat, with growth in our natural leaf cigars offsetting declines for our HTL or homogenized tobacco leaf varieties. In local currencies, also when adjusting for COVID-19 related impacts, we estimate that operating profits declined slightly.

On Slide 23, we've presented a quarterly trend of Swedish Match cigar shipment volumes as well as our estimate of U.S. mass market cigar category which, in this case, excludes little cigars and segment volume development based on distributor shipments to retail. Swedish Match utilizes the externally developed MSA data set, and revisions to historically reporting periods are common as retail stores and distributors are added to the data set. Based on MSA measures of distributor shipments to retail, total cigar category volumes increased by close to 8% in the first quarter compared to category growth rate of slightly more than 2% for the full year of 2019.

Swedish Match's volumes under the same measure increased by 11% in the first quarter of 2020, with Swedish Match outperforming the category in the faster-growing natural leaf segment, while growing at a slower rate than the category for HTL cigars. As this data set uses distributor shipments to retail, there is likely some degree of COVID-19 retail hoarding influence in the acceleration of Q1 2020 growth rates relative to the full year 2019 growth rates. However, the MSA data also indicated growth for the period leading up to the point where the positive COVID-19 impact set in. And it is further more positive to note, the MSA data set now indicates that the category showed growth for the full year 2019 as to the previously reported slight decline.

Moving on to Slide 24, in our Lights product segment. Sales for the segment were up 1% in local currencies, but down 2% on a reported basis due to the weakening of the Brazilian real versus the SEK. While shipment volumes declined for both matches and lighters, favorable product and market mix as well as pricing resulted in improved sales and operating profit development for the segment on a local currency basis. Operating profit within this segment also benefited from reduced operating expenses and raw material costs, particularly nylon, compared to the prior year quarter. The quarter also included a benefit of SEK 60 million related to favorable resolution of indirect tax disputes in Brazil.

On the regulatory front, on Slide 25, in the U.S., the FDA has just this past week announced that the May 2020 date for PMTA and substantial equivalent filings would be delayed to September 9. However, Swedish Match has already, on March 19, been notified by the FDA that its filings



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for PMTA applications for ZYN nicotine pouches has met its filing required -- the FDA's filing requirements. We do not anticipate any decision on the PMTA filings over the coming months, however.

On Slide 26, we've summarized relevant metrics for our interim report relating to finance costs, our financial position and earnings per share. Net finance costs during the quarter increased relative to levels that we have experienced during the past few quarters, principally due to cost incurred in connection with our Q1 debt offering as well as lower returns on our cash surplus position. The weighted average interest rate of our loan portfolio at March 31 was 2.03% compared to 2.08% at the end of 2019. Our net debt-to-EBITA for the 12-month period ending March 31 was 1.9. As of March 31, Swedish Match had SEK 15,912 million of interest-bearing debt, excluding retirement benefit obligations, but including the recognition of lease liabilities of SEK 247 million.

In February 2020, Swedish Match issued a 7-year EUR 300 million bond at a fixed annual coupon of 87.5 basis points corresponding to an all-in hedge adjusted fixed rate of 1.81%. And after having repaid SEK 100 million of our June 2020 bond maturity, we have SEK 1.2 billion in remaining maturities this year. The capital duration of our bond portfolio was 4.2 years with 98% of the portfolio subject to fixed interest rates. The EPS bridge illustrates the components of a 38% year-to-date growth in EPS. And apart from the after-tax effect of our increased operating profit, the reduced number of shares had a meaningfully positive impact. And during the first quarter, we made share repurchases in the amount of SEK 935 million buying 1.6 million shares at an average price of SEK 571.4 per share.

On Slide 27, we have presented the Q2 guidance with regard to COVID-19 that was included in our interim report. Factors that we currently believe will represent earnings headwind include the unwinding of Q1 trade hoarding in the U.S., the continued closure for at least a portion of the quarter of the travel retail and border trade channels in Scandinavia, and increased cost in responding to sanitation and social distancing requirements of COVID-19 that due to the timing of the onset of COVID-19 only minimally affected Q1 reported results. Also for the left...

(technical difficulty)

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

I think we have a problem with Tom's line. So we take over from Stockholm here. So for the Lights product segment, while inventories were sufficient to cover needs during Q1, the currently reduced capacity of our Manila light manufacturing unit is likely to negatively affect sales during Q2. While difficult to estimate with any level of certainty, our current view is that the net adverse effects from COVID-19 during Q2 could exceed the net favorable benefits reflected in our Q1 results.

And then on Slide 28, it simply restates our 2020 outlook from the interim report, which remains unchanged. Our CapEx plans remain on track to be considerably above the 2019 level, and we continue to foresee good market growth for smokefree nicotine products. While we continue to expect the effective corporate tax rate for the full year to fall within the 22% to 23% range noted in the outlook, further strengthening of the U.S. dollar or a more rapid growth of the U.S. business compared to our Scandinavian business could add upward pressure on our consolidated group effective tax rate.

And 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 second quarter 2019 for the U.S. dollar was SEK 9.44; the NOK, SEK 1.09; and the Brazilian real, SEK 2.41.

And with that, we will open up to the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Sir, your first question comes from the line of Niklas Ekman from Carnegie.

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

I have a couple of questions, if I may. Firstly, I would like to start with the ZYN operating margin. We saw smokefree here a very strong margin expansion in this quarter. If I try to calculate backwards, it sounds like or it looks like your ZYN margin is now around 50%. So it's continued to rise. Firstly, wondering if you could confirm that. And if you could also say something about what to expect? Because you've been talking about ZYN margins most likely trending lower and instead it keeps trending higher. So just your thoughts on this would be very interesting.

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

No, I think, Niklas -- I know there was some issue with my audio earlier. Can you hear me okay?

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

Yes, okay now.

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

Okay. Yes. Now that is something that historically we were saying that kind of framing our smokefree businesses and from an operating margin perspective, that Scandinavian snus, obviously, with its Premium branded products, with limited opportunity to market would have margins north of 50%. Our U.S. moist snuff, where we participate largely in the price value segment, would be considerably lower. And the expectation was that ZYN operating margins would be kind of somewhere in between. What I would say is we still benefit from the growth of what we're experiencing within ZYN. And we are seeing ZYN margins that are approaching our Scandinavian snus margin level, in part due to reduced manufacturing cost associated with this product and the scale efficiencies that we've been able to achieve at our Owensboro facility.

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

Okay. Is there any reason to think that, that margin will trend lower going forward? Or is this a level around 50% that you think you could sustain?

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

Yes. I think it's fair to say, Niklas, that we've been -- to this point, largely been traveling with kind of clean air in front of us, where we have had competitive activities from one major player in the U.S. with a fairly limited traction in terms of volume growth. I think that will change as another competitor ramps up capacity with a product that's much similar to ours in the U.S. market. So one could see increased marketing cost prospectively as competitive activities intensify within this category.

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

Okay. And speaking of competition, I noticed on Slide 17, you mentioned a trip player called Rogue that seems to be on the rise quite strongly. I have to be honest and say, I haven't heard of this name before. Can you just provide us with some background here and where this player is coming from?



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

Yes. I mean, this is a -- as you say, a fairly new player in the market. And you can buy the product on e-commerce channels and to some increasing degree in the brick-and-mortar level. And as far as we understand it, there is some type of cooperation or distributorship with Swisher. But I think you should ask them for the details.

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

Okay. But this is a product that was available before the August 2016 deadline?

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

That's a question that I suggest that you direct towards them. We don't have any indications of it having been available.

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

Okay. And nicotine pouches in your European or global rollout, you mentioned 18 markets here. Can you provide any kind of input here on what kind of volumes we're talking about, both for full year 2019 and now in Q1?

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

I'll have to look up the data here. But at this point, we are talking fairly limited volumes, I would say.

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

What is that, a few hundred thousand cans or 1 million and above or?

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

Yes. I mean, it's more than 1 million on an annual basis.

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

Maybe you can come back on that. So just a final question on Norway. I was curious about you -- you're talking about border trade here being down very significantly. I was wondering if actual consumption in Norway is also down. Otherwise, it seems like eventually Norwegian consumers would have to buy snus in Norway or you would see massive restocking once the border is open. So, I'm just curious if the actual consumption is also lower.

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

No. I think you raise a good point. I mean, one can speculate if consumers after buying a lot at the same time in tax-free or border outlets consume a little bit more. But over time, we expect the impact on consumption to be minimal. So it could well be that you see some increased volumes in the domestic channels in Norway. And if you look at the retail level, in Nielsen, March in Norway actually suggests that you start to see a little bit of that effect. At the same time, you need to remember that when we talk border and tax-free outlets, while Norway is a very important part of that equation, and you have a relatively significant border trade towards Finnish consumers in Sweden as well, as well as tax-free on Paris going to Finland and so forth, as well as some general travel consumption and purchasing of people going elsewhere, buying in airports and so forth. So in



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some of those markets, then you will have difficult finding products. So there, I think, we have to count on a bit of, so to say, permanent effect on -- or not permanent in terms of everlasting, but lost forever, this type of decline that we're seeing there.

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

Just to answer on the nicotine pouch comment earlier, it's important to note that when you look at our international smokefree business, we are selling in through distributor partners in large part in these new markets that we're entering. But I think if you look at our -- the total smokefree volumes, for Q1, roughly 20% or so were nicotine pouches of that delivery.

Operator

Sir, our next question comes from the line of Gaurav Jain from Barclays.

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

I have 3 questions. First is on the U.S., now in the prior cycle when oil prices had declined, and I'm going back to 2014 and '15, we have seen an increase in underlying tobacco consumption. So what you are saying is that all the inventory benefits that we have seen in Q1 will substantially unwind in Q2 and Q3. So you are not seeing any benefit on underlying tobacco consumption because of oil price declining. Is that the correct way to look at it?

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

Yes, Gaurav, this is Emmett. We have -- let me say 2 things. One is, in terms of general economic cycles, you don't tend to see huge differences in total nicotine/tobacco consumption, but you do see some shifting between different types of products. We've seen that in the past. And in the past, we have seen under normal circumstances, when gas prices go down, people have a little extra money when they go to the convenience store or a gas station, and they might buy some extra product when they're there. Currently, in the U.S. not -- a lot of people are under lockdown, and they can't go to the gas stations and so forth. So we can't really -- your theory is correct. But we can't really say with good certainty in this particular climate what will happen because there's also the driving effect, not just the gas price effect. So we'll see.

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

Sure. That's really helpful. Now second is just on pricing on the -- on nicotine pouches/Longhorn in the U.S. So it does seem that your pricing per can has gone down mid-single digit this quarter on a Y-o-Y basis. And part of that might be due to Longhorn and the EDLP strategy that you were talking of. But it does seem that ZYN's pricing has also come down by mid-single digit. Is that a correct way of reading the numbers?

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

Yes. I think there has been some level of kind of price erosion. What I would say is it's not so much a function of a reset of pricing or factory selling price to distributors. We do have a kind of in a total other tobacco products merchandising contract program in place with many of the large retail chains in the U.S. And as part of that program, whether they'd be rebates or opportunities for retailers to earn money that are directed toward in-store marketing activities, those programs were enhanced in 2020, and the accounting for those items is as a reduction of sales. So what I would say for the Longhorn brand, through this EDLP strategy, I don't want you to get the idea that there was a reduction to the factory selling price to distributors. However, as a function of how we promoted the product historically, which was a function of temporary price reductions at retail, we would -- state by downs at given retailers and even the degree to which we would promote Longhorn with promotional towers at retail, those activities have been reduced as part of this EDLP strategy. So on a net absolute realized price per can, the EDLP strategy was not as pronounced as one would otherwise expect.



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

Sure. That's very helpful. And my last question is on the recruits for ZYN, and you highlighted cigarettes and vapes as well from which consumers are coming into nicotine pouches. Would you have an estimate of the share of recruit from these 3 different product categories, from cigs, vape and moist snuff?

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

I'd say, I mean, we have some data, but we are gradually getting more and more data. But I think it's fair to say that in our portfolio, it seems like the majority of the consumers are those with smokeless experience or previous smokeless experience. But it's about half. So about half is also coming from other sources like cigarettes and vape. But within cigarettes and vape, we have less visibility on where it's pulling from.

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

Sure. So just to clarify, you're saying about half the consumers in ZYN are from cigs and vape?

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

I would say that that's a reasonable estimate.

Operator

(Operator Instructions) And sir, can you continue if you have some topic to discuss? I got some technical issue happening now. But I'll be -- I will try to tell my colleague to cover up for me just now. Is that okay, sir? Give me a second. We will just fix this.

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

I think we will wait for you to get your line in order, so that we can get the questions.

Operator

Yes, sir. I'm sorry about that.

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

Operator, the participant list, can you send that to me? And I can...

Operator

No problem.

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

And that way I can contact them to e-mail questions or something.



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Operator

Okay, sir. I will just take a list of the people who will ask question. Then I will inform our other department to give you the list of the people who want to ask question aside from the participants who have chimed.

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

That's correct. Thank you.

Operator

Is that okay?

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

Yes.

Operator

No problem, sir. Sir, is that okay? I will just leave for a few minutes. Then I will come back. My platform is okay now.

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

Okay.

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

Okay. Yes. I think it's best we continue.

Operator

Sir, one moment. I will...

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

We have a question that I got via e-mail. Composition of the slowdown in same-store sales growth in the West. What are some of the factors on that? For example, hoarding, what would it look like? The second question would be, underlying price/mix in Scandinavia. This person appreciates it would be difficult to disaggregate the impact of border movements. But can you talk about how ZYN and the category are performing in markets where you have an overlap? So underlying price/mix in Scandinavia, composition of the slowdown in the same-store sales growth in the West and also ZYN, ZYN and the category -- and the category, how are they performing in markets where we have overlap between the 2.



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

Okay. So I believe you can hear us on the line. When it comes to Scandinavia, our reported price/mix component is fairly weak in the first quarter year-on-year, but that is basically exclusively a consequence of the weaker Norwegian krone. So if you look at on a constant currency basis, we are close to within 10th of decimals to the Q4 level. So just shy of 2% price/mix.

And then on the Western region there, we -- it's important to note that we continue to see increased overall velocity, as depicted on one of the slides there on the -- in the prepared presentation. And we did generally add during this quarter. As you can see, we added 13,000 stores. And some of these stores represented new chains, like, for example, Walgreens. And those stores came on very late during the quarter. So there is not a full quarter of sales in there. Plus that I think one should expect that those, so to say, new type of outlets where you don't have tobacco consumers buying their part on -- are not as used to buy these type of products. The pickup may take a little bit longer time. But overall, there is continued nice growth, both in the West and in the -- as well as in the expansion market.

And if we look at the set of earlier in-stores within the West like stores where we install in 2016 and all throughout 2017 and so forth, all those velocity lines keep on pointing upwards in a very impressive way. I mean, if you take the 2016 stores, we are over 70 cans per store per week. And I think a good reference point is really the slide where we show the MSA data relative the moist snuff category. There you can see how the ZYN volumes in MSA have grown to represent 24% relative to moist snuff category in Q1 compared to 21% in Q4 and 17% in Q3 of last year. So it continues to trend very, very well in the West and also the expansion market.

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

And there's a question from Adam Spielman from Citi, and he's talking to that same Slide 18. And he's asking if you can talk about the difference by region, Central, Southern and so forth and give some indication of the overall trends in that.

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

Yes. I mean, I don't have those exact numbers split out by region. But what we can say is that all the expansion regions, they show a very similar trend in terms of slope of the curve and its pointing efforts. But among the 3 regions, the Eastern region has been performing a bit above in terms of velocities, the Southern and the Central region, but the gap has been very consistent over a period. So the Eastern and the -- or sorry, the Central and the Southern regions, they are -- those lines follow each other very closely.

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

The next question is from Fredrik Ivarsson at ABG. And he asks on the 25 million ZYN volumes in the U.S. About how much of that was shipped from Sweden?

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

It was actually a relatively low amount ship from Sweden during the first quarter. So we've done very well on the manufacturing side in U.S. and -- but we did have to use a little bit of inventory. Meaning that we went in the year with slightly higher inventories than the levels when we exited the first quarter. But the ramp-up of production has gone very well. So at the end of the year, we spoke about being up at the run rate of around 80 million cans for domestic U.S. production. And that one has now come up, and it could be more like 90 million or slightly above 90 million cans. And on top of that, we still count on continuing supporting the U.S. market for the remainder of the year with shipments from Sweden that we did.

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

And he had a second question. But I think Tom covered this. Can you say anything about the price/mix and margin development within moist snuff?

And I think the answer to that is covered a bit in terms of the change in the pricing and promotional strategy from a more promotional-driven strategy last year to the EDLP pricing this year. That affects year-on-year quarterly numbers a bit, but it doesn't have a major impact over a longer period of time.

Next question is coming from Canterbury Capital. Can we expect a further extension of the number of ZYN doors through the rest of the -- rest of 2020? Could it be 100,000 stores by the end of the year?

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

I think you should have reasonable expectations on how many more stores we can add during 2020. The first quarter, the number of incremental stores were a little bit higher than we had counted on ourselves. And so what happened is that some of the chains that had put the product in their doors, so to say, they themselves expanded it to more outlets. And given that it's not towards the end of the year and the beginning of next year, where we have a meaningful increase in capacity, we need to make sure, first and foremost, that we can serve existing customers well. So there could be some increases, but it could also be that in terms of incremental stores during 2020, the majority may have occurred during the first quarter when we sum up the year.

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

There's a follow-up question for Slide 17. What you read into the fact that ZYN is steady at a 75% share -- volume share of the market. What will happen when ON production accelerates? Also, can you repeat who is collaborating with Rogue?

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

When it comes to Rogue, our understanding it's Swisher. And going forward and on the market shares, it's obviously difficult to predict. And we don't know exactly what type of plans and strategies any of our competitors will apply. But I'd say it is clear that ON has taken some share, while our other main competitor has lost share. But we also see that ZYN performs well in stores where it already competes with ON.

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

Now moving over a little bit to Sweden. This is from Karri Rinta at Handelsbanken. Karri, the first -- your first question was already answered, so I'm going to jump into the second. Status on ZYN expansion projects in Sweden, any help already in Q2. And do you have any early anecdotes on Deep Freeze, any light on that, Deep Freeze?

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

Only anecdotes, I'd say. There seems to be some liking of the product in Norway, but we're talking very small numbers and decimals of share points here. But at least the reception has been positive. And I think it's fair to say that the initial reception seems to have been more positive in Norway than in Sweden. And we think it is a type of product that caters to a larger segment in the Norwegian market. And sorry, what was the other question, Emmett?



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

It was just any light on some of the expansion, things we're doing in Sweden and U.S. anyway.

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

I mean the capacity plans also in Scandinavia are despite the COVID-19 situation at this point continuing to follow the plan. But there won't be any volumes to speak of during the second quarter -- incremental volumes coming out of the Scandinavian operations from the new machinery. That is more an installation that will be expected to become operational after the summer vacations, and then you'll see a ramp-up during the second half of the year, according to plan.

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

From Sanath Sudarsan over at Morgan Stanley. He has 2 questions. One is, can you update us on the split of your cigars business by flavors? And how we are positioned for the substantial equivalence filings? That's one. Also, the second question is on ZYN. I assume, Swedish Match has an exit rate capacity of about 160 million cans in the U.S. alone, plus other dry capacity in Europe, which is 40 million to 50 million cans per quarter. We're currently selling closer to 20 million underlying ZYN volumes in the U.S. Can you share your sense on the category development and capacity utilization going forward in the U.S.? And how do you expect non-U. S. sales and capacity utilization to develop? So let's start with the first one on cigars for the flavor split?

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

Yes. So on the cigar flavor split, what I would say is, generally speaking, the growth that we've experienced within our natural leaf varieties has moderated somewhat our overall exposure to flavors within our portfolio year-on-year. And at this point, it depends upon the kind of the granularity of what could be a future regulation and the definition of what constitutes a flavor. But we are fairly well aligned with the overall category at slightly less than 50% of our portfolio subject to flavors. The -- that relationship, as I mentioned, is most -- is -- the reliance on flavors is be leased within our natural leaf, excluding rolled leaf varieties. So that's the one that's been growing nicely for us. And as that grows, our dependency on flavors dissipates. And we stand at a very good position right now. And we did comment in the call that the deadline has been pushed back to September 2020 for substantial equivalence filings, but we are well positioned to file substantial equivalence for a vast majority of our portfolio by that deadline. We're in good position to file at the original deadline of March 2020, but obviously the incremental 6 months is helpful just to make sure the i's are dotted, the t's are crossed.

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

And if you take the same capacity, I'm not sure I completely understood what was the question, but if you look at the, what you call the underlying volumes in the first quarter, we were selling close to 25%. And we estimate that about 3 of them were related to COVID-19 plus the pipeline. But also, as you may recall, from not the least the second quarter of last year, when -- while there is pipeline associated with entering into new stores, given the general growth that we're seeing in this market, we actually hardly noted any negative effect the following quarter from that pipeline. And as I commented earlier, the trends are continue to be very positive in terms of velocities, both in the West and the expansion markets. So we are very glad that we have taken the decision to effectively double the capacity sometimes in -- during next year.

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

And the second part was, can you share your sense on the category development and capacity utilization going forward in the U.S.?



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And I think that, that was covered when Lars discussed Page 18 or Slide 18 within the commentary in the investor presentation. It gives you some idea. It's not perfect, but gives you some idea about the relative growth versus moist snuff or moist snuff and pouches, even though we are pulling from others as well.

Let's see. Some of these questions I'm not going to keep asking the questions because the way this is working some of the questions are being repeated.

Operator

Excuse me, sir.

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

Yes.

Operator

Sorry, I'm back. And if you want to continue the Q&A over the phone lines, just advice me.

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

Yes, please.

Operator

Your next question comes from the line of Andreas Lundberg with SEB.

Andreas Lundberg - *SEB, Research Division - Analyst*

My questions have been answered through the e-mail conversations. So I can skip.

Operator

Our next question comes from the line of Fredrik Ivarsson from ABG.

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

I think most of my questions were answered as well, but I can follow-up with the one moist snuff. Can you say anything about the margin development there?

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

Yes. The margin development in the quarter was improved relative to the first quarter of the prior year. So what I would say is the benefits of increased volumes and scale more than offset any level of pricing compression we would have seen with the new EDLP program.



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Operator

Another question comes from the line of Adam Spielman from Citi.

Adam Justin Spielman - Citigroup Inc, Research Division - MD, Head of EMEA Consumer Staples Research and European Tobacco & Beverage Analyst

This is a follow-up question. Slide 16 shows what's happening in the Western region. It shows the number of stores accelerated slightly, but the cans per store per week grew perhaps more slowly in Q1. Now when I first looked at it, I assumed well because you were selling more stores. And I think you mentioned Walgreens. That would expect why the cans per store per week didn't grow so nicely. But really, the question is about the footnote. Because the footnote node implies, you're just talking about stores that were opened through Q4 '19. And I suppose the question is, can you explain -- is that footnote wrong or what? Because -- I'm sorry, I'm buffering now. I didn't quite understand why velocity has gone down if we're really talking about stores which are only opened in Q4.

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

Yes. I mean, as a general -- we have a few different velocity sets that we look at. And as a general remark, some of the numbers are impacted by the add-on late stores in the quarter. And I mean, as you can see on the graph, the velocity -- it does continue to increase also in the first quarter based on the stores through Q4 2019. But I think it's also reasonable to assume that at some point, when you add stores, you will end up with smaller stores that has, say, less potential. It's -- when you look at -- that's why I said, when you look at the store by installs, so to say, and those during 2016 for the various quarters and 2017 for the various quarters and also 2018, then you don't -- we don't really see any slowdown of the velocity.

Adam Justin Spielman - Citigroup Inc, Research Division - MD, Head of EMEA Consumer Staples Research and European Tobacco & Beverage Analyst

And very quickly, Slide 18, I think you said in your prepared remarks that things are -- in the expansion region, taken as a whole, things are growing faster than they did in the Western region. If you had to sort of put that, is that sort of 10% faster or 20% faster, any way of quantifying that?

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

I mean it's -- yes. Faster -- maybe, I'd say, a similar trend in terms of increases. But the curves are above the corresponding curve in the Western region after the same number of months in the market.

Adam Justin Spielman - Citigroup Inc, Research Division - MD, Head of EMEA Consumer Staples Research and European Tobacco & Beverage Analyst

10% above, 20% above?

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

I mean more like 20%. But I think you need to be a little bit careful there because when the product was initially installed or launched in the Western region, it was completely new product. In the rest of the country, some of the consumers have been buying it online or heard about it and so forth.



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Operator

Sir, we got another question comes from the line of Robert Rampton from UBS.

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

Just a follow-up. In terms of stores where ZYN and ON are both present, previously, you've commented the velocity of the growth in -- velocity of both has been generally unaffected by the presence of the other. Is that still the case?

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

Yes. I mean, we're seeing growth across the whole of the nicotine pouch category in those markets where we compete with ON. So our velocities continue to grow, and then ON is obviously growing. I think the third player is the one that if we were to talk about velocity rates at points of retail is the one that's suffering.

Operator

Another question comes from the line of Martin Arnell from DNB Markets.

Martin Arnell - *DNB Markets, Research Division - Analyst*

So my question is on the ZYN margin outlook that you discussed previously. I mean, what would be the timing for you to step up your marketing activities in the U.S.?

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

One element that has been stepped up already is this trade program that Tom spoke about. And that one, you can say, is volume dependent. So we have benefits of scale, but it's also then a payment per can. So in absolute terms, that one would self regulate. But the first quarter margins include that trade program. And then it's a relatively new program. So it could be that you have a gradual increase in terms of the percentage of stores that have signed up to the program, which would be very positive.

Martin Arnell - *DNB Markets, Research Division - Analyst*

Okay. So -- but -- so we should not expect sort of a large sequential drop in the same margin in Q2 or...

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

I mean, it's very difficult to predict operating margin with a lot of moving pieces, but, generally, this type of growth that we have had and also where our manufacturing efficiencies have been phenomenal, quite frankly. It is -- it's been very positive for the margins. And then I'm sure there will be some ups and downs as we move forward.

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

I also think it's fair to note that Q1 as a kind of a reporting quarter is historically a lighter marketing quarter relative to the other quarters in a given calendar year. So that we would have otherwise expected to see increased marketing in Q2 and Q3 relative to Q1 levels. Now obviously, that can



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be affected by some of this COVID-19 situation as well. So our ability to actually put in place previously planned marketing activities could be affected.

Operator

Sir, we got another question comes from the line of Faham Baig from Crédit Suisse.

Mirza Faham Ali Baig - *Crédit Suisse AG, Research Division - Research Analyst*

I just have one. Just in light with -- just in light of the category being in a customer acquisition mode at the moment, do you think that COVID-19 could potentially impact the ability of your sales force to meet customers and consumers and also your marketing campaigns that could have a short-term hindrance on customer adoption rates that we should be thinking about?

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

Yes. I think the point I made just in terms of phasing of marketing activities for 2020, I mean, there were obviously some event activations that were planned, Q2, Q3. To the extent we have state lockdowns and social distancing requirements that there's limit that ability, then the absolute consumer adoption over the course of 2020 may be slower than what would have otherwise been in place. But I would say that the -- there's a general knowledge base as to nicotine pouches in the market. We're national. We're going to have support by another large competitor with expanded capacity, driving interest through this category. They're even -- I think, what COVID has elevated is general health concerns. So to the extent you've got a product like ZYN in the marketplace, you could even see more accelerated migration from combustible products to these smokefree nicotine products.

Operator

And sir, we got our last question comes from the line of Karri Rinta from SHB.

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

Yes. Thanks. My questions have been answered.

Operator

Thank you. And sir, no more question at this time. Please continue.

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

Okay. Then we apologize for the technical difficulties during this call. Thank -- I'd like to thank everybody for participating. And I can inform you that the release of our second quarter report will be on July 17. Thank you.

Operator

That concludes our conference for today. Thank you for participating. You may now all disconnect.



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