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PRESENTATION

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

This is the Swedish Match Q1 2021 Telephone Conference. And with me today are Lars Dahlgren, our President and CEO and Anders Larsson, our CFO. In the Investors section of our swedishmatch.com website, you will find our Q1 investor presentation. We encourage you to have that presentation at hand as you listen to our prepared commentary for this call. Several of the slides in the investor presentation repeat key messages from the interim report that we published this morning. We will focus our commentary on selected slides only. And while doing so, we will refer to the applicable page number of the 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 today's interim report as well as the annual report, which are available on our website. Swedish Match assumes no obligation to update information concerning its expectations. A recording of this call will be made available on the Swedish Match website.

And with that, I will now hand the call over to Lars.

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

Thank you, Emmett. And good afternoon, everybody, and thank you for joining today's call. I'm excited to report that Swedish Match delivered outstanding results in the quarter with double-digit growth in sales and operating profit across each of our product segments on a local currency basis. ZYN in the U.S. was a key contributor to this growth, but our Cigars and Scandinavian smokefree businesses also contributed substantively to our performance.

Volumes for our Scandinavian smokefree business benefited from timing effects, most notably the replenishment of trade inventories during the quarter, following the year end destocking ahead of the January 1 excise tax cap in Norway as well as extra deliveries in advance for the Easter holiday.

In addition, price/mix in Scandinavia continues to benefit from positive product and channel mix effects due to COVID-19-related travel restrictions. However, it's important to note that when adjusting for these factors, our Scandinavian smokefree business delivered a solid performance during the quarter on an underlying basis, benefiting from both volume growth as well as improved pricing.

We continue to ask much from our Cigar business as they work responsibly in a COVID-19 environment in responding to rapid market growth. And I'm very pleased to note that they delivered record shipments, sales and operating profit during the quarter. The challenges posed by COVID are most pronounced in the production of our natural leaf cigars. And while the first quarter represented an all-time high in natural leaf production levels, further improvements are needed to meet the very strong market demand.

Our performance benefited once again from our dual plant strategy, for HTL varieties, resulting in increased volumes and market share within this segment. In addition, pricing played an active role in sales and operating profit growth, with sales per stick increasing by 5% despite mix shifts to HTL and enhancements under our merchandising rebate program for cigars.

In light of the recent FDA announcement on its intent to advance product standards to ban menthol cigarettes and flavored cigars, we believe that comprehensive product standards regarding flavors applicable to the entire category are preferable to the FDA potentially attempting to restrict or limit flavored cigars in the market through what could be more arbitrary processes, for example, through the SE route.

However, we recognize that potential proposals of this nature would take time to go through the regulatory process and note that the discussion surrounding a potential flavor ban for cigars is far from new. We had already taken proactive measures to best position ourselves in the marketplace for any required changes to our cigar portfolio. And Swedish Match has among the broadest portfolios of both flavored and non-flavored cigars.

For the Lights segment, quarterly volatility is not uncommon. But the sharp depreciation on currencies, especially the Brazilian real, compared to the prior year as well as onetime gains on tax disputes recognized in the prior year period, obfuscated the significant improvement in underlying operating profit, driven by volume gains from matches and lighters as well as improved price/mix.

The Q1 operating profit from product segments of SEK 2.092 billion represents an all-time high for Swedish Match for an isolated quarter. As explained in our interim report, the results include tailwinds related to COVID and/or temporary factors such as the extra high shipments in Scandinavia. However, the 26% reported growth in operating profit from product segments also needs to be viewed in the context of a significant negative currency translation effect that amounted to close to SEK 240 million.

Nicotine pouches or what some refer to as modern oral, continues to demonstrate strength in its potential to transform the nicotine landscape. In just about every market where the product has been introduced, we see strong growth. And this includes markets within oral tobacco traditions, such as Scandinavia, as well as markets unfamiliar with oral tobacco where the base typically starts lower but where adoption rates often have proven to be impressive.

From its sheer size, the U.S. market is most striking and penetration and conversion rates among cigarette smokers are remarkable. It is worth noting that Swedish Match was the pioneer, and the significant ramp-up in focus and investments on modern oral from large cigarette companies was expected, and we believe will help in further driving adoption and growth.

In the U.S., Swedish Match enjoys a distinct first-mover advantage. And consumer research indicates that ZYN is generally preferred by consumers also untested on an unbranded basis. Nonetheless, Swedish Match plans for increased market investments in the U.S. compared to Q1 levels, which were unusually low due to phasing of activities and COVID-related restrictions.

In Scandinavia, Swedish Match is the clear #2 within nicotine pouches, and the competitor has managed to secure and maintain the first-mover advantage. Also in Scandinavia, our future plans include significant increases to the depth and breadth of our marketing activities. As an example, in Sweden, in the coming weeks, we will complement our ZYN portfolio with a completely new product brand range, which we believe has strong potential.

In other markets, despite the challenges brought on by COVID-19 restrictions, we're committed to continuing to invest behind nicotine pouches. In the U.K., the nicotine pouch category has demonstrated impressive growth and we look forward to broadening our distribution and increasing our marketing efforts as restrictions ease.

In Switzerland, we have launched ZYN at the largest convenience chain, Valora, and we're successful in achieving excellent coverage in just a few weeks despite the COVID situation, thanks to our new local sales force. Also in Poland, we have expanded our presence in the modern convenience class of trade.

While we will increase investments to drive awareness, trial and conversion among adult tobacco users, Swedish Match will remain diligent and disciplined in its approach to responsible marketing practices. The potential for nicotine pouches is enormous, but proportionate, sound and responsible regulations are of paramount importance for the viability of the category, longer term. The lack of harmonized regulations, not the least in Europe, remains a risk to the category. In that respect, it is encouraging to note that concrete steps to regulate nicotine pouches have been taken in several European markets during the year.

Before handing over to Anders, who will start by providing some more color to the impressive development for ZYN in the U.S., I'd like to share my appreciation for the decisive and invaluable work that Swedish Match staff around the world has performed in efforts to minimize the operational disruptions and risks related to COVID-19.

Apart from the challenge to fully meet demand for our natural leaf cigar varieties, we have successfully mitigated potential large operational disruptions. And we are fortunate to operate in an industry where consumer demand, in aggregate, has not been adversely affected.

As in all larger organization, we have employees that have been directly affected by the pandemic and our thoughts are with them and their families. With vaccine programs well underway in most of our operating locations, we are beginning to see rays of light in the COVID tunnel but we remain vigilant in monitoring the situation and taking appropriate measures.

As have several companies, we have lately noted the impact of strained transportation systems and have seen prices for certain raw materials rise due to scarcer-than-normal availability. But with a continued focus on operational risks, we are hopeful that one day, we will be able to finally leave the COVID-19 situation behind us without any material, operational or financial issues.

With that, I will hand over to Anders.

Anders Larsson - Swedish Match AB (publ) - CFO & Senior VP of Group Finance

Thank you, Lars. We will start a more detailed commentary on Slide 8 of the investor presentation where we take a closer look at the development for ZYN in the U.S. The chart illustrates the impressive development of ZYN shipment volumes on a 12-month rolling basis. During the first quarter, we delivered close to 37 million cans, which brought the 12-month shipment volume to well above 120 million cans. Comparing to 1 year ago, this measure of trailing 12-month volume increased by an outstanding 82% or more than 50 million cans.

Slide 9 illustrates the development of the entire nicotine pouch category in the U.S. as measured by MSA data that captures deliveries from distributors to retail for Swedish Match and for competition. The MSA data is helpful in understanding market trends, especially when viewed over longer periods.

The 13-week periods, largely representative of calendar quarters, are somewhat volatile as they are susceptible to waves of distribution expansion and promotional offerings that cause retailers to stock up.

Viewed over several quarters, however, the chart clearly depicts the impressive growth trend of the nicotine pouch category. In Q1, the data indicates an acceleration of category growth, but this needs to be viewed against the background of heavy distribution builds and aggressive promotions by competition.

It is encouraging to note that the solid volume trajectory for ZYN, depicted by the dark blue bars in the chart, has continued despite the intense competitive activities. Market share-wise, we believe it is reasonable to assume that the intense competition will further fuel category growth, and that we will likely see some share declines relative to 2020 levels foreseen over time.

However, the decline in distributor shipment market share from Q4 to Q1 is not necessarily fully representative of market share based on consumer purchases. And particularly in terms of market share measured based on value, our estimate is that ZYN has held up very well as ZYN sells for a notable price premium compared to competition when their products are being sold under deep discount promotional programs.

Slide 10 provides some further details on the trajectory for ZYN based on the same MSA data. Volume growth for ZYN has been sourced from the combination of expanded store distribution and increased velocities in existing stores. Distribution was expanded somewhat during the quarter, and the product is currently available in a little more than 100,000 stores.

Velocities continue their upward trajectory. And on a sequential basis, the velocities in the first quarter increased in both the Western region and the expansion markets.

Turning to Slide 11. Data continues to indicate that nicotine pouch consumers, to a large extent, are sourced from the cigarette smoking population but also vapers. If we look at the first quarter MSA volumes for the Western region, the data indicates annualized nicotine pouch category volumes, measured by number of cans, represent well above 6% of the number of cigarette packs in the Western region. Despite being present in the rest of the U.S. for less than 2 years, the corresponding number on a national basis exceeds 2%.

Consumer research confirms that nicotine pouch consumers gradually increase their weekly consumption as they transition from other tobacco products, but also that the average consumption is still well below the average number of packs that the cigarette consumer consumes.

Thus, the penetration measured in relation to the number of cigarette smokers is well above what the volume benchmarks indicate. And with the superior functional and emotive benefits, there exists a significant potential for further increased penetration as well as average consumption.

Turning to smokefree in Scandinavia in Slide 12. With continued COVID-19 related restrictions and timing effects on shipments, it is a challenge to determine the underlying consumption numbers with precision. However, our analysis is reassuring in confirming that the category has continued its robust growth trajectory.

Nicotine pouches has continued to lead the way. And in our market research, we note a significant uptick in female penetration across all markets. While in sum, we estimate that the COVID-19-related travel restrictions have had a favorable impact on the financial development for the Scandinavian smokefree business, volumes have suffered due to the fact that purchases from travelers to Scandinavia, most notably Finnish consumers, have been very low.

Swedish Match's underlying volumes in the first quarter are estimated to have grown by more than 1%, with the market share erosion mainly being attributable to segment mix effects driven by the rapid growth for nicotine pouches.

When looking at snus in isolation on Page 14, you will note that our share, as measured by ACNielsen, has been variable and continues to be more than twice that of the #2 competitor. On country level, Swedish Match recorded slight share declines in Sweden that were largely offset by share gains in Norway.

Also for nicotine pouches, as depicted on Slide 15, our overall market share has remained stable lately, but a close to 16% share number is far below our ambitions. Our volume development has been very strong, however, on the back of the remarkable category growth. And according to Nielsen, nicotine pouches now represent close to 20% of the Scandinavian smokefree market.

The most impressive growth was seen in Denmark, where Swedish Match's share increased, both sequentially compared to the fourth quarter and year-on-year versus the first quarter of the prior year. The accelerated growth of nicotine pouches in the Danish market demonstrates the significant potential of innovative smokefree offerings that cater to a broader consumer base than traditional tobacco products.

Turning to Slide 18 that highlights new product offerings and product enhancements that were introduced during the first quarter. In the upper left-hand corner of this page, you can see line extensions of nicotine pouches under the popular XR and G.3 sub-brand of General. On the right-hand side, you see number of cans of our XR line now presented in a more discrete and environmentally friendly can.

While the product in the can is the same, the new modern can brings the benefit of a 12% reduction in plastics with a notable favorable impact on carbon emissions. In Switzerland, until now, we have marketed nicotine pouches exclusively under the G.4 brand. We are excited to now also offer the #1 global nicotine pouch brand, ZYN, to Swiss consumers.

As Lars mentioned, we will step up investments and marketing efforts for nicotine pouches in several markets. An important element will be product innovation. In Sweden, ZYN is the strongest brand in certain target audiences, but we see further potential in different segments of the market.

In the coming weeks, a completely new brand family of nicotine pouches with a distinct modern appeal will be introduced on the Swedish market, accompanied by significant marketing efforts. In the U.S., we have previously rolled out ZYN Smooth, an unflavored variety, that has received positive consumer feedback.

We recently added to our non-flavored portfolio by starting national expansion of the successful ZYN Chill variety. We are likewise excited about the national expansion of ZYN Menthol and understanding how this product performs by adult menthol cigarette consumers.

Turning to Cigars, an outstanding performance with operating profit growth of 47% in local currency, driven by record shipments, improved pricing and limited increases in selling and distribution expenses despite the sharp increase in volumes.

As Slide 20 illustrates, looking at the left hand, the first quarter was the third quarter in a row with volume growth of around 20%. Our supply chain organization in the Dominican Republic has done an outstanding job in coping with the combination of challenges brought on by COVID-19 and the very strong demand.

While we have made notable progress in production levels for our natural leaf cigars, including rolled leaf, during the quarter we had not been able to keep pace with a significant increase in demand for natural leaf cigars. The effect of this is visualized on the right-hand side of the slide that illustrates growth for the category, excluding little cigars and its subsegments, according to MSA data.

As can be seen, shipments of Swedish Match's natural leaf varieties from distributors only increased marginally despite the very strong market growth. For HTL varieties, Swedish Match continue to benefit from the strength of the White Owl brand and its highly automated dual factory production footprint, which resulted in a notable outperformance on a segment level.

Due to the segment mix effects, overall shipment volumes of Swedish Match products at the distributor level trailed the impressive category growth. While COVID-19-related effects likely have had a positive impact on the cigar category, our assessment is that we have witnessed a strong development of underlying demand during the past year.

Slide 21 shows that despite the challenges that we faced in terms of fulfilling demand for natural leaf cigars, our cigar portfolio remains well positioned for future growth as we continue to be overrepresented versus the category within the fastest-growing natural leaf segment. The dark blue bars in the chart to the right also illustrates the gradual pickup in our ability to produce and ship natural leaf varieties.

On Slide 25, we have summarized relevant metrics from our interim report relating to finance costs, our financial position and earnings per share. Net finance costs during the quarter were in line with the levels that we have experienced during the past few quarters, bearing in mind a onetime charge during the third quarter of 2020 related to an adverse ruling in an ongoing tax case.

The weighted average interest rate of our loan portfolio at March 31 was 2.11% compared to 2.07% at the end of 2020. Our net debt-to-EBITDA for the 12-month period ending March 31 was 1.6, but 1.9 when adjusting for the SEK 2.4 billion dividend that was paid out to shareholders in April of this year.

As of March 31, 2021, Swedish Match had SEK 14,527 million of interest-bearing debt, excluding retirement benefit obligations, but including the recognition of lease liabilities of SEK 295 million. During the remainder of 2021, SEK 803 million of the bond debt falls due for payment. The capital duration was 3.9 years, with 98% of the portfolio subject to fixed interest rates.

The EPS bridge illustrates the components of our 36% year-to-date growth in adjusted EPS, driven by the after-tax effect of our increased operating profit. The adjustment highlighted in the EPS bridge refers to the after-tax effect of a settlement income related to a previously ongoing arbitration.

During the first quarter, we made share repurchases in the amount of SEK 300 million, buying 0.5 million shares at an average price of SEK 611.1 per share.

A couple of other items to note with regards to the stock split, it has now been submitted and registered and the new shares and ISIN numbers begin trading on May 10.

Regarding currencies, if current exchange rates prevail, we will continue to face currency headwinds over the next 2 quarters. For reference, the Q2 2020 average exchange rate for the U.S. dollar was SEK 9.68. For the NOK, it was SEK 0.97, and for the Brazilian real, it was SEK 1.81.

And with that, operator, we can open the floor for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Gaurav Jain from Barclays.

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

So I have a few. So first one is you're now comparing the nicotine pouch category to the cigarette category, which is on Slide 11. And clearly, prices of cigarettes vary around the U.S. because of different state taxes. So can you talk about the cross price elasticity between cigarettes and nicotine pouches? And within the context of all these tax increase proposals, which are there on the table, the Tobacco Tax Equity Act, et cetera. So I'm just curious to understand how the cross price elasticity could work.

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

Thanks for your question. I mean I would say that while we conduct a lot of market research, comparing nicotine pouch is still to what is much bigger is actually challenging to, with accuracy, derive relative price elasticities and so forth. But -- and generally, we -- what we hear is that the consumers that migrate to ZYN, they see a lot of benefits with the product.

And price very seldom comes up as a key component for making a migration. It is things relating to the ease of use and the hygienic and practical way. And also what consumers perceive as health benefits, although, as you know, we're not marketing that.

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

Yes. Sure. My second question is on the margin expansion. Very strong margin expansion in all categories, and you are highlighting increased expenses latter half -- in the latter half of this year. So could you quantify that? That's one question related to margins.

And then on the Cigar side of things, clearly, pricing is strong, volume is strong and you are selling the higher-mix product. So if that sustains, then wouldn't your cigar margins -- like would they be up 400, 500 basis points for the full year what we have seen in Q1 '21.

Anders Larsson - Swedish Match AB (publ) - CFO & Senior VP of Group Finance

Anders here. I think on the margin, it's a bit tricky, of course, to quantify and provide too much details without disclosing too much of our activities. But I think we have said and continue to plan for a ramp-up in marketing initiatives for ZYN in the U.S. But not only that, we also continue to invest internationally, and we will see a ramp-up also in Scandinavia.

And then how that will play out, margin-wise is, of course, dependent also on the volume traction and the sales performance. But I don't know if that was a detailed-enough answer, but we expect to see higher marketing spending with a lot of initiatives in our plans.

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

One of the things that we can note that we alluded to a bit in the conference call was the portfolio mix as well and the pricing for cigars. And during the first quarter, our volumes for our lowest priced brand, Jackpot, were quite low, were quite low. And it was skewed, heavily skewed toward the White Owl brand, which enjoys somewhat higher selling prices and somewhat -- and quite nice profitability.

Now as the COVID situation changes, as the world opens up a little bit, there may become different competitive dynamics going on with the different competitors and so forth, and that may have some impact on the overall portfolio mix as well.

Anders Larsson - Swedish Match AB (publ) - CFO & Senior VP of Group Finance

And I mean, especially in the portfolio mix in the first quarter is a bit bolstered by the effects in Scandinavia, of course, with a positive Easter effect and the replenishment of inventories and following the destocking in the first quarter and so forth. So it's a lot of things affecting the development on a sequential basis from the fourth quarter.

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

Sure. And just on the regulatory side of things in the U.S., like the flavored cigar ban, and we have gone through that cycle once before. But that was before the substantial equivalence process as well and which you have filed the SEs on your flavored cigar portfolio. So how does one expect this sort of cycle to evolve over the next 2, 3 years or whatever time frame you have in mind, before something could happen?

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

I think the honest answer there is that it's difficult to know with any degree of certainty when and if there will be any final proposals and not to mention also the regulatory process to enact such proposals.

I mean the FDA has, as you're fully aware, spoken about menthol ban since 2013 and since redeeming regulations in 2016, they are already then clearly stated that they intended to prohibit characterizing flavors in cigars, and there have been advanced notices of proposed rule-making in various times thrown out there in terms of ambitions. And at this point, there hasn't been any final rule.

And as we indicated, or as I commented, we think that this uncertainty that this creates with this type of system is not optimal from an industry point of view, and particularly, you start to see -- you have already in several states, local flavor bans and so forth, where actually, the business continues to do well.

But it would be certain advantages also with regulation that would be clearly defined and applicable to everybody. But we think it's more likely than not -- but difficult to know with certainty, but more likely than not that things will take quite some time and even uncertain whether it will really be implemented at all.

Operator

Our next question comes from Faham Baig from Cr dit Suisse.

Mirza Faham Ali Baig - *Cr dit Suisse AG, Research Division - Research Analyst*

Can I start with ZYN, please? I know, Anders, you highlighted that the MSA data is not representative of the retail data. However, could you help us a bit with what the retail growth might be in Q1 and then how that compares to FY '20 for the category? As well as ZYN retail share, you said, held up relatively well. So -- or the retail share be compared to the 65% volume share you had. And the final question on this is you mentioned that clearly ZYN's volume share has been impacted by significant promotional activity by your peers. But your retail -- your value share has held up. Again, what would be the value share with this regard as well?

And then the second question is -- I appreciate it's Q1, but I saw that your working capital had a big reduction, I think, around SEK 400 million in the quarter. Is there anything you would highlight there? Yes, I'll leave it at those 2 questions.

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

All right. If I take the market share question and leave it on the working capital for Anders to explain. I mean, first of all, as Anders said, one needs to look at longer periods than isolated quarters to look for real trends. But the reason that we shared the shipment data from retail is that that's the broadest set of data that we have available.

And unfortunately, the Nielsen data set is not entirely representative given it's a sample size in some of the SKU inclusions and so forth. And I'm sure they're working to address that. And hopefully, it will be better going forward. But that makes it challenging to give -- to share an exact value market share. But if you look at the average prices out there, the maths are pretty clear that ZYN is, let's say, above 70% in terms of value share.

And importantly, these type of fluctuations that you also see in the MSA data, and they are -- while there are certain -- there can be certain timing things for us as well with our more, so to say in percentage terms, modest, distribution build and not these type of deep promotions, we believe that the MSA data is, so to say, more accurate in -- as a proxy for underlying trends with regards to ZYN compared to some of the competitive volume that is very volatile. And we remain encouraged, as Anders said, with the trends for ZYN in that respect in terms of continued increased velocities.

Anders Larsson - *Swedish Match AB (publ) - CFO & Senior VP of Group Finance*

Yes. And then in terms of working capital, I'd say that there is nothing special really more than timing. And if you look at the fourth quarter, we had a quite sizable benefit working capital wise. So it's, I would say, a majority timing driven. And it depends a lot of when we do payments of tobacco tax in Scandinavia.

Operator

Our next question comes from Richard Felton from Goldman Sachs.

Richard Felton - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

My question is on ZYN margin. Now my understanding is that now that you're no longer capacity constrained in the U.S., you would look to increase marketing support for ZYN. Now looking at U.S. smoke-free margin performance in Q1, it seems like that hasn't really happened yet.

And I know you've been very clear that you've got plans for the rest of the year, but I'd be interested to know why there hasn't been that increase in marketing support just yet. That's my first question.

Anders Larsson - *Swedish Match AB (publ) - CFO & Senior VP of Group Finance*

Yes. Anders here. One reason, of course, being the kind of environment still with COVID affecting certain activities. And then there is a phasing, and the plan is phased where we will see an uptick in the coming quarters. I would be very surprised unless we -- because I mean we want to do more things and some are dependent on COVID restrictions, but there are certain other things that we can do and have in the plans like digital initiatives and so forth.

And then, of course, one might have plans when you start the year and then it can take some time to effectuate on those plans. But we are confident that we will ramp up activities. And especially with all -- we have the rollouts also of the new varieties and certain activities connected to that.

Richard Felton - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

Great. And then my follow-up, on Slide 11, you show the size of nicotine pouch category relative to cigarettes. My question is, do you see any reason why the total U.S. might not catch up to the Western regions over time? Or put slightly differently, is 7% the size of cigarettes a reasonable benchmark for the nicotine pouch category on a national basis over the next 3 or 4 years?

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

On the first question, the answer is no, we don't see any reason why the rest of the U.S. -- why cigarette smokers in the rest of the U.S. also wouldn't make the transition.

On the second question, I'd say it's difficult to have to determine the pace and timing, there can be various factors influencing. There are some things that could cause it to go even faster. One of the most notable ones is, of course, the enormous focus by several players on modern oral.

Then you also have some other things that one could argue should indicate a slower trajectory. Pricing was mentioned. And yes, although we don't believe that's a driving factor, it can be a factor that could have some influence, particularly when you compare to moist snuff, where also some consumers are coming from where the Southern states typically have an average lower prices. And there can be certain demographic factors and so forth.

So timing and pace wise, but so far, we will see a similar trajectory in the rest. And we see no reason why it shouldn't continue in the rest of the U.S., and also no reason why it should stop at the current penetration levels in the Western region either.

Operator

Our next question comes from Jon Leinster from Societe Generale.

Jonathan Stephen Leinster - *Societe Generale Cross Asset Research - Research Analyst*

Some questions on the U.S. cigar market. I mean, obviously, you've now, as you pointed out, seen cigar volumes growing at 20% almost for the last 3 quarters. Can you give us some idea as to what you think is driving that in terms of the market? And in particular, whether it's being driven by flavors or whether that's not -- or whether the flavors category is not really driving that?

Secondly, I was wondering, clearly, your natural -- you've still got some capacity constraints on the natural leaf side. And if you think there, can you give us some idea of the timing as to when that will improve and when your volumes on that side might start to grow more in line with the market?

And lastly, you obviously moved pricing on -- particularly on Jackpot. Did any of the competitors follow suit with price increases on cigars? Or is that something which you're still waiting on?

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

Let me start from the bottom. As Emmett said, volumes of Jackpot were extremely low in the quarter. And also competitive volumes in the segment were very low. So it's -- other segments have been prioritized. So it's too early to tell in terms of how it's going to evolve price wise.

When it comes to the volume growth, we see very good growth, both for some flavored varieties and some rotated limited time offerings with flavors as well as unflavored, very nice.

And we think COVID and the kind of not only usage occasions, but treat-yourself type of mentality. Almost people speak a little bit about this roaring '20s mentality, right? I mean that kind of -- it caters well to cigar consumption. But we also -- it's so strong compared to also what we see in other categories. So we are fairly confident that it would be wrong to attribute all of the, so to say, growth related to COVID.

So it's -- sometimes, it's a little bit difficult to say exactly why these type of consumer trends evolve. But I would say, though, that if you take a longer-term view and look at the cigar category, the slowdown that we saw in parts of 2019 and in 2020 that was more of the exception to the rule. So growth has generally been very strong over the past 10 years in the Cigar category.

Jonathan Stephen Leinster - *Societe Generale Cross Asset Research - Research Analyst*

And on the natural leaf -- sorry, on the natural leaf supply?

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

Yes. I mean they've done a fantastic job, and it was actually record levels in March. It's just that -- so the answer depends on how much more demand is going to continue to grow. But -- but we expect to them to continue increasing output from where they are.

But it's -- there is a clear risk that this will be a difficult year for Swedish Match in terms of serving the full demand for natural leaf. And hopefully, we can more than compensate for that on the HTL side, and we do expect the situation to get gradually better in that respect. But it's a positive problem to have. Not the COVID, of course, but the fact, that -- the demand is going to grow.

Anders Larsson - *Swedish Match AB (publ) - CFO & Senior VP of Group Finance*

I think it's quite clearly indicated on the slide, I don't know which slide number it is, but you see the kind of gradual ramp-up of natural leaf volumes in the investor presentation in one of the slides.

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

Natural leaf cigars, just by their nature, are more labor-intensive as well. So it requires training, bringing people in, there's a little bit longer time involved in terms of ramp-up of the production than there would be for HTL cigars, which were much more capital intensive and less labor intensive.

Operator

Our next question comes from Sanath Sudarsan from Morgan Stanley.

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

Three questions from me, please, and all on nicotine pouches. So first one on the U.S., could you just tell us more about the promotions made by your peers? Are they now sustaining at a very high level? Or do you still see the trend where they kind of lose share or cede share back to you when the promotion phases out? And is there still a strong-enough incentive for retailers to stock up ZYN versus the competitors?

Secondly, on your own strategy here. I just wanted to understand, are you carrying more inventory, let's say, versus last 2 quarters? Or are you running at similar level of inventories, and it's rather a reflection that this is the maximum amount you could sell and the capacity you had? The question I'm trying to ask is basically, is there more in terms of promotions you could do to kind of push your product or you're just holding back here?

And then finally, on your Scandinavian and European business, could you just give us a bit more color on your brand fragmentation strategy? What kind of price points? What is the product differentiation that you offer? And any update on your European ZYN volumes?

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

Thanks. So I mean if we start with number one there, in terms of incentive for retailers, there is a strong incentive for retailers to carry ZYN, the #1 brand that is very popular among consumers, and we continue to experience strong demand from retail.

And in terms of promotions from the peers and how long are they going to last and so forth, I suggest that you ask our competitors those questions. So they can just explain to you what they see in the market here now, and we continue to see very deep promotions. For example, products sold \$0.99 but we also see, for both of our major competitors, elements where you get free cans if you purchase any tobacco product. And we do see volatility, so to say, shipment share going up and then going down. But I would say that -- but there is also distribution build. And I would say that you need more history to conclude whether shares will, so to say, revert. During the fall of 2020, where we had good data from specific change, we could very clearly see how the market share for ZYN reverted and actually ZYN volumes was relatively unaffected during these promotional periods.

But there is obviously more competition with broader assortments out there now. And I say, it's too early. And as I explained before, the -- we have limited -- we don't have -- the Nielsen data set is not huge, but if you take average prices in the latest period of nicotine pouches, we have ZYN at SEK 4.95, and then you have ON at SEK 2.93 and then you have Velo at SEK 2.42. So those are average prices. So that tells you something about the scale of the promotions.

On your second question, we've done a good job on the production side, and we're pleased to see that we can start operating with a little bit higher safety inventories. It -- we think that the fact that you -- that we haven't spent that much on marketing and so forth in Q1, you shouldn't read into that, that it has any connection with production constraints. As we said, we have largely -- before, as we said, we have largely put our capacity constraints behind us.

And in Scandinavia when it comes to nicotine pouches, I mean we have ZYN, we have a smaller brand also from our -- from our acquisition of Gotlands Snus that is actually -- that actually gets a lot of positive feedback. But -- and we need to take the new quite broad -- the broader range and the full national launch that is going to occur relatively soon in Sweden. Let's wait and see more details on the brand profile and so forth until we get it out in the retail, but the price level is the same as for ZYN.

Operator

(Operator Instructions) Our next question comes from Ravi Sharma from Citigroup.

Ravi Sharma - Citigroup Inc., Research Division - Research Analyst

I have a couple of questions, if I can. My first question is again on your comments on increasing marketing activities in coming quarters in the nicotine pouch category. If I understand -- I understand that some of it is driven by innovation plans in coming quarters. Let's say, if you compare this with our plans as it were in December or, say, in January this year, how much of that has changed? Just to clarify, what I'm trying to understand here is if there is any -- if some part of it is in response to...

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

We lost you. Operator?

Operator

Ravi, could you please unmute your microphone? Ravi, if you can hear me, please unmute your microphone.

Okay. We'll come back to Ravi afterwards. Our next question comes from Jared Dinges from JPMorgan.

Jared T. Dinges - JPMorgan Chase & Co, Research Division - Analyst

I just wanted to ask about this increased commercial spend on nicotine pouches that you've mentioned, and more specifically in Scandinavia. So should we be thinking about this as a one-off brand launch for 2021? Or do you expect marketing spend to stay elevated kind of over the next 2 to 3 years or even longer?

And also, you mentioned the launch in Sweden, but is there anything you can do in Norway, given the communication restrictions there?

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

Norway is -- there are more challenges in Norway, but the answer is, yes, in the sense that we have some concrete plans for the Norwegian market as well. And partly, it's things that are more effective in implementing once you don't have travel restrictions because then you have higher degrees of freedom, but there are certain things you can do domestically as well. And for example, you can, of course, always introduce new products. But specific for Norway, we will need to come back to.

When it comes to the duration, so to say, of stepped up marketing for nicotine pouches generally in Scandinavia. I mean it is a very fast growing category. It is very logical, and you see that from several players. Then there will probably be some peaks in relation to specific activities. But it's a fair assumption that you can expect increases, generally speaking, higher levels going forward.

However, you also need to bear in mind that it's likely that there is marketing restrictions. The proposal is for Sweden, which is the biggest market, is the initial proposal here is July 2022, which would basically, apart from some minor exceptions, put nicotine pouches at par with tobacco snus from a marketing restriction point of view and which would severely limit the possibilities to spend behind it.

But the final proposed rules and the exact timing on that one is -- will need to be seen, but that is likely to impact spending levels generally across the industry.

Operator

Our next question comes from Andreas Lundberg from SEB.

Andreas Lundberg - *SEB, Research Division - Analyst*

Just a few short ones. What kind of CapEx levels do you expect after you're done with the capacity increases for nicotine pouches? That's the first one.

Anders Larsson - *Swedish Match AB (publ) - CFO & Senior VP of Group Finance*

No, I think for this year, our -- as indicated in our outlook, we do expect higher spending than in the prior year, which was SEK 1.2 billion, I believe, in 2020. And then, of course, it's a bit dependent on how things evolve with the nicotine pouch category and so forth. But I think it's -- once we've kind of taken us over the hurdle of our ongoing projects, CapEx levels will likely decline a bit. But then if we need to do further investments, we will do whatever we deem necessary.

Andreas Lundberg - *SEB, Research Division - Analyst*

Okay. And on your balance sheet with the financial gearing of -- was it 1.6? I think you said 1.9 as the dividend payout, which is rather low also in a historical perspective. Are you still looking for this 2.5-ish as a target for your financials?

Anders Larsson - *Swedish Match AB (publ) - CFO & Senior VP of Group Finance*

Yes. It was a bit low in the quarter, but we haven't changed our financial policy. And it's -- I mean we do buybacks and asset distributions based on the number of metrics, not only the gearing level, but also we look at needed liquidity and so forth. So that can go a bit up and low.

Andreas Lundberg - *SEB, Research Division - Analyst*

Okay. And lastly, what's your distribution plans for nicotine pouches in the U.S. in 2021?

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

We think there will be some continued distribution build on the part of Swedish Match as well. Having said that, the brand is very well represented in -- by now in stores with meaningful category size. So -- and if we look at the gap that there is certain stores where you can see that you don't have ZYN, but there are competitive products, they are typically low-performing stores.

It's not obvious that it makes sense to go into each one of those stores. But generally, we expect some growth and importantly, over time, we expect quite a quite meaningful growth in terms of distribution that category continues to evolve. I mean, in the long term, there is no real reason why basically you shouldn't be able to buy nicotine pouches in just about every store where you can buy cigarettes.

Andreas Lundberg - *SEB, Research Division - Analyst*

One last again here, sorry for that. But if you look at your market share, you suggest, for ZYN in the U.S., your shipments, is that fair to use those numbers to calculate the overall market where -- how big was the overall market in the first quarter?

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

I mean, trend-wise, yes, but avoid these exact cuts around year ends and quarters and so forth. But I mean if you take a longer-term trend, there is no doubt that there is very healthy growth in the category and velocity for ZYN as well, in addition to some distribution. So very encouraging category growth rates, I would say.

Operator

Our next question comes from Ravi Sharma from Citigroup.

Ravi Sharma - *Citigroup Inc., Research Division - Research Analyst*

I'm sorry, my line got disconnected. So I hope you are able to hear me now.

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

We hear you well, Ravi.

Ravi Sharma - *Citigroup Inc., Research Division - Research Analyst*

Okay. So my first question is on your comments on increasing marketing activities in coming quarter in nicotine pouch category. I understand some of it is driven by your innovation plans in the coming quarter. But if I say, I want to ask you, if you compare your plan, marketing plan as it were in December or in January at the start of this year, how much of that has changed in the recent quarter? What I'm trying to understand here is how much of this -- if there is an element of this as a response to the intense competitive activities that you are seeing in the U.S. market? So that is my first question.

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

Yes. Ravi, this is Emmett. The -- we have planned activities during the course of the year. There are some minor adjustments that need to be made, if you think that an event might happen and all of a sudden, it doesn't happen because there's an issue in COVID in a particular state or something like that. Seasonally, you tend to have more events, for example, in the good weather months. So you're going to have that involved.

You also have a loyalty program that we are implementing, and that is growing. So that grows over time. So you would have more in latter quarters than you would have in earlier quarters. We're also stepping up some of our other types of social media activities with strict firewalls and so forth to make sure that we're targeting the adult tobacco user who is willing to accept this type of advertising. And on top of that overlays like April 26, we launched -- not launched, but are expanding the availability of menthol and some of the other varieties as well.

And on the pricing front for -- I think a lot of people get very kind of hung up on all the pricing dynamics going on from the competition. They're building distribution. They're trying to get initial trial, trying to get those types of things. Our pricing has been quite stable over time with some variations due to state mix, of course, and some other things.

But we -- new competition was coming in. They were quite clear in what they were doing and what's going on. Another thing that we have done is rather limited consumer research in our markets and in our expansion markets. And we find that ZYN consistently scores higher than the 2 big tobacco -- the 2 huge cigarette companies' products on a number of key consumer matrices -- metrics, overall impression, appearance, duration, flavor, mouth feel, nicotine experience, pouch size, brand, average, all of these things.

So not only do you have good consistent pricing and better attributes and first-in-mover advantage and new products coming in and growth of these loyalty type of programs, we've got a pretty good plan in place. Pricing doesn't need to be the driver.

Ravi Sharma - Citigroup Inc., Research Division - Research Analyst

Okay. That's very helpful. I have a second one, a very smaller one. If you can comment a bit more on your sales velocity in the Western region in the recent quarter? So that's it from my side.

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

With the caveats that we are trying to remind people that please avoid drawing to conclusions on isolated quarters, we can confirm that it increased notably. So if you take a longer period, it looks very good.

Operator

Our next question comes from Jared Dinges from JPMorgan.

Jared T. Dinges - JPMorgan Chase & Co, Research Division - Analyst

I just wanted to ask quickly in terms of distributor inventories in the U.S. Like, I know in Q3 and Q4 last year there was some movement that affected your shipments. Is there anything to call out for Q1? Or broadly, did your sell-in sort of match your sell-out in the quarter?

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

Yes, not really. I mean it was that -- you're right. There was that large distributor shipments that went in for their own reasons, and then they were able to pull back to more normal levels. You do have normal kind of seasonal distributor flows and retailer flows, but nothing huge to call out. You did have the California effects, where there was rather light shipments to a distributor that we're shipping to California pre decision to delay flavor restrictions on that. And that did come back in the first quarter. So we did get some of that as well coming in. But nothing huge to talk about other than that.

Anders Larsson - Swedish Match AB (publ) - CFO & Senior VP of Group Finance

No. And then on the other hand, you had a few very icy days where we couldn't ship at all. And it's a little bit difficult to say whether all of that volume was recovered or not.

Operator

There appears to be no further questions registered. So I will now hand over back to the speakers.

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

Okay. Thank you very much for attending today's call. And the release of our Q2 results will be on July 20. So we hope to see you back for that. Thank you very much.

Anders Larsson - *Swedish Match AB (publ) - CFO & Senior VP of Group Finance*

Thanks.

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

Thank you.

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