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SWMA.ST - Q2 2015 Swedish Match AB Earnings Call

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**Lars Dahlgren** *Swedish Match AB - President and CEO*

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## PRESENTATION

**Emmett Harrison** - *Swedish Match AB - SVP, Investor Relations and Corporate Sustainability*

This is Emmett Harrison speaking. Welcome to the second-quarter results telephone conference for Swedish Match. With me today are Lars Dahlgren, our President and CEO, and Marlene Forsell, our CFO. After a brief results discussion, we will be taking questions. For further information on the second-quarter performance, please visit the [SwedishMatch.com](http://SwedishMatch.com) website.

During today's call, there may be certain comments that constitute forward-looking statements. Because such statements deal with future events, they are subject to risks and uncertainty. While management believes that these statements are based on reasonable assumptions, it can give no assurance that its expectations will be achieved. Risk factors are outlined in the latest annual report, which is 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.

I will now turn the conference call over to Lars Dahlgren.

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**Lars Dahlgren** - *Swedish Match AB - President and CEO*

Thank you, Emmett, and good afternoon, everyone. Swedish Match is the leader in the Scandinavian snus market, a market where over time there is a clear and long-term trend that demonstrates that increased snus consumption and decreased cigarette consumption go hand in hand.

The Swedish snus market also represents our largest profit contributor. Here, our aim has been to grow this market, maintain our share, and provide consumers the highest quality assortment of both traditional and margin varieties across the pricing spectrum. Maintaining our share position represents a challenge, given our historical market position and the underlying market dynamics. During both 2014 and this year, we have taken concrete steps to address this challenge. I will go into this a little bit later, but I will start by saying that I am very pleased to see that our actions have led to significantly improved performance in our share trend in Sweden.



## JULY 17, 2015 / 12:00PM, SWMA.ST - Q2 2015 Swedish Match AB Earnings Call

For the second quarter, Swedish Match continued to report strong growth in sales and operating profit from product areas, driven by yet another quarter of impressive results from our US businesses, further enhanced by the strengthening of the US dollar.

For the snus and moist snuff product area, we knew that the second quarter would be financially challenging given the timing effects on snus shipments in Scandinavia related to Easter and the price mix effect that result from our measures to strengthen our long-term market position in Sweden.

Our lights business had an unusually soft quarter whereas strong performance from matches did not fully did not compensate for weakness in lighters.

Our Group operating profit development benefited from a very good performance by STG in the quarter, but was adversely affected by the recognition of the restructuring charge related to the strategic initiative to consolidate our distribution center in Sweden.

With continued solid category growth in Norway and the slightly higher growth in Sweden than what was experienced at the beginning of the year, we were very pleased to note that, based on our estimates, the Scandinavian snus category grow by more than 3% in volume terms in the quarter. This is a sign of category strength, given excise tax increases in both Norway and especially in Sweden where it was rather high at the beginning of the year.

The competitive landscape of the Swedish snus market remains dynamic and, while our market share in volume terms in Sweden was down by 1 share point year on year, I am very pleased to see the development in the second quarter as our market share growth sequentially from the first.

Stabilizing the market share has required a considerable and consistent focus and the positive development we saw in the quarter is a direct result of dedicated efforts in line with well-articulated strategies that have been in place for some time. A key element of these strategies has been to strengthen our position in the growing value segment. Activities have included focusing on quality across all price segments, broadening our product offerings for the Kaliber and Kronan brand families, prior to repositioning on the Kronan brand, and enhancing distribution and visibility at the retail level not the least for our value-priced products, and articulating clear targets for the organization.

Throughout last year, we saw our market share within the Swedish value segment growing and this positive trend continued in the second quarter. Compared to Q2 of 2014, our market share within the value segment has increased by more than 3 share points. We continue to find it strategic strategically important to provide high-quality products to more price sensitive consumers, and in September we will complement our portfolio within the value segments with a new [Mustang] brand, that gives rich and excellent snus experience at an attractive, but not the deep discount price points.

In addition to our share trajectory within the value segment, another important contributors to our positive market share development in Sweden during the quarter has been the excellent reception among consumers of our new innovative XRange snus series that combines classic premium brands with features in demand by modern consumers at a competitive price point. With the current market share, well above 3 share points, XRange has attracted consumers from all price segments. And it is an important contributor to the fact that premium products have remained stable as a share of the total market in the quarter.

In Norway, we have engaged in a series of initiatives to address the share erosion we have been experiencing. Our General G.3 lineup, which was complemented by additional SKUs in Q2, has delivered solid market share gains and has demonstrated that modern products with quality features can help us mitigate this challenge. However, so far, we have not gained enough traction in all segments of the market. And this, together with continue designs declines for loose product in Norway, where we have an exceptionally strong market position, imply that we have not yet managed to reverse the negative share trend.

In the US, our moist snuff and snus businesses developed nicely in the quarter. Within moist snuff, we have identified tubs and especially pouches as strategic growth is segments and within these segments, it continues the steady volume growth in the second quarter. For loose varieties, we continue to face volume decline partly impacted by the timing of promotions.



## JULY 17, 2015 / 12:00PM, SWMA.ST - Q2 2015 Swedish Match AB Earnings Call

Regarding snus, data from the distributors indicate that the category growth for Swedish type snus in the US accelerated in the quarter. Our volumes grow significantly stronger than the category as we continued to gain share despite the fact that the number of stores where our snus is present is comparable to the number of stores one year ago.

With regard to our submission to the US FDA for modified risk tobacco product spaces, we are now expecting to hear back from FDA late in the summer or during the fall and remain confident that our applications provide all necessary support for a modified risk basis for general snus.

In the US cigar business, we once again shipped more than 300 million cigars in the quarter. Our cigar organization has done an excellent job in addressing the highly competitive market situation. With product innovation and attractive pricing and state-of-the-art supply chain, the growth has been impressive in key segments of the market. While retail pricing is anything if has continued to trend down on a year-on-year basis, the portfolio shift has generated positive mix effect with the result that sales and earnings growth outpaced the volume growth in the quarter. Earnings also benefited from the absence of tobacco quota buy-out fee that were payable through the third quarter of last year.

Also the chewing tobacco business had a relatively good quarter. Volumes declined in the quarter but at a less pronounced level than in Q1. For the first half of the year, the volume decline was at historical rates. In terms of sales in local currency, pricing more than offset volume declines.

This was a difficult quarter for lighters and the main issue was low shipments to Russia. According to our Russian distributor, however, [sell-out] volumes picked up significantly towards the end of the quarter, and hopefully the worst is behind us in terms of the impacts from the turmoil in that market. Matches continued deliver solid performance but this was not enough to compensate for the unusual weakness in lighters.

With regard to regulatory development in Scandinavia, there has not been any further official news on the plain packaging proposal in Norway, and after the end of the commentary period in June. If standardized packaging would be implemented [with this] in Norway, we believe that the most likely implementation date is sometime during 2017 or 2018.

In Sweden, with regard to further tobacco control measures such as standardized packaging and display bans, we don't expect any official news before March next year when the committee inquiry report is due.

Finally, I would like to mention the announcement made yesterday about the mutual decision to dissolve the joint venture for smoke-free products outside Scandinavia and the US that we had together with Philip Morris International. I am very pleased with all the hard work and the dedication from all involved in the joint venture as well as with the excellent corporation of the JV partners. Going forward, Swedish Match will continue to [sell their own] snus in Canada, Russia, and Malaysia.

I will now hand over to Marlene for some more detailed comments on the financial performance.

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### **Marlene Forsell** - Swedish Match AB - SVP and CFO

Thank you, Lars. Turning to our financial performance, Group sales for the second quarter were SEK3.644 billion, up 9% from the prior year, and operating profit from product areas also increased by 9%. The strongest growth in sales as well as operating profit came from other tobacco products, which includes US cigars and US chewing tobacco. Sales also grew for lights but were [less] for snus and moist snuff and operating profit in decline for both these product areas.

In local currencies, sales and operating profit were negatively impacted by low shipments of snus in Scandinavia due to the Easter calendar effect. The timing of Easter also affected our [Swedish] distribution business negatively and Group sales in total are estimated to have a negatively impacted by [somewhat less] 2% from this timing effect.

The second quarter reported results, benefited from significantly stronger US dollar versus SEK. In total, currency translation had a positive effect of SEK290 million on sales and SEK6 million on operating profit from product area. In local currencies, the sales grew by less than 1% versus the second quarter of the prior year, and our operating profit from product areas declined by 1%. At current spot rates, we will see further positive currency effects in the coming quarters.

## JULY 17, 2015 / 12:00PM, SWMA.ST - Q2 2015 Swedish Match AB Earnings Call

Operating profit includes larger one-time charge of what a SEK2 million relating to the relocation of the distribution facility in Sweden. Operating profit including this one-time item and also a share of the net profit from Scandinavia tobacco group amounted to SEK1.021 billion compared to SEK941 million in the last year second quarter. Operating profit excluding the one-time item and including the share of net profit from STG grew by 13%.

Earnings per share in the quarter increased to SEK3.62 from SEK3.27 in the prior year, adjusting for the fact of the large one-time item, earnings per share in the quarter increased to SEK3.79, up 16% from SEK3.27 in the prior year.

For product area comments, I will generally refer to sales and operating profit development on the local currency. Within the snus and moist snuff product area, sales grew from moist snuff and snus in the US but declined in Scandinavia. Operating profit was up in the US and down in Scandinavia. In Scandinavia, treatment volumes were down by close to 3% due to the timing of Easter, which resulted in some destocking by the trade in the quarter. However, adjusting for this timing effect, consumption of Swedish Match products is estimated [as being up by 1% nationally in] number of accounts. And as you may recall, the timing of Easter did affect the shipment positively in the first quarter, [and] the first quarter shipments were still negatively impacted due to the destocking following year-end ordering.

During the fourth quarter of 2014, the entire portfolio of General snus brand was being offered at its new lower price, and this coupled with our momentum in the market share grew within the value segment, as well as the launch of the competitively priced premium assortment of XRange products, led to negative price mix effect in second quarter compared to second quarter last year for our Scandinavian snus portfolio. As a consequence, sales decline also adjusted for the timing effect.

In Sweden, as already noted, our overall volume share of Swedish market increased to 69.1% through the second quarter compared to 68.8% during the first quarter of 2015. The overall market share has sequential increase for the last two consecutive four-week measures and was up at 69.2% in Nielsen latest four-week measure. However, due to the share declines in the first quarter of calendar 2015, the overall volume share in the second quarter declined by 1.0 percentage points compared to the same period last year.

The volume share of the premium segment has been relatively stable and during the quarter it was approximately 93.5%. Our share of the value segment has grown to 40.7% compared to 37.5% in the corresponding prior last year. And all else equal, given this sequential share growth within the value segment over the past year, and the fact that there is not adjusted list prices in Gen snus 2015 only to recover the excise tax increase. We expect on a year-on-year basis to continue the negative price mix component in the coming quarters.

In Norway, our market share during the second quarter was 56.8%, down from 60.5% during the same period last year. For US moist snuff, the sales increase was due to higher net realized pricing. For US snus, the sales increased (inaudible) both higher net realized pricing and higher volumes. Our net spending to expansion out Scandinavia was down in dollar terms on an improved gross profit with Swedish snus in the US and reduced spending. However, in a Swedish krona, the total spending for international expansion of SEK76 million were slightly up.

The operating model for the product area was 40.5% compared to 44.4% in Q2 2014. The operating model has been negatively impacted by the increased proportion of sales coming from the US snus and moist snuff business. This geographical mix shift is affected both by low sales in Sweden and by the underlying sales growth in the US, which was further accentuated by a very strong currency effect. The profitability of US snus and moist snuff business has improved versus last year's second quarter. However, the operating model in the US is lower than in Scandinavia with the US business significantly impacted by costs incurred behind the development of General snus in the US.

The [model] for the product area has also been negatively affected versus last year second quarter by both price mix effect in Scandinavia and by absorption impact from the Easter effect. I would, however, like to note that higher volume in Scandinavia in the second quarter versus the first quarter of this year contributed to higher margin in Scandinavia.

For other tobacco products, sales increased by 10% in US dollars while operating profit increased by 20%. The sales increase was primarily driven by the very strong performance of cigars, while sales of chewing tobacco was slightly up. Operating profit dollars also increased in cigars while operating profits in chewing tobacco [was down]. Cigar volumes during second quarter were up by 9%.



## JULY 17, 2015 / 12:00PM, SWMA.ST - Q2 2015 Swedish Match AB Earnings Call

With regard to operating profits, cigar profits were favorably affected by, besides volume, an improved product mix as well as elimination of the tobacco quota buy-out, the impact being approximately \$2 million per quarter. While the FDA begins to regulate cigars, it is estimated that this favorability was largely offset by the requirements to pay FDA user fees.

Chewing tobacco shipment, including excluding contract manufacturing volumes, were down by 3%. [Positive fluctuations] on volumes of chewing tobacco are common due in large part to promotional timing. And for the first six-month period, chewing tobacco volumes were down at historical rates by less than 6%.

For lights, sales grew by 6% while operating profit declined by 26%. Adjusted for currency translation effects sales grew by 3% while operating profit declined by [29%]. For matches, sales and operating profits grew to (inaudible) pricing which was aided by currency movements. Lighters, on the other hand, had an unusually tough quarter with low volumes significantly affecting the operating profit negatively. The volumes were low, especially in Russia, in the beginning of the quarter, but we have been encouraged by some recent recovery of volume.

Moving over to moving Scandinavian Tobacco Group, which also had a good quarter. Sales for STG increased [both] as reported, up by 14% to DKK1.748 billion, and in local currency. Also, underlying sales adjusted for the acquisition of Verellen increased, driven primarily by handmade cigars and pipe tobacco. With an overall good performance, coupled with the contribution of Verellen and positive currency effects, the reported EBITDA for the period increased to DKK376 million from DKK286 million in the prior year.

Next, financial costs in STG increased from DKK11 million in the prior year to DKK32 million reflecting exchange losses due to currency fluctuations between quarters. Net profits for the period amounted to DKK206 million versus DKK153 million in the prior year, which reflects the reassessment of useful and certain intangible and tangible assets.

Swedish Match reported share of net profit in STG amounted to SEK126 million versus SEK78 million in the prior year. If the effect from the reassessment of useful is applied also to the 2014 numbers, Swedish Match share of net profit of SEK126 million should be compared to SEK92 million in the prior year.

And now I will provide some commentary on taxes, cash flow, and financings. The net final cost for the second quarter was SEK10 million lower than in the second quarter of 2014, mainly due to the lower average debt levels in the prior year. The net interest terms on our financial liabilities amounts to SEK94 million, down by SEK18 million, whereas the interest on pension liabilities increased to SEK20 million from SEK13 million, affected negatively by the stronger US dollar.

For the first six months of the year, the reported tax rate excluding associated companies and joint ventures was 24.5%. The rate is higher than in 2014, due in part to the strong US dollar and earnings growth in US, which gives [higher rates relative to high US tax rate] as well as some taxable deductions having less of an impact due to the increased earnings.

The cash flow from operating activities in the first six months amounted to SEK1.741 billion down from SEK1.921 billion in the corresponding prior period. This decline is mainly attributed to cash flow from changes in working capital, noting that cash flow from working capital [essentially] timing effect.

Investment in property, plant and equipment during the first half of the year was SEK5 million than prior year higher, while the total level of net cash used in investing activities was SEK3 million lower.

I also would like to remind you, as earlier communicated, that our investment in a new distribution center in Sweden of approximately SEK150 million. It is expected to be paid during the fourth quarter. However, after divestment of the current distribution center in Solna is closed during the first quarter of 2016, we will at that time have the capital inflow of approximately SEK150 million.

During the first six months, 2.6 million shares were repurchased, while the 0.7 million shares from treasury was sold all in the first quarter as a result of option holders exercising [the loss of] options on the now-ended option program.



## JULY 17, 2015 / 12:00PM, SWMA.ST - Q2 2015 Swedish Match AB Earnings Call

As of June 13, Swedish Match had SEK9.1 billion of interest-bearing debt including the time of benefit obligation compared to SEK8.7 billion at the December 31, 2014. During the first six months, we have repaid maturities of SEK139 million and issued new bonds in the amount of SEK498 million. The new bond was issued after five-year fixed all-in interest rate of approximately 1.5%. The average maturing and duration of the bond portfolio was 3.3 years and the weighted average interest rate was 4.3%. Approximately 94% of the debt has fixed interest. The net debt in relation to EBITDA excluding share of profits in STG, was 2.3 for the 12 month period ending June 30.

And I would now turn the conference call back to Lars.

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**Lars Dahlgren** - *Swedish Match AB - President and CEO*

Thank you, Marlene and, operator, let's go ahead and open the floor to questions and answers.

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### QUESTIONS AND ANSWERS

#### Operator

(Operator Instructions) Owen Bennett.

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**Owen Bennett** - *Nomura Securities Co., Ltd. - Analyst*

A couple of questions, please. And, firstly, on XRange. I know it is early days, but just wanted a bit more detail on consumer dynamics. So I know you said if you have taken share from all segments, but is this more skewed to consumers actually trading back up or is it more so on acceleration of down trading and by perhaps cannibalizing the full price General SKUs? And the second question, just on the end of the JV with PMI, what were the reasons for this and how do you see this now impacting your ability to grow snus internationally? Thanks very much.

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**Lars Dahlgren** - *Swedish Match AB - President and CEO*

Okay. When it comes to XRange, it is still of course relatively early days, but we are starting to get some period of data and what is very clear is that it attracts consumers from all price segments and also, I would say, all players in the market in a sense. But it's absolutely not limited to Swedish Match's portfolio.

And so, it is a little bit of complicated with these type of switch analyses to see exactly what is coming from where, but if you compare -- if you look historically between the first and second quarters, then you can see that their value segment, as a percentage of the total market has [since] started to have a much more intensified competitive situation on the Swedish snus market has increased from the first quarter to the second quarter. But, it didn't this quarter. And which, for us, clearly tells the story that XRange has helped stabilizing the value segment. But it is coming from both the classic premium and the value.

On the second question, on the [SM/PMI] joint venture, first of all, I would just like to reiterate that it has been a very good cooperation and there are definitely valuable insights coming out of this. And when they put these businesses together, our organizations together, we had the view that our organizations would be even more complementary than what is the case. And today, given the fact that it has taken longer time than we anticipated to establish that category, the new category in the geographies. So the frank answer is that, from both sides, they are mutually contributed that the scale to where we are now, does not motivate the cooperation in the joint venture format with the structure that it is attached to that. But we do see a small, but growing, consumption in these markets. And as a side comment, Russia, for example, had the strongest volume quarter ever this second quarter, but still then at relatively low levels.





JULY 17, 2015 / 12:00PM, SWMA.ST - Q2 2015 Swedish Match AB Earnings Call

**Owen Bennett** - *Nomura Securities Co., Ltd. - Analyst*

Okay. Thanks very much.

**Operator**

Andreas Lundberg.

**Andreas Lundberg** - *ABG Sundal Collier - Analyst*

Follow-up on Owen's question about XRange. Can you comment a little bit on your view of the price on the product so far, given the strong volume pickup or volume performance and all the given potential mix effects in your portfolio? Thank you.

**Lars Dahlgren** - *Swedish Match AB - President and CEO*

Yes. If you look at -- if you take the latest Nielsen prices that we have on that represents weighted average in prices, then you have General excluding XRange in that if we only took a portion because XRange only is present in portion, at 47.8 SEK, you have XRange at SEK34.1, and then you have the value segment that starts at SEK23 and up to around SEK36 with the highest priced ones.

**Andreas Lundberg** - *ABG Sundal Collier - Analyst*

Yes, well, maybe more curious about what your own take on the pricing on the XRange products given its performance and given the potential mix effect that product could drive.

**Lars Dahlgren** - *Swedish Match AB - President and CEO*

Yes. I mean, clearly, the manufacturers take on the can on XRange, [if you take in they are all white] for example compared to they are all the XRange variety, then the price is a lower. But actually, if you measure it per pouch, the difference is less pronounced. And it is still lower, but it is less pronounced and it is significantly higher than -- in the value segment.

**Andreas Lundberg** - *ABG Sundal Collier - Analyst*

If you assume this product is doing extremely well, is it fair to assume that we could see some price hikes on that product? Thank you.

**Lars Dahlgren** - *Swedish Match AB - President and CEO*

I mean, we will continuously review pricing over our entire portfolio, but it is clear that to us XRange is a premium offering. It is a very good and modern type of product. And based on the experience introducing a new premium product in the Swedish market has been very challenging. And we wanted to make sure that we give XRange the full support also in terms of an attractive price point. So in that sense, I would say without going into details of future pricing and so forth, it is not impossible that you can see the relative pricing and shifting a little bit. But it is -- you shouldn't consider the current price as an introductory pricing and that is it will go up all the way to premium, the classic premium one. I think it has its role where it is relative to the others. But it can change a little bit going forward.

**Andreas Lundberg** - *ABG Sundal Collier - Analyst*

And the cost to launch the product, was that more of a one time in nature or should we expect continuance in launch costs in coming quarters?





## JULY 17, 2015 / 12:00PM, SWMA.ST - Q2 2015 Swedish Match AB Earnings Call

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**Lars Dahlgren** - *Swedish Match AB - President and CEO*

No. I mean, as you know, marketing restrictions are pretty severe in the Swedish market. So there are, of course, still costs associated with introducing new products, but I wouldn't say that that has had a material impact on the financials in the quarter.

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**Andreas Lundberg** - *ABG Sundal Collier - Analyst*

Okay. And, lastly, on Scandinavia, did you see any meaningful under absorption effects from lower volumes in the quarter? Thank you.

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**Marlene Forsell** - *Swedish Match AB - SVP and CFO*

Yes. I mean, of course, if you are looking at in general, our overhead is sensitive to the volume. So yes, we did see effect coming out from the Easter absorption.

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**Andreas Lundberg** - *ABG Sundal Collier - Analyst*

Thank you. That concludes my questions.

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**Operator**

Erik Bloomquist, Berenberg.

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**Erik Bloomquist** - *Berenberg Bank - Analyst*

I was wondering, firstly, if you could talk about the Mustang launch and how that is different relative to Kaliber and where that might fit in terms of the pricing ladder that you are developing or putting finer levels on in Sweden?

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**Lars Dahlgren** - *Swedish Match AB - President and CEO*

Yes. A little bit, given that it is not out in the market yet, but it is presented to the trades so that is why we decided to talk about it today. And what we are seeing -- a little bit as a background -- if you look at the trends on what you refer to as the pricing ladder, we have seen lately that the products -- several of the products that have very low prices that the steep growth that we saw a year or two back for those type of products, actually has slowed down quite dramatically. And that there is a stronger demand even within the value segment for products that give a little bit more of a full experience in terms of content and moisture and so forth.

And the Mustang launch is catering to that trend so it is high quality, rich, full body, close to tobacco flavor large launch with good-size pouches and good nicotine strength and so forth. And the pricing is, of course, up to the retailers, but is aimed at the, I would say, the upper level of the value segment.

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**Erik Bloomquist** - *Berenberg Bank - Analyst*

Okay. Great. Thanks. And then, related to the slowdown in the value segment, you noted that a lot of that appeared to be attributable to the early success of the XRange. But, longer-term, do you think that at a certain point we are going to see the value segment growth flatten out and then we will reach some kind of equilibrium between value and premium? Or is this something that you see as kind of inexorable and we will gradually



## JULY 17, 2015 / 12:00PM, SWMA.ST - Q2 2015 Swedish Match AB Earnings Call

see increasing share in the value segment, albeit with maybe the definitions blurring a bit as you launch different products and narrower price gaps between them? Thanks.

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**Lars Dahlgren** - *Swedish Match AB - President and CEO*

It is, of course, difficult to look long into the future, but I think the key word that you used there yourself was definitions blurring a little bit and it goes back to my earlier comment as well where we see that, if anything, within the value segment now the little bit higher-priced products are actually the ones that show more positive trends. And when we look at 2014 and 2013, the value segment grew by about 4 percentage points on a full-year basis. That is the share of the total market.

And is XRange affecting this? We definitely think so. That it could be a positive in that remark. Having said that, also just to caveat, is that typically during the summer months, late spring, and over the summer the premium segment shows more resilience. But, as I said, between the first and second quarter, this looks unusually good from that perspective. But we do expect that in the fall here that we will see normal fall effect and that it could potentially even be a little bit accentuated if we are successful with the Mustang launch where we think we have a very good offering. So I would say, for now, that underlying trend is there, but there is room for providing value in terms of high quality products and, therefore, capturing price premiums relative to lowest price products.

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**Erik Bloomquist** - *Berenberg Bank - Analyst*

Okay. Great. Last question for me, then, is with respect to US snus. I was hoping you could expand on your comment about the snus growth, but on a stable base in terms of point-of-sales, is there churn in the point-of-sale and so you are dropping some out and replacing others? And what is the outlook for that? Is that kind of where Swedish Match is content? And then, finally, with respect to the volume for the year, can we expect something around a 5 million-can level, or is it going to be a bit higher? I am just trying to think about the -- how does the point-of-sale mature that average cans per week per store metric. Thank you.

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**Lars Dahlgren** - *Swedish Match AB - President and CEO*

On the store base, yes, there is a little bit of -- but it is relatively small or very small in terms of additions and deletions. But I would say normal churn in the sense that very low performing stores are removed from the mix and some new stores are introduced. In terms of the category first of all, it is, given that the category is still relatively small compared to other categories, it is, of course, difficult to get exact date based on especially for shorter periods. But if we strictly look at the distributor date that we get that indicates that the category is up by 9% year to date. That is, in itself, positive, but it can also be impacted by some timing of temporary promotions and so forth. In terms of cans in the store per month and so forth, given that we are in the same amount of stores, clearly we have an average increase there. But where we wind up last year from the top of my head I think we were at around 4 million cans and we will see them -- some very healthy growth to that whether exactly where we will land there. I think we will have to get back to.

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**Erik Bloomquist** - *Berenberg Bank - Analyst*

Thank you.

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**Operator**

Anders Hansson.



## JULY 17, 2015 / 12:00PM, SWMA.ST - Q2 2015 Swedish Match AB Earnings Call

**Anders Hansson** - Danske Bank - Analyst

I had a question on share buybacks with your net EBITDA of 2.3 times, [after] the dividend being paid out. And just wondering, do you think it is fair to assume that all free cash flow from now on should be -- or will be used for buybacks? Or if there are already good reasons not to assume so? Thanks.

**Marlene Forsell** - Swedish Match AB - SVP and CFO

When moving onwards here, we have been saying that our financial structure remains and that we have been talking about 2.4 net debt to EBITDA. When talking about that, we should, though, on the other hand, be aware of that is what is happening now is that the currency effects coming out from the US earnings is more or less returned to shareholders by a factor of 2.4. And saying that, I mean, it might be prudent to say that more so that we would probably come out at the lower range of 2.4 and than at the higher end of the 2.4. But still the 2.4 is in that ballpark.

**Anders Hansson** - Danske Bank - Analyst

Okay. So free cash flow sounds reasonable and then we will see what happens with earnings and the sort of leverage off EBITDA.

**Marlene Forsell** - Swedish Match AB - SVP and CFO

Yes. I mean, when it comes to that, you look at your forecast (multiple speakers) future, then, and with that guidance on the net debt to EBITDA, yes.

**Anders Hansson** - Danske Bank - Analyst

Okay, thanks.

**Operator**

**Stellan Hellstrom** - Nordea Markets - Analyst

**Stellan Hellstrom** - Nordea Markets - Analyst

I was wondering on the rationale of launching a new value brand in Sweden. It seems that you already have a very good momentum in the value segment and also with Kronan in the upper value range. Isn't there here a risk that this product will more cannibalize on premium rather than winning from deep discount? Thanks.

**Lars Dahlgren** - Swedish Match AB - President and CEO

We wouldn't do this if we thought that there wasn't demand. When we look at our brands, our position, and the consumer types that use Kaliber and Kronan, respectively, and it differs a little bit between males and females, what they see in these brands. We see an opportunity -- call it -- I wouldn't call it the white spots. There are very few white spots on the Swedish snus market, but we see spots where we are not strong enough. And yes, we have Kronan up there, but Mustang might even be slightly above Kronan. We'll have to get back to that.



## JULY 17, 2015 / 12:00PM, SWMA.ST - Q2 2015 Swedish Match AB Earnings Call

**Stellan Hellstrom** - *Nordea Markets - Analyst*

Okay. Just maybe you touched upon this before, but I have to ask also on the finalization of the PMI joint venture here, what happens next here? Isn't it fair to assume that you would have to increase your costs for distributing these products in the markets that you see will remain? Thanks.

**Lars Dahlgren** - *Swedish Match AB - President and CEO*

No, I wouldn't say so, and given that one important reason why we take this decision is that the scale of the business and [thus] motivated type of setup so -- and if you look at the SM/PMI joint venture on what Swedish Match will continue with, if you take Canada, the majority of the business is under the General brand. And so, we will take over that and then we will look in, of course, and make our own plans and so forth for next year. And how that is spending is going to relate to what the total JV is spending today for the Canadian market we will have to get back to. And if you take Russian market, which is relatively expensive market in the JV mix, there the majority of the business is actually not under Swedish Match brands. And so the number of stores, for example, for General, are present is fewer.

So everything as equal, if we just kept and given that we don't continue in Israel and Malaysia is a very small market. So everything else equal, if we just continue with the General brand, I would say that the costs for doing that would be lower than our share in the joint venture. But then, of course, exactly how much we spend in the future as regards snus outside Scandinavia and the US, depends on what decisions that we make as we develop those strategies.

But the learning here is that it takes time to develop completely new category. But it is possible to create demand. And, quite frankly, if you look at the stores, for example, the ones that are doing the best, it is typically specialty stores like premium tobacco [in essence] and so forth. That is also our experience from how we started in the US. A few years ago we were basically present in [parts] and premium cigar outlets where you have a very well-educated staff and so forth. And understands the product very well and can explain it to the interested consumers. And that created a solid base to build on for them and for the US market. So it could well be that our efforts take a little bit more of a niche type of approach going forward. But, again, these are things that we will decide as we take over the full responsibility for the [overall] brands in those geographies.

**Stellan Hellstrom** - *Nordea Markets - Analyst*

Okay. Thanks.

**Operator**

Stephan Nelson.

**Stefan Nelson** - *SEB Enskilda Inc. - Analyst*

As a follow-up on XRange and the success you are having in this new product, just to understand with the lower price points, are you able to protect or keep your margins in this snus business with this kind of deliberate price mix through more efficient production, et cetera. Or should we expect the margins to kind of come down a bit more gradually?

**Lars Dahlgren** - *Swedish Match AB - President and CEO*

If you look at XRange, as I said, the manufacturers' take per can is lower than the classic premium. And so, if you play with the thought that 100% of the portfolio would be XRange, clearly everything else equal profitability would be -- or the profits would be lower. But given the very high growth margins on this business, the operating margin differential is not as pronounced as one intuitively thinks from the beginning, at least in -- when we run the numbers based on -- compared to our intuition. But it does affect -- we shouldn't forget that it does affect the operating profit if the price goes down.

## JULY 17, 2015 / 12:00PM, SWMA.ST - Q2 2015 Swedish Match AB Earnings Call

**Stefan Nelson** - *SEB Enskilda Inc. - Analyst*

Okay. Good. And then, maybe on a broader question, regarding the market, obviously becoming more stable, you were the ones who are kind of most offensive right now with various launches. Are you kind of prepared for that -- your competitors in the market will push back in any way or do you believe that this kind of -- your success will rather contribute to that competition goes rather for profit maximization than market share? Just a bit of your thoughts what this will do to the rest of the market.

**Lars Dahlgren** - *Swedish Match AB - President and CEO*

I think, first of all, that is a question to the competitors what their plans are, but it is important to be clear here that the Swedish market remains extremely competitive and so if you look, for example, specifically within the value segment, while we have seen one of our main competitors gradually moving up the price a bit, and again catering to this trend that it is not absolutely lowest price products that are more in demand and they have done relatively well with that, we have seen another competitor especially in certain premium outlets such as drop the price rather dramatically on one of its products. So it is still very competitive. And it is, of course, very hard to know what plans they have.

**Stefan Nelson** - *SEB Enskilda Inc. - Analyst*

Okay. Great. And then, just a final question. Just as a follow-up on the upcoming FDA decision. Will your investments in the US be depending on a decision on the modified risk label?

**Lars Dahlgren** - *Swedish Match AB - President and CEO*

It could be that, going forward, of course, we will make investments based on what we see in the market and the demand for the product and what we think makes sense from time to time. Given that on the long-term basis, we definitely think that the FDA ruling that gives modified risk status to General snus would be a very positive for our business. And that could potentially merit higher investments, but it would also merit or generate higher -- maybe a quicker payback and also higher growth margins. The current business is doing well without an MRTP status and if we would get the negative outcome from FDA, we don't have a backup plan where we would significantly scale down the current investment level. But I would say that there is probably no dramatic effect either way. It is more or less we would cater it to how the business develops.

**Stefan Nelson** - *SEB Enskilda Inc. - Analyst*

Okay. Okay, great. Thanks.

**Operator**

[Katarina Ferrence]

**Katarina Ferrence** - *Analyst*

I was hoping that you would be able to just add a little bit more color on the cigar business for me, please. Clearly, it is another quarter that where there is a lot of strength in that business, both in terms of sales, but also on the other tobacco products on the profitability. And I was just hoping you would be able to kind of give a bit of color on how much effects matters to the margin of that business, I would have thought less so than some of the others. And also, whether it -- the trends that you are seeing in terms of the (inaudible) to what extent that is helping. Just to get a feeling. Because I think you talked a little bit about the buyout fee, but if I am right, I think that is about 20 basis point potential hit to the margins where if we have got a 200 basis point move up year on year. So I'm just trying to understand the sustainability of that, really. Thank you.



## JULY 17, 2015 / 12:00PM, SWMA.ST - Q2 2015 Swedish Match AB Earnings Call

**Lars Dahlgren** - *Swedish Match AB - President and CEO*

Yes. First of all, if you take FX and margins, it doesn't affect much given that this is a US dollar business. We have a very little business that is not denominated in US dollars in the other tobacco products area. But it does, of course, affect the amount of profits when translated into SEK. But, in the report, we provide the underlying development in local currency.

The tobacco buyout fee is about \$2 million positive per quarter so it has been that for the first quarter and the second quarter compared to last year. And most likely, also for the third quarter and potentially also now it looks like we haven't heard anything from FDA, so there is a good chance that we don't have to pay any FDA user fees that are the fees that Marlene said we estimate to be in the same magnitude, i.e. around \$2 million per quarter. But when we come into Q4 on an anniversary basis and then of course we left Q4 where we also didn't pay full tobacco quota buyout fees. They actually expired in Q3, but we paid a little bit in last year's Q4 based on old inventory.

In terms of the other thing that has really improved profitability in this business is the improved mix that we have seen. Because, as I said, initially, the pricing as such -- the market remains extremely competitive and this is the result of us focusing on segments where we have seen that we could make a difference where margins have been a little bit higher and that [track] started last year. So I would say the anniversary effect of that, everything else equal, might subdue slightly in the second half. But importantly also, when it comes to the cigar business, it is a business that is based on experiences and very hard to forecast. And so, therefore, in terms of our ambition is to grow the volumes in the second half and continue this good trajectory, but we don't give any forecast for the remainder of the year.

**Marlene Forsell** - *Swedish Match AB - SVP and CFO*

But when it comes to also then the FDA or the tobacco buyout, I don't recall what number you gave there, but it is more than 1.5 percentage points on the margin.

**Lars Dahlgren** - *Swedish Match AB - President and CEO*

I am not sure if I answered all your questions so please, if you are --

**Katarina Ferrence** - *Analyst*

No, you did. It is helpful. It sounds like it did a lot of moving parts, really, and it is going to be a function of how the mix continues to develop, predominantly.

**Lars Dahlgren** - *Swedish Match AB - President and CEO*

And that is important, but of course volumes are very important as well.

**Katarina Ferrence** - *Analyst*

Thank you.

**Operator**

Martin Arnell.



## JULY 17, 2015 / 12:00PM, SWMA.ST - Q2 2015 Swedish Match AB Earnings Call

**Martin Arnell** - DNB Markets - Analyst

I think most of my questions have been asked, but I will shoot one on the cash flow. I saw it was down year over year in the quarter due to working capital and timing effects, and I guess this was the same communication as you gave in the Q1 report. So my question is then will this affect some positive going forward?

**Marlene Forsell** - Swedish Match AB - SVP and CFO

I believe that in Q1 I was talking about we had the positive effects from the timing of working capital during 2014. And when it comes to the structure of the working capital as such, I don't see any real difference between the periods. So saying that, this is mostly due then to timing effects and with 2014 being that positive, I would suspect the full year also to be affected by that. When it comes to cash flow as such, I also wanted to -- do remember that SEK150 million that is coming up for payment in October when it comes to also investments. Because we have been talking about sort of underlying investments before in the area of SEK300 million, but the SEK150 million of course comes in the product area, which usually have very low investments. So that more or less comes on top of everything else. Besides that, also, the investments that we are having our properly coming out from the US business and there we will of course have a currency impact as well.

**Martin Arnell** - DNB Markets - Analyst

Okay, thanks.

**Operator**

James Bushnell.

**James Bushnell** - Exane BNP Paribas - Analyst

Just one question, really. I think that your end goal, I assume, is to return to regular pricing in Sweden as that does exist in most tobacco markets. You are the market leader. You are now also leading in all the main segments. Your share is stable, at least it last quarter sequentially. How far away are we from the points where you as the market leader will see the conditions good enough to start bringing back regular pricing either on an annual or more frequent basis? Thanks.

**Lars Dahlgren** - Swedish Match AB - President and CEO

We are refrain from commenting specifically on pricing decisions, but it is something that we continuously review. And my long-term view is that there is definitely room in this newest category in Sweden and, in particular, I would say in the value segment there is room to increase prices over time.

But, having said that, it remains very competitive and, as I pointed out before, we recently saw some what you could call positive news, in that sense, of competitor taking out prices, but at the same time another competitor taking down prices quite dramatically. And then, of course, if you can work also with the portfolio as such, clearly another way to read the effects of the coming Mustang launch there is that provided that we are successful there, our aim is to bring up the price regardless of the price movements on individual products. Our average price in the value segment given that we -- today, we have Kaliber and (inaudible) Kaliber is quite a bit lower and then Mustang is going to be at that upper end.

**James Bushnell** - Exane BNP Paribas - Analyst

Okay, understood. Thank you very much.



JULY 17, 2015 / 12:00PM, SWMA.ST - Q2 2015 Swedish Match AB Earnings Call

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**Operator**

Erik Bloomquist.

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**Erik Bloomquist** - *Berenberg Bank - Analyst*

With respect to the tax rate, each one, I guess it was around 24.5%. Is that a good run rate for the year or with the US dollar effect lessening as we go through, will that come down a little bit, if you could help us on that? Thank you.

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**Marlene Forsell** - *Swedish Match AB - SVP and CFO*

Yes, I mean, when it comes to -- in general, of course now the currency movements we have seen have been fairly steep so they affected the business more than usual. And when it comes to the tax rate, I have been mentioning that that has been also causing that one to go up together with some other effects coming out from increased earnings. We have now reported then the 24.5%. That 24.5% could go up or it could go down for the full year.

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**Erik Bloomquist** - *Berenberg Bank - Analyst*

Okay.

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**Marlene Forsell** - *Swedish Match AB - SVP and CFO*

[Staying] in both directions. But --

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**Erik Bloomquist** - *Berenberg Bank - Analyst*

I mean, given that the FX impact appears to be lessening through the remainder of the year, it would seem more like likely that it comes down, or I guess if FX strengthens further that would drive it up. I'm just trying to understand how it goes up from this level.

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**Marlene Forsell** - *Swedish Match AB - SVP and CFO*

Yes. Of course. We partly take into consideration also the coming quarters when recognizing the tax rate. But, of course, it is hard to predict the development in the second half fully. But it is taken into consideration partly.

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**Erik Bloomquist** - *Berenberg Bank - Analyst*

Okay, thank you.

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**Operator**

There are no further questions. Please continue. Thank you.

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## JULY 17, 2015 / 12:00PM, SWMA.ST - Q2 2015 Swedish Match AB Earnings Call

**Lars Dahlgren** - *Swedish Match AB - President and CEO*

Okay. Then we thank everybody for listening in today. And the final comment, just to inform you that the release of our third quarter results will be on November 4. Thank you.

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