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SWMA.ST - Q3 2017 Swedish Match AB Earnings Call

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## PRESENTATION

### Operator

Thank you all for standing by, ladies and gentlemen, and welcome to today's Swedish Match Interim Report January-September 2017 Conference Call. (Operator Instructions) Please be advised the conference is being recorded today, Friday, 27 of October, 2017.

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

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

Thank you. Yes, this is Emmett Harrison. And this is the Swedish Match Third Quarter 2017 Telephone Conference. And with me today are Lars Dahlgren, our President and CEO, and Marlene Forsell, our CFO.

In the Investor Section of our [swedishmatch.com](http://swedishmatch.com) website, you will find a Q3 presentation for today's call, which is intended to be viewed in conjunction with our prepared commentary, so we encourage you to follow along with that presentation. In that same Investor Section, you will find copies of the interim report. After our prepared commentary, we will be taking questions.

During today's call, there may be certain comments that constitute forward-looking statements and are subject to risks and uncertainties. Management believes that these statements are based on reasonable assumptions but can give no assurance that expectations will be achieved. Risk factors are outlined in the latest interim report and annual report, which are available on our website. Swedish Match assumes no obligation to update information concerning 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.

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

Thank you, Emmett, and let me start on Slide 3, by touching on a few of the financial highlights from the third quarter.



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We knew that the third quarter would represent a challenging quarter from a comparison perspective given the relatively strong financial performance by our businesses in Q3 '16, where we grew both sales and operating profit from product areas by roughly 10%.

The third quarter of 2016 also represented the last quarter where our results were not burdened by FDA user fees for cigars. Given these challenges, I'm pleased with the financial performance in the third quarter of this year, where we were able to grow both sales and operating profit from product areas in local currencies.

Earnings per share, adjusted for largely onetime items and share of net profit in STG, increased by 12%, reflecting the benefit of historical share repurchases and the improved financial metrics.

On Slide 4, we highlight a few of the key developments during the quarter. Our biggest product area, snus and moist snuff, performed well with profit growth for snus in Scandinavia. And in the U.S. market, we saw profit growth for moist snuff as well as a marked reduction in net operating loss relating to our snus and ZYN business.

The biggest product launch during the quarter was the launch of the new Snus Series One in Sweden, which has been well received by consumers. One comes in 3 different premium products at a popular price point, with pricing similar to our XRANGE products.

In Norway, it's very encouraging to note that we grew market share sequentially from the second quarter as our successful G.3 range continued its solid progress. Snus and ZYN both grew in the U.S. product, but particularly ZYN showed strong traction with increased velocity as well as wider distribution.

Strategically, both snus and ZYN are very well aligned with the July 28 announcement by the FDA, where the agency reaffirmed its intention to impose regulations that stimulates migration from more harmful to lower-risk nicotine-containing products.

We are also very pleased to have completed the acquisition of V2, a Danish manufacturer who makes chew bags and snus, and particularly for chew bags in Europe has established successful brands and growing niche positions.

Marlene will now provide a brief overview of the financial performance of our largest product area, snus and moist snuff.

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### **Marlene Forsell** - Swedish Match AB (publ) - CFO and SVP of Group Finance

Thank you, Lars. For the snus and moist snuff product area, we saw sales improving by 4% in local currency, and we had growth also in operating profit. In Scandinavia, we estimate that core key market growth in volume terms approximated 4%, up slightly from the second quarter levels. Nielsen reports a slower growth than our estimate, mainly due to the fact that Nielsen does not factor in the e-comm channel volumes in Sweden, which have become relatively large and are also growing rapidly.

We estimate that our underlying volumes were up by 1%, with growth in both Sweden and Norway. Pricing also improved in both markets. And in some, our Scandinavian snus business posted a healthy growth in profits during the quarter.

For moist snuff in the U.S., Swedish Match shipment volumes were soft, largely due to promotional phasing, which should correct itself somewhat in the fourth quarter. However, operating profit improved, driven by higher average price following category price increases and lower levels of promotions as well as improved cost of goods.

The net operating outside Scandinavia improved by SEK 15 million. Much of our efforts in this business are directed toward the U.S. market, where we continue to experience growth for both snus and ZYN in volume terms, as well as higher realized pricing.

Market-related costs were comparable to the prior year in local currency. ZYN growth has been robust, and we're stepping up production here in Sweden for both increased demand in existing stores as well as future expansion. This is expected to cover demand until we have our U.S. ZYN



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production setup completed, an investment project that has recently been initiated which will add approximately USD 40 million to capital expenditures, mainly in 2018.

Turning to Slide 6. This slide provides some more detail to top line drivers in our Scandinavian snus business quarter-by-quarter. It is positive to see that the market growth rate has picked up from the lows in Q4 2016 and Q1 2017.

The estimated industry volume growth and Swedish Match underlying volume growth were both slightly stronger than in the second quarter, while our own price mix effect was marginally weaker. It should be noted, however, that we had a positive currency impact from the stronger Norwegian krone in the second quarter. And when looking forward at today's exchange rate of the new versus (inaudible), the price mix component would face some currency headwind in the fourth quarter.

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

Turning to Slide 7, where you can see some of our new product activities. And I've already mentioned the One series in Sweden. In Sweden, we have previously had ZYN available on a very limited scale, mainly in our own snus stores. We are currently in the process of making the product available in the Capital convenience store franchises.

In Norway, G.3 Volt has done very well since its introduction in March, and the latest addition to the range is G.3 Wire, with similar positioning but in a different flavor.

Our G.4 All White product has recently been complemented with G.4 Blizzard, an All White product with the same appreciated mint flavor, but with a higher nicotine delivery.

Turning to the next slide, which shows Nielsen growth rates for Sweden on a trended basis in both value and volume terms. As noted earlier, our assessment is that Nielsen underestimates market growth, but the main takeaway from this slide is that the improvement in retail value growth -- the improvement in retail value growth versus the improvement in volume growth. And this dynamic results from price increases by Swedish Match and some competitors, as well as a slowdown in the overall value segment growth.

And the next slide illustrates Nielsen metrics for Sweden on a quarterly basis, and shows the size of the value segment and Swedish Match's market share within the value and premium segment, respectively, as well as our overall market share in volume terms. As you can see, the value segment share has been relatively stable for a number of measurement periods. With market share losses in both the value and premium segments, this has resulted in our overall market share being down by 0.6 share points on a sequential basis from the second quarter and down 2.2 share points from the same quarter of the previous year.

Moving over to Slide 10, and looking more closely at the development and size of the different price segments in Sweden. After several years of decline, the premium segment has been relatively stable over the past 2 years as a share of the total market. The more traditional higher-priced varieties of premium pouch and loose products, what we call the premium 1 segment, has continued to decline at a fairly constant long-term rate. Since the launch of XR, the popular price premium segment, what we call the premium 2 segment, has grown, as has competition within this segment. Our launch of General 1 and GR.1 supports our position within these growing premium segments.

Turning to Slide 11, in Norway, the market growth in both volume and value terms remains healthy. And this year, the volume growth has been in the range of 5% to 6%. The volume growth is entirely attributable to the pouch segment, as loose snus has continued to decline. As in previous years, the growth in retail value has outpaced volume growth as a consequence of excise tax increases and manufacturers' price changes.

Slide 12 shows that we have shown clear progress in terms of mitigating market share losses in Norway over the past 18 months. Our share decline attributable to pouches was by far the best we have experienced in several years in the most recent quarter.

And turning to Slide 13, and as mentioned, our market share in Norway has been improving in recent periods on a sequential basis, and not only in the pouch segment, but also in the market as a whole.



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Turning to moist snuff in the U.S. and next slide. In the U.S., a relatively reliable indicator of category performance is our CMPP data that measures shipments from distributors to retail for the main players in the market. As can be seen by the dark blue line, the overall category growth has trended down. It should be noted, however, that during the course of this period, industry price increases have become more meaningful, so the development in retail value trends more favorably. It is also worth noting that the pouch segment is far outpacing the loose segment in terms of growth, and pouches now account for an estimated close to 17% of the moist snuff market in volume terms.

The next slide shows our volume development for pouches on a 4 quarters rolling basis. Our strong trend took a slight dip in the latest quarter due in large part to promotional phasing, and we expect the growth to pick up again going forward.

Turning to Slide 16, and that shows the trajectory for the combination of snus and ZYN volumes outside Scandinavia. Volume acceleration is attributable to ZYN in the U.S.; snus volumes outside Scandinavia has also continued to demonstrate good growth.

And the next slide, and some comments on the regulatory landscape for snus in Europe. In Norway, we have taken complete steps to challenge the decision to fold snus into the plain packaging legislation that is now effective, but with a transition period. We are firmly of the opinion that the plain pack measures for snus are not supported by scientific evidence. Other types of products that either have an obviously higher risk profile or lack the strong epidemiological fact base that snus has are exempt from the regulation.

As such, the plain packaging on snus is both disproportionate and discriminatory. We have therefore decided to litigate the legislation and have completed the first round of hearings, where we soon expect a verdict on our request for a temporary injunction until the full case has been tried.

We are also looking forward to the hearing in the European Court of Justice on the legality of the snus ban within the European Union. We expect a hearing on this issue to take place at the beginning of next year. This ban is clearly disproportionate in view of the solid scientific fact base in support of snus, and similar to Norway, it's discriminatory.

The proposed excise tax increases are 1.6% and 1.9% for Sweden and Norway, respectively, and are valid from January 1. In both countries, they are part of budget proposals yet to be enacted, and in the case of Sweden, the inflation index on which the increase is based is finally determined in November.

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### **Marlene Forsell** - Swedish Match AB (publ) - CFO and SVP of Group Finance

And this is Marlene, again. And we are on Slide 18. Within other tobacco products, sales and profits were lower than for the third quarter of 2016 in reported currency, but sales were up in local currency. The weakening dollar versus the Swedish krone, the FDA fees, unusual adverse seasonal weather and negative product mix, FX, combined to negatively impact operating profit for other tobacco products during the quarter.

Mix effects were negative for both cigars and chewing tobacco. The negative mix effects within chewing tobacco were a result of our more aggressive response to value segment growth within the U.S. chewing tobacco market that muted average sales price benefit that we have historically experienced within this category.

The inclusion of 1 month of chew bags sales and operating profit from V2 had a small positive effect for this product area.

And turning to Slide 19. For cigars, this slide illustrates our shipment volumes on a quarterly basis, split by natural leaf cigars and HTL. We had previously indicated that we were to be faced with difficult comps this quarter. Still, our volumes grew by 1% year-on-year in the third quarter, delivering an impressive 11% volume growth over the last 9 months. As you can see on the slide, our natural leaf varieties, in particular, continue to trend well, which may seem counterintuitive to my earlier comment regarding negative mix effects. But within HTL, our value priced Jackpot brand had relatively high deliveries in the quarter, and within natural leaves, the mix effect related to differences in production costs for different forms.



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As you can see on Slide 20, quarterly fluctuations for chewing tobacco shipment volumes in the U.S. are common. And the third quarter was a decent quarter compared to historic trends. Year-to-date volume decline for our own brands amounted to 5%, but it should be noted that the first quarter showed an unusually strong volume comparison.

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

Thank you, Marlene. With regard to regulatory developments in other tobacco products and our cigar business, the most concrete indication from the July 28 announcement was the extension of the deadline for SE applications and the ambition to publish clearer guidance for the applications of these newly deemed products. While our preparations for SE applications for cigars were already well underway, we welcomed the new deadline of August 8, 2021.

With regards to flavors, the FDA will look at the role flavors play in youth use, but also the role flavors can play in moving people away from cigarettes.

In Europe, a case is being referred to the ECJ to help interpret TPD articles regarding the characteristics and definition of chewing tobacco. We believe there are strong arguments as to why our chew bag assortment differs from the definition of snus in the tobacco directive, and a good example is Denmark, where the authorities have thoroughly evaluated some of V2's products and determined that these products do not fall under the definition of snus.

The ECJ case on chew bags is expected to be heard after the case on the legality for snus, when the snus ban has been heard and ruled on.

Talking about V2 and turning to Slide 22, I would just like to reiterate that we are very excited about this acquisition. V2 is a profitable, dynamic and growing company with known brands and a presence in both the chew bag and snus segments.

While volumes are still relatively small, their chew brand provides us with a stronger platform for growth. Their production facilities in Silkeborg, Denmark are state-of-the-art, modern and flexible.

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### **Marlene Forsell** - *Swedish Match AB (publ) - CFO and SVP of Group Finance*

Turning to lights on Slide 23. Sales and volumes for both matches and lighters were lower. Sales held up relatively well for matches on improved pricing and product mix. In addition to lower volumes, sales for lighters were also affected by negative product mix.

Our financial results reflect the challenging market condition this year, but we saw continued strong performance for our complementary products. Regarding lighters, the Russian market has presented volume challenges this year, but we are seeing some improvements there recently.

Two other markets that burden the quarter-on-quarter comparison are Japan and Brazil. In Japan, we had good volumes of advertising lighters in comparison periods. And in Brazil, we as like many other FMCG companies, have suffered from inventory reductions in the trade.

We are now on Slide 24. As you note from the graph, the net finance expense for the quarter was significantly lower than in the third quarter of 2016. This is due to the costs incurred last year on repurchasing bond loans. It is good to remember that the dividend received from STG during the second quarter of this year amounting to SEK 65 million was recognized as a finance income, and thereby significantly reducing our reported finance net.

The net interest income expense in the third quarter has been relatively stable over the course of the year. The third quarter interest expense remains in line with the prior year as lower average interest rates offset the effect of higher interest-bearing debts.

Turning to Slide 25. During the quarter, Swedish Match has issued new bond loans of SEK 600 million. These new bond loans have a tenure of 5 years. The interest rate of the falling -- bonds falling due in November is approximately 5%. And the interest rate of the newly issued bonds are approximately 1.4%.



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Since that issuance, interest rates relevant for Swedish Match have increased somewhat. At September 30, the weighted average interest rate of our bond portfolio was 3.18% compared to 3.41% on the same date 1 year ago. Average interest rates will be further lowered after the payment of the November maturity.

During the period, we have continued to repurchase shares. Share repurchases during the third quarter amounted to SEK 689 million. And for the full year, that means that we have repurchased shares of a total of SEK 2.1 billion. Together with the ordinary special dividends paid, the total shareholder distributions during the year have amounted to SEK 5 billion. The net debt-to-EBITDA at the end of the period was 2.4x.

With regard to the outlook statements on the last slide, it is good to note that FDA user fees will only impact the year-on-year comparison up to and including the third quarter, as FDA user fees for cigars started to be expensed from the fourth quarter of 2016. I would like to reiterate that these volume-based fees are ongoing and will continue to be paid off beyond the third quarter.

Because these fees are volume based, they may fluctuate from year-to-year, and there is a risk that they may increase.

From October 1 this year, fees will increase to about \$2.6 million per quarter until September 30 next year, when once again, fees will be adjusted.

The ZYN production project, as has already been mentioned, has just been initiated and will run through the whole of 2018. We expect capital expenditures of approximately USD 40 million in support of this project to primarily be incurred during the course of 2018.

For this year, we expect group-wide capital expenditures to come in below the level of capital expenditures in 2016, as some capital expenditures are moved into 2018.

The capital expenditures in 2018 will likely exceed 2017 and 2016 levels, primarily as a consequence of the ZYN capacity project.

Currency developments are another area to keep in mind, and at the current spot rates for relevant currencies versus the Swedish krone, we expect the currency translation effect to be negative over the coming quarters.

Operator, we can now open the floor to questions and answers.

## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Your first question is from Stellan Hellström from Nordea.

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

First, to start with one, did you -- I don't know if you mentioned what market share you have achieved so far? And again, also talk a little bit about what you expect here in terms of -- from whom one is gaining share? Is it -- to what extent it's not cannibalizing only on your full-price offering?

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

Hello, Stellan, this is Lars, and congratulations again, you're very fast with your fingers. One was launched towards the end of that, so it's still quite early, but according to our latest measure, it has 1.7% of the market and that's 5 weeks after the launch then. And I think it's also too early to get accurate analysis on where it's pulling from, but I think a good hypothesis is that you will see some consumers trading up from the value segment, but naturally, you will also see some consumers that may abort more classic premium products and buy One at this more popular price point.



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

All right. Also regarding pricing on snus in Sweden, I think you mentioned in -- when you presented Q2 numbers that you've seen retail prices go up for 2 of your competitors. Are those increases sticking? And/or have you seen any other developments in the Swedish market?

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

I would say that it looks very similar. If you look at Nielsen data now and you looked after Q2, it looks very similar. And it's still the case you see Swedish Match prices on average come up, and you see the same thing for 2 of our main competitors.

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

Yes. And the third one has increased prices or not?

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

On the third one, you get down to decimals where you don't know whether it depends on channel mix and so forth. But there is a very minor increase on the third one as well. But that -- it's probably attributable to channel mix.

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

All right. And then on the white products and the success it has had in Norway, why do think that your -- you have not lost as much share to this product. Is that because of your launch in Q4 or are there any other expenses?

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

I think if you look deep into the market share data and positioning of our products to them, it's clear that our main competitor is the one that has suffered most when BAT's product [Vapour] has grown in the Norwegian market. So it seems to be the case that they had more consumers that appreciate this white type of offering. And if you look at our own development within the worldwide segment with G.4 and now G.4 blizzard, our total market share is still relatively small. It's about half the SharePoint of the market. But it's a segment that we believe will continue to grow. And we, of course, have the ambition to grow our share within that segment.

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

And any view on how this segment is developing in Sweden compared to Norway? Or any idea why it's not growing so fast?

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

There is growth in Sweden as well, but the pattern, you can say, is not dissimilar to some of the patterns we've seen historically for strong products and so forth, where things tend to happen a little bit quicker in the Norwegian market. And this is, of course, a reflection of the Swedish market being bigger and a little bit more traditional. So you have some similar sort of consumer groups that are making these type of choices, but they're spread out, so to say, on a bigger base.





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**Operator**

The next question is from Adam Spielman from Citi London.

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

So my question is also around Scandinavian snus. Clearly, something has improved for you, and particularly the Norwegian market share is much better. And you also, I think, said that the whole industry volume growth has been accelerating during the course of 2017. But when I actually look at your volume, and I assume on top of that -- sorry, there's some pipeline fill related to your new introduction through samples of the 1 range, and also maybe Wire and G.4 Blizzard in Norway. And yet -- so despite all these good factors, when I look at the actual volume that you've talked about on Slide 6, it's 1.2%, which is not that much better than where it was in Q2. So I'm just trying to understand why, despite all the good things you're talking about, it hasn't really shown up in the volume that you're reporting for Scandinavia on an underlying basis.

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

I mean, you have to factor in one thing to start with, Adam, and that is that we -- a lot of these improvements that we've seen now, for example, the share trajectory in Norway, where we point to a sequential improvement between the third and the second quarter, it's sequential. While as -- when you look at year-over-year one year ago comparison, then, of course, if we take the Swedish market as an example, we had a relatively poor market share development at the end of 2016 and the first quarter of 2017. And on a comparison basis, of course, that still hurts, so to say. So the -- this slide that we present, the 1.2%, that we announced some time ago have decided to share with you for complete transparency, is our absolutely best estimate of what's going on in underlying basis. And we made exactly those kind of adjustments that you're referring to in this graph, like for example, if there is pipeline volumes for launched active 1 products. And that actually happened this quarter. So we made -- it's a small adjustment, but there is an adjustment for that. So it's our best take on the underlying basis. And, of course, the better -- the longer into the year, the better our estimates become, especially on a year-to-date basis then. So that's also actually why you may have noticed that we have increased our estimate also for the category growth in the second quarter from what we showed in conjunction with the release of the second quarter. That is because we have more data points, we have all these Easter effects and things like that are out of the system. And this is our current best estimate of what's going, including our real market share developments that comes out of this and that can differ a little bit from Nielsen.

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

Okay. Can I also ask a question on Slide 16, which shows the very good improvement in shipments of snus and nicotine pouches outside Scandinavia. There, you've quoted on a rolling 4 quarter basis. But my guess is if you've done it quarter-by-quarter, it would be, a, a bit more volatile, but, b, show a bigger improvement in the final quarter. Would that be right? There's a curve upwards there anyway. So I'm guessing if you did individual discrete quarters, it would be more dramatic, the upwards.

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

Yes, you're right. That's the -- there's much more volatility on a quarterly basis. So therefore, we think it makes sense in this case. I mean uniting some stores for ZYN and so forth, it gives a more accurate picture to show it on a rolling basis. And I'm not going to say you're wrong. You're probably right on your assumption on how it would look on a quarterly isolated basis, but since I don't have that in front of me, I prefer to keep silent on that one.

**Operator**

Your next question is from Alberto Lopez from JPMorgan, London.



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**Alberto Lopez Rueda** - *JP Morgan Chase & Co, Research Division - Analyst*

I have a couple of questions. First, I was wondering if you could give us a bit more color on the moving parts of the margin expansion in snus and snuff for this quarter, which was strong even if you exclude the international losses. Marlene mentioned, for example, the change in promotional and this could reverse in Q4. But a bit more color would be appreciated.

**Marlene Forsell** - *Swedish Match AB (publ) - CFO and SVP of Group Finance*

Yes, I'm talking then about that margin. What I'd first like to point out is that the absolute number here, normally, that is actually so that we have somewhat lower costs than in the third quarter, especially considering that the Scandinavian people actually go on vacation, and there's typically a little lower activity. So it's nothing unusual to see that the margin peaks in the third quarter compared to the other quarters of the year. But having that said, yes, you see also an improvement then compared to the prior year. And talking about that improvement, it is so that it's primarily driven then by our U.S. businesses. And that is, as you mentioned, on the snus and nicotine pouches. But also then our moist snuff business, where the lower promotional levels actually has a significant impact on the average pricing and then on the gross profit. That, in combination with the fact that we actually have also some positive impacts on the cost of goods sold coming from some automation, and as well there's some successful procurement activities. You also see that on a year-to-date basis, there is a slight improvement in the volume for snus and moist snuff coming from such items.

**Alberto Lopez Rueda** - *JP Morgan Chase & Co, Research Division - Analyst*

If I can turn to cigars, if I look at -- given that the yearly -- year-on-year comparison sort have been distorted because of a lot of factors. If we look at sequential volume growth, shipment growth, it seems that total growth has moderated from a very strong point, it has moderated. So I was wondering how should we think about this category in Q4 and also going into 2018 in terms of growth?

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

You should think about it as we have a growth of 11% year-to-date. It is a growing category. But we are very pleased with our performance year-to-date. And then as you said, we were up against a strong comparison period. And it is typically more volatile than some of our other businesses, but then we operate in different segments, in HTL and natural leaf and so forth. And while there is sometimes there's quite a bit of volatility within the various segments, on the totality, it can look like a smooth line, so to say. But we think we have a very compelling product assortment for the U.S. market, and the competitive activity remains very high, I would say. But we will do our utmost to continue to try to outpace total category growth.

**Alberto Lopez Rueda** - *JP Morgan Chase & Co, Research Division - Analyst*

And just the last question, is there any impact on raw material prices for cigars because of all the weather events that we have seen over the last quarter?

**Marlene Forsell** - *Swedish Match AB (publ) - CFO and SVP of Group Finance*

Yes. When it comes to -- we have seen some slight compression of margins on our tobacco products during the course of the year here coming partly from some higher raw material costs. But when it comes to what we've mentioned, when we talk about weather-related, it has more to do with sort of production and some downtime in production due to the weather. We need to wait and see if there will be -- if the tobacco sort of crops will be affected. But that I'd come back to when having more information on that.



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**Operator**

The next one is from Gustav Sandström from SEB.

**Gustav Sandström** - SEB, Research Division - Research Analyst

If I can turn my question regarding Norway, what's your base case for how this market will develop if we assume that the plain packaging law indeed does go through in fall? Is your base case that the strong -- there will continue to be strong price discipline amongst the competitors? Or would you expect price to be more of a focus to attract new customers as other measures are limited?

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

If you look at the Norwegian market, it's an impressive story when you look at the past 10, 15 years. And with this rapid growth, the demographics of that market are very healthy where you have higher penetration of snus usage among young adults, and then it goes down, so to say, the older the bracket you're looking into gets. There is, of course, a limit to that type of mathematics, but it still looks very favorable going forward. And this year we're in I think the exact number is 5.1% as our year-to-date, and it's been hovering around 5% to 6% in the Nielsen periods. So it's still very solid growth in the Norwegian market. Will plain packaging be positive from a category point -- growth point of view? No, probably not. Will it be negative? It's actually hard to say, and I think it's too early to draw any conclusions. If you look at some of the other tobacco markets out there in the world where plain packaging has been implemented, it is hard to draw any conclusions that plain packaging legislation actually has affected consumption. When it comes to other potential implications on the market dynamics, that is also, in my opinion, too early to have a view on. We haven't at this point in time noted any particular behavior. It is a very competitive market in Norway as well in terms of new product initiatives and so forth. So it's not so much about price levels in Norway, but the competitive activity remains high. And we haven't seen any particular activity that we, so to say, relate to the plain packaging legislation. But that isn't to say that it couldn't happen in the future. We'll have to wait and see.

**Gustav Sandström** - SEB, Research Division - Research Analyst

Okay. And then one more question from me. Given the weather situation we've all seen on the news from some southern parts of the U.S. and Caribbean and so forth. Has this had any effect on your production volumes for the quarter? And if so, was this isolated to Q3? Or would we expect -- should we expect any implications going into Q4 for U.S.?

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

I think it's fair to say that we produced -- we could fulfill demand, but it had impact on certain days in terms of production. And that's why we had some extra costs, because we actually had to have some factory shutdowns. But I also -- and it's good to know that in terms of our loss prevention activities, that we had very little direct impact in our production. And all the routines, so to say, worked very well. But we did have to stop production both in Dominican Republic and in the south of the U.S., in Alabama, where we also have a cigar factory because of the -- when the hurricanes passed by.

**Marlene Forsell** - Swedish Match AB (publ) - CFO and SVP of Group Finance

But more so also due to the fact that people actually have problems coming in to work when these things happen.

**Gustav Sandström** - SEB, Research Division - Research Analyst

So basically you're feeling good about your inventory levels and so forth, the supply and demand for Q4, is that how we should interpret that?



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

Yes. I'd say we weathered out the weather well.

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**Operator**

(Operator Instructions) And the next one is from Karri Rinta.

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

Karri Rinta, Handelsbanken. A detailed question -- or detailed question about Norway. If you hadn't filed for this injunction against plain packaging, would you have been able to launch the Blizzard and Wire products in the sort of the non-plain packaging format? Or how does it actually work now during this transition period? That's my first question.

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

And the answer on your first question is, yes. And we have requested an injunction, but we haven't received the ruling on the injunction. So we launched these products into the market prior to the cutoff date. The answer to your second question is that, if we wanted to come with one additional variety now, then it would have to be in plain packaging unless we get the favorable ruling in our request for an injunction.

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

Okay. That's very clear. Then moving over to ZYN, you discussed increased velocity at your existing stores where you're selling ZYN. Can you give us a little bit more color on what exactly do you mean by that? And then I think you disclosed that your non-Scandinavian snus and nicotine pouch volumes were 3.5 million cans in a quarter, including V2. I assume that V2 has produced more, but did it have a sort of a noticeable impact on that 3.5 million volume? And then finally, this USD 40 million investment, when should we at the earliest expect that you can start producing? And a -- maybe a ballpark figure on what kind of volumes you will be able to produce in terms of ZYN once this investment is ready?

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

Starting with the V2 question, it is a small -- a very small addition. We report these volumes, snus and ZYN, outside Scandinavia. Actually, the majority of the sales in V2 are within other tobacco products and chew bags. So it's very small, you can hardly see it on that graph. And then when it comes to velocity for ZYN, it is clear that now we're well -- for most of our stores, we are well past initial launch and pipelining and so forth. And it's clear that ZYN in the Western regions and in these 8,000 stores where we are, has had a very strong appeal with consumers, and is turning at a fast rate. We have also managed to secure a good display in most of these stores, with very good visibility and so forth. So it's been a rapid growth in velocity per store, but then, of course, you also have to factor in that we're talking fewer stores than, for example, our store base of snus. And snus is also available basically in the entire United States. And this is concentrated to one region. And then the capacity, we count on the U.S. operations to be up and running in the beginning of 2019, give or take, and we are also ramping up capacity here in Sweden in the meantime. So we can play a little bit there. We don't need to rush in opening of the U.S. plant, also, as we are well covered in terms of capacity during this building phase.

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

Maybe just a follow-up. When will that Swedish capacity become available? Because if I look at the -- essentially the only online stores selling ZYN, as far as I know, they seem to be sold out for most of the ZYN SKUs. So when is that Swedish help coming, roughly?



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

No. We have -- we're gradually installing more and more capacity. And with the new products like that, it's not uncommon that it can be out-of-stock for some limited period of time. But you should soon be able to find your favorite product again online.

**Operator**

Your next question, it's from Chas Manso.

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

Yes, I have a number of questions. On Sweden, you talked about the e-commerce channel. Maybe you could give us a bit more color on that, the size of the channel in terms of the overall snus market in Sweden. What kind of growth in your penetration, your share? And whether that channel is more skewed to the premium end or to the value end?

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

It's not entirely easy to get a perfect estimate of the size of the channel. And the reason for that is that there are stores in Sweden that also operate online. We are -- we know certain clients that are more or less exclusively e-comm. And they have been doing very well growth-wise in the last -- this year, but I would actually say in the last 18 months or so. And we're talking impressive growth of not too far from doubling on a year-over-year basis. And if you take one example, there is actually one e-comm chain in Sweden now are an e-comm store, that if you compare it to the size of the organized chains in Sweden and go at least on what Nielsen indicates, it is the 6th largest chain in Sweden. And it looks like it will soon be #4 or even -- yes, #4. But I'd say my best estimate of the share of the total Swedish market on volume terms is between 8% and 9% of the total market. And it typically skews a little bit more value than price products than in the overall market. And as you would expect from e-comm, they typically offer a very wide assortment.

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

Interesting. And in terms of your share and your growth there?

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

Our share is we are a bit underrepresented in the e-comm channel. And again, since I can't get exact split of what's e-comm -- that we know for -- we have better data for some of the clients. We underrepresent a bit in market share compared to what you've seen in some. But we also have actually an improved share trajectory this year.

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

Moving on to moist snuff. You talk about promotional waves and all that, but this is now the second quarter of high single digit volume declines there. So maybe a little bit more color on really what's driving that negativity? You did say that you expected improvements from now on. And maybe you could explain why. And an update on sort of pouches and tubs.

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

Yes, I mean, if you look on the year-to-date basis, we have nice growth in pouches and tubs. But as you saw from that slide I commented on, we actually did not grow our pouches in the third quarter year-on-year. And that is very clearly related to promotional phasing, and we're relatively confident that you will see a different scenario in -- after Q4. But you're right in pointing out that even on a year-to-date basis, we are lagging the



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overall market growth. So we have lost some share in the U.S. moist snuff market. And we have then lost some meaningful volumes in the traditional loose segment, and we are gradually, so to say, improving our positioning in the market as we grow in pouches and tubs that we strategically think will improve our foundation for growth going forward. But it is still the fact that regular loose products dominate the market in the U.S. moist snuff market. But similar to Scandinavia, we see consistently that pouches outgrow the loose in terms of category growth. So we think that the prospects will become better over time, but we're not in a position where we manage to keep up with overall category growth.

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

Okay. And then on the mass cigars. Can you give us an update on -- because of the comps and all that, it's very difficult to get a kind of a trend of what's really going on there. So maybe you could just talk to us about what the mass market cigar category growth is trending at? And maybe also market share trends on the sellouts?

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

Yes. I think, Marlene will be looking up some more accurate data for you. And then -- you had several questions. I'll take the next question, meanwhile.

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

Well, there are 2 housekeeping ones. One, is there any update on the FDA discussions of the reduced risk application? And then the ZYN plant, will it be also be able to produce the snus for the U.S.?

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

At this point, the capacity we're installing is for ZYN. But I mean, this is a factory that will have ZYN and U.S. smokeless at some point in the future. It could well be that we take a decision to add snus, but that's not the case right now. When it comes to FDA and the MRTP, our consumer research with revised claims is well underway, but it's a complicated consumer research that stretches over some time in order to make sure we have the necessary statistical significance and so forth. But we're zooming in on which revised claims that we will amend our application with.

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**Marlene Forsell** - *Swedish Match AB (publ) - CFO and SVP of Group Finance*

Okay. And it's coming back to the question then on the market growth for cigars. First of all, I'd like to point out, I mean, the data that we have on market growth is not perfect. We have referenced before then that we use the CMPP data, which is the data then from distributors to retail, and it doesn't, of course, cover all the distributors. And as such this data, the market data that I'm referring to now, then may also differ then from our shipment data that may fluctuate more then between quarters. But if you look then at the category assessment for mass market cigars the way we classify it or define it, it has been up in the high single digits in the third quarter, and it's up around 10% in -- for year-to-date '17, and we have grown somewhat faster than that.

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**Operator**

Your next question is from Fulvio Cazzol.

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**Fulvio Cazzol** - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Just a few questions from me. On the capacity investments in the U.S., can you give us an idea of, in number of cans, what that would equate to, please?



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

No, that we keep to ourselves.

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**Fulvio Cazzol** - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Okay. then my second question is on the legal costs relating to the challenges that you've got going in Norway and the EU. Is this pretty much already in the base in Q3? Or could there be any meaningful changes in the coming quarters?

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

There can be changes in coming quarters. But we are on our own, the European side of the Atlantic here. So while still high legal fees from time-to-time, I wouldn't call them material. But they can show up as quarterly fluctuations in our corporate functions costs under our operations.

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**Fulvio Cazzol** - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Okay. And then the last one from me is on other operations. I noticed that the losses from other operations have been coming down in the last quarter. What should we expect for the run rate? I mean, is this the new norm now? Or was there some special factors that drove the lower loss?

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**Marlene Forsell** - *Swedish Match AB (publ) - CFO and SVP of Group Finance*

What I would say that the other operations, since it includes some various assumptions then that service the rest of the group, there are costs that are from time-to-time temporary in nature. But I think to some extent they're reoccurring temporary costs, so they may fluctuate between quarters. And this time and in this quarter, I would say that they are relatively low, and again, back a little bit to Sweden having vacation periods and so on. But most notably is that the prior year then was relatively high on costs coming from IT-related costs, but those other costs are temporary in nature.

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**Operator**

The next one is from Dan (inaudible)

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**Unidentified Analyst**

I had to get here at 7:00 Chicago time, guys. You're making it tough on me. I know it's still sensitive since you're still in the process with the FDA, but I wondered if you had any comments on the statement that was put out recently which seemed to be focused more on nicotine reduction rather than harm reduction, which received so much news. I wonder if you have any comments on that and what it means for Swedish Match? I know it's bit speculative at this point, but I'm asking anyway.

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

I would say that there was lot of commenting done by the FDA that was focused on harm reduction. Then maybe in the media and so forth and in the capital markets, the topic of potential nicotine -- restrictions on nicotine levels in cigarettes got the most attention because of the potential effects that that could have on the market. But the way I read it is that the FDA is very clearly standing behind harm reduction as a concept and reiterating the importance of containing of risk and definitely wants to impose regulations that help migrate away from more dangerous forms of nicotine consumption to less risky products. And I would say that if you go back where maybe the alternatives to migrate to, and I'm a bit speculative now, then maybe the FDA reasoned that it was more riskier to start to talk about nicotine reduction because where should consumers should go.

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But now where they see and they encourage innovation for alternatives, then there is not necessarily any contradiction between reducing nicotine levels as long as consumer find alternatives.

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**Operator**

(Operator Instructions). And Adam Spielman wishes to ask a question again.

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

Two brief questions. The first one, is there any correlation, or what is the correlation, between the use of your cigars, sales of your cigars, and those states where cannabis is legalized? In other words, I have heard people argue that somehow the growth of cannabis in states like Colorado is helpful for cigars? And I was wondering whether there was any evidence really to support that speculation.

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

I honestly don't know. I don't have the, on top of my mind, development state-by-state for the cigar business.

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

Fair enough. And then just a rather detailed question on the chew business. I was under the impression that, actually, mix had been helped by less co-pack this quarter. I guess, in the presentation, I think Marlene said that mix had been negative because of a greater use of value in the chew segment. And I was just wondering if you could talk a little bit about that and give it a bit more color.

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

Yes, I mean, we have seen the value segment growing as a share of the U.S. chew market for some time. I wouldn't say that there is -- as a share of the total market, I wouldn't say that it's dramatic in development. But what we have seen is that the price competition within the value segment has become more fierce. And we have decided to defend our position within that segment a bit more aggressively this year compared to the prior year. And so our negative price mix within chewing tobacco stems from, you can say, normal -- a little bit of a normal shift between the value and the premium segments, but then within the value segment, we have a, clearly a negative price mix in development this year.

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**Operator**

And there are no further questions at this time. Please continue.

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

Then I thank you all for listening today. And I'd like to inform you that the release of our full year report will be on February 14, 2018. Thank you very much.

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**Operator**

Thank you. That does it for the conference for today. You may all disconnect. Thank you all for participating.

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