SCANDINAVIAN TOBACCO GROUP

26 April 2017

# Report of the Board of Directors Presented at the 2017 Annual General Meeting

*Chairman Mr. Jørgen Tandrup:*

This is my last report to you as chairman of Scandinavian Tobacco Group and I am pleased to report to you: Our company is in good shape.

Scandinavian Tobacco Group is a world leading producer of cigars and pipe tobacco. It is a diversified business with activities across multiple geographies, tobacco categories and brands. Furthermore, it is a business with a strong base for organic growth and for acquiring peers.

Scandinavian Tobacco Group is mostly active in the part of the tobacco market where craftsmanship and smoking pleasure come first. Our focus is on creating a good smoking experience for adult consumers who make an active choice to smoke our products. Many of our consumers have a deep passion for our products, especially when it comes to our handmade cigars and our pipe tobacco. They take an interest in where the tobacco is grown, how it is fermented and stored, and how it is blended.

At one and the same time, Scandinavian Tobacco Group is a business with the benefit of an old man's wisdom and a young man's vigour and vitality. Our company's roots date back 250 years, but we've been a global leader in cigars and pipe tobacco for less than ten years. Over the past few years, the management of our company has undergone considerable change, both in the Executive Management and on the Board of Directors. In addition, our company was listed on Nasdaq Copenhagen just 14 months ago.

In our first year as a listed company, we delivered solid financial results. Revenue totalled DKK 6,746 million, a 0.2% improvement on 2015. The underlying business grew by 0.4%, net of currency fluctuations. The like-for-like EBITDA margin was up by 0.9 percentage point to 21.4%, whereas our net profit was DKK 681 million, an increase of 1.9% on 2015. In addition, we delivered strong free cash flows. In other words, we met the overall guidance we provided to the market in November 2016. Our CEO, Niels Frederiksen, will review and explain the company's financial highlights a little later.

The equity market has responded to our performance by trading our shares up by approx. 25% since we were listed on 10 February 2016. In addition, we paid dividends of DKK 5 per share in 2016. The Board proposes to increase the dividend this year by 10% to DKK 5.50 per share.

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Today, our ownership structure is more diversified than ever before. We have welcomed new owners. The original owners from the pre-IPO period are represented today by way of the 33.1% ownership interest of the Augustinus Foundation and the Obel Family Foundation through Skandinavisk Holding and the 9.1% interest held by Swedish Match. Geographically, our owners are based predominantly in the United States, Great Britain and Denmark.

On the whole, we are satisfied with our performance.

LET ME BRIEFLY REVIEW OUR PERFORMANCE IN OUR DIFFERENT CATEGORIES before we move on to a presentation of our strategy and of what we do to create value for our shareholders.

Let's begin with our *handmade cigars*. Our core market is the United States, where two of every three handmade cigars in the world are consumed. We have a presence through two companies and we are the market leader:

One of them, General Cigar, develops and produces branded cigars sold through retailers. Some of the most well-known brands are Macanudo and CAO as well as Cohiba, Partagas and several other brands of Cuban origin which we hold the rights to in the United States.

The other business, Cigars International, is an online retailer selling direct to consumers and through catalogue retailing. Online and catalogue sales are big business in the United States. General Cigar and Cigars International both have leading positions in their respective segments of the US market. They each have market shares of close to one-third of the segments they are active in, and both are reporting growing sales to retailers and consumers, respectively.

The handmade cigars category in the United States is making excellent progress for Scandinavian Tobacco Group. The overall market, by which we mean total consumption of handmade cigars, is relatively flat, but underlying the stable development of the overall market is a dynamic force that is redirecting an ever growing share of sales from brick and mortar to online retail. We have successfully exploited the resulting benefits to generate growth in our consolidated business, but more about that later.

In the *machine-made cigars* category, our core business is in Europe, where market developments are very similar to what we are seeing in other parts of the tobacco market. The overall European market for machine-made cigars declined by 3-5% in volume in 2016. We are the market leader in the machine-made cigars category in Europe.

In the *pipe tobacco* category, the market for traditional pipe tobacco is also declining, but in some markets pipe tobacco is to some extent used for rolling cigarettes. That is a practice supporting the overall markets, for example in the United States and a few other geographies. We are the global market leader in the market for traditional pipe tobacco.

We are also doing quite well in our active markets in the *fine-cut tobacco* category. We are the market leader in the United States and Denmark and have significant positions in Norway, Israel and Switzerland. Germany is one of the largest markets for fine-cut tobacco. In the German market, we have built a market share of a few percent over the past few years.

To sum up briefly: We have a presence in tobacco categories with relatively stable consumption and in categories with declining markets. Each category has its own scope and challenges. We are working diligently to deliver on the opportunities available in each category. Overall, we have a strong, balanced business. And we have opportunities to make the business even stronger.

FOR YOU AS A SHAREHOLDER, IT IS OBVIOUSLY IMPORTANT that the company is working to create value for its owners. Our model for doing that is quite simple and can be briefly explained: Moderate growth, increasing earnings and strong cash flows. We must also successfully contribute to industry consolidation by making value-adding acquisitions.

Our efforts to achieve moderate organic growth are currently spearheaded by our handmade cigars category, but our objective is to generate stable or growing sales in all tobacco categories.

We consistently work to optimise our business. We currently have major initiatives underway in our machine-made cigars category, but our focus on costs applies to our entire business.

Lastly, we apply capital discipline, especially in terms of reducing our inventories. Our focus is to generate strong cash flows from our day-to-day business and to ensure optimal capital application.

At Scandinavian Tobacco Group, our vision is to become the undisputed global leader in cigars and pipe tobacco. We have designed our strategy to support that goal, and I will now give you a current status on the initiatives launched in 2016.

VERY BRIEFLY, OUR STRATEGY IS to win market share, globalise our business further and become ever more efficient, the entire process being driven by competent and curious people with the motivation to achieve extraordinary results.

Let me start with our employees.

We have a strong organisation and a strong corporate culture. We have successfully recruited competent employees for our company, and we have a large group of people with many years of experience from the tobacco industry. But... our company is the result of mergers and acquisitions, and that means we also have many different cultures in our organisation and several different ways of running our business.

We have a big challenge ahead of us over the next few years, as we strive to achieve our vision to become the undisputed leader in cigars and pipe tobacco. That will place considerable demands on our organisation and to that end we are currently investing to create a winning mindset among our employees, build stronger HR capabilities, create global centres of excellence and achieve ambitious targets across our organisation.

In November 2016, we announced new initiatives to improve our operating model. These new initiatives will create a more streamlined and cohesive organisation enabling us to plan and execute better and faster throughout the entire process from buying tobacco to delivering finished cigars to our customers and end-users. By pooling our expertise in a number of disciplines, we now have group-wide global procurement functions, we have centralised our sales excellence initiatives and are working diligently to get the most out of our company's talent base and capabilities. In other words, we are investing to build a more cohesive organisation.

We've had good results from investing in optimisation and efficiency enhancements.

In 2015, we launched an ambitious programme to optimise our costs and become more efficient. We call it the 140/500 programme. The name refers to DKK 140 million in cost cuts and DKK 500 million in inventory reductions on a like-for-like basis relative to 2014. We have now implemented the initiatives and expect to complete the 140/500 programme in 2017, a year ahead of schedule.

Through the programme, we have simplified our production by considerably reducing the number of SKUs (Stock Keeping Units) in our product portfolio. Combined with new production lines, this means we can produce our products more efficiently. Lastly, we have adapted our network of factories and soon operate 12 instead of 14 sites.

Let me briefly touch on this last matter. Regrettably, but as previously announced, we will have to shut down our cigar factories in Wuustwezel, Belgium, and in Nykøbing Falster, Denmark, later this year. I would like to take this opportunity to thank our employees at the two sites for their strong commitment and loyal effort, many of them over a period of many years.

I'm afraid the decision to shut down the sites was necessary. Given the developments in the overall market for machine-made cigars, we are compelled to align our production capacity with our current needs in order to improve our competitive strength. That applies to our business in general, but to the machine-made cigars category in particular.

Optimisation and efficiency-improvement programmes such as the 140/500 programme have made us a more profitable business and they have turned us into a stronger business. Such initiatives are a prerequisite if we are to have the strength to leverage the opportunities we have for growth in all of our categories.

Let me explain how we operate in our two cigar categories:

As previously mentioned, the overall market for handmade cigars is stable, while the market for machine-made cigars is declining. Yet, our principal task is the same in both categories.

We must use our existing portfolio and new, innovative products to win market share. We must exercise discipline when it comes to implementing price increases, and we must work to consistently enhance the efficiency of our operations.

A large part of our 140/500 optimisation and efficiency-enhancement programme was applied in the machine-made cigars category. This is where we have taken the most aggressive steps in rationalising our portfolio, closing factory sites and relentlessly implementing LEAN and other measures. These initiatives have served us well and we are thankful to a big group of employees who put in such a great effort during the many changes. The overall markets for machine-made cigars were negative in 2016, but we managed to increase our underlying gross margin for the category by almost half a percentage point to 52.6%.

We failed to adequately grow our market share of the machine-made cigars category in 2016 and doing that will be our main priority in 2017.

Innovation is key to achieving that goal. We are investing in attracting more cigarette smokers to the cigar category. We work to develop products with appealing and, in many cases, milder tastes than traditional cigars and of a size designed to appeal to today's consumers who often have less time to smoke; products that stand out from products already on the market and that provide consumers with the enjoyment they seek from smoking.

One example is our most recent product, Granger, which was launched in Germany and several other markets this spring. This is a mild cigar with a dark Maduro binder. Granger is an example of the type of product we hope will eventually convert more cigarette smokers to the cigar category.

In the handmade cigars category, 2016 was our first year of running General Cigar and Cigars International under a single management. This move has had the intended effect, resulting in higher sales for both companies and growing collaboration between the two. General Cigar continues to skilfully nurture its brands and to work on sales and production in the Dominican Republic, Honduras and Nicaragua.

Cigars International continues to win market share in a growing market. Customer traffic in the online and catalogue retail businesses continues to grow month by month and average order sizes are increasing.

In January, the rest of our North American activities, i.e. the sales organisation STG Canada and STG Lane, our producer of fine-cut tobacco and pipe tobacco in the United States, came under the management that also runs our handmade cigars business. As a result, we now have one single North American business. The change has created a better platform for continued growth and greater efficiency.

ON THE BOARD IN 2016, WE REGULARLY DISCUSSED our company's strategic initiatives, which I have just reviewed, as well as our financial performance. In addition, we continued to comply with the corporate governance recommendations, as described in our Annual Report and in our statutory corporate governance report posted on our website, which sets out compliance with and explains any deviations from the recommendations.

We welcomed several new faces to the Board in connection with the IPO of Scandinavian Tobacco Group. The candidates proposed at today's general meeting have considerable international experience, experience from the tobacco industry and from related industries, experience from our core markets in both Europe and the United States and extensive financial experience from major international companies.

Mr Henrik Brandt is being proposed as a new candidate to the Board. He brings management experience from listed international companies in the fast-moving consumer goods category, and he also has a background in tobacco as former CEO of House of Prince.

I warmly recommend all candidates standing for the Board today.

Naturally, we have also discussed management remuneration in the past year. Our objective on the Board is to align management's remuneration with our goals for value creation in the company. For that purpose, the total remuneration package consists of a fixed basic salary, and both short-term and long-term incentive programmes. The aggregate remuneration of the entire registered five-person management team amounted to DKK 29.5 million and consisted of salary, bonus and pension components.

In addition, our costs have included stay-on bonuses, IPO-related share option programmes and bonus, as appears from the company's Annual Report. The remuneration of the Executive Management is consistent with the company's remuneration policy and the Board considers it appropriate.

Let me finish my report by raising an issue that was not submitted for today's meeting, but which could reasonably be discussed:

Supported not least by its significant inventory reductions, Scandinavian Tobacco Group generated very strong free cash flows in 2016. As a result, the Group has successfully reduced its debt by a significant margin. At 31 December 2016, the Group had a debt to adjusted EBITDA of 1.7.

According to our financial policy, our target is a debt to adjusted EBITDA of about 2.5. In other words, we will still have significant cash holdings even after paying ordinary dividend of DKK 5.50 per share. The Board will continue to evaluate distribution of possible excess cash in relation to the third quarter announcement. If it becomes relevant it could take the form of either a share buyback or an extraordinary dividend.

RUNNING A TOBACCO BUSINESS has always been demanding, and the mounting regulations have not made it any easier. Nevertheless, I have thoroughly enjoyed each of the 42 years I have spent in and around this business, and I'm pleased to have been a part of the fantastic journey which first Skandinavisk Tobakskompagni and since Scandinavian Tobacco Group have been on during my time.

I am grateful for the trust the shareholders and the Board have shown me while I have served as chairman. I would like to thank our employees, our management, current and former board members, business partners and colleagues in the industry for the many hours, days, weeks and years we've spent together. I'm honoured to have had the privilege of working with such highly competent, but also extremely loyal and committed people while I've been onboard with Scandinavian Tobacco Group.

There have been no 'quiet' years during my time, but few have been as eventful as these last couple of years.

Today, we have a strong business, a strong strategy and a strong management. We deliver good products that are highly appealing to consumers. We deliver moments of great enjoyment to smokers, and that is why I can say with great confidence: Our company is in good shape.

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*CEO Mr. Niels Frederiksen:*

2016 was yet another year of considerable change. However, the many tasks we were faced with have been addressed and solved with great commitment and enthusiasm. It gives me great pleasure to look back on a year in which we achieved good results despite the implementation of EU tobacco regulations and the FDA's new tobacco regulations in the United States. And I'm pleased to be able to present the best financial results in the history of Scandinavian Tobacco Group for the second straight year.

While the year turned out differently and more difficult than we had expected going into it, we largely managed to deliver on our guidance and, more importantly, we maintained the pace of change to our company that will make us a stronger and better business.

GOING INTO 2016, we expected to grow our revenue at a moderate 1-3%, to increase EBITDA by 3-5%, and to reduce our inventories by around DKK 250 million relative to 31 December 2014. We also anticipated capital expenditure of around DKK 250 million. As I said before, we have largely delivered on our guidance.

- The organic growth rate was 0.4% in 2016 compared with 0.3% in 2015. Our revenue ended the year at DKK 6,746 million. That fell slightly short of our expectations, and I will touch on the reasons for that in a moment.
- Our EBITDA grew organically by 4.0%, lifting our EBITDA margin from 20.5% to 21.4%.
- While already high in 2015, our free cash flows climbed by 7.8% to DKK 1,139 million. The improvement was driven in particular by the DKK 261 million reduction of our inventories. Relative to 31 December 2014, we have now reduced our inventories by a total of DKK 486 million. Well ahead of plan.
- The sum of our capital expenditure amounted to DKK 235 million.

Our *revenue* performance conceals a number of underlying movements. Relative to the previous year, revenue grew considerably in the handmade cigars and fine-cut tobacco categories, but fell in the machine-made cigars and pipe tobacco categories.

Our handmade cigars business has been growing for consecutive years: in 2016 by no less than 7.2% organically. In 2016, handmade cigars accounted for 31% of our revenue. Our gross margins were consistent with the year before at 43.7%. This is a good performance, because the gross margins in our faster-growing online business are lower than the margins in the part of our business that sells our strong brands, such as Macanudo, CAO and Cohiba.

On the other hand, our organic revenue from machine-made cigars fell by 3.9% relative to 2015, due to the combination of the market volatility caused by the EU Tobacco Products Directive and unsatisfactory developments in a number of our core markets. However, a number of other core markets performed really well, and we also managed to lift our gross margins through our ongoing efficiency improvements. The adjusted gross margin was up by 0.4 of a percentage point to 52.6%.

Factors such as weaker sales to Nigeria and the Middle East impacted our pipe tobacco sales in 2016, and our revenue in the category fell by 8.9%. On the other hand, I am pleased to note that we improved the gross margin by 0.9 of a percentage point to 61.2%.

The fine-cut tobacco category had a good year with 13.3% organic growth and an adjusted gross margin of 58.3%. The increase was driven by our pricing management, a favourable geographical mix in 2016 and growing sales in Germany where we continue to win market share.

In other words, our business improved in two categories and declined in two. Overall, we achieved 0.4% organic revenue growth. I believe that confirms the chairman's message from a little while ago that we have a diversified and generally quite stable business.

Moving on, our 2016 gross profit amounted to DKK 3,225 million, which was 0.4% less than in 2015. If we adjust for the non-recurring costs of implementing new EU regulations and the currently ongoing reduction from 14 to 12 production sites, we raised our gross margin by 0.4 of a percentage point to 49.1%.

Our EBITDA improved by 2.5% to DKK 1,279 million. Adjusted for non-recurring items and currency, EBITDA was up by 4%, i.e. at the mid-range of our guidance of a 3-5% increase in adjusted EBITDA.

The net profit after tax was up by 2.2% to DKK 681 million. This is another best-ever performance since Scandinavian Tobacco Group was formed in 2010.

Cash flows from operations were up by DKK 73 million to DKK 1,358 million. Net of investing activities, our free cash flow amounted to DKK 1,139 million, a 7.8% improvement on 2015.

At the end of 2016, we had equity of DKK 9,272 million.

AS I MENTIONED EARLIER, our revenue expectations going into 2016 proved to be a little higher than what we actually achieved. We had guided for 1-3% revenue growth, but as it became clear that we would fail to meet that target, we guided for flat revenue growth in November.

The reason was changing dynamics, especially in the European market for machine-made cigars. The EU countries had committed to implementing the new Tobacco Products Directive in their national legislation by 20 May 2016. Many of them failed to do so. In fact, almost half of the EU member states, including Denmark, had not implemented the directive a week before it were to take effect. Three countries still have not implemented the directive. From an industry perspective, this is completely unacceptable.

It is still too early to determine, whether the new directive will change tobacco consumption to any significant extent. However, the resulting legislation will impose costs and extra work on the companies in the industry. Being the largest player in our markets, we believe we are best positioned to address such challenges. However, it doesn't mean that we won't be affected by the volatility and short-sighted changes occurring in the market. The extremely late implementation of the EU directive had a greater disruptive impact on supplies and market dynamics during most of 2016 than we had expected.

As market conditions normalise, we will be better able to determine the short and long-term effects on the various markets. However, we are still seeing aftershocks in the overall market and will most likely not have a clear picture until in the second half of 2017.

So, have we heard the last of the EU's new Tobacco Products Directive? Hardly. We believe that most of the necessary investments are now behind us, but the EU Tobacco Products Directive constitutes the very foundation of market regulation for the current 28 EU member states. It sets out the framework within which each country can implement its own initiatives.

Take France, for example. The French authorities have informed us that our Café Crème brand name cannot be used after February 2018, because the brand allegedly makes reference to how the cigars taste, which is not permitted. We strongly disagree! Café Crème cigars do not taste of coffee, and we have obviously appealed the decision to the French courts. As a consequence of this matter, we may be forced to rename the Café Crème brand in the French market.

IN THE UNITED STATES, THE FDA ANNOUNCED, unsurprisingly, new regulations governing cigars and pipe tobacco in May 2016. In fact, the new regulations had been long awaited. This is another case of legislation that will hardly change general consumption patterns, but instead will impose new costs on us. Our task is to pass on these costs to end-users without losing them as consumers of cigars.

By introducing these regulations, the FDA is markedly reducing the scope of any launch of new cigar or pipe tobacco products in the US market. Over time, this will change the dynamics of a market where the question consumers most frequently ask their cigar vendor is: "What is your newest item?" We believe we are well positioned in this market. General Cigar is the largest and one of the oldest cigar companies in the United States. We have a large back catalogue of products that we can continue to market and which consumers will continue to perceive as new items.

I'm not saying this to give you the impression that the new FDA regulations will not affect us. They will, and they will impose extra costs on us. However, we believe that our market-leading position makes us strongly positioned in the US market.

An interesting side effect of the new regulations in the United States is that they reduce the prospects of Cuban cigars gaining access to the US market. The FDA regulations ban the sale of cigars that were not on the market in February 2007, or are not largely identical to products that were. Cuban cigars have been banned from the US market for more than 50 years. This means the FDA has created a barrier that will make it very difficult and very costly to have Cuban cigars approved for the US market. Can all this change at a later point? Perhaps. We believe that under the current US President, Cuban-American relations now rank lower on the agenda than they did under his predecessor.

OBVIOUSLY, LEGISLATION HAS A SIGNIFICANT IMPACT ON OUR MARKETS, but end-user smoking preferences, smoking habits and our ability to run our company efficiently are more important.

We will persist in our efforts to launch new cigar and pipe tobacco products demanded by end-users. One of our most important tasks is to develop products that will convert cigarette smokers to cigars or pipe tobacco. Over the past few years, new regulations have taken up much of our time. We can now again focus entirely on developing new, innovative products and concepts. which we obviously prefer to do.

We have also been – and still are – entirely focused on optimising and making our company more efficient. The chairman reviewed the progress we've made in the 140/500 programme that will reduce our costs by DKK 140 million and our inventories by DKK 500 million.

This is an important project, not only because it will turn us into a more profitable business, but also because it will make us a better business.

We will continue to implement our optimisation and efficiency programme.

2016 TURNED OUT DIFFERENTLY than we had expected at the start of the year. New regulations were a major factor in the changes occurring to market dynamics during the year. We will continue to feel the aftershocks of those changes in 2017.

We expect our machine-made cigars business will continue to be affected by the overall market changes resulting from the new EU regulations. In addition, there have been challenges in connection with the implementation of a new IT platform for Cigars International. The previous IT systems in this part of our business were quite old. Cigars International has grown rapidly and strongly. As we still have high ambitions for the business, it was necessary to replace the IT systems, even though such projects are rarely executed without a glitch. Unfortunately, we had multiple problems in relation to sales, invoicing and customer service. We are working to resolve them and are now seeing light at the end of the tunnel.

So, what can we expect from 2017?

We have a stable and diversified business. Despite the challenges posed by the implementation of a new IT system in Cigars International and the new EU tobacco legislation, we expect flat organic revenue growth and 1-3% organic EBITDA growth, and we expect our cash flows to remain strong. However, as previously announced we will see a first quarter of 2017 that will come out negative compared to 2016.