10 April 2019

Chairman's report - 2019 Annual General Meeting

Scandinavian Tobacco Group's Annual General Meeting is a special occasion for me and I am pleased to be reporting for the second time as Chairman of the Board. I have been looking forward to be presenting the Board's report for the past financial year - and especially so as I will be reporting on good results and solid progress on our strategy.

Scandinavian Tobacco Group has been a global leader in cigars and pipe tobacco for less than ten years and our vision is to become the undisputed, global leader in cigars and pipe tobacco. In 2018, we took significant steps towards achieving our vision as we continued the modernisation and development of our Group while seeing good progress on our strategy and delivering on our financial guidance for the year.

LET ME START OFF BY REVIEWING THE FINANCIAL HIGHLIGHTS FOR THE PAST YEAR. For the full year 2018, Scandinavian Tobacco Group delivered net sales of DKK 6,718 million and EBITDA before special items of DKK 1,304 million. This is 0.4% organic growth in net sales and 3.5% organic growth in EBITDA - and is in accordance with the financial guidance for the year. Net profit was DKK 666 million while free cash flow before acquisitions was DKK 668 million.

The Board of Directors proposes dividend of DKK 6.00 per share, an increase of 4.3% compared to 2017 and an increase in the ordinary dividend for the third consecutive year. The DKK 6.00 per share means a dividend for 2018 of DKK 600 million.
This is testament to the strong underlying business and strong cash flow in Scandinavian Tobacco Group.

NOW, LET'S TURN TO OUR PERFORMANCE IN OUR FIVE CATEGORIES

LET'S BEGIN with our *handmade cigars.* The handmade category continues to be our main growth driver and in 2018 we saw organic net sales growth of 5.6% while our gross margin was 41.4% equal to that in 2017. It is now our largest category and accounts for 35% of our net sales equalling DKK 2,376 million. With the exception of 2017, the handmade category has delivered positive organic growth in net sales every year since 2010.

Our core market in the category is the US, where two of every three handmade cigars in the world are consumed. Total consumption of handmade cigars in the US is relatively flat with slightly more than 300 million cigars sold annually.
We have market leading positions in the handmade cigars category in the US and in 2018 we strengthened across the value chain by growing our branded business, expanding our brick and mortar retail network and acquiring the online retailer Thompson Cigar.

Our branded business is anchored in General Cigar, which develops and produces branded cigars sold through retailers. General Cigar had a record good year based on a series of successful product launches, for example Cohiba Spectre and the launch of the first flavoured Macanudo cigar, M by Macanudo.

Cigars International is our online retailer which also sells direct to consumers through catalogues and brick and mortar stores. For 2018, Cigars International showed good organic growth and expanded our retailing brick and mortar platform with a new cigar superstore in The Colony, Texas. The superstore opened in September 2018 and the first six months in business are encouraging. We plan to open a second superstore in Fort Worth, Texas in the course of 2019 and plan to add two further locations in Florida.

In 2018, we also closed the acquisition of Thompson Cigar, the third largest online retailer of cigars in the US. Online retail has been the fastest growing channel in cigar sales in the US for the past many years and Thompson Cigar is a great addition to our existing US business. We are a year into the integration of Thompson Cigar and I am pleased to see that we are making good progress as the acquisition earlier than expected has contributed with organic net sales growth and positive EBITDA. Full integration of Thompson Cigar is still expected to happen in 2019.

In the *machine-made cigars* category, our core business is in Europe where we are a strong player. Our net sales in machine-made cigars were DKK 2,367 million with organic growth of -3.4% and a gross margin of 51.4% - up half a percentage point from last year.

Total market volume development in the machine-made cigars category is currently estimated to be negative by 3-5% per year across the markets where we operate and we had a disappointing 2018 for the category primarily due to market development in France, our largest market. In an intensified competitive market following substantial excise tax increases, we lost market shares in France as consumers traded down resulting in a growing value-for-money segment at the expense of premium and mainstream machine-made cigars which traditionally are our strongest segments.

In hindsight, we must admit that we did not react fast enough and with appropriate determination to the market changes in France. We have since strengthened our value-for-money portfolio as well as our pricing and go-to-market strategy in France. We intend to defend our leading position and expect to be able to improve our position in France going forward.

In other key machine-made cigars markets like the UK, Belgium, Spain and Canada we grew our market share during the year and excluding France, the machine-made cigars category delivered positive organic growth in net sales.

In the *pipe tobacco* category, we for 2018 recorded net sales of DKK 478 million; an organic decline of -6.7% compared to 2017. Our gross margin was stable at 59.5% compared to 59.9% last year.

During the year, we acquired the premium brand portfolio of Peterson Pipe Tobacco, a small Irish pipe tobacco business with brands like Sherlock Holmes, Old Dublin and Connoisseur's Choice. This strengthened our position in the premium pipe tobacco segment which has been growing in recent years and increased our presence in important pipe tobacco markets like Germany, the UK, the US and Asia.

In the *fine-cut tobacco* category, the overall trend of declining consumer demand continued and we saw stronger volume declines compared with previous years in Norway, a key market. So, while our total volume development in the fine-cut tobacco category improved compared to last year it remained negative in 2018 with net sales of DKK 562 million with of -2.4% organic decline in net sales and a gross margin of 59.1% compared to 60.9% in 2017. Despite the headwinds, we improved our market leading positions in the US, Denmark and Israel.

The Accessories and Contract Manufacturing (ACM) category, previously called Other, delivered good financial performance in 2018 with net sales of DKK 935 million, organic growth in net sales of 3.5% and a gross margin of 41.1% compared to 37.6% in 2017.

The ACM category comprises several activities and the 2018-results were driven by a successful expansion of contract manufacturing of tobacco products, sales of tobacco accessories and fire products as well as a strong performance of chewing tobacco in Slovenia and Croatia. The ACM is now our third largest category as it is approaching DKK 1 billion in net sales - and we expect the category to deliver positive organic growth going forward.

To briefly sum up our categories, we have a presence in tobacco categories with relatively stable consumption, in declining categories and in growing categories. Each category has its own scope and challenges and 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 this is quite simple and can be briefly explained: Moderate to stable growth in net sales, increasing earnings and strong cash flows. We also wish to successfully contribute to industry consolidation by making value-adding acquisitions as we have done continuously since 2008.

We operate in attractive niche segments of the global tobacco industry and our efforts to achieve moderate to stable organic growth are currently spearheaded by our handmade cigars category and the ACM category, but our objective is to generate stable or growing sales in all tobacco categories.

We consistently work to modernise and optimise our business and develop new efficient ways of working. It is an integrated part of how we run our business. So is 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 allocation.

IN 2018, WE LAUNCHED FUELLING THE GROWTH and took a significant step in the development of our company and towards increasing shareholder value.

Fuelling the Growth is a groupwide transformational program which will make Scandinavian Tobacco Group a stronger and more competitive company better equipped to achieve our vision of becoming the undisputed global leader in cigars and pipe tobacco.
It represents an acceleration of the on-going modernisation of our company and is intended to increase shareholder value by raising earnings capabilities, driving efficiencies and stimulating market share growth.

Fuelling the Growth constitutes a comprehensive change to how we are organised and how we work – and consists of five overall work streams. 1) Our organisation, 2) Our commercial efforts 3) Our global logistics set-up, 4) global procurement 5) improved operational cost efficiency.

LET ME elaborate on some of the initiatives within each of the five work streams.

On the **organisational** front we have developed a more simple and agile organisation with an efficient operating model and new ways of working that will enable us to win in the marketplace by improving the execution of our strategic agenda and drive internal collaboration. In doing so, we have reduced organisational layers from 10 to 7 and increased team sizes to become more agile and adaptable. As part of this restructuring, unfortunately approximately 100-120 white collar positions across the organisation was made redundant to ensure that we have the right organisation in place to support our long-term ambitions.

To get closer to consumers in the local markets **we have established four new focused commercial organisations**: A Machine-made cigar division, a Smoking Tobacco division, a North America Branded Business Division and North America Online & Retail Division. The head of each of these divisions now have a seat in the Executive Board, the management team responsible for the day-to-day operations of the company. This increases our capability of coping with rapidly changing market conditions and increasing consumer demands.

We want to simplify our global **logistics network** as this represents a significant cost and productivity opportunity. This includes a streamlining of the production allocation across our factories as well as a reduction of excess inventory and distribution cost.

We are in the process of establishing a global **Procurement** organisation with standard rules, processes and policies. The new organisation will be tasked with increasing spend transparency and deliver cost savings based on the around DKK 4 billion worth of goods and services that we as a company purchase yearly.

The complexity in our operational set-up is high and we are looking to **increase operational cost efficiency** through complexity reduction. To this end we accelerate our lean effort, introduce new technologies, optimize our production allocation and reduce complexity in blends, formats and packaging. This includes an SKU-rationalisation, i.e. a reduction in the number of products and product variations we sell, as well as an improvement in our capacity utilization.

Fuelling the Growth is estimated to deliver net savings of approximately DKK 250 million from the end of 2021 and combined the five work streams will – as they are rolled out in the next couple of years – increase the competitiveness of Scandinavian Tobacco Group and make us more cost efficient and better equipped to execute on our strategic priorities.

WHILE FUELLING THE GROWTH IS CHANGING THE WAY WE ARE ORGANISED AND THE WAY WE WORK, our strategy and strategic objectives remain the same – and in 2018, we saw significant progress in all areas of our strategy.

Our strategy is built on a simple framework with four business priorities and six must win battles. The four business priorities outline the strategic focus for decisions; and the six must win battles represent our key priorities and dictate the prioritisation of time and resources.

Our four business priorities are:
To **outperform** the market and win market share,
To **globalise** our business further
To **simplify** by improving efficiency and doing more with less
And all should be driven by competent and engaged people **empowered** to achieve extraordinary results.

Our six must win battles are:
Win in machine-made cigars
Accelerate North America
Drive M&A
Lead performance to the next level
Enable a winning organisation
Raise IT capabilities

Let me walk you through the progress we have seen in 2018 within each of our six must win battles.

I'll start with **win in machine-made cigars** where we aim to increase market share and optimise and manage prices effectively. As I have mentioned earlier, we have in France started the implementation of a turn-around that will allow us to defend our leading position and we had market share growth in the UK, Belgium, Spain and Canada.

To allow us to **accelerate growth and improve efficiency across our business in North America**, we strengthened our platform in North America on all parameters. We re-organised our business into two new commercial divisions that will bring us closer to our consumers and increase our agility in the market. Also, our announced brick and mortal retail expansion in the US materialised in the opening of a cigar superstore in Texas, General Cigar had a record year and our online business grew.

During the year, we also **executed on our M&A strategy to strengthen our position**. We closed two acquisitions: of Thompson Cigar and Peterson Pipe tobacco. Thompson enhances our position in the online channel in the US and Peterson is an interesting bolt-on acquisition to our premium pipe tobacco category. M&A remains an integrated part of our strategy and in 2018 we further developed and matured our M&A pipeline.

To **take our performance to the next level**, we have launched several initiatives to develop leaner, faster and more agile operations. We have accelerated our Lean efforts across our production facilities to create more value for our customers with fewer resources. We have also optimised our European logistics set-up and launched a pilot project on new technologies in production.

We have over several years invested in stronger HR capabilities to **enable a winning organisation** and as part of Fuelling the Growth we have invested in a new organisational structure and a new operating model to increase performance, rolled-out a global performance

management process to foster accountability and established a global strategic procurement, to increase spend transparency.
Finally, we have made solid progress on our IT agenda. In order to **raise IT capabilities** and bring IT to the next level to fully support the business we have during the year launched two significant IT systems: First, a new global HR IT system that will provide us valuable insights and data on our people and organisation ,and secondly, a new CRM system that will increase the efficiency of our sales representatives

To sum up, we have in 2018 made significant progress within each of our six must win battles and given ourselves every chance to deliver good results in 2019.

THIS BRINGS ME TO THE COMPOSITION OF THE BOARD OF DIRECTORS. Today, Søren Bjerre-Nielsen resigns from the Board of Directors after joining in 2016. As Board member and as Chairman of the Audit Committee he has contributed significantly to the continued professionalisation of the Group and to the collaboration between the Board of Directors and the Executive Management. I would like to use the opportunity to thank Søren Bjerre-Nielsen for his hard work and contribution to the Group.

We are also parting ways with Kurt Asmussen, employee representative on the Board of Directors since 2011. I would like to thank Kurt Asmussen for his years on the Board representing the employees of Scandinavian Tobacco Group.

The Board of Directors proposes election of Marlene Forsell and Claus Gregersen as new members of the Board of Directors.

Marlene Forsell knows the Group very well as she served on the Board from 2014 to 2017 in her capacity as CFO at Swedish Match. She has extensive experience from and insights into the tobacco industry from her almost 15 years with Swedish Match.

Claus Gregersen has both management and board experience from international, private and public enterprises. He was CEO and Country Manager at Carnegie Investment Bank from 2010 to 2017 and is currently CEO of Chr. Augustinus Fabrikker Aktieselskab.

I warmly recommend Marlene Forsell and Claus Gregersen for the Board.

During the second half of the year, the Board of Directors carried out an evaluation of the performance of the Board of Directors and its collaboration with the Executive Management. The evaluation process was carried out as a combination of a survey and interviews conducted by the Chairman. The evaluation did not identify a need for any significant changes to the way the Board works.

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 base salary and both short-term and long-term incentive programmes. For the year 2018, the total cost of remuneration for the Executive Board amounted to DKK 62.1 million compared to DKK 40.5 million in 2017. The increase is driven by the extension of the Executive Board to eight members, a higher bonus pay-out following better results, increased cost in relation to the share-based incentive programme and severance payments.

In 2018, we published for the first time a Remuneration report to increase transparency on remuneration for Executive Management and Board of Directors. The Remuneration report can be found on our corporate website. The remuneration of the Executive Management is consistent with the company's Remuneration Policy and the Board considers it appropriate.

LET ME FINISH BY LOOKING FORWARD to 2019, where we expect to leverage our growth opportunities, to progress our strong product pipeline and to expand our lead in the market.

We will continue to invest in the future of our business to create greater long-term value while driving cost and operational efficiency to optimise cash flow. This balance is key to creating shareholder value.

We remain committed to maximizing total shareholder return. We recognize the importance of the ordinary dividend to many shareholders and regularly evaluate our total cash distribution to ensure it is aligned with the performance and investment needs of the business.

For 2019, we have changed both our financial guidance, our financial ambition and dividend policy.

Our financial guidance for 2019 is an organic growth of more than 5% in EBITDA and a free cash flow before potential acquisitions of more than DKK 750 million. With the new guidance, we are not down-playing the importance of net sales and growth. We are, however, emphasizing that profits and cash flow have the highest priority and are important performance drivers that supports the creation of shareholder-value.

We have also changed our financial ambition. Our financial ambition is our estimate of what the business can deliver over time and it does not have an expiration date. Our financial ambitions is to grow organic EBITDA by 3-5%, to deliver continuous growth in the free cash flow before acquisitions and to secure a continued steady increase in the annual ordinary dividends. Any capital that the board evaluates is in excess will be distributed to shareholders either as an extraordinary dividend and/or as in a share buy-back program.

The change in dividend policy from "a payout of at least 70% of reported net profit" to "secure a continued steady increase in the annual ordinary dividends" reflects that stable growth in dividend has priority and is supported by underlying growth in cash flow. It is our believe that the old policy did not give the same assurance.

THIS MARKS THE END OF MY REPORT TODAY. On behalf of Scandinavian Tobacco Group's Board of Directors, Executive Management and all employees, we would like to thank our shareholders, business partners and customers for the interest and trust they have shown in our company in 2018.

Let me round off by congratulating all employees, Executive Management for a job very well done in 2018 and thanking my colleagues on the Board for their constructive and positive collaboration during the year.

Thank you.