Imperial Tobacco

15 July 2014

IMPERIAL TOBACCO GROUP PLC

Acquisition transforms US business

A subsidiary of Imperial Tobacco Group PLC ("Imperial" or the "Company") has entered into a purchase agreement with Reynolds American Inc. ("Reynolds") for the acquisition of assets, including a portfolio of US cigarette brands, Winston, Maverick, Kool, Salem and US and international e-cigarette brand *blu*, plus the national sales force, offices and production facilities currently owned by Lorillard Inc. ("Lorillard", and together, the "Transaction"). The assets are to be acquired for a consideration of $7.1bn (£4.2bn) following the proposed acquisition of Lorillard by Reynolds (the "Acquisition") After adjusting for the present value of the expected tax benefits of c.$1.5bn[1], the net acquisition cost of $5.6bn (£3.3bn) implies a multiple of 6.9 times EBITDA.

Strategy

- Builds on Imperial's strategy of investing in Growth Brands and Growth Markets.
- A major investment in the world's largest profit pool (excluding China) with structural growth potential underpinned by relative affordability.
- The enlarged US business will be c.24% of combined[2] tobacco net revenues.

Execution

- National distribution and sales force transforms Imperial into a major US competitor with a portfolio including Winston, Maverick, USA Gold, Kool and Salem and total market share of c.10%.
- Delivers leadership in e-cigarettes with *blu* to combine with Imperial's e-vapour know-how and offers international roll-out potential.
- Clear integration process for US business with Martin Orlowsky, former Chairman, President and CEO of Lorillard, appointed Executive Chairman Designate of the enlarged US business.

Financial

- All debt financed transaction. Imperial expects to maintain its investment grade credit rating on its debt, underpinned by the strong cash flows from the acquired assets.
- Cigarette brands will be acquired excluding historic product liabilities which are subject to an indemnity from Reynolds.
- Financially attractive deal that is expected to offer a return of over 10%, well in excess of Imperial's cost of capital in its first full year and is expected to be significantly EPS enhancing in the first full year post completion.

Alison Cooper, Chief Executive of Imperial Tobacco, said:

"This is a great opportunity to transform our US business and secure a significant presence in the world's largest accessible profit pool. We plan to build a US brand portfolio through national distribution and create a stronger, more competitive business. We intend to internationalise *blu,* the US leader in e-cigarettes and enhance its growth opportunity with our know-how. We expect opportunities for cost optimisation through integration. The acquisition of these assets, without historic product liabilities for the cigarette brands, on reasonable terms means that it is expected to offer a return of over 10%, well in excess of our cost of capital in its first full year and is expected to be significantly earnings enhancing in the first full year post completion. The value this will create for shareholders and the strategic transformation of our position in a key growth market, makes this an outstanding opportunity."

1. <u>The Transaction</u>

On 15th July, a subsidiary of Imperial entered into a purchase agreement with Reynolds to acquire certain brands in the US and other assets to be disposed as a consequence of the Acquisition of Lorillard by Reynolds announced today. Certain obligations of the Imperial subsidiary have been guaranteed by Imperial. The Transaction is therefore subject to the acquisition. The Acquisition requires US anti-trust approval. This approval process is likely to take a minimum of 6 to 9 months. On completion of the Transaction, Imperial will acquire:

- Cigarette brands in the US currently owned by Reynolds, comprising *Winston, Kool and Salem.*
- A cigarette brand in the US currently owned by Lorillard, *Maverick.*
- The e-cigarette business currently owned by Lorillard, consisting of *blu* in the US and UK.
- The infrastructure and factory currently owned by Lorillard at Greensboro, North Carolina, USA.

The Transaction will include a series of interlocking supply and transitional agreements between the enlarged Reynolds and Imperial in relation to continuity of supply of the acquired brands, their visibility at the point of sale and the route to market for the acquired business. The key terms of these agreements have been agreed, and further details will be included in the circular to shareholders.

The brands to be acquired had Calendar Year 2013 volumes of 20bn stick equivalents, net revenue of $2.4bn, brand contribution of $1.2bn, EBITDA of $0.8bn and operating profit of $0.6bn. The Company expects the value of the gross assets that are the subject of the Transaction to be approximately $0.8bn (which excludes deferred tax assets, inventories and other current assets which are not being acquired as part of the Transaction).

The consideration of $7.1bn (£4.2bn) will be wholly financed by new committed bank facilities. Imperial may consider options to refinance all or a portion of these facilities in the period ahead of closing of the Transaction. The rating agencies (Standard & Poor's, Moody's and Fitch) have been consulted on the financial parameters arising from the Transaction. Imperial expects that the Company's existing investment grade credit rating will be maintained following completion of the Transaction.

The present value of the expected US tax savings from the step-up in amortisation of intangibles is c.$1.5bn[1].

The Transaction is conditional on, *inter alia*:-

- The completion of the Acquisition of Lorillard by Reynolds.
- US anti-trust approval of the Reynolds/Lorillard Acquisition.
- The approval of shareholders of Imperial at a General Meeting.

The Transaction is expected to deliver both a Return on Invested Capital at over 10% in its first full year, in excess of the Company's weighted average cost of capital and be significantly EPS enhancing in the first full year following completion. The consideration implies a multiple of 8.8 times EBITDA. After adjusting for the present value of the expected tax benefits of c.$1.5bn[1], the net acquisition cost of $5.6bn implies a multiple of 6.9 times EBITDA.

<u>Cigarette Brands</u>

The cigarette brands to be acquired in the US are as follows: -

- *Winston,* a premium brand and current No.7 brand in the US with 2.2% share of the US market. Winston is the world No. 2 brand with strong inherent brand equity which Imperial intends to rejuvenate with investment and focus.
- *Maverick*, a value brand with 2.0% US market share and a strong position in key states. Maverick has been growing in recent years and has potential in the value segment alongside Imperial's existing USA Gold brand.
- *Kool*, a menthol brand with 1.9% US market share. Imperial intends to refocus and invest behind Kool as part of the enlarged portfolio.
- *Salem*, a menthol brand with 1.2% share of market.

These brands will combine with Imperial's existing US portfolio at Commonwealth-Altadis. Imperial's existing US brand portfolio currently accounts for a 3% share of the US market, principally with USA Gold (share 1.2%) which is growing its presence in its target 19 states in the US with a focused marketing and distribution strategy.

<u>Historic Product Liability</u>

The Winston, Maverick, Kool and Salem brands are to be acquired without historic product liabilities. An indemnity against such liabilities will be provided by Reynolds under the terms of the Transaction.

Following completion, Imperial will assume Original Participating Manufacturer obligations under the MSA on the acquired brands (other than the *blu* brand), and its affiliates expect to retain the grandfathered share benefit under the MSA for Imperial's current US brands.

E-Cigarettes

Imperial will also acquire the e-cigarette business currently owned by Lorillard, which consists of *blu,* the number one brand of e-cigarette in the US market in measured retail distribution with a reported 45%[5] value share of the market at retail. In the financial year to December 2013, *blu* had net revenues of $230m. Lorillard has also recently acquired a UK business, *SkyCig*, through which it has begun to launch *blu* in the UK market. The e-cigarette market has been growing strongly in the US in recent years, and now exceeds $1.7bn[6] in total, including a growing online marketplace. Internationally, the e-cigarette market is in an early stage of development with considerable consumer interest suggesting opportunities with stronger branding and improved technology.

Other Assets to be Acquired.

In addition to the brands, Imperial will acquire certain assets (the infrastructure) currently owned by Lorillard including the factory and office at Greensboro and c.2,900 employees[7], including a substantial national sales force.

The enlarged US business

The enhanced portfolio has a combined[2] cigarette market share of approximately 10% of the US cigarette market. Imperial also has a major presence in mass market cigars with its leading brands *Backwoods, Dutch Masters* and *Phillies*. Imperial's premium cigar business is managed separately in the USA. The acquisition of *blu* will deliver immediate leadership of the US e-cigarette market at retail.

2. The US market

The US tobacco market is the second largest in the world (ex-China) by volume but the largest by profit pool (ex-China). The latest market data indicates the total US market size as 272bn stick equivalents.

The US market accounts for a significant proportion of the world profit pool, accounting for an estimated 25% of world tobacco profits (ex-China). Estimated[3] total profits of the tobacco industry in the US were in excess of $14bn in the last calendar year on net sales of over $35bn.

The market is in modest volume decline (estimated[4] -4% MAT to March 2014) but offers continuing opportunities going forward. This is mainly due to the highly affordable price of cigarettes in the US market relative to local purchasing power.

The competition in the US market comprises local companies with minimal international business, being principally Altria and the enlarged Reynolds.

The US, through the Food and Drug Administration, provides a relatively stable regulatory environment.

3. Imperial's strategy for the enlarged US business

Imperial has a clearly defined strategy to invest in Growth Markets, markets where it can grow its share of the available profit pool. The US is one of Imperial's Growth Markets given the size and growth of its profit pool and Imperial's under-representation in the market. Imperial has a clear strategy for growth set out below:

Brand portfolio strategy with a primary focus on *Winston* and *blu*, supported by a secondary focus on either *Maverick*, *Kool* or *USA Gold* on a state by state basis.

- *Winston* will be the main focus of Imperial's US strategy. Research in the US has reinforced Imperial's confidence that Winston can be rejuvenated. It is a leading global brand (global No.2) which has strong latent brand equity in the US and has previously demonstrated its capability to grow supported by increased investment.
- *blu* will be the primary focus of the brand portfolio in the e-cigarette market, combining strong branded equity, *blu* technology and consumer recognition of *blu* with the know-how and expertise of Imperial's subsidiary Fontem Ventures.
- *Maverick* will continue to be a focus in the value segment of the market which is showing consistent growth.
- *Kool,* a menthol brand with distinct regional strength, will benefit from investment on a state-by-state basis to build on its existing equity.
- *USA Gold* will continue to be a focus in line with its rejuvenation strategy but with broader, national distribution.

The other brands in the portfolio will be largely run to maximise cash.

Distribution transformed by national platform, presence and scale.

We believe the Transaction will enhance Imperial's existing sales force and will create a proven and experienced team with strong knowledge of brands and customers. The move from a focused presence in 19 states to a material presence across the whole of the US will significantly improve the ability of Imperial to compete and realise its ambitions to grow. Larger scale will support greater investment in sales technology. A cigarette portfolio across different price points, including mass market cigars and a national brand leader in e-cigarettes, will make our business much more important to retailers. More sales visits, stronger retailer relationships, better coverage of key accounts and the resulting ability to achieve greater shelf space, merchandising and point of sale presence will be a key difference post the Transaction and one that will support the increased brand investment.

Cost optimisation from the combination of the businesses.

There are synergy opportunities from integrating the acquired assets with Commonwealth-Altadis. Synergies are expected to arise from integrating and rationalising the enlarged business in respect of: purchasing of tobacco and non-tobacco materials; manufacturing; marketing costs; sales and marketing integration; and back office functions.

It is Imperial's intention that all synergies arising from the Transaction will be reinvested in driving the enlarged brand portfolio strategy, focusing on Winston, *blu* and the combination of Maverick, USA Gold and Kool.

Internationalisation of *blu* e-cigarettes

Building on the strong branded platform and technology that *blu* has established in the US market, combined with Imperial's know-how and expertise through its subsidiary Fontem Ventures, there is a clear opportunity to accelerate the roll-out of *blu* e-cigarettes internationally as the market develops.

4. Integration Plan

Martin Orlowsky, previously Chairman, President and CEO of Lorillard, has joined Imperial as Executive Chairman Designate of Imperial's enlarged US business. He has an outstanding reputation in the industry from his highly successful track record at Lorillard. He has been working on a consultancy basis so far and prior to closing his focus will be on preparing the integration plan. He will assume his formal role on completion of the Transaction to work on:

- the integration of the business.
- the delivery of the interim arrangements covering supply and route to market with Lorillard and Reynolds.
- the implementation of the portfolio strategy for the enlarged business.

For the period up to completion, interim arrangements will allow Imperial access to Lorillard's and Reynold's management whilst preserving independence and confidentiality between the relevant parties.

Building on experience from previous acquisitions, Imperial will put in place senior integration resource designed to ensure that the resulting enlarged US business has a strong management team and is built on the best of both Commonwealth-Altadis and the acquired assets.

Once the Transaction is completed, a transition period will commence during which Reynolds will contract manufacture Winston, Kool and Salem for Imperial and Imperial will contract manufacture Newport for Reynolds.

5. Financial Impact on Imperial

The consideration will be met in cash from new committed bank facilities already put in place. Imperial may consider options to refinance all or a portion of these facilities ahead of closing of the Transaction. This new borrowing facility will also refinance existing core bank borrowings. The main bank facility has been renegotiated on attractive terms, with a new five year term until 2019.

The rating agencies (Standard & Poor's, Moody's and Fitch) have been consulted on the financial parameters arising from the Transaction. Imperial expects that the Company's existing investment grade credit rating will be maintained following completion of the Transaction.

In order to accelerate the pace of debt repayment, Imperial has suspended its share buy-back programme (previously £500m a year). The shares purchased to date in the current financial year are 14.16m at a cost of £339m.

Imperial's intention to increase dividends by at least 10% for financial year 2014 is unchanged.

The Transaction is expected to deliver a Return on Invested Capital in excess of the Company's Weighted Average Cost of Capital and to enhance Imperial's EPS significantly in the first full year post completion.

Based on combined[2] financial information, the USA will become c.24% of Imperial's tobacco net revenue.

6. Shareholder Information

Given the size of the Transaction relative to the size of Imperial, the transaction constitutes a class 1 transaction for the purposes of the FCA's listing rules and is therefore conditional on approval of Imperial's shareholders. Approval of the Transaction will be sought at a General Meeting which is expected to be held in the coming months. A circular setting out further details of the Transaction, including the resolution seeking approval, is expected to be sent to shareholders in due course.

The Board considers the Transaction to be in the best interests of shareholders as a whole. Accordingly, subject to their on-going fiduciary duties, the Board will unanimously recommend that shareholders vote in favour of the resolution at the General Meeting.

Shareholders are advised to read the whole of the circular to be sent to them before deciding what action to take in respect of the General Meeting and should not just rely on the summarised information set out in this announcement.

Credit Suisse Securities (Europe) Limited ("Credit Suisse") is acting as sole sponsor and joint financial adviser and Goldman Sachs International ("Goldman Sachs") is acting as joint financial adviser to Imperial in respect of the Transaction.

Cautionary statement

The release, publication or distribution of this announcement in jurisdictions other than the United Kingdom may be restricted by law and therefore any persons who are subject to the laws of any jurisdiction other than the United Kingdom should inform themselves about, and observe, any applicable requirements. This announcement has been prepared for the purposes of complying with the Listing Rules and the information disclosed may not be the same as that which would have been disclosed if this announcement had been prepared in accordance with the laws and regulations of any jurisdiction outside of England. This announcement is not intended to, and does not constitute, or form part of, any offer to sell or an invitation to purchase or subscribe for any securities or a solicitation of any vote or approval in any jurisdiction, including the United States. Imperial shareholders are advised to read carefully the formal documentation in relation to the Transaction once it has been despatched. Any response to the proposals should be made only on the basis of the information in the formal documentation to follow.

Credit Suisse Securities (Europe) Limited ("Credit Suisse"), which is authorised by the Prudential Regulation Authority and regulated by the Prudential Regulation Authority and the Financial Conduct Authority in the United Kingdom, is acting exclusively as sole sponsor and joint financial adviser to Imperial Tobacco Group PLC and for no one else in connection with the content of this announcement and the Transaction and will not be responsible to any person other than Imperial Tobacco Group PLC for providing the protections afforded to clients of Credit Suisse, nor for providing advice in relation to the Transaction, the content of this announcement or any matter referred to in this announcement. Apart from the responsibilities and liabilities, if any, which may be imposed on Credit Suisse by the FSMA or the regulatory regime established thereunder or any other laws, neither Credit Suisse nor any of its subsidiaries, branches or affiliates owes or accepts any duty, liability or responsibility whatsoever (whether direct or indirect, whether in contract, in tort, under statute or otherwise) to any person who is not a client of Credit Suisse in connection with this announcement, any statement contained herein or otherwise, nor makes any representation or warranty, expressly or implied, in relation to, the contents of this announcement, including its accuracy, completeness or verification or for any other statement made or purported to be made by Credit Suisse, or on behalf of Credit Suisse in connection with Imperial Tobacco Group PLC or the Transaction and nothing in this announcement is or shall be relied upon as a promise or representation in this respect, whether as to the past or the future. Credit Suisse accordingly disclaims to the fullest extent permitted by the law all and any responsibility or liability to any person who is not a client of Credit Suisse, whether arising in tort, contract or otherwise (save as referred to above) which they might otherwise have in respect of this announcement or any such statement.

Goldman Sachs International, which is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority in the United Kingdom, is acting for Imperial Tobacco Group PLC and no one else in connection with the Transaction and will not be responsible to anyone other than Imperial Tobacco Group PLC for providing the protections afforded to clients of Goldman Sachs International, or for giving advice in connection with the Transaction or any matter referred to herein.

Information regarding forward-looking statements

This announcement includes statements that are, or may be deemed to be, "forward-looking statements". These forward-looking statements can be identified by the use of forward-looking terminology, including the terms "believes", "estimates", "plans", "projects", "anticipates", "expects", "intends", "may", "will", or "should" or, in each case, their negative or other variations or comparable terminology, or by discussions of strategy, plans, objectives, goals, future events or intentions. These forward-looking statements include all matters that are not historical facts. They appear in a number of places throughout this announcement and include, but are not limited to, statements regarding Imperial's intentions, beliefs or current expectations concerning, among other things, Imperial’s business, results of operations, financial position, prospects, growth, strategies and the industry in which it operates as well as those of the Reynolds and Lorillard assets that are the subject of the Transaction. By their nature, forward looking statements involve risk and uncertainty because they relate to future events and circumstances. Forward-looking statements are not guarantees of future performance and the actual results of Imperial’s operations and financial position, and the development of the markets and the industry in which Imperial operates, may differ materially from those described in, or suggested by, the forward-looking statements contained in this announcement. The same applies in respect of the Reynolds and Lorillard assets that are the subject of the transaction. In addition, even if the results of operations, financial position and the development of the markets and the industry in which Imperial operates are consistent with the forward-looking statements contained in this announcement, those results or developments may not be indicative of results or developments in subsequent periods. A number of factors could cause results and developments to differ materially from those expressed or implied by the forward-looking statements including, without limitation, general economic and business conditions, industry trends, competition, changes in regulation, currency fluctuations, changes in its business strategy, political and economic uncertainty and other factors discussed in this announcement. Forward-looking statements may, and often do, differ materially from actual results. None of the future projections, expectations, estimates or prospects in this document should be taken as forecasts or promises nor should they be taken as implying any indication, assurance or guarantee that the assumptions on which such future projections, expectations, estimates or prospects have been prepared are correct or exhaustive or, in the case of the assumptions, fully stated in this document. Any forward-looking statements in this announcement speak only as of their respective dates, reflect Imperial’s current view with respect to future events and are subject to risks relating to future events and other risks, uncertainties and assumptions relating to Imperial’s operations, results of operations and growth strategy. As a result of these risks, uncertainties and assumptions, the recipient should not place undue reliance on these forward-looking statements as a prediction of actual results or otherwise. You should specifically consider the factors identified in this document, in addition to the risk factors that may affect Imperial’s operations which are described under "Risk Factors" in the Company's 2013 Annual Report, which could cause actual results to differ before making any decision in relation to the Transaction as well as those of the Reynolds and Lorillard assets that are the subject of the transaction. Subject to the requirements of the FCA, the London Stock Exchange, the Listing Rules and the Disclosure and Transparency Rules (and/or any regulatory requirements) or applicable law, Imperial explicitly disclaims any obligation or undertaking publicly to release the result of any revisions to any forward-looking statements in this announcement that may occur due to any change in Imperial’s expectations or to reflect events or circumstances after the date of this announcement. No statement in this document is intended as a profit forecast or profit estimate and no statement in this document should be interpreted to mean that the earnings per share of Imperial, as altered by the Transaction will necessarily match or exceed the historical or published earnings per share of Imperial or the relevant entities which form the basis for the Transaction.

15 July 2014

Notes to Editors

Imperial Tobacco Group PLC is a multi-national tobacco company, with international strength in cigarettes and world leadership in fine cut tobacco, premium cigars, rolling papers and tubes. The Group has 46 manufacturing sites and around 35,000 employees and operates in over 160 markets.

In 2013, the Company realigned its geographic footprint into Growth Markets and Returns Markets and now manages markets based on the strategic role they play, rather than their geographic proximity.

Growth Markets are characterised by large profit and/or volume pools. We tend to have shares below 15 per cent and see considerable opportunities for share and profit growth over the long term. Our main Growth Markets include the USA and selected markets in the EU, Eastern Europe, Asia, and the Middle East. We measure the performance of our Growth Markets against market share and revenue metrics and our quality of growth by the progress our Growth Brands are making.

In Returns Markets we have relatively large shares, mostly above 15 per cent. Our objective is to maximise profit, whilst actively managing our market share. Our main Returns Markets include UK, Germany, and other markets in the EU, Australia, Eastern Europe and Africa. We measure the performance of our Returns Markets against market share and revenue metrics and our quality of growth by the progress our Growth Brands are making.

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Sources of Information and basis of calculation

All US market and share data is derived from MSAI data as at April 2014 and The Maxwell Report is based on stick data.

US dollar to GB Sterling translated using an illustrative rate of $1.70 equals £1.

[1]The present value of the expected tax benefits is calculated by taking the assumed purchase price post certain purchase price adjustments and deducting the expected book value of the fixed assets to be acquired and other intangible assets to be acquired, which are not intended to be held within the US group post-closing, to derive the book value of the intangible assets to be acquired held within the US group (fair value thereof and purchase price allocation to be determined post-completion). These are then assumed to be fully amortised on a straight-line basis over 15 years. The annual amortisation charge is assumed to be fully deductible for US tax purposes from the annual taxable profits realised over the 15 year period against an assumed effective US tax rate of 39%. This benefit is then discounted at 7%.

[2]Combined data reflects latest complete financial year and, where appropriate, is derived from unadjusted public historical financial information. For Imperial Tobacco Group PLC the year to 30 September 2013. For Lorillard, Inc. the year to 31 December 2013. For Reynolds American, Inc. the year to 31 December 2013.

[3]SEC reports, Wells Fargo Research.

[4] Maxwell Report

[5] Lorillard Form 8-K, 24th April 2014. 45% market share excludes online sales

[6]Exane report on total US e-cigarettes quoting data from Tobacco Manufacturer's Association

[7]Lorillard Form 10-K, 12th February 2014.

Presentation, Webcast and Conference Call

A presentation for analysts and investors will be given by Alison Cooper, CEO, and Oliver Tant, CFO at 1400hrs BST at the offices of Goldman Sachs, Peterborough Court, 133 Fleet Street, London EC4A 2BE.

A live webcast of a presentation for analysts and investors will be available on www.imperial-tobacco.com from 1400hrs (BST). An archive of the webcast and the presentation script and slides will also be made available during the afternoon.

High-resolution photographs are available to the media free of charge at: www.newscast.co.uk

Alison Cooper will host a media conference call at 1300hrs (BST), at which there will be the opportunity for questions. Dial-in number: +44(0)20 3427 1900 / Participant code: 6695651
A replay of this call will be available for one week. To listen, please dial: Replay number: +44(0)20 3427 0598 / Access code: 6695651