26 April 2018

Chairman's report - 2018 Annual General Meeting

I am pleased to be reporting for the first time as Chairman of the Board, particularly as Scandinavian Tobacco Group continues to be a company 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.

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.

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. And we have been a listed company for only 26 months.

OUR SECOND YEAR AS A LISTED COMPANY WAS DIFFICULT. We encountered some financial headwind due to the implementation of a new IT system in Cigars International, our online retailer in the US. As a consequence we had to issue a profit downgrade in May 2017. With our annual results which we published on March 8 we delivered on our revised guidance with total revenue of DKK 6,464 million and an adjusted EBITDA of DKK 1,283 million. This equals a 2.2% negative organic growth in net sales and an organic decline of 7.4% in EBITDA. Net profit for the year increased by 4.4% to DKK 712 million while free cash flow was DKK 955 million. Our CEO, Niels Frederiksen, will review and explain the company's financial highlights a little later.

Despite the financial headwinds, we were still able to deliver an extraordinary dividend of DKK 350 million to our shareholders and today The Board proposes to increase the ordinary dividend for the second year in a row to DKK 5.75 per share, an increase of 4.5% compared to 2016. This will take the overall dividend for the year 2017 to DKK 925 million. This is testament to the strong underlying business and cash flow in Scandinavian Tobacco Group.

LET ME BRIEFLY REVIEW OUR PERFORMANCE IN OUR FOUR MAIN CATEGORIES before I move on to a presentation of the progress on our strategy and how we create value for our shareholders.

Let's begin with our *handmade cigars.* Our core market is the US, where two of every three handmade cigars in the world are consumed. We are the market leader and operate two companies in the US which deal with handmade cigars.

One of them, General Cigar, develops and produces branded cigars sold through retailers. Some of the most well-known brands are Macanudo, CAO, Cohiba and Partagas.
The other business, Cigars International, is an online retailer which also sells direct to consumers through catalogues and brick and mortar stores. General Cigar and Cigars International each have significant market shares in the segments they are active in.

The handmade cigars category in the United States continues to be an important growth engine for our company. The overall market, by which we mean total consumption of handmade cigars, is relatively flat, with slightly more than 300 million cigars sold in the US.

General Cigar had a good year and continued to increase market share across all sales channels. Cigars International lost market share as the implementation of a new IT system caused disruptions to our otherwise high-quality customer service.

We have, however, in 2017 strengthened both our retail and online channels in the US. We announced the intention to expand our retailing platform and will in 2018 open two large brick and mortar stores in Texas which will be added to the existing three stores we already have in Pennsylvania.

And we have recently acquired Thompson, the third largest online retailer of cigars in the US market. Online retail has been the fastest growing channel in cigar sales in the US for the past many years and Thompson is a great addition to our existing US business.

In the *machine-made cigars* category, our core business is in Europe where we are the market leader. Total market volume development is currently estimated to be negative by 3-5% per year across the markets where we operate.

In 2017, we saw progress in this category and regained market shares in a number of important markets, e.g. the UK and Spain, as a result of an intensified strategic focus on innovation and on winning with core brands in our largest markets. We did however lose market shares in France and Belgium as a consequence of SKU rationalisation in relation to the implementation of the EU Tobacco Products Directive.

Our principal task in our machine made category remains the same: 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.

In the *pipe tobacco* category, the market for traditional pipe tobacco is also declining. However, the long-term trends of high consumer loyalty to the category and to brands continue. Traditional pipe tobacco is predominantly sold in Europe and the US where we on both overall markets have leading positions with a market share of approx. 50%.

In the *fine-cut tobacco* category the overall trend in consumer demand declined further and we experienced a negative volume impact in 2017 partly due to phasing of volume. We are market leader in the US, Denmark and Israel and have significant positions in Norway and

Switzerland. In Germany, one of the largest markets for fine-cut tobacco, we are building our position and continued to take market share and realised good volume growth.

To briefly sum our categories up, 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 also wish to 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 and throughout our categories we focus on costs.

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.

SIMPLY PUT, OUR STRATEGY RESTS ON FOUR pillars: We want to outperform the market and win market share, we want to globalise our business further and we want to become ever more efficient. And all should be driven by competent and curious people with the motivation to achieve extraordinary results.

Let me walk you through the progress we have seen in 2017 in each of the four pillars of our strategy. I'll start with our employees.

We have a strong organisation with engaged employees and a strong corporate culture. In 2017, we carried out a Group-wide engagement survey to capture the general level of engagement and satisfaction among all our employees. The response rate was 93% and the engagement rate was high, 87%, compared to an external benchmark of 70%. This means that, among our employees, there is a very high degree of general satisfaction with the workplace and their job.

We have over the years successfully recruited competent employees for our company, and we have a large group of people with many years of experience from the tobacco industry. Becoming the undisputed leader in cigars and pipe tobacco will be demanding for our organisation and to that end we are currently investing to further strengthen the winning mind-set in our organisation, build stronger HR capabilities, create global centres of excellence and achieve ambitious targets across our organisation.

Moving on to efficiency, we have during 2017 steadily reduced complexity and improved efficiency in our business. We finalised our optimisation and efficiency programmes announced in 2015 and 2016. The cost optimisation programmes have delivered cost savings of DKK 200 million with full effect for 2018. Our inventory reduction programme has delivered DKK 667 million in accumulated inventory reduction versus 2014, well beyond the original plan and one year ahead of time.

We have also improved our global manufacturing footprint by reducing the number of factories and SKUs (Stock Keeping Units) in our product portfolio.

The optimisation and efficiency-improvement programmes have made us a more profitable and stronger business. We have not announced any new restructuring programmes, but we continue to consider cost optimisation and efficiency improvement as an integrated part of the way we run our business and we will continue our daily focus and efforts in this area.

To outperform the market and to win market share, we have in 2017 established a new business unit covering our largest market, The Americas. This keeps us well positioned to develop and expand business opportunities in this region – both organically and in the form of mergers or acquisitions. And with the acquisition of Thompson and our two new brick and mortar retail stores in Texas, the platform for future growth in North America has been strengthened.

In the past year we also continued to expand our geographical footprint. We established a new sales organisation in Sweden and launched Granger, an innovative filter cigarillo, in key markets such as Germany, Spain, Finland and Denmark and launched the handmade cigars Macanudo Inspirado White and Black in the US.

To sum up, we saw significant progress towards the realisation of all parts of our strategy during 2017 – and the work that has been carried out across the organisation means that we have the right building blocks in place to support the long-term success of the Group.

IN 2017, WE SAW A NUMBER OF CHANGES TO THE BOARD OF DIRECTORS. We were delighted to welcome Henrik Brandt while Marlene Forsell and Conny Karlsson stepped down ending three and seven years of service respectively as Swedish Match divested their shares in Scandinavian Tobacco Group. I would like to thank Marlene Forsell and Conny Karlsson for their valuable contribution to Scandinavian Tobacco Group over the years.

And today, Henning Kruse Petersen resigns from the Board of Directors after almost eight years of service. I would like to use the opportunity to thank Henning Kruse Petersen for his hard work, contribution and loyalty to the Group.

Anders Obel is being proposed as a new candidate to the Board. He brings extensive experience in management of industrial and investment companies as well as economic and financial expertise. He knows the Group very well as he served on the Board of Scandinavian Tobacco Group from 2010 to 2016. I warmly recommend Anders Obel for the Board.

In 2017, we completed - for the first time – a Board evaluation with the purpose to align expectations of engagement and co-operation within the Board and between the Board and Executive Management.

The results provided valuable insights on several aspects of the work of the Board including strategy, effectiveness, succession planning, risk management, as well as the composition and work of the various committees on the Board. Based on the evaluation we implemented a few effective changes to further optimise the composition and structure of the meetings of the Board - and Board evaluation will be a tool we will use actively going forward.

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. The aggregate remuneration of the entire six-person Executive Board amounted to DKK 40.5 million and consisted of salary, incentive programmes, bonuses and pension components 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 BY STATING THAT WE ARE LOOKING FORWARD TO 2018 WITH CONFIDENCE. We are one of the world's largest manufacturers of cigars and pipe tobacco and we remain committed to maximising total shareholder return and we will pursue the opportunities available to us in the form of organic growth, value-creating strategic acquisitions and payout of cash to shareholders.

We 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.

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 2017. We are looking forward to 2018 where we expect to leverage our growth opportunities, to progress our innovative product pipeline and to expand our lead in the market.