Annual General Meeting 26 April 2016

Report of the Board of Directors for 2015

Chairman, Jørgen Tandrup

I would like to begin this first management report for Scandinavian Tobacco Group as a listed company by telling you a bit about what kind of business you and I have invested in: What characterizes Scandinavian Tobacco Group other than revenue, EBITDA and cash flows?.

First and foremost, 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. It is a business with a strong base for organic growth and for acquisition of peers.

It is also a business that is mostly active in the part of the tobacco market where craftsmanship and smoking enjoyment come first. Our focus is on creating a good smoking experience for adult consumers who deliberately choose 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 comes from, how it is fermented and stored, and how it is blended.

That puts considerable demands on us. We have to develop new products, find new tobaccos and create new smoking experiences.

Obviously, Scandinavian Tobacco Group is much more than that, and our CEO, Niels Frederiksen, will tell you more about that in his part of our report today. First, I would like to play a short video to illustrate what we mean when we talk about creating moments of great smoking enjoyment.

In 2010, Scandinavian Tobacco Group and Swedish Match combined most of their cigar, pipe tobacco and fine-cut tobacco operations. The combination was based on a desire to build a powerful business in the cigar and pipe tobacco categories. Since then, Scandinavian Tobacco Group has become an even stronger player through acquisitions in both the United States and Europe.

By 2015, Scandinavian Tobacco Group had reached a stage where it was ready to take the next step in the plans made during the autumn of 2010: to float the company. Preparing for the IPO was a demanding process, but very much a learning process as well. The huge amount of work it took to carry out the IPO would not have been possible, had it not been for the major contribution made by so many of our valued employees. The fact that we also managed to deliver the best results in our new company's history is, of course, something we're extremely pleased with.

Niels Frederiksen took over as our CEO in March 2015. Since taking up his position, Niels has put together his own management team, a team deeply committed to delivering on the long-term targets we announced to the market in connection with the IPO. This especially applies to our goal of reducing our operating costs by DKK 140 million and our working capital by DKK 500 million by the end of 2018 relative to 31 December 2014.

Let me review a few of the highlights of the 2015 financial year. Revenue totalled DKK 6,732 million, a 9.9% improvement on 2014. The underlying business, net of acquisitions and currency fluctuations, improved by 0.3%, so, as you can see, we've benefited from currency tailwinds, especially from the strong US dollar. The like-for-like adjusted EBITDA margin was up by 0.2 percentage point to 20.5%, whereas our net profit was DKK 668 million, which is up 4.4% from 2014. In other words, we've met the overall guidance we provided to the market.

The agenda for today's meeting includes a separate item involving the election of members to the Board of Directors. We will get back to that. But first I would like to say a few words about the changes we made to our Board in connection with the IPO, when Mr Søren Bjerre-Nielsen, Ms Dianne Neal Blixt and Mr Luc Missorten were all elected to the Board as new members. They each bring extensive experience from previous management and board positions with major international corporations. Standing for election today is Mr Nigel Northridge, who first of all has a great deal of experience from the tobacco industry. Until 2007, when the company was sold to Japan Tobacco, he was CEO of the Gallaher Group, a listed company and one of the world's leading tobacco companies. Nigel also has extensive board experience, including from his time as chairman of Debenhams PLC. I warmly recommend that you support the election of Mr Northridge when we get to that item on the agenda.

As a company, Scandinavian Tobacco Group is, and should continue to be, known for its ability to generate strong and stable cash flows that provide the foundation for stable and attractive dividends.

To this end, the company's Board of Directors has defined a financial policy consisting of two main components.

First is the dividend policy of a payout ratio of at least 70% of our reported net profit each year, and, second, we have defined a target for our net interest-bearing debt that is about 2.5 times our adjusted EBITDA. If we believe our debt-to-adjusted EBITDA will remain below this ratio, we will consider returning any excess capital to our shareholders, either by way of extraordinary dividends or through share buybacks.

Consistently with these targets, the Board proposes to the shareholders that the company pay a dividend of DKK 5 per share in respect of the 2015 financial year. That equals a total payout of DKK 500 million and a payout ratio of approx. 75%.

I've received a few advance questions from some of our shareholders, which I'd like to answer before I pass the floor to our CEO.

1. We've been asked about our strategic approach to the increase in tobacco regulation and whether we use lobbyists. I can tell you that we work to ensure that politicians and civil servants are aware of the conditions specific to our products, typically through our local and international industry organisations, such as what makes cigars different from cigarettes in relation to product costs, consumer profiles etc. You see, in many cases politicians and the authorities only consider cigarettes when drafting new legislation. As men-

tioned, we generally use people in our industry organisations to communicate our views, but we also use lobbyists when we deem this to be relevant. That is for instance the case in a huge country such as the United States, and of course we do things completely by the book.

2. Is Scandinavian Tobacco Group contemplating involving a small group of shareholders in the company's board work? The answer to that question is 'No'. The Board consists of people with very extensive experience and different background. We believe that we are able to take into consideration the interests of all shareholders, also the smaller ones.

3. Does Scandinavian Tobacco Group have plans to launch products supporting smoking cessation? The answer to that question is 'No'. We're in the market to provide smoking enjoyment for adult consumers who choose to smoke.

That concludes my part of today's report, and I will now give the floor to our CEO, Niels Frederiksen.

CEO, Niels Frederiksen

2015 was a year of significant change. However, the many tasks we were faced with have been handled with great commitment and skill. The targets we set for ourselves for 2015 have been met, and it's a great pleasure for me to be able to look back on a year in which the majority of the projects we launched are off to a good start. And I'm pleased to present the best financial results in the history of Scandinavian Tobacco Group.

Before I go into the details of our financial results, allow me to talk a bit about the business of Scandinavian Tobacco Group.

Our business is grouped into four main categories, and we have market-leading positions in all four. This applies to cigars, which we divide into machine-made cigars and handmade cigars, and to smoking tobacco, which consists of fine-cut tobacco and pipe tobacco. Combined, these four categories accounted for 87% of our revenue in 2015. The remaining 13% of revenue derives from the 'Other' category, which covers sales and marketing of tobacco accessories and third-party contract manufacturing.

For Scandinavian Tobacco Group, holding strong market positions is a big part of our business. We are the largest manufacturer of handmade cigars in the United States, and we also own that country's largest online cigar retailer. The United States makes up about two-thirds of the world market for handmade cigars.

We are the leading manufacturer of machine-made cigars in Europe, which makes up about half of the world market for machine-made cigars. We are the largest player in the world within traditional pipe tobacco. And lastly, we have leading positions in fine-cut tobacco in the United States and Denmark. So overall, we are in a strong position.

Scandinavian Tobacco Group owns some of the strongest brands in our four main categories, for example, machine-made cigar brands like Café Crème, Henri Wintermans and La Paz and handmade cigar brands like Macanudo, Cohiba and Partagas. However, for the two last brands, we only own the trademark rights in the United States.

For both cigar categories, the selection, storage and processing of the many different qualities of tobacco we use are essential to achieving the desired quality. A cigar is more than just a cigar. As with wine and whisky, there are countless variations in taste, texture and user experience in smoking a cigar, and many people who enjoy a good cigar also like to try new products alongside their regular brands. As a result, having a broad assortment and being committed to product development are key parameters in retaining and strengthening our market position in the cigar categories.

Overall, Scandinavian Tobacco Group owns a total of more than 200 brands, each with its own unique characteristics.

The cigar and pipe tobacco industry differs from the cigarette industry in many ways. Our product categories contain significantly more brands and product types, and the production process is much more complex. Just think about how complicated a process it is to make the cigars that our highly skilled cigar rollers produce by hand. It takes several minutes to make each cigar. Cigarettes are produced by machines at a rate of several thousand per minute. These are two very different production processes and two entirely different products.

We currently have thirteen facilities in Europe, Asia, the Caribbean and the United States; three in Denmark; two each in Indonesia, Belgium and the Dominican Republic; and one each in the United States, the Netherlands, Nicaragua and Honduras. Our factory locations are based on our desire to be close either to the tobacco-growing regions or to our customers. Our facilities in Central America are mainly a part of our handmade cigar business, whereas our European and Indonesian facilities are mainly a part of our other business areas.

Regulation is a very important matter for any tobacco company, because we are such a heavily regulated industry. Being one of the largest players in our tobacco categories, our ambition is always to be at the forefront of any new regulations, and we aim to always be in compliance with all requirements and to adapt to new regulations.

The tobacco industry is – and always has been – subject to extensive restrictions. So, the significant role that changing regulations play in our industry is nothing new. Tobacco excise duties are also a significant factor, because they are a sizeable part of the price paid by consumers in all of our markets.

Let me briefly talk about three important regulatory changes that we are currently preparing for: the new EU Tobacco Products Directive (the TPD), pending new FDA regulations for pipe tobacco and cigars in the United States and, lastly, the potential lifting of the US embargo against Cuba.

The TPD introduces new rules on how tobacco products may be produced, presented and sold, and it must be implemented in national legislation by 20 May of this year, when the new rules take effect. Not all countries have yet passed the necessary national legislation, so we still don't know the exact wording of the legislation in the various countries. Some of the main components of the TPD are stricter requirements as to the size and quantity of warnings on the packaging, a ban on referring to taste or smell, stricter reporting requirements on additives, reporting of sales volumes and other data, and further restrictions with respect to product descriptors. Although the final consequences of the TPD have yet to be determined, we believe we are well prepared for it. We have invested some DKK 200 million in new machinery that will allow us to meet the new requirements for health warnings, which in effect will require new types of packaging.

Another major change currently underway involves our businesses in the United States. The FDA, the US Food and Drug Administration, has long been regulating cigarettes and fine-cut tobacco. The FDA is expected to also start regulating cigars, pipe tobacco and electronic cigarettes soon. We don't yet know what the final version of the regulations will contain, but it is highly likely that they will restrict the tobacco industry's ability to launch new products and introduce stricter requirements for the approval of and reporting on existing products. In this context, we also believe we are well prepared, not least because we are already subject to FDA regulations in our fine-cut tobacco business.

Finally, there is the US trade embargo against Cuban cigars and other goods from Cuba. We believe that the embargo will be lifted sooner or later, but not within the next two or three years. Obviously, however, this is a highly complex and political matter. How lifting the embargo will affect the US market for cigars depends entirely on the terms to be agreed on by the two countries. Competition in the US market will especially depend on the extent to which non-Cuban companies will gain access to Cuban tobacco so that competition can be created in the market for Cuban cigars. It is difficult to predict the final outcome of the potential lifting of the embargo and what impact it will have, but we believe it is also a challenge we will be able to handle well, and we are actively preparing for it.

I will now get back to our financial results for 2015. For any listed company, there is always a great deal of focus on whether the company has lived up to the market's expectations. This also applies – or, should I say, applies especially – to recently floated companies. From that perspective, it was a great pleasure for me to release our financial statements on 10 March, since we met all parts of the guidance we had provided for the 2015 financial year.

Our revenue was up by 9.9% to reach DKK 6,732 million. Our guidance had been for growth in the high single digits.

Our adjusted EBITDA margin was 20.5%, compared to 20.3% in 2014. Our overall capital expenditure amounted to DKK 236 million, against our guidance of about DKK 250 million.

Currency effects accounted for 7.8% out of the 9.9% revenue growth. In particular, the strengthening of the US dollar drove our revenue growth. We also had a positive contribution to revenue from the 2014 acquisition of Belgian cigar manufacturer Verellen. That left our consolidated organic growth at 0.3%. Our four main categories generated combined organic growth of 1.2%. That means the 'Other' category detracted from our overall growth, which was due exclusively to the fact that we had terminated a contract for the sale of our Captain Black brand in the Russian market. Effective this year, we have begun our own distribution of the brand, and we expect this move to have a positive effect on 2016 sales in the otherwise very difficult Russian market.

Our handmade cigar business delivered the highest growth rate. Cigar sales through our online business, Cigars International, remained extremely strong in 2015. Online sales of handmade cigars continue to grow, and we continue to win market share. The organic growth rate for the handmade cigar category was 7.9%. Pipe tobacco also delivered positive growth, but sales of both fine-cut tobacco and machine-made cigars fell by a respective 1.3% and 2.3%. We achieved positive price/mix developments in all categories.

Gross profit was up by DKK 292 million to reach DKK 3,239 million. Every category but 'Other' made a positive contribution to growth. The reported gross margin was unchanged at 48.1%, while the gross margin net of non-recurring costs improved to a level of 48.7%.

EBITDA improved by DKK 70 million to a total of DKK 1,247 million. Adjusting for non-recurring items lifts the improvement to DKK 138 million and brings the total to DKK 1,385 million. Underlying this performance are a number of factors that deserve mention. First, the declining volume of several of our categories puts our profitability under pressure. That is why we need a committed approach to raising our prices while at the same time keeping a sharp eye on all costs. We succeeded in both of these endeavours in 2015 and, combined with the additional synergies harvested from the integration of the Verellen acquisition in 2014, this helped us achieve the EBITDA improvement.

Before I continue my review of our financial results, let me elaborate a bit more on our specific focus on costs and working capital.

In 2015, we launched a programme to improve our efficiencies and optimise our production footprint, aiming to lower not only our costs, but also our working capital, especially the capital tied up in inventories. We call the programme '140/500', because our goal is, on a like-for-like basis, to lower our costs by DKK 140 million and our working capital by DKK 500 million. Both targets were set with end-2014 as the base, and the goal is to achieve them by the end of 2018.

The progress we made in 2015 shows that we're off to a good start. We achieved the planned 10% cost savings and DKK 225 million of the DKK 500 million target. However, part of this strong reduction in working capital was due to non-recurring events and timing.

The optimisation programme is mainly aimed at improving efficiency in our machine-made cigar production. One of our efficiency initiatives is to reduce the number of stock-keeping units ('SKUs'). In fact, we expect to be able to phase out some 45% of our machine-made cigar SKUs. This is a large number, but we also have to say that we've added too many SKUs through all the acquisitions we've made over the years. We're taking action on that now.

The second element of our optimisation programme is, as I've already mentioned, reducing our working capital. A very large part of the reduction will affect our inventories: inventories of leaf tobacco, inventories of semi-processed products and inventories of finished products. In other words, we're looking at changes across the board.

I will conclude this review of our financial results for 2015 by noting that our bottom line, the net profit after tax, improved by 4.4% to reach DKK 668 million. This is our best performance since Scandinavian Tobacco Group was formed in 2010. Our cash flow from operating activities was DKK 1,285 million, up 21.7% from DKK 1,056 million in 2014. Net of investing activities, our free cash flow amounted to DKK 1,057 million. This is an improvement of DKK 472 million that was due to the improved underlying financial results, to the fact that – unlike in 2014 – we made no acquisitions in 2015, and to the extraordinary liquidity improvement from the working capital reduction achieved in 2015.

This brings us to our equity, which amounted to DKK 8,998 million at 31 December 2015, slightly lower than the DKK 9,087 million at the end of 2014. This change results in part from the positive contribution from the profit for 2015, in part from the total dividends of DKK 1,327 million paid during the year.

I will conclude my report by giving you an update on our financial guidance. In November of last year, prior to the IPO, we issued guidance for the next few years along with our profit guidance for 2016. Based on our performance for 2015, we are maintaining our current guidance.

In the medium term we expect adjusted net sales growth to be 1% to 3% annually.

We expect adjusted EBITDA growth to be 3% to 5% annually and, lastly, we expect capital expenditure to total approximately DKK 150 million per year starting in 2017.

For 2016, we expect growth in line with this guidance; with the exception that capital expenditure will be approximately DKK 250 million due to the TDP-related investments in machinery that I mentioned earlier.

That marks the end of my report, and now I will give the floor back to the chairman of the meeting.