

Nomura Investment Forum 2018

Questions and Answers

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Presenter: Masamichi Terabatake, President and Chief Executive Officer

Japanese domestic tobacco business

Q. Please tell me the reason for and background to your setting the deadline for the launch of your new products at March 2019 amid the intensifying competition in the RRP market?

- In Japan, the RPP market had a share of only several percent of the overall tobacco market in 2016, but the share grew to 18% by the end of 2017. The plan that we announced at the beginning of this year was drawn up in view of this growth momentum, but the growth has recently slowed down.
- In this environment, we started nationwide sales of Ploom TECH only in July this year because of a problem with the capsule production capacity.
- Among T-Vapor tobacco products, there is a significant difference between competitors' products and Ploom TECH, a tobacco-infused vapor product which is heated at low temperature. The advantages that set Ploom TECH apart from other products include a relative absence of odor and the reduction of 99% in substances potentially harmful to health. We are devoting efforts to increasing the presence of tobacco-infused vapor products and developing a market for this type of tobacco.
- In light of the slowdown of the market's growth, we revised downward the sales target for Ploom TECH from 200 million packs to 140 million packs when we announced the Q3 financial results. We have recognized a lack of awareness among consumers about the benefits of the tobacco-infused vapor type. We have decided to devote efforts to raising awareness among consumers about the benefits as the first step and to launch the new products by the end of March.

Q. Have you judged that a quick product launch is unnecessary because the market's growth is slowing down?

- Although we have revised downward the sales target for Ploom TECH, we have not changed the forecast of a full-year profit for the Japanese domestic tobacco business this year.
- Japan is the main market for tobacco-infused vapor products, but manufacturing and selling ready-made cigarettes is also a very important business for us. In securing and managing profits, we will look at ready-made cigarettes and T-Vapor products as a whole.

Q. What is your view of the potential of tobacco-infused vapor products?

- In the Japanese market, the benefits of Ploom TECH tend to be accepted by consumers particularly easily.
- One conspicuous example is an increase in the number of restaurants and bars which permit the consumption of only Ploom TECH among tobacco products (Ploom TECH-only restaurants and bars) to more than 2,800. Restaurants and bars which prohibited smoking have expressed willingness to permit the consumption of Ploom TECH. From the fact that the number of Ploom TECH-only restaurants and bars increased so much in just about one year, we have recognized the potential of Ploom TECH once again. The arrival of Ploom TECH has enabled harmonious cohabitation of smokers and non-smokers.
- The absence of a need to use fire is well suited to the aging society of Japan, so there is ample room for tobacco-infused vapor products to be accepted.

Q. Let me ask you about the new products, Ploom TECH + and Ploom S. The launch of Ploom S will mean that you are entering a market developed by your competitor with heated tobacco products. The competitor launched a new device in November. What is your view of the competitiveness of JT's products (including new products)?

- Ploom TECH+ is a tobacco-infused vapor product. Ploom TECH is similar in flavor to ready-made cigarette products with a tar content of 1-3 mg, a category which has a share of around 30% in Japan's ready-made cigarette market. On the other hand, Ploom TECH+ is similar in flavor to ready-made cigarettes with a tar content of 5-6 mg, so it has a stronger flavor than Ploom TECH. Cigarettes with a tar content of 5-6mg form another volume zone in the market.
- Ploom S is a heated tobacco product, and this is the first product that JT will launch in the heated tobacco category. As JT is a latecomer in this category, we will grab market share away from other companies. Let me provide some more details about Ploom S. Among heated tobacco products, Ploom S is heated at a lower temperature than others. Its odor is weaker compared with the odor of other heated tobacco products. We also have strong confidence in the taste of Ploom S, which will be launched as a product of the Mevius line. We believe that Ploom S is superior in quality to competitors' products.

Q. Is there any production problem like the one that occurred at the launch of Ploom TECH?

- There is no problem concerning production of consumables like the one that occurred at the launch of Ploom TECH. Regarding Ploom TECH, we faced many problems as we developed the capsule-producing equipment from scratch. We plan to apply the capsule-producing equipment for Ploom TECH to Ploom TECH+.
- In addition, as Ploom S is a stick type, we can apply our technological knowhow concerning ready-

made cigarettes to it. The production equipment was installed around this summer, and it is ready to start operation.

- As for the heating device, it is difficult to quickly increase capacity at first, so we will expand sales areas in consideration of the supply volume.
- Regarding our plan for the future, we would like you to wait until our announcement of the full-year financial results scheduled for February next year, but we plan to inform you of the details of the new products by the end of January.

Q. What will be the key to capturing a share of 40% in the RRP market by 2020? JT is said to have a strong sales force, but can you turn that to your advantage at a time when convenience stores account for 70% of overall tobacco sales?

- The key to capturing a share of 40% is the attractiveness of products.
- We will capture share by taking advantage of our sales force with its large scale and high quality, and on top of that, all of us within the JT Group will dedicate ourselves to sales promotion.
- In the case of ready-made cigarettes, we can expect to increase sales by securing good shelf exposure, but the story is different when it comes to T-Vapor products. Consumers need to make an initial investment in the form of purchasing a heating device, so if we are to convince consumers to consume T-Vapor products on a regular basis, it is essential to let them experience the benefits of the T-Vapor type first-hand.
- Therefore, we have shifted emphasis in our sales activity to communicating directly with consumers. For example, we have started a program to let consumers try Ploom TECH in a closed space and experience its relative absence of odor first-hand.
- As we are communicating the benefits of Ploom TECH to hotel chains, coffee chains, rent-a-car companies and logistics companies, this product is being gradually accepted, mainly outside metropolitan areas.
- Unlike previously, we are making proposals directly to consumers.

Q. Please tell me about switching and retention with respect to T-Vapor products. Heating devices break down sooner or later, and this is expected to provide switching opportunities.

- As devices are electronic products, they have a limited operating life. The period of guarantee for devices is generally one year. Switching can be either a risk or opportunity, but as a latecomer in the market, JT regards it as an opportunity.
- As for retention, considering the importance of a product's brand in the case of ready-made cigarettes, the key in the T-Vapor category is whether we can make consumers see value in the product itself.
- Our understanding is that the T-Vapor category is still in its early days, and now is the time when consumers are willing to try new products without caring about brands. We believe that it is important

to create good products and provide opportunities for consumers to experience their benefits first-hand.

Q. When it comes to the attractiveness of products, devices are also important. Are you well prepared to defeat competitors in the race to develop better products?

- Frankly speaking, it is true that until four or five years ago, JT was lagging behind competitors. In 2014, when I was stationed in Geneva, we established a global team responsible for RRP, and by the end of last year, we invested 100 billion yen. The investment covered the buildup of capacity to develop RRP, the acquisition of Logic, collection of scientific data necessary for acquiring certification for risk reduction in various countries, and the acquisition of intellectual property and technologies. We believe that we have now built up sufficient R&D and manufacturing capacities to keep abreast or ahead of competitors in the product development race.
- Under the medium to long-term plan that we disclosed when we announced the full-year financial results in February this year, we announced a plan to invest an additional 100 billion yen in RRP in 2018 to 2020. The investment will cover production lines for new products, device supply capacity, and R&D.
- In November, we announced a new management team, and one important point about the new team is the appointment of an officer responsible for global R&D activities. As we have shifted to a system to centrally control R&D activities of both JT and JTI, we will accelerate our product development.

Q. Pricing strategy related to tax hikes for T-Vapor products.

- For T-Vapor products, the tobacco excise tax is scheduled to be raised for five consecutive years from 2018, and the tax system has been revised so as to levy both specific rate and ad valorem taxes, instead of levying only a specific rate tax as was previously the case. Currently, the excise tax on Ploom TECH is around a quarter of the tax on ready-made cigarette products, but eventually, it may be increased to a level equivalent to 60 to 70% of the tax on ready-made cigarette products, although the proportion may vary depending on the price level. Even though Ploom TECH enjoys an advantage in terms of taxation, it is true that the profit margin will gradually shrink in the future.
- Regarding Ploom TECH, as there is room for cost reduction, we will implement measures to secure a certain level of profits, such as improving manufacturing efficiency as well as reducing cost.
- Whether or not to set different prices for products in the ready-made cigarette category and RRP category when raising prices at the time of a tax hike will depend on our future pricing strategy. This year, we set the price of Ploom Tech at 490 yen, 10 yen higher than the price of 480 yen set for the ready-made cigarette category. As we are a latecomer in the RPP category, we will consider pricing in light of how competitors are pricing their products. Regarding ready-made cigarettes, we plan to pass on the additional tax to the price, as we have done until now.

Q. In the medium to long term, smoking opportunities may decrease, but how are you going to manage profits in Japan?

- We are doing business on a global scale. In other developed countries, overall tobacco demand is declining 3 to 7% annually, but we have achieved profit growth by raising prices at the time of tax hikes. While this will be the first time for the tobacco excise tax to be raised for successive years in Japan, we believe that this has given us an additional pricing option.
- In the most recent two years, our profit has declined mainly because of our late entry into the RRP category. Our challenge for now is finding ways of increasing our profit for ready-made cigarettes and RRP as a whole once again next year and beyond from the bottom reached this year, so we are making efforts toward that goal.
- In April 2020, the revised Health Promotion Act will be put into force. Under the revised act, the regulation of T-Vapor products is expected to be less stringent than the regulation of ready-made cigarettes, and as a result, the growth of the RRP category may accelerate. While the market environment is volatile, we will draw up plans based on various scenarios.

International tobacco business

Q. Please tell me about future M&A opportunities and your strategy for the future.

- As it is difficult to implement large-scale cross-border M&As from the viewpoint of the Antimonopoly Act, we have implemented “bolt-on” acquisitions in various countries. We implemented M&As in the Philippines, Indonesia, and Ethiopia last year and in Russia and Bangladesh this year.
- As there are some white spaces of opportunity, we will maintain the strategy of establishing a business foundation through organic growth and build on the growth through bolt-on acquisitions.

Q. At a time when foreign exchange and other risks are growing due to your geographic expansion, how are you going to manage profits?

- As for transactional foreign exchange effects, we are maximizing the effects of natural hedging by matching the income currency with the cost currency. The construction of factories in Taiwan and the Philippines in recent years is a typical example of that approach.
- On the other hand, as transactional risks are very volatile, it is difficult to manage them.
- From a long-term perspective, we expect that the expansion of the market portfolio will lead to the improvement of our capability to respond to various situations. Previously, we depended on profits from the UK and Russian markets, but now, we can generate profits in various markets. Through our diversified market portfolio, we will manage profits of the tobacco business as a whole.

Q. Amid global geopolitical risks such as Brexit and the imposition of sanctions against Iran, what is the status of your supply chain's flexibility?

- In Iran, we have continued to do business for around 15 years under the sanctions regime, and our current market share is higher than 50%. Import of raw materials is a cause for concern, but we have until now been able to continue to do business without any particular problem.
- Regarding Brexit, none of the global tobacco companies, including JT, have a manufacturing factory in the UK, as they have created supply chains on an EU-wide basis. Taking into consideration the possibility of the UK ending up with a hard Brexit, we will develop a contingency plan.

Overall business matters

Q. Please tell me about your shareholder return policy.

- We will deliver a competitive shareholder return compared with the capital market while increasing our corporate value through business investments. For the past 15 years, we have continued to increase DPS based on the policy of ensuring stable and continuous DPS growth, and there will be no change in this policy.
- Although repurchasing own shares is an option, we are now placing the priority on making investments in RRP and other businesses.

Q. Since the share repurchase implemented in 2015, you have refrained from repurchasing own shares. Amid the weakness of JT's share price, what are your thoughts on the possibility of repurchasing own shares?

- In the most recent year, tobacco companies' share prices have declined at similar rates. It is probably difficult for investors to make investment judgment due to uncertainty over the RRP market. For our part, we must regain investors' trust by delivering results.
- First of all, we will devote efforts to increasing DPS in a stable manner through business growth. Share repurchase is not a high priority.

Q. Regarding JT shares, which factors have not been fully reflected in the share price?

- We aim to achieve mid to high single digit profit growth on a consolidated basis, including both the international and Japanese domestic businesses. In Japan, the RRP category is growing significantly, but outside Japan, South Korea is the only country where the RRP category is growing rapidly. Globally, ready-made cigarettes remain the mainstream. We have the impression that the market's attention is focusing on the RRP business in Japan and that JT's share price has been fluctuating depending on the situation of this business. We will seek to achieve stable and continuous growth in profit and DPS by growing the ready-made cigarette business, which represents our fundamental

business core.

- On the other hand, competition in the RRP category in Japan is very important, so we will achieve successful results in Japan and transfer the knowhow acquired and products developed in Japan to overseas markets. In any case, the competition has just started.