PMI Investor Day

February 10, 2021

Event Transcript

Nicholas Rolli - Philip Morris International Inc. - VP of Investor Relations and Financial Communications

I'm Nick Rolli, Vice President, Investor Relations and Financial Communications. Earlier today, we issued a press release containing information that will be presented during today's event. You may access the release on www.pmi.com or the new PMI Investor Relations app.

Today's remarks contain forward-looking statements and projections of future results. I direct your attention to the forward-looking and cautionary statements disclosure in today's presentation and press release for a review of the various factors that could cause actual results to differ materially from our forward-looking projections or statements.

Please also note the additional forward-looking and cautionary statements related to COVID-19. A glossary of terms, including the definition for reduced risk products or RRPs, are posted on our website. Please note also that the growth rates presented on an organic basis reflect currency neutral underlying results and like-for-like comparisons where applicable. Unless otherwise stated, all references to *IQOS* are to our *IQOS* heat-not-burn devices and consumables.

Let's take a quick look at the agenda. We have three presentations from senior management. We'll have a 10-minute break in between each presentation and before the Q&A session.

This event is a live video webcast. We will post the slides of each presentation at the start of each presentation. And following today's meeting, we plan to also post the full transcript, including the Q&A session, as soon as reasonably practicable to our website.

It's now my pleasure to introduce Andre Calantzopoulos, our Chief Executive Officer.

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Thank you, Nick, and welcome to all of you. Good morning, good afternoon, depending on the time zone you're in. We'd, of course, have loved to have this meeting in person, but we'll try to do our best, looking at the screen, to explain our strategy and our mid-term outlook.

But before that, I would like to first summarize what we achieved so far. It is just over five years now since we launched full-scale *IQOS* and also the beginning of our smoke-free transformation. And I think we've made tremendous progress. We did try many things. We innovated a lot. We invested a lot, as you all know, and learned a lot. But all this, I think, made us a much better organization, much more prepared and even more confident for the years to come.

So in summary, almost $7 billion in net revenues coming from *IQOS*, almost one quarter of our business and 35% if we aggregate the three regions where *IQOS* is meaningfully present. Almost 18 million users, which is just the beginning, obviously, with scratching the surface with *IQOS* across 64 markets. We have maintained 80% plus segment share of heated tobacco products with premium positioning and despite all the competitive activities. And very importantly, we focus on responsible marketing practices to minimize unintended use because we know from a regulatory and public health perspective, this is a very important subject.

PMI and the *IQOS* brand are the clear leader in smoke-free, I think both in volume and in brand equity, as we will see today just as *Marlboro* is in cigarettes. Actually, *IQOS* is already the #5 nicotine brand despite only being present in less than half of the world. And I believe it could reach the #2 position just after *Marlboro* by 2023.

I think we are pioneering in tobacco-harm reduction, and that supports a unique ESG impact story, which we'll elaborate today. And obviously, the product change and switching smokers out of cigarettes into less harmful alternatives is the biggest contribution we can make to society and public health. But we excel in many other important ESG areas as Emmanuel will explain later on.

Note: Edited by Philip Morris International for significant transcription errors

And finally, this -- all these achievements didn't come without investments. $8.1 billion in cumulative investments in central developments. That excludes clearly commercial activities. And I think we have now built the platform from which we can expand further.

Of course, during the last five years, we had prolonged currency headwinds on our dollar earnings. And this year, I think we have for the first time a positive currency, and I hope it will remain. That will help us, clearly, enormously.

And the big question still is the effects of the COVID crisis disease, especially on the combustible business. And as we all know and explained in the investors' calls previously, *IQOS* is remarkably resilient, although we had obviously some delays compared to our original plan.

So having said all that, what are we going to cover today? We have gathered a lot of investor feedback in preparing this event, and we plan to address the main questions.

First of all, what is the RRP category growth outlook? What are the obstacles and the enablers? And I will spend some time on the most important one, that is regulation. But reality is we are just at the beginning of the RRPs, and I think the potential is still enormous.

The second question is, why do we believe that we will maintain PMI's leadership in smoke-free products, which I'm convinced we will, and we will explain why. We'll give you more granularity on category economics and profitability, especially on *IQOS* because there are many questions to understand how the top line translates into bottom line.

And of course, we had the questions from investors. Yes, we do keep an eye on combustibles. I'll explain the strategy we have and the outlook also in a post-COVID context. We will talk about capital structure, shareholder returns and especially the resumption of share buybacks, and as I said previously, ESG and sustainability because I think we have a unique story and contribution. And I think we need to do a bit more work or much more work actually with ESG investors as PMI story and contribution is not fully understood.

And I'll also touch upon how we can leverage existing capabilities we have developed in life sciences, preclinical and clinical, in formulation of substrates and respiratory capabilities and aerosolization capabilities so that we can start expanding beyond nicotine over the longer term. So we are not just a tobacco or nicotine company but more than that.

I will touch upon all these subjects to provide context to the extent possible. And obviously, Jacek and Emmanuel will give much more details and color.

So the first, I think, highlight is we aim to reach over 50% of net revenues from smoke-free products or noncombustible products by 2025. I think we are on the right path to get there. And I think we can -- we're driving, I would say, a new phase of category development.

So far, I think we used only one platform and essentially one technology. I think we can do much more to accelerate in this field. And now we have the infrastructure know-how and product pipeline to do so. We will continue leveraging, obviously, a leadership in combustibles so that we can support the smoke-free expansion. And obviously, smoke-free products don't need financing from combustibles, but still access to smokers and infrastructure, especially for new markets, is important.

And an accelerator to all this can be a differentiated regulation that applies specifically to smoke-free products, both in terms of taxation, ability of communication, premarket and post-market elements. So that -- this can be, I would think, an important accelerator to growth. But we have not taken this into consideration at least for 2021 to '23 projections.

So let's come to the numbers now. So we -- starting from the top, obviously. We project more than 5% organic growth at revenue level over the next three years, and I will explain how we get to this. We expect an acceleration in margin and EPS growth and target more than 9% earnings per share. We believe that by 2023, we'll be around 40% of net revenues from smoke-free products, on the way to 50% by '25.

The important number here is the heated tobacco shipment volumes of a range of 140 billion and 160 billion. And we also target cost efficiencies that Emmanuel will explain, but they come both from manufacturing. I would say half of it and also half of it from SG&A. And obviously, this is gross. Some of that will be reinvested to fuel the growth of the RRPs.

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Now let me explain a little bit how we come to this more than 5%. And it may well be higher, obviously, and I will explain the factors.

First of all, if we look at heated tobacco units, and we take, just as an example, 10 billion heated tobacco units growth. Then we have to subtract, obviously, the cannibalization of our own portfolio of tobacco products. So I would say that if we compare the markets we are in and assuming existing pricing and existing tax rates, 10 billion heated tobacco units for PMI will give incrementally something between $650 million and $700 million of net revenues, to which we can add 8% to 10% for device sales in terms of revenues. And that would translate to around $525 million to $550 million in gross profit, and Emmanuel will come back on how now that can flow to the bottom line.

So that's the first thing to remember, and I'm trying here to give as much color as possible so that everybody can calculate more easily their numbers. The -- if we look now at the range of 140 billion to 160 billion units, that gives approximately 1.5 compound average growth difference from lower to upper end of the range, net of cannibalization.

And then we come to the impacts of COVID. The first question is, when is duty free going to come back? So duty free full recovery can add up to 1.1% compound average growth rate. But we don't know exactly when it's going to happen, to which extent this is going to happen, 100% or 80%. So I give you this range from 0% to 1.1% CAGR.

Now we said that we lost a lot of consumption last year, and some of this volume can come back during the '21, '23 period. So I would say the COVID recovery could be between 0% and 1.4% compound average growth rate. That is all combustible. And then the easier numbers to calculate, to see the ranges in which we can be above 5%, is to know that a 2% combustible volume decline, if we now have excluded already the cannibalization, is about 1 point -- minus 1.7% CAGR. And a 3% volume decline is minus 2.5% CAGR. But typically, we cover and much more than cover these numbers through price.

So that's the parameters to see what ranges we can have. And as you see, there is some degree of uncertainty, especially because of COVID during this period. So I think we spent a lot of time here on this slide, but I thought it was important.

Now if we look at a little bit of the outlook, we expect the total nicotine industry to decline about 1% to 2% over the next 3 years. Also, as I said, depending on COVID rebound. And we assume, I would say, cautiously, 10% of international industry by volume to be smoke-free by 2023 and heat-not-burn to be at least 70% of the category.

Now bear in mind that in the markets where *IQOS* is present, these 2020 percentages are approximately double. And obviously, as I said, this does not assume a major acceleration in regulatory progress. So heated tobacco products we continue operating with the same restrictions as cigarettes in many markets.

If we look at differently the retail value, we estimate that, although heat-not-burn was 3% or 3.3% of industry volume, it was 4.7% of retail value and obviously, more at the net revenue level due to higher net revenue per unit. On the contrary, e-vape -- I mean, conversely, the e-vapor is lower because also of the prevalence of open tax systems that particularly reduce the average value and the absence of excise tax, although the trade margins are much higher.

So over the next five years, we expect the overall retail value to grow by approximately 4%. This, of course, includes pricing and taxation. And this includes an over 25% growth of heat-not-burn and 10% to 15% growth of e-vapor depending on the mix of open and closed systems and the conversion rates to full use.

So I think this is moving in the right direction. And clearly, better regulation and a more unanimous front amongst the industry competitors would accelerate these results.

A different way to look at this is now we look at the markets in the first 2 columns left and right, both in terms of number of consumers or users and in billion units. As we can see, *IQOS* just in the current footprint, we have still to go for 150 million people. And if we address the entire footprint in the current market without even expansion, we have 250 million users potentially and 1.2 trillion units. So just in the markets we are in, and of course, we're planning geographic expansion, I think we can -- we have room to grow. I'm not saying it's the easiest thing on earth, but I think we are well equipped to progress.

Now I tried to list here what we have learned from commercializing RRPs now for five years, and what it takes to excel in this category. Obviously, the first one is product. We need to master -- and the common denominator as we all know of these products is the absence of combustion. I'll come back to this, but that's the problem in cigarettes.

So all these products are noncombustible products. Clearly, you need to master aerosolization, and we all know that internal heating gives the best sensory. Of course, we have electronics and electronic supply chains. And most importantly, we need constant innovation, and I will come to our innovation philosophy.

The second thing is we need to bring -- to build new brand equity. And it takes time, but I think *IQOS* has the highest equity and by and large, among all products in the RRP space.

Obviously, we need life sciences for substantiation and pre- and post-market surveillance, including very strict surveillance to make sure that youth and other unintended audiences are minimized. The manufacturing and supply chain is very different because we have electronics. We have third-party partners. We have reverse logistics, and we need investment, obviously, new machinery.

The consumer journey is completely different because we need own retail, third-party retail, customer service, aftersales care. And it's a full journey from category understanding to post-market surveyance.

As I said, the regulatory landscape is still uncharted. Except for the U.S. FDA, very few countries have regulation in place that is comprehensive. And I think that is very important. I'll come back to this.

And it's very important to have high conversion rates, both from a harm-reduction perspective and public health, but also because otherwise, the infrastructure costs that you have to do to make upfront as we did to have a meaningful entry in the category, if we don't have high conversion and high consumption of consumables, and if it's scattered or you have dual use, clearly, it takes you much more time to break even. And all this, obviously, requires many new organizational skills as there are very many new areas that you don't have in cigarettes and completely different ways of working.

So that's what you need to compete successfully and lead, in my view. The rewards are also significant: much more positive public health impact, obviously, higher profitability and growth potential as we have the ability to gain market share, and it's a much more sustainable business model that has potential adjacencies as we now have introduced many new areas in the business.

Now what has been our philosophy? And I think I have explained this a few times, but I will repeat it because we always get the question why not first e-vapor products and so on. So we knew from the beginning that the best product in the category is heated tobacco products. And internally, heating is much better than any other form of heating the tobacco.

So it was natural to launch this product first because it has the highest capability to convert the adult smokers and also build trust in the brand. Because if you try a product and you don't like it, then obviously, your trust and brand equity are not there.

And I think we are succeeding with *IQOS* having also a first-mover advantage. Clearly, *IQOS* needs still work to build its brand equity, but I think we're on the right path. And our ambition is, in a few years, we'll be as high up there in the minds of consumers as *Marlboro* and other iconic brands have been.

The second thing is to establish all the science and start building public health credentials. And I think an increasing number of countries are recognizing that this product is different than cigarettes and has harm-reduction potential. And obviously, the PMTA and subsequently modified risk tobacco product authorization of the FDA have helped.

I talked about upfront investment in order to build profitability later, and I think we are at this stage. Organizational capabilities. So we have all that established, and we can leverage all these to have better growth.

And a very important thing is the *IQOS ILUMA*, and I'll talk about it. But it's a brand-new product with new aerosolization technology, always internal heating, but using induction. And I think that will be a major accelerator, both in terms of consumer adoption but also doing with lower costs.

So overall, if I just start with heat-not-burn, I think that we will need two to three technologies. So we have the blade technology. We have, obviously, now the induction technology. Jacek is going to talk much more about that. And with -- maybe in different markets, we also need a different, I would say, technology. I don't know if it's peripheral heating or any other type of heating. But it's very unlikely that we'll deploy three different technologies in the same market.

And then to cover the entire spectrum of price segments, you may need 3 to 5 price points in maximum. In Europe, obviously, two to three in total to cover everything. If you go to countries like Indonesia or Russia, we may need four price points and -- but never all in the same place.

And the pace of innovation, in our view, should be aerosolization engine changes every four to five years, and *IQOS ILUMA* is a very good example because it comes after the blade. Obviously, as consumers interact with the product, you need to constantly upgrade the interface, the user experience, the smaller things that make the life of consumer easier. And the consumer portfolio changed the sensory experiences with expansions and additions every six to 12 months. And I think more or less the same philosophy applies to e-vapor as not one platform and not only one price point of cartridges will win the market over time.

So now if we move to e-vapor and the other categories, I think *IQOS VEEV* device and consumables, and we announced the gradual introduction in 20 markets, they're all going to be introduced with premium position. Now the issue here and the focus is different. We don't need to build category understanding and awareness to the extent, and by and large, not to the extent that we have done for *IQOS* and heat-not-burn.

So the second thing here is differentiation. So we need to prove our product is better in terms of usage, experience and also trust and brand loyalty, brand equity, than other products. You see here the audiences, and I think we will elaborate on this also during the Q&A with Jacek. But -- and then addressing the category concerns, especially youth access, is fundamental for every platform. But for e-vapor products, even more fundamental. And that's why we are now developing technology that the device cannot be activated without age verification. But I will come to all these points a bit later.

The key success factor in e-vapor, although its economics are good, is minimize dual use but also the dilution you get as consumers own 5, 6 different devices from different manufacturers. So an individual manufacturer has very low consumption of their own cartridges or pods, so the profitability takes a lot of time to come and hardly pays for the infrastructure sometimes.

We believe that over time, consumers need to be offered different products. There will be predominant of one, say, heat-not-burn. And we believe heat-not-burn for the foreseeable future is going to be the product that can switch consumers more successfully out of cigarettes.

But clearly, consumers will use two or three products as -- if I take an example from beer, we drink beer from alcohol. I'm sorry, we can -- we drink beer, we drink wine, we drink whiskey. We're predominant of something, but we also use the others. So we need to enlarge the offering, but we'll use this offering to the extent feasible and logical under *IQOS* umbrella for premium. And clearly, we may need a second brand in the time for the lower end of the market.

Now if I look at the economics, we aim to, as we said, approximately double the heated tobacco unit volume by 2023 because there is the range. This means a significant expansion in net revenue per unit, and I explained the economics previously and how to calculate this.

Of course, there are questions and concerns of investors. Will there be excise tax increases, closing the differentials between heated tobacco products and cigarettes? Of course, we have very good reasons to believe we can keep the differentials. But there is room if there are tax increases that close the differential because the *IQOS* price productivity is significantly above cigarettes, as I will show you in a few slides.

And secondly, *IQOS* because we pass a large part of the tax advantage to the consumers also, it's kind of mid-position on a weighted average price. So we have also, compared to the premium cigarette segment, room to grow. But obviously, excise tax differentials are important. They make sense, and we're watching this very closely.

Now if we look at below the gross margin, obviously, we think we have capacity to at least cover 150 billion heated tobacco units. And you have here the number, every 10 billion cost $150 million in capex. And we got to this number because we also increased substantially productivity.

SG&A costs will grow, and I don't want to steal Emmanuel's thunder. So he will explain to you the split between what we consider fixed and what is variable and volume-related.

And there's always been new market entries, but we -- as we will see over time, we are -- our time to break even is becoming shorter and shorter. And now we're at below one year on average. So overall, we will see expansion also of the operating margin of *IQOS* and its contribution to PMI in the years to come.

Now the *VEEV* economics, and I tried to explain it a little bit, are slightly different. It's much less fixed investments needed as we already have the *IQOS* commercial platform being physical or digital. So the majority of the costs are variable. They are volume-related, and it's about differentiating, so much more classic marketing.

And the *IQOS* brand, we believe, will help add credibility to a category that still is very fragmented. Our objective, as I said, is premium positioning, increasing conversion and minimizing dual use and brand loyalty so consumers consume our pods and cartridges and not somebody else's.

And if we look at the gross margins, at premium, the e-vapor category, assuming full conversion and full brand loyalty, it's 1.6x cigarettes. So it's not bad. And if we avoid fragmentation, profitability can be pretty good, especially since we don't have to amortize infrastructure.

The taxation is more favorable than heated tobacco products. Actually, it's 4% compared to 30% of the retail price, 33% of the retail price if I'm not mistaken. And -- but the trade margins are much higher. Sometimes they are 3x that of also cigarettes, so they act a little bit like an ad valorem tax. But over time, I think this can be reduced.

Now there is always a big conversation of why we don't have unanimous acceptance of harm reduction through smoke-free alternatives. And I'll come to why there is a position, but let's get a rational and factual look.

I think that there are 1 billion people that smoke today in the world, and the projection is there's going to be the same number of smokers by 2025 based on the World Health Organization. So the current fiscal regulatory measures and they can raise from -- to extreme ones like plain packaging, display bans, continuous tax increases are not truly accelerating cessation. So without stopping them. Clearly, a second pillar is required and absolutely actually necessary, makes sense for the public health.

And harm reduction is not a new concept. It's applied in many industries. We have climate change. And we incentivize people and we promote alternative energies, solar panels, aeolian or electric cars. It's not that these products have no impact on the environment or they don't use energy. Of course, they do because you need to build them, you need to maintain them, you need transport them and so on. But they are better than burning coal. So better in harm reduction is good, and the same applies to our category.

So scientifically substantiated products can play a very important role and can switch consumers out of cigarettes much faster than restrictive measures only. Now we have absolutely differentiated regulatory frameworks if we want to be successful and have acceleration. By differentiated, I mean differentiated taxation. And there, we are fairly successful. But also differentiated communication because in many markets, it's quasi impossible to speak to consumers if we apply cigarette restrictions.

Of course, we don't talk about some free-for-all situation. It has to be highly regulated with the right post-market and premarket reviews, but a notch better can give information to people that they need to make their own decisions within reach.

So the key here is to put the interest of the 1 billion people who smoke at the center of the conversation, not politics and ideology. So I would say we must stop debating whether RRPs should be made available, but how fast and how best to minimize an intended use so that we can help the men and women that would otherwise continue smoking.

Now here is the first problem of confusion: nicotine. Nicotine is not the real problem in cigarettes, as tobacco is not. Combustion is. Yes, nicotine is addictive but does not directly cause disease. Yet 70% of smokers, almost, and also the vast majority of regulators think that nicotine is the problem. So that needs to be diffused. And as you've seen the small print underneath, that's clearly the position of the FDA issued in September 2017. It's clearly stating that nicotine is not directly responsible. It's the smoke created by combustion that is the issue. And when we have NGOs and people in public health creating confusion, clearly, that does not incentivize the people who smoke to switch because all the smoke-free products do contain nicotine as well.

Now the other issue is what is going to be the reduction in morbidity and mortality? It's pretty clear logically that the 90% to 95% reduction to the exposure in harmful chemicals and 99-plus for e-vapor products will result in better public health outcomes. But to be absolutely precise, we need long-term epidemiology. And to establish long-term epidemiology, we obviously need protocols because today, if we go to a doctor, it's very unlikely that they ask you whether you use an e-vapor product or a heated tobacco product. You are either a smoker or nonsmoker. If we just have this device, it's difficult to establish epidemiology.

Now let's look at first signs, I would say. If we take Japan, we all know that in Japan, the advent of heated tobacco products led by *IQOS* has resulted in the highest reduction in cigarette use ever seen, especially in a market of this size. So you would expect to see some first signs.

And what we did -- this is not epidemiology, clearly, but we did what we call an ecological study, just looking at admissions in hospitals of COPD exacerbations or -- COPD is chronic obstructive pulmonary disease. And we looked at admissions where there is aggravations of COPD symptoms. And you see the line that changes direction in a way that is rather significant after 2016, and the only intervening event is the introduction of heat-not-burn.

Now the first indication is not epidemiology, but it's an encouraging sign that positive effects will occur. And we have an open -- a PMI Open Science event in February 17th, so you can follow a bit more this and the other work we are doing already in this field.

As I said, there is a position, and I -- we're not going to read the slide, but there are two important things here. And that says ideology biases many things. But what we start seeing over the last two years and many of you experienced also with e-vapor controversies in the U.S., we have a lot of ideologically biased research that confuses both the consumers and regulators. And we got to a point where 50%, 60% of smokers believe that e-vapor products are equally bad or worse than cigarettes, which is not something that makes sense. And people should be held accountable for that.

The second is the World Health Organization, which truly has anachronistic positions and its special interest influence, NGO influence and by and large, not facts and science. So it is about time that we see the World Health Organization looking at real facts, real evidence, read the research and doesn't just listen to extremists in order to define their positions. And if that happens, clearly, we can have an enormous acceleration in people switching out of cigarettes.

The other thing is very wrong focus on companies, not 1 billion people who smoke. And the thing is if we ban completely or recommend that all these products are strictly regulated or banned, then essentially, everybody perpetuates smoking. And I think that's what NGOs, the World Health Organization and people in public health have to understand. So we have to stop the confusion. Because if the confusion stops, we have -- we can have the acceleration I talked about.

Now I think I covered these subjects in my previous introduction. But I think the right regulation, first of all, eliminates confusion in the minds of consumers, increases consumer confidence in the products that have been through the right pre- and post-market process. And more information gives them knowledge to make the right sale.

Obviously, as I said, closed markets can reopen if we have clarity like Singapore and others, and some have. And growth can be accelerated in what we call restricted markets, markets like, I don't know, the U.K. or Canada or so on, where essentially, there is very little to do if you don't differentiate smoke-free products from cigarettes. And you can do it also with much lower cost from a company perspective. So it makes sense for consumers. It makes sense for the company.

And at least regulation needs to give short-term premarket notification, at least with product standards in place, post-market monitoring of use and design the epidemiological studies so they're -- we have to learn the long-term effects. And once the products are in place, and sufficient penetration of the smoke-free products has occurred, then we can think of supply-side measures like cap and trade, taxation based on share of combustibles, nicotine reduction or not probably the best measure as the FDA suggested. But these are all stick-and-carrot policies so that the manufacturers innovate and put their heart behind these products as we did. And I think then we can arrive in the elimination of cigarettes much faster.

Youth prevention is very important. And here, I listed all the things that need to be done. And I think we are all familiar from age verification, age limits, education at schools. Because so far, we told teenagers "Don't smoke" and they can rightly say, "That's not smoking." So no use of nicotine and the right post-market surveillance systems as the FDA has imposed in the U.S.

for a very simple reason. It's -- we can easily take any activity that is commercial and say, "Oh, that may influence teenagers." But it's only by measuring what the actual effect is with the right way that we can define whether this is a problem or not.

And that's the only way, through an interactive process where we measure intended audiences, we measure unintended audiences, and then we accentuate the intended communication if we are not achieving awareness and go the other way, obviously, if we have any problem with teenagers. That's the only way to maximize adoption and minimize unintended. And the good news for us is that we don't have any underage issue with *IQOS* because we pay a lot of attention in everything we do in this field.

I think I talked about engaging with various stakeholders. I think we are making progress. There is more and more national authorities that recognize the science behind our heated tobacco products. Obviously, the FDA was the precursor. And also as consumers adopt the product, governments have to listen to what people say. And this is a long journey. This is not done. Progress is there. It could be much faster and much better. And we will continue the dialogue with governments and different groups in the public health sphere and use consumer advocacy where needed because we need to resolve the regulatory issues as fast as possible.

Now on combustibles, I think our combustible portfolio is sufficiently invested. But clearly -- Jacek will talk more about that. Clearly, we may need some more investment depending on how the post-COVID impacts unfold.

I think, in particular, we need to focus on price gap management as we did in 2008 crisis. We need to continue putting some effort to grow share in the low-price segment as we may have some temporary down-trading, and we will continue the progress on SKU consolidation and also in the efficiency of our new product launches. We have much fewer but much more successful ones. So we're on the right path.

If I talked about variations we can have in volumes when I gave the explanations on the guidance, overall, if we look at the fiscal environment, okay, for 2021 is well known. But the most important thing is that fiscal structures in terms of more specific continue to improve. That helps our portfolio but also helps price productivity. Overall, the price elasticities do remain around minus 0.4.

Combustible pricing will continue as I said previously. And overall, as *IQOS* volume grow and has more importance in the mix, price productivity will increase despite cannibalization for the reason you see here. If we look at the evolution over the last 10 years, and we look here at incidents and also composition of the tax, the specific has increased over time, and the ad valorem has decreased. And obviously, it's not as good as the heated tobacco units where the taxation is mostly specific. And it's only in Japan we have ad valorem taxation. And as Japan grows less in the mix, obviously, we will have even further improvement.

So overall, I think the environment is good. And during the last week, we discussed the specific of the excise tax outlook for '21. We had an above-average increase in Russia, but we have a minimum pricing that helps price gap management. The increase in Indonesia was significant, but for us, a bit smaller because of the favorability we have for the hand-rolled kreteks. We have an excise structure improvement in Turkey. So overall, the environment is good. What, obviously, we need to watch out is as governed around bigger deficits that we have gradual tax increases as we have normally and not fast and once that clearly create contraband and other undesired effects.

I would like to spend two minutes on the organization. I described previously all the success factors. Obviously, these need organization and people to make them happen. So we started at the top. We have 45% external talent coming here -- the senior management team -- in the last three years, a lot of new skills. Our ways of working have changed. We are organized on a project basis because nobody can deal with the complexity and all function individually.

All our working practices are along the consumer journey, and the performance management has changed. So overall, I wouldn't say we're where we want to be, but we made an enormous progress. And that transformation is a continuous thing. It doesn't stop. And we are also making very good progress in terms of diversity, inclusion and equity. You can read the numbers here. We're equally salary satisfied -- sorry, certified and satisfied. We're named at the Bloomberg Gender-Equality Index. So good progress, much more to be done here.

Now this is our projection of how we will fare in the years to come. We have 28% of the value of combustibles, and I think we can maintain it. And clearly, we will have an increasing share of RRPs, including e-vapor products. I think we have the innovation capability, sometimes with partnerships. We have the brand equity and the first-mover advantage. And we have the engine to continue growing with the category and expanding the other new categories of e-vapor and pouches or P3.

Finally, a few words about new avenues or adjacencies. As I said, we do have developed new capabilities in certain areas. So we are looking at leveraging these capabilities so that we bring new products or services to consumers.

So we look at -- as a first cut in three specific areas. First, botanicals in the broader term, and I will explain the focus areas in a second, either to extend RRP consumables into new sensorial experiences, and here we can think of a lot of things. The obvious is cloves, but also star anise, chamomile and so on, but also moving into botanicals that have no nicotine. And they can apply more broadly and using our expertise in substrates.

Respiratory drug delivery is an interesting area. I think we understand inhalable delivery. And here is not to become a pharma company, to be clear. This is about taking existing drugs, existing molecules, where a respiratory delivery can increase the bioavailability of the molecule by an enormous factor that can be very vital in certain conditions.

If I use an obvious example, if you have a myocardial infarction, the first thing you do is take aspirin, it takes 30 minutes, 25 to 30 minutes to act. If you take it through a respiratory way, assumingly, then you can have bioavailability in one or two minutes. And that can save a lot of lives, just by a different way of delivery.

So our business model in this area is not to build everything from upstream to downstream. Stay at the center with our clinical capabilities, our formulation capabilities, our delivery capabilities and then partner, outsource and orchestrate an ecosystem that has the skills we don't have. So we are trying to minimize investment here but maximize what we can offer through these new products.

And here is some indication of the initial areas of focus and the projected addressable market value. Of course, that's the beginning in areas of opportunity in botanicals is sleep aid, energy and focus, calm control, and I described respiratory drug delivery.

And finally, but very importantly, is sustainability at PMI. So Emmanuel is going to talk more about that. But clearly, there are 4 things that are important to retain here.

First of all, we have a statement of purpose that covers all stakeholders of the company, that describes the impact on all constituencies of our transformation process to a smoke-free company. We have established a rigorous materiality analysis. So we have identified 4 areas: innovating for better products, operating with excellence, caring for people who work with us and protecting the environment. And we have established for all these Tier 1 topics 2025 road maps with KPIs that we will every year publish in our annual integrated reporting. I think the bottom line here is product is clearly, as I said previously, the most important part. But we are doing extremely well in many other areas. For example, our CDP A list on water, on waste, on forests and obviously, on carbon. And we have a target by 2030, probably earlier, hopefully, to be carbon-neutral, at least for our own Tier 1, scope 1 and 2 which is our own facilities, I would say.

So our product can have the biggest impact on society and the sustainability of our business. Beyond nicotine products obviously play in the same ground. And Emmanuel, he would explain all the other areas and how we prioritize them.

So I would conclude my part by saying smoke-free future is within reach. I think there can be, with the right frameworks and dialogue, countries where we can stop cigarettes in 10 to 15 years and replace them for the people who would continue smoking with smoke-free products.

I think we have an ambitious goal of reaching 50% of our net revenues by 2025. I think our profitability, both at the revenue line and at the bottom line, will continue growing. And I think over the long term, we can develop sustainable growth and superior shareholder returns as we will be successful in these areas.

So that's all from me. I think we have a break just now, and Jacek will join us in about seven minutes.

[Break]

Nicholas Rolli - Philip Morris International Inc. - VP of Investor Relations and Financial Communications

Welcome back to PMI's 2021 Investor Day. Our next speaker will be Jacek Olczak, our Chief Operating Officer.

Jacek Olczak - Philip Morris International Inc. - COO

Thank you, Nick. Good morning, good afternoon. Nice to be with you here, although this virtual arrangement is not my preferred style, but I guess we have no other options or choices at this moment.

For an hour or so, I will be talking about how we are leading industry transformation with *IQOS*. There will be some repetition to what Andre has told you the moment ago, but this is intentional repetitions, and I hope I'm going to add you some granularity to some of the points, which Andre has highlighted in his remarks.

Well, I will be talking about how our commercial approach maximizes consumer and financial impact, how relentlessly focused on consumer -- being relentlessly focused on consumer feeds our continuous innovation and serves consumer needs along the entire consumer journey. I will also cover how we are scaling profitably along three vectors: so innovative products; and range of consumables across the platforms, including brand marketing and campaigns; the deeper geographic and consumer segment penetration in existing *IQOS* markets; and obviously, how efficient and fast entry and scaling of new *IQOS* markets and categories contribute to our further growth.

I will also talk about our strong leadership in combustibles to drive performance and how do we leverage our strong position in combustibles to support our smoke-free strategy.

Before I start with PMI leadership in industry transformation, let us have a look at progress so far from a different and broader perspective. And I do admit that it's more for the illustrative purposes, but it took an attempt to compare the speed of penetration of other industries where a new technology is replacing existing consumptions. I pick here very much the solar power energy and the hybrid and electric cars. Smartwatches might be questionable whether it's the right comparison. And I compare it to penetration of *IQOS*, in this case, of Russia and Italy, over the same period of time in terms of -- measured by the share of market penetration.

Another interesting observation is that the hybrid electric car and solar, also examples, if you like, of harm reduction strategies, which unlike *IQOS* so far actually enjoy the regulatory and political support, although was confronted at the beginning with some controversy as well. So we can see clearly that *IQOS* adoption is at least on par, if not ahead, of the selected few other industries. And frankly speaking, *IQOS* has demonstrated so far a stunning pace of adoption. And please note that they have not put *IQOS* performance in Japan and some other very fast-growing markets on this chart.

Our transformation is led by the product, which Andre highlighted very well for the reasons, obviously, that this is the biggest positive impact on the harm reduction. We are the segment leader, we have the strongest brand, and obviously, we are leveraging the first-mover benefits. And this is not all given, obviously, this is all earned. And from the very beginning, we are very serious about this opportunity.

The highest investments from our side are parallel with internal transformation. We built from scratch our significantly enhanced capabilities which were not needed in the combustible business, which is very much business-to-business type of arrangements. And obviously, it is being conducted at the maturity of the category.

The rigor and scientific validation standards was prioritized from the very beginning. The fact that we have successfully passed the bar of FDA PMTA ultimately MRTPA authorization is as first and so far the only heat-not-burn product, is a proof that our strategy was right. And it comes without saying that the responsible and sustainable marketing practices are a backbone of everything which we do.

You're all familiar with this chart from our last week earnings call. We're approaching 18 million users of *IQOS*, very importantly, more than 70% of them have fully left smoking behind them are either fully converted, it's about 13 million smokers at the year-end of 2020. A very spectacular result. You see our continuous progress from the very beginning of our journey with heat-not-burn with *IQOS*.

Heat-not-burn is the biggest and fastest-growing smoke-free category of size with above 80% of category share, our leadership is undisputable. Our value share is even higher and stands at around 60% for total RRP. And this is still with essentially no presence in the e-vapor, which I will cover later on.

Building a strong brand is a key component of our strategy. And as there are big categories in its early stages, strong brands bring so much needed credibility to consumers. And taking into considerations that *IQOS* is merely six years old, these are very spectacular results. If I compare it later on to *Marlboro*, which have a five decades of marketing support, international presence, et cetera.

The gap to the next strongest competitor is ever more meaningful as currently there is no other competition brand so broadly available with one uniform look, feel and experience. *IQOS* is already #3 brand in the market where it is present. Considering *Marlboro*, again, as the reference brand with 13% share and more than five decades of history, *IQOS* with already more than half of *Marlboro*'s share and five years of history is again a testimony of a very strong result.

And if you want to be serious about and believe in the opportunity, you need to put adequate resources behind, which we did from the day one and are continue doing so. This chart presents our cumulative resource spend behind *IQOS* because the -- behind the heat-not-burn plan from the very beginning of our journey. So we exceeded $8 billion. This covers -- this spend covers the product and marketing development, scientific substantiation, including regulatory reviews, manufacturing capacity, the expanse -- build up and expansion, but excludes commercialization expenses at the market level.

As we move forward, the annual increments, which you see at the bottom of this chart, are somehow moderating as many of the big-ticket items has been already addressed. Our new initiative, frankly speaking, are leveraging on the past learnings and development.

Let me move to *IQOS* performance. We have delivered very strong and repeated share gains in key geographies. You have here, Russia, Japan and the U.S., the total block of the market. And these are truly very spectacular results and will continue growing. These results are leading us to more balanced geographical contributions to *IQOS* growth. So you remember, for the first two or three years, we've been very much secure, essentially dependent only on Japan. And now by additions and opening *IQOS* to other geographies, few first markets in the EU region, Russia, other markets in the Eastern Europe, Latin America and Canada and so on, we expanded IQOS. We're now in 64 markets, 76 billion unit sales, and it gives us more balanced geographical footprint. So *IQOS* enjoys the growth by the mix of expansions into new markets. But again, let me repeat continuous growth within existing markets.

IQOS is able to meet consumer taste expectations across various markets archetypes. I'm here focusing on the taste type of an archetypes. I brought here these five markets which are fairly good -- constitute a good representation of the market, which are very much full flavor-skewed like Portugal and Malaysia, more menthol-skewed, so you have here Japan and Poland. And the markets, which are very low -- relatively low on full flavor and have almost non-existing menthol segments, which is the case in Russia. And the common denominator across all of these markets is, if you like, that *IQOS* has already produced a significant inroads in this place.

So in addition to meeting the taste expectation of *IQOS*, *IQOS* also responds well across level of affordability, works in emerging and developed markets, works in e-vapor markets and all tobacco markets. And during the next few slides, I will show you *IQOS* penetration level across the -- a very long list of key cities which are representative of various archetypes, which I just mentioned, which is, again, the e-vapor market, oral to the nicotine products, different affordability levels and again, different spectrums of traditional full flavor lights or menthol segmentations.

So I start with the very strong double-digit penetrations market shares in key cities. You have here Vilnius, where we crossed the magic one-third of the market; Tokyo, which is approaching in -- well, actually exceeded almost 25%, so a quarter of the market; Kiev, Athens and so on and so on. You've seen some of the slides during, I believe, Emmanuel's earnings call. But I thought that we can look at this also by visualizing the underlying market archetypes behind these markets to demonstrate that *IQOS* has a potential across the number of geographies.

You could see here, as mentioned again on earnings call, some quarterly fluctuations in share, which I know sometimes some of my audience here is excited about. But I think there is this volatility, which is coming through the combustible market due to the seasonality of pandemic-related factors, we can -- if you're interested more into this, we can cover this during Q&A.

Strong growth in Western Europe, finding great formula amid the stricter regulations and more skeptical consumers. And long-awaited good progress in London when we're approaching 4 share points, showing *IQOS* can and does work in markets with a big e-vapor presence.

We have also good progress in emerging market key cities. And here, I brought a couple of markets across the -- coming from Asia, Latin America and Eastern Europe. And also is very pleased to have the fast recovery in Cape Town in South Africa, following the most drastic restrictions which we have been confronted with during COVID, when essentially there was a ban on sale on any nicotine product for the -- quite a good few months over last year. And you see a very strong recovery of *IQOS* in the geography.

2020, as you know, very well offered us a multitude of challenges. This makes us and me very pleased with *IQOS* performance in the geographies which we entered last year. So I'm very satisfied with a good progress in Mexico. We just focused on Mexico City. Very quickly, we'll start climbing to the almost 1 full share point on the Mexico City. Greater example in Stockholm, and I would read this as the first proof that *IQOS* also can have a significant inroad in oral tobacco market. Very good progress and a fast progress in Vienna and was one of the few European Union markets which we didn't enter with the first waves of our rollouts. And this was despite the very severe COVID restrictions.

And also excellent progress in Georgia. Georgia in Eastern Europe, not the Georgia in the U.S. But very strong progress in a very short period of time. We have also started in Philippines, and in line with our strategy tested in other geographies, remaining razor focused on Metro Manila first before we start going to the remaining geographies in Philippines.

So obvious question is if *IQOS* had such a spectacular growth, what is in front of us? And how far we can go with our *IQOS* heat-not-burn? I have put on the chart here, key select geographies with the national and key city market shares in Q4 of 2018 and the Q4 of 2020. The national shares in all of these markets now above key city shares of two years ago, and key city shares continue growing, as we know.

So to illustrate, if this was repeated over the next three years from Q4 of 2020, we would already be very close to our targeted range of 140 billion to 160 billion units in 2023. I admit this is a bit of oversimplification. However, this also assumes that there would be no further growth in the key cities, which I think is highly unrealistic. And obviously, will favor geographical expansion within existing markets. We are moving to new consumer groups. We have different profiles. We are moving to less urban territories. However, we've covered and continuously evolving portfolio of *IQOS* proposition, it's a strong brand and a recognizable and strong brand, and infrastructure tested to operate at scale, this target is within our reach.

This led me to this slide, what I'm showing in a more granularity, how the expansion within a country looks like. And I have obviously brought here Russia, which is the best market to demonstrate how that expansion -- focused expansion strategy worked and serve us well so far.

We had so far three waves of expansion. First wave was the bigger cities, eight cities when we started in 2017, then we followed a year later with the expansions to the next 27 largest cities. And a year later, we have another 40 cities. So altogether, we are now present in Russia with more than 70 cities, which represents about 90% coverage of cities with population more than 250,000 citizens. This gives us today a coverage of about half of legal-aged smokers in Russia.

And again, the most important takeaway from this slide is that as we were continuing, as we are expanding, we continue our growth across all waves of expansion. So you see under wave 1, we started with 100,000 users went to 600,000s, 1.3 million, and the last year, we closed with 1.7 million, while obviously, adding new geographies and they to continue growing.

So I think this is a good example how that focus expansion works. And I believe we can all use it as a proxy, how we will be and we are and how we will be expanding further *IQOS* to the more sizable and more complex, if you like, geographies.

We wouldn't be where we are today with *IQOS* and our transformation if we didn't put consumer at the center. We all, as consumers of many other products and services, experience our own consumer journeys. Consciously or not, concept of a consumer journey is not new to us, right? Many consumer-centric companies are applying. But bringing a consumer journey to this industry is new. Remember, we're going through the combustible business, which is very much based on a business-to-business model, and we're transforming this company to the business into the business-to-consumer model.

Again, in addition to a great product, understanding consumer needs at this stage of the journey, ability to listen to and back it up on consumer feedback, a long critical consumer journey results from awareness to retention is, in our opinion, a critical contributing factor to adoption and conversion. And this is especially more paramount for the product or categories which did not exist before, which are new to the world.

The consumer journey, in our case, drives downstream commercializations, like channels, programs, other enablers. And upstream activities like product and consumables and brand marketing development. So this is how we're using consumer journey of essentially a backbone of our activities.

In 2020, last year, we have conducted more than 2 million Net Promoter Score surveys. We're covering more than 1.6 million unique consumers. If you remember, the scale of the consumer base, which we have, we definitely are above industry norms, at least at this stage.

In addition to this, and this is the most interesting part, I believe, in addition to this, we conducted 180,000 callbacks. And the callbacks is nothing else than the longer format conversations, 20, 30, 1 hour -- 30 minutes, 1 hour, 2 hours on occasions with our consumers performed directly by our front-liners and by management. And that's the interesting thing which you never had in Philip Morris before, and I doubt you will find it in other companies in our industry. This allows us to get firsthand feedback from a consumer. Over 600 improvements so far -- improvement initiatives on product changes, consumer engagements and our operations were actually coming from that direct contact with the consumers.

And needless to say how happy are consumers when they receive a call from us, which is without any strings attached. It is not a promotional call. It is a genuine curiosity, how well are we serving them, how well our channels perform, how our product is per se, is there anything which continues bothering our consumers and do they have any recommendations. So we try to incorporate it and serve it back to our consumers.

You're very familiar how we have expanded the portfolio of *IQOS* devices. This is one of the examples how we are applying the real-life consumer feedback, translated into insights and converted into product or service features. This allow us to further improve performance through higher conversion, higher NPS. And very importantly, higher retention on new devices. So you see on the chart, *IQOS 3*, which many of us already almost don't remember, compared to *IQOS* 2.4+, increase our conversion rate by 6 points. And when we come about two years ago with *IQOS DUO*, we managed to lift our conversion rates by additional 5 percentage points. This is obviously a big -- the release, if you like, from that productivity and also efficiency. So it also flows to the -- or is behind our continuous margin improvement.

So customer feedback also resulted in many other improvements or additions beyond the products which I'm -- physical products, which I'm showing you here. And these programs are covering referral programs, the search engine optimizations, bridging initiatives, which are very important to accelerate bridging within the existing *IQOS* device families, but also bridging from combustible product to *IQOS*. Device lending, a new feature, which we roll out about 18 months ago, where consumers can take the product home for the week, two-, three-weeks, and have, in the peace of his home, proper trial, we offer support via virtual coaches which can connect with the consumers, and our results with the consumers are getting better educated and they successfully migrating to the full usage of our proposition.

Now the one of the remaining major opportunities in existing markets, which lies in front of us is obviously moving consumers along the journey. We see on this chart, and this is the group of seven key markets so far for *IQOS*. And we're all aware, we all remember the already significant market share when *IQOS* generates in all of these geographies. But here I'm showing how many users, smokers, adult smokers in a given geography, are still not even aware that *IQOS* category exists, okay? So you see in case of Russia, 41% of the consumers are not aware, legal-aged smokers are not aware that *IQOS* exist. Followed Poland, 60% is at the most extreme type of a case. Obviously, on the one hand, this is a reflection of our geographical focus in the given geography.

And on the other hand, is a result of relatively restricted communications environment in which we operate. So we don't have access to the full channels to communicate to talk with smokers.

So while continuously working on awareness of *IQOS*, even more important, however, is the consumer understanding of category. And Andre highlighted a couple of a few issues, which are pretty painful at this stage and would argue slows even accelerated growth and adoption of this category.

So everyone knows that smoking causes lung cancer and other serious disease, but there are misperceptions about what are exactly the causes of this harm? So misperceptions of tobacco harm risk is evident on this chart. When we're conducting the research in a number of the European markets and Japan. And clearly, you can see that nicotine is perceived by smokers as most harmful or one of most harmful. And we all know that this is not the case, and there is enough of the scientific evidence

Note: Edited by Philip Morris International for significant transcription errors

to confirm that this is not the nicotine, which is a prime cause of harm created by smoking. It is tar, but look what the tar is in the consumer understanding.

So obviously, the category understanding is improving on what we call the educated awareness. People understand truly the benefits and how the category works among *IQOS* users. However, burning, for example, still ranks low. This translates into misperception of differential in heated tobacco risk -- heated tobacco product risk relative to cigarettes. And the same, unfortunately, also applies to electronic cigarettes. And this obviously leads or may lead to the wrong choices made by consumers, by smokers, who clearly are unaware that as long as if they wish to continue smoking, they should definitely consider the better alternatives which are available today.

Now as legal-aged smokers go through the consumer journey, the perception of harm gets closer to reality. However, even among *IQOS* users, we see here, the perceptions are relatively high compared to the -- to what the science would tell us. Clearly, there's a -- this is a territory which requires concerted effort by all stakeholders, obviously, us, industry regulators and NGOs, and Andre was talking about it.

However, still today in too many places, unfortunately, consumers are confronted with contradicting messages being a mix of science of science-backed facts, and they are mixed with opinions, which are serving nothing else than the old, entrenched political views.

Now this slows down the progress or even worse as we have experienced in a few places. You may remember what we had encountered some time ago, for example, in Korea or Romania, where we have experienced, in a few places, that consumers, confused now by the messaging coming from the very much regulators and NGO. We just go back to combustible cigarettes, which from the harm perspective -- from the harm reduction perspective is, frankly speaking, a disaster.

So as we continue to engage with regulators and other key stakeholders, we're also doing our part of building category benefits understanding. So here's an example of our newly launched developed launch campaign. It's more lighter approach, focusing on understanding the combustion is a triggering point in a causing harm. For some people who are more on the vegetarian side, that picture on the left on the yellow background is the sausage. I was told that it was closer to the German sausage. However, whatever origin of the sausage is, the fact is that they taste better if this is not burnt. And the same applies to *IQOS*, that it's tobacco is better if you don't burn tobacco.

We have another example here. I have another example here of a more lighter approach. Focus again on a burning versus heating and delivering on satisfaction. So you can deliver the satisfaction with heating and burning is essentially not needed here. And for those people who don't like previous animal, we also have a version with another animal. But you understand which directions we're going, it is less about creating the brand. Obviously, it is more about creating the basic principles of a category and informing consumers what is the real problem of smoking, where this coming from, i.e., combustion generation of tar and allowing them to consider, try and hopefully adopt the existing and substantial -- and scientific substantiated alternatives.

There is, however, growing recognition by voices in public health speaking up more frequently about the tar -- tobacco harm reduction and the reduced risk. I think the progress is visible but not sufficient yet. And I believe that the next 3 years will be pivotal in recognizing the RRP category as large as opportunity in accelerating, and finally, solving the problem of smoking once and for all.

Let's now move to our commercial model. *IQOS* business model is built on consumer journey. I mentioned this already a few times. It covers all key critical episodes and experiences from how adult smokers can learn about the category, can do their own research and evaluation, can try the product and eventually move forward to buy and use and become a brand advocate. If you do this exercise, well, which I believe we're doing well, you're essentially creating a very happy consumers who solve the problem of smoking, they are willing to share their experiences with others, and this whole commercial engine starts really working very well.

All the episodes or steps for the journey are taking place across the multiple channels and cover, obviously, online and offline. And the right combination and almost seamless connections between channels creates a great experience, which is appreciated and rewarded by consumers. So very often, we have these conversations, and I get the questions. Can you just only go online? Is online not cheaper? Or can you just stay with an off-line and use your existing retail type of infrastructure? The answer is very simple. If you want to deliver on this unique experience, I believe you need to be both in online and offline. And, frankly speaking, I think we have parallel with many other industries that this is not just the one solution which fits all, it's the combinations and around blend of the solutions, which creates this unique experience, which serves, in our case, on the one hand, of obviously having the highest conversions because we do take care of consumers along this journey. We don't leave them unattended. On the other hand, the consumers are very willing and very open to advocate to other smokers around them to consider and to try the *IQOS*.

So it is not enough to be present in a multichannel environment, is how do we make an omnichannel experience really matter. So we have one *IQOS* brand with one consolidated digital platform across all markets with consistent branding experience and communication, and that's very critical. This provides for brand experience, content, support for engagement, awareness and understanding. So we cover all these territories. And it is not just about transactions. I think this is the biggest mistake. Some people are very excited, I bought the device, doesn't matter if it's e-vapor or *IQOS* and then people don't understand, people don't have proper conversations, people don't get the smokers, don't get the proper support, and the devices land in the drawers and neither it solves the problem from a harm reduction perspective. And definitely is the -- is economically almost impossible to sustain.

So iqos.com is our #1 flagship store and is undergoing now its final platform consolidation, which we should be completed with by 2022 next year. And it offers consumers this connectivity with off-line channel. So it is about digital-first approach and very often, most of us, wherever we're looking for the first place to go is not that we're strolling the streets and knocking at the door of an outlet, which is going through Google, we're going through Internet. We're doing our own research. But then there's a right mix and the ease of finding, okay, in our case, *IQOS*, et cetera, starts playing an important role.

So our infrastructure altogether, both digital and physical, enables us -- enables our significant competitive advantage. You have key numbers here, how many stores we're operating in a different -- in the format. This *IQOS* platform, which we can leverage to deploy new products. So we'll be soon talking about our entry into P4 and other platforms. This also allows us to roll the programs like, for example, lending, which I mentioned before, it also obviously serves for any extensions of an *IQOS* more vertically and horizontally.

As we digitalize or establish our presence in a different geography, we are adjusting our infrastructure. So you can see on this slide that by changing mix on the slide, which is reflected when we change the mix in other format. So you have less of exclusive *IQOS* retail touch points versus prior year. Less of the commercial people, so demand activities. But at the same time, we increased the *IQOS* stores, the unique outlets, penetrations. And obviously, we move a lot of activities that are truly fully served by the digital solutions.

Also moving within direct retail expansions drives our regional efficiency. And this was the case when we started expanding very much in the third phase of expansion in Russia. So our better execution is obviously the critical driver in generating consumer satisfaction. *IQOS* brand experience increasingly speaks for itself. I mentioned a number of times that this consumer satisfaction and earning the consumer satisfaction throughout the journey pays back at the end when we move to the advocacy. And this chart shows percentage of our total user acquisition coming now in an organic way.

So we have Italy, with almost 3/4 of the user acquisitions coming organically. So it's consumers who've heard about an *IQOS*, who were recommended to *IQOS* by already converted users, they were confronted with so-called word of mouth, et cetera, and they're coming to our infrastructure, which is waiting to serve them from any moment they come in contact with us. We move significantly in Portugal, and we also have a very good progress in Russia.

So as we can see, as our acquisition is increasingly organic driven, as I said, by word of mouth and the general awareness of the brand and obviously, ease of finding *IQOS*. And this is what is physical also, infrastructure plays a role is very important in this whole exercise. And this accelerates clearly the growth and lowers our cost.

So many of you are familiar with this slide as we used it during our last -- at least the last investor meeting. Scale efficiency, growing organic acquisitions allow us to significantly reduce further cost per user over the last years. You are familiar with format of our slides. We use the first year on the slide as the index, as the 100, and we're showing the relative progress over the last two years.

Acquisition cost per user is higher, obviously, in the early launch phase. And obviously diminish significantly over a time and you can see this across the -- our major key geographies, as is also the cost of retention. And obviously, this will vary -- or it does vary across the market, and it's depending on the stage of maturity of the market and category and competitive

Note: Edited by Philip Morris International for significant transcription errors

environment. This is what we have achieved so far. And this is, again, a key support to our margin expansions, which I believe very happily Emmanuel will expand on.

We're working on the category for more than five years, and clearly, gave us opportunity to learn, right? So obviously, this is on the positive tone, which also means that we have made some mistakes. But usually, when people talk about the learnings, they look at the positive side. Sometimes you need to make mistakes. So the question is not about the making mistakes, but how quickly you stop making something wrong, how quickly you learn from the mistakes and correct the activities going forward.

So we are trying to incorporate these learnings when we enter the new geographies. Here, you have three exemplary markets, Italy, Germany and Russia. So this is sort of the first cohort of the markets from a period 2015, 2016. And I am adding here the cohorts of the markets from 2017 and 2018, and you could see that our path to the more significant market share has been significantly shortened versus the initial group of the market. And obviously, if I add the last wave of 2019, 2020, I think it's very well visible how we're applying the learnings and how we're getting better and better over time when opening the new geographies.

Some improvements in our ability to achieve success earlier is a very important component. Andre mentioned this drive us that initially. Remember, I was, myself, saying that we need about 2 years or so to achieve the breakeven. We can now do it on the 11-month period, and we need less of the market share points, if you like, in order to achieve the breakeven. Again, there are other factors at play, which impacts these numbers, but I just wanted to focus here only on our executional capability and its excise.

Let me now move to the next stage of growth. So, so far, I was talking about not only success to that of *IQOS*, but also near-term growth opportunities. I used this example of existing markets and how we can expand in the existing markets. But let's now move to what else PMI can deliver and will deliver on its path to become smoke free.

So I mentioned earlier, brand. To start with the brand is a very, very important component of a sustainable success. And we have started, from the very beginning, with building the brand. This is what we had in mind from the very beginning. We have no brand fragmentation. We have strong brand identity, and we start enjoying this very hard to build brand equity. And *IQOS* is, by far, the leading smoke-free brand across all RRPs or RRP category.

We are working on taking *IQOS* to the next level from functional benefits, category understanding to brand appeal highlighting the points of difference and building the emotional connections. That's very essence of any brand in the world. So I hope you will get a sense of where we are going with *IQOS* from this video.

Can I have video, please?

[Video]

Jacek Olczak - Philip Morris International Inc. - COO

Okay. As you know, why *IQOS* as well. So as we're continuing building further the brand, we're also cognizant of further opportunities lying in untapped consumer occasions, segments and geographies. So as shown before, driving awareness among legal-aged smoker is a key enabler, broadening and reaching the category offers further revenues of growth. So we're expanding the portfolio of the devices, but also expanding the portfolio of the consumables, and this includes the new platforms.

Adding premiumizations and extending pricing coverage and segmentations allows us also for reaching more adult consumers in new and existing markets with new and existing products.

I will now show you what we have in mind and what we have in place. But before I go there, just a quick snapshot of where are the nicotine users, the product users -- nicotine users today. So as we know, heat-not-burn is the most compelling smoke-free category for consumers. It's obviously the most compelling from a public health and economics perspective as well. However, we have always said, and I vividly remember our investors conference six or seven years ago, when we announced that we're opening this completely new chapter in the history of this company of going smoke-free. And we have already, at that time, said that there will be a place for other formats, but just heat-not-burn, okay? There will be a place for platforms,

Note: Edited by Philip Morris International for significant transcription errors

which is delivering a satisfying different experiences. Also satisfying different taste preferences. And thus, the multi-category approach is required.

So we have now built the *IQOS* brand and infrastructure that we can now leverage to address consumers looking for a variety of our experiences, which heat-not-burn *IQOS* in its current shape and format cannot deliver. Poly-usage in the category is common. We all know about it. Currently, there is significant poly-users of RRPs and combustible. These consumers already in the smoke-free category, but are not fully converted. And this creates an opportunity for us.

So for offering of a compelling *IQOS* multi-category portfolio, we can migrate these consumers over time to exclusive use of smoke-free products. And obviously, offer more opportunity to start smoke-free journey, importantly, for 66% of exclusive combustible smokers, which are not -- who are not, at this stage, interacting in any shape and form of any of the reduced risk alternatives available in the market.

Now to seize the opportunity, we need great technology. I think if you have a great technology, obviously, can translate it into the winning products, which we have demonstrated both on the development and substantiation scientific substantiation side, but also when it comes from the user experience point of view.

So technology expansions, which we now have in mind, which Andre highlighted at the beginning is from the blade, internal heating, pin, which is our collaborations with KT&G to internal induction technologies, and then we're going to the vapor and the nicotine pouches. So we will be focusing also on a consumable technologies and innovation, allowing for different experiences and taste. And these innovations drives higher conversion and enables faster expansion at the lower incremental cost as we're leveraging, as I indicated earlier on the chart where we had this cumulated $8 billion spend that many of the learnings from a platform one and the current executions, we can apply "free of charge" to the new platforms.

So our RRP offerings provide a broad choices and alternatives for legal-aged smokers and support also legal-age users in all of their moments. So we are moving from a single product brand to multi-category portfolio master brands. So *IQOS* is becoming sort of an umbrella brand over many platforms. Heat-not-burn is obviously our flagship platform, and it's at the forefront of our innovation for the reasons that it offers the closest experience to combustible, and hence, also backed by our excellence in execution offers the highest conversion rates. We will be evolving from blade to induction is a step change in science-based innovation taking *IQOS* to the next level, and I will cover this in a moment. And our aim is to extend the region so horizontally to cover all critical need spaces and vertically to address the affordability.

So you could see on this chart, we're going through the very rooted ritual type of expectations, familiarity, authenticity, similarity of the product is very important, combustible cigarette is very important, and we're going to that group, which is where there is more playground for the versatility and the discretion of use, et cetera.

The same approach we follow with regards to consumables. We're expanding horizontally to cover all critical need spaces and vertically to address affordability, which we know from a combustible business is an important component. We are reinforcing the product superiority with a premium-priced enhanced indulgent taste like *HEETS Dimensions*, when you see this black facing packs on the top of the charts, which is the first executions which we did in Russia, very successful. And we're also fortify our leadership with new to the world beyond tobacco propositions and some sustainability initiatives and this is in the square box on the right of your chart.

So okay, now is the time to talk about the key major initiatives in front of us. And I hope you will appreciate that you are literally the first public audience learning about these initiatives, but also please before giving that for competitive reasons, I will not be granular enough at this stage. So thank you for your understanding.

Let me move to *IQOS ILUMA*. So here is *IQOS ILUMA*. It's the next-generation of *IQOS* heat-not-burn. In my opinion, and you know that I am a very, very, very good user of current *IQOS*, this is really amazing. This is truly amazing proposition. If a new word was to be invented to describe what it is, the word would be revolution. Trust me, this is really revolutionary what we are bringing to the market. This is still internal heating but provides the optimum taste and satisfaction, however, delivered via Smartcore™ induction internal heating technology. This is same great taste *IQOS* has today, but it should not only help us enhancing the experience, the user interface with the device, et cetera, but I think it's going to result -- and I'm convinced it's going to result in a higher conversion rates going forward.

As innovators, our job is obviously to enhance consumer delights and address the feedback, I mentioned this before. And *ILUMA* does this relatively -- does this relative to the very successful *IQOS* blade. So the bar was very high for us to go and address still unmet need. Some people may call it the pain points of what we had on *IQOS* blade product, but I think we delivered on the promise and expectations from consumer.

So by eliminating blade, obviously, improve our reliability. So there's no accidental blade breakage. I know that some of you are the users of *IQOS*. I am user of *IQOS* blade product, not anymore, to be very honest and frank with you. And I have to tell you, that is a highly irritating factor that you cannot use your product because that blade has broke.

So superior satisfaction from the first till the last puff. It brings next level of simplicity, no maintenance, no cleaning needed. It offers self-activation after stick insertion with stick recognition technology. Remember, we got these questions from you some investors days ago when we ever developed the stick recognition technology. Here we are, here *IQOS* brings it to the interplay.

So less explanations will be needed, which should further help with the time and cost of acquisition. And I'm very excited about this whole thing because I can't wait when we will launch this product into the market.

So this is coming from PMI and from *IQOS*. So obviously, will be in a premium design and customization options for enhanced lifestyle appeal. We'll have three devices. Two in a charger and holder configuration, so it's the same as we have here, the same setup, and one in 'mono' form factor, all with consecutive uses. *IQOS ILUMA* will be accompanied by the new broad range of consumables, as consumables between blade and Smartcore™ induction devices are not interchangeable. You'll hear this from my voice, I believe even in this virtual world, you can sense that how excited I am about this new innovation and even more I am excited after seeing results from early user testing.

Let me now move to the next thing, which we have in heat-not-burn, which is *LIL HYBRID*. We're working on broadening our offer to accelerate user acquisition and grow the category, while expanding -- by expanding target audiences of adult smokers. Thanks to our cooperation with KT&G, we have launched *LIL* in Russia and Ukraine and *LIL HYBRID* in Japan last month and -- yes, last month. Early market feedback confirms our assumptions that this proposition can deliver on high levels of conversion. We're talking conversion levels, which we enjoy with *IQOS* blade product and already started to drive new users. So *IQOS* endorsement clearly drives awareness and credibility of that proposition. And PMI commercial engine, which I talked before, drives take-up and retention of these propositions. We will be expanding this proposition into further geographies this year.

Now let me now move to e-vapor. Category, as we know, is growing and slowly moving into a consolidation sort of a phase. We expect annual growth in users of this category between 7% to 9%, 7% to 10% over the next five years, albeit concentrated in specific geography. The category offers the different consumer or satisfies different consumer experience and occasions, obviously, compared to the heat-not-burn, for example, puff on demand. But category remains low when it comes to the adoption, okay, so the conversion. And these first conversions to the category is very low and within the category is still a very low loyalty to the product or to the brand. And this results in a high number of devices per user driving up acquisition cost and, obviously, calls for aggressive retention for that. So we're trying to enter this category from a completely different angle.

Now I mentioned the fall of use and the loyalty to the category and loyalty within the category. And here is an example. Here is the illustration how does it translate into the user economy. So why I'm showing here this for illustration from EU based on the selected markets, in select markets from the EU region and how this category user economics looks like. So while obviously, brand loyalty and full conversion in e-vapor is currently low, a user switching completely to closed systems, which is the third bar from the left, generates a significantly better marginal contribution per user. Capturing the benefits of these differences requires scale to absorb the cost of a commercial infrastructure.

So we have a scale, which I believe I demonstrated to you. We also see opportunities to move dual e-vapor, combustible users, so people who are mixing e-vapor and a combustible, to do an e-vapor heat-not-burn user, delivering a substantial, obviously, benefit to the consumer and with better economics for us because we're leveraging on the -- our presence, our infrastructure. User economics, obviously, is -- and we said it from the very beginning, is a key consideration in our portfolio strategy. And this inform us on the priorities which products will enter first the market and subsequent target segments, et cetera, when it comes to the introductions of the next products or the next categories. Now in general, obviously, we see that the smoke-free products have a superior gross profit per user. However, as I said, again, the switching, switching and switching smokers fully to this -- to the one category and the loyalty drives the higher returns.

So I think it's the time now for my second video, which will be essentially announcing our entry into e-vapor category.

[Video]

Jacek Olczak - Philip Morris International Inc. - COO

Okay. I hope that the quality of the video was -- and the sound was okay. This is the whole problem of this virtual setup. You don't really know what is -- how this is being played on the other side. But I am informed that everything was okay. So it was my colleagues here.

So we -- with the introduction of *IQOS VEEV*, we're clearly leveraging *IQOS* infrastructure. With a bespoke route-to-market approach, we are leveraging the power of *IQOS* brand. We will offer premium product with superior experience to existing offers. This is backed by the unique *MESH* technology delivering smooth, consistent, customized experience. There will be additional feature, responsive draw, which is new in that -- in the marketplace. And obviously, it will be offered with a rich taste lineup of a consumer. We see this as a potential accelerator of conversion to *IQOS* franchise for RRP poly users and dual users with cigarette. And our plan is to launch *IQOS VEEV* in about 20 markets this year, leveraging again on *IQOS* infrastructure, including the major markets highlighted before, but also markets where it can complement *IQOS* heat-not-burn conversion.

The very important point, the youth access prevention. So as you know, is key to our sustainable -- to the sustainability of the category and is very key to our sustainability. So we're in the final stages of testing and preparing for scaling up the age verification technology, which works in a way that device is only activated remotely after positive age verification. So you're buying a device. You open the box and you cannot use the device unless you're connecting via an app, via the digital solutions with us. You go via the age verification process. If you positively verify, we will send a code to the device and activate your device.

Pretty revolutionary, but I believe this will offer at this stage, I mean, at the highest level of protection that the product will really not go to underage people, which we all know is something which we cannot accept, tolerate that. And this is also part of our sustainability effort, as I mentioned. And we aim as having all devices covered by this technology by 2023, as is our commitment, and we have made it very clear in our last issue of integrated report. This is obviously the effort on the using a technology to help with the age verifications is, obviously, in addition to our continued effort for a good conversion practices, which I hope you remember from our earlier investors meeting.

So let's now move to nicotine patches. It is a small, concentrated but growing category with potential to advance also harm reduction. Still is very early in category developments, very early stages. Offers convenience, discretion, flexibility of use, satisfaction, a different sort of experience, different ritual, but may offer satisfaction. Does offer attractive economics. Operates today in the very evolving regulatory landscape. And we have a plan to enter this category still this year, later on this year.

And very quickly update on our two remaining platforms, Platform 2 and Platform 3. So as you remember, Platform 2 is a heated tobacco product, which is closest to conventional cigarettes ritual and experience. And we have, I think, sorted out that the problems which we have with the heat source, with the tip of that, at the beginning of that -- of this product at the cigarette looking product. And we are ready for the new commercial test this year. And on Platform 3, which is electronic-free nicotine product, which offers hygiene and the simplicity and the convenience compared to any other products, which we have today in RRP technology, but does employ some complex technology. And we aim to commercialize this product, not this year, but within a three years period, which we target this time.

So we are now in 64 markets worldwide, of which over half outside the OECD. So over half of the markets are developing markets. Those are often being asked, I mean, are we offering this heat-not-burn or smoke-free solutions to the richer countries? No, it's not true. We're going very systematically in trying to cover broader geographies. And I do believe that with the current and future portfolio of our various platforms, brand and the commercial engine, we are ready to be present in 100 markets in a five year period. So we're starting with 64, which we have today, 36 to go. Very confident these products --

portfolio of our products in a different configurations will be well received and will bring the solution to combustible smoking in all of this place.

I should mention a few words about the U.S., which remains clearly one of the largest opportunity outside our classical international-focused markets. We know very well that the U.S. consumers use and are interested in the smoke-free products. I think I demonstrated already today also that *IQOS* addresses taste and satisfaction preferences, which makes me believe that *IQOS* potential in the U.S. is real. We obviously have also a very well-defined regulatory environment with a very rigorous science-based regulations. So if I compare actually the operating marketing -- operating environment in the U.S. compared to many most -- to many other international markets or most international markets, it's actually regulations in the U.S. offer the very clear path to talk about the benefits of this proposition.

There were a number of positive *IQOS* regulatory developments since launch in September 2019. MRTP added, obviously, to the growing international recognition of *IQOS* from a harm reduction attribute perspective. And we are continuing with FDA engagement as with *IQOS 3* to bring that more the same line of the products, which we have on international to the U.S. market, and we're extending HTU variants. Then I believe you heard about ongoing U.S. expansion plans by Altria.

Okay. Let me now move to the combustible part of our business. I put on this chart here, cigarette industry evolutions on the -- only cigarette industry evolutions on the left part of this chart and the cigarette industry evolution in the *IQOS* markets, right? So obviously, with the penetration of RRPs, in this case, in case of *IQOS*, I mean, they will have different dynamics of how the combustible -- remaining combustible business is performing. So obviously, there is a distortion because of COVID in 2020, and it's fair to assume the potential rebound over the next 1 to 2 years. However, I think it is fair to expect that the underlying cigarettes -- combustible cigarettes volumes CAGRs over the next period will slow to reflect the RRP growth. So hence, underlying outlook for the combustible business is more in the -3% to -4% type of territory than the -2% to -3%, which we remember from the past. And again, this is the -- we start seeing or reflecting here in this estimate the further penetrations of RRPs.

Now we'll note that we had a pretty challenging -- very challenging 2020. And we said that there was an impact of COVID. But where exactly that impact of COVID come? We had some interruptions with the supply chain, I mean, in Argentina and a few other places, I mean, these things came to act relatively at the normal or pre-COVID level. However, let's look what has happened at the consumer level. Growth here in five markets as an example. But they are very sizable markets, and they also represent a very disperse geography. So I have Turkey, Argentina, Indonesia, Italy and Philippines.

And as we know, the way consumers are consuming cigarettes, right, there is obviously the moments when I am more alone in my home settings, et cetera, which is represented here under this name umbrella label of solo, the blue bar. And then obviously, they're consuming these products in some social occasions. The social locations can be everyday occasions, on the way to the office, the way to the work. I have my morning coffee in the corner coffee shop. I enjoy my coffee and I have my cigarette, right? Or I have -- I also enjoying this product, also enjoying smoking on some really special social moment. This is parties, events, concerts, sport events, you name it.

Now what we see, what has happened in this growth across the geographies is that, yes, the fact that all our daily routines, most of us -- for most of us, our daily routines were impacted during -- or are continue to be -- continuously to be impacted during the COVID. Yes, we could compensate and use the product more in our own settings. However, I mean, the impact on the consumptions in -- is coming from the impact that we lost this -- everything, which was around our social life essentially, partially driven by the fact that many people are grounded, I mean, essentially working from home.

So obviously, all your daily journeys, physical journeys, the bust of the smoking break, the lunch break with colleagues, the evening and beer in the bar, et cetera, all of these things have almost disappeared during COVID time. And we see the impact of that consumption here and anything special essentially disappear as well. So this makes me believing that this is fair to expect the rebound in this consumption showed our ability somehow to perform our daily routines will come back to the normal. Clearly, we are not at this stage yet in essentially all countries. But I believe the social consumption will be a big part of the rebound coming forward.

We also look how is this evolving through the price segmentations in the combustible business. So we see relatively stable over years, including the quarters of 2020, i.e., the COVID time, share of the premium at 25%, 26%. Mid segment, which is shrinking, and this is this down trading, which we observed in some markets. We have seen it before in some places, some sort of acceleration. So low and super low segments in the last quarter of last year at 51%. And I used for a comparison here, what has happened during the economic crisis of 2008 and the years following, how the segments were evolving. So you could see, it's a pretty much similar situation. The premium segment was holding and over a period of time actually improved, grew. And the mid segment was under pressure and the low-price segment somehow was growing.

Our share -- the most important is that during this economic pressure times in 2008 through 2011, we were managed with our portfolio at that time to actually deliver pretty strong share. Yes, *Marlboro* was under pressure, but other brands contributed well to grow overall company combustible shares. Better for I think that whilst the social interactions, the social moments, consumers will be allowed to perform, that rebound is going to come. We obviously are going to benefit from that. And then I feel confident that the portfolio, which we have, not just the *Marlboro*, but other brands, will allow us to have a more decent -- a much decent, a much better performance with regards the share.

I look here what is our share -- how is our share of combustible performing in our top RRP markets. This is the blue. And the dark blue and the other bar shows the top 30 CC market by ROI. And you could see that actually we're doing much better with maintaining or growing actually our share of combustibles in the markets where we have an *IQOS*, than, frankly speaking, in other markets when barely the half of this group of 30 markets we have a growth.

You are familiar with this chart. Emmanuel had it during the earnings call. I mean, we had the big pressure in Indonesia, partially COVID, partially the situations with proliferation of the products, which are being allowed to be sold at the module of our tax levels, which are not allowed to us, is a famous loophole. There are certain products below the certain annual volumes allowed to have significantly lower tax. I think portfolio-wise, we have a number of initiatives how to address it. I would expect that this year Indonesia should come with a share recovery. Duty free, Andre talked about this. I mean, that's really most beyond our control, and there is a group of the market, which contributed to the 40 basis points of a decline.

Let's look at the *Marlboro*. *Marlboro* had a very good performance until the year -- until 2019 until pre-COVID. We do *Marlboro* to historically -- historical high share, 10%. And you know what's happened during the quarters of this year. *Marlboro* is one of these brands, which is very much driven and used on this social special occasions, special moments. So this occasional type of usage, obviously, penalized the luck of the situation -- penalized *Marlboro*. On the positive side, the *Marlboro* equity, *Marlboro* strength as a brand continues to be phenomenal and by far I compare it again to the closest major competitor in the industry. The gap is extremely big, extremely big.

You know that we have a very focused portfolio, one of the most focused portfolios from the -- in the industry, with the three other key brands, *Philip Morris*, *Chesterfield* and *L&M*. You see that they continue doing very well during pre-COVID time and the COVID times. These are the brands, which serve us well in the mid, but very much in the low-price segment. I talked about the concentration of the global brands in our portfolio, almost 73% is our global brands. And we also see here a drastic reductions in the SKUs in the market, which is part of our strategy to take out from the market nonperforming SKUs because the cost maintaining them in the market essentially prohibitive to the benefits, which we can have, which then creates us also a spray of continuously where is needed deploying or launching new products.

Now we have significantly reduced the number of the new products in production from 160 or even higher before to about 60 to 70 range. However, what we have delivered is a much better strike rate. As you remember, we benchmark ourselves with the successful launches being considered, if it exits within 12 months after launch, 70 basis points. And we have a 57% strike rate, again, historically high. So this is just an example of a couple of the product introductions to the market, which also, I think, will continue in 2021 and should better support our share recovery.

This is how do we look across the key segments, new taste dimensions, full flavor, low tar and slims segment. We are #1 and very strong #1. With a good performance, knowing that obviously, *Marlboro* presence in the segments put our share -- segment share under pressure. And the only segment when we are not #1, this is the super slim segment, but also is the smallest -- or almost the second smallest segment.

Now very often, I am being asked, okay, so why, for example, if you want to go smoke-free, why are you still selling a combustible cigarette? So obviously, I don't want to remind everyone the economics of the combustible cigarettes. And as much as we are extremely happy with 25% of the revenue coming from RRP, 75% of our revenues are coming from a combustible business at the very attractive margins, a very high cash conversion, the benefits of the category. But while we're going and supporting that business, not to lose our competitive position versus the rest of the market, we're obviously also looking on that portfolio from a different perspective.

And the fact that we're selling and continue selling the cigarette gives us every-day-access to smokers. And this is all about what we need in order to accelerate and make any further significant inroads with regards to the smoke-free. So obviously, these are smokers of our brands. We know the industry. We know the trade. And this is where the paths are crossing. So we're using our brands also for so-called bridging type of a program, which is nothing else than wave the communications to the *Marlboro* smokers on the pack, within the pack, et cetera, all through our brands reinserting information about the alternatives because I believe also our duty that the smokers should know that the better alternatives do exist. And should they seriously consider either quitting, obviously, remember our philosophy or switching because these alternatives exist to RRPs product.

We have deployed the Scanpack, which is a digital -- semi-digital solutions in 30 markets. And the last year, it allowed us to reach or engage with 850,000 legal age smokers for the fact that we had an access to our brands, obviously. I cannot execute that sort of the things on the competitive products. What I can do is on my own products on my way. We have a huge reach and we are an important partner for the trade. And as we're progressing with the digitalization of our relations with the trade, we're also using a trade, for example, as the lead generations for the smokers. So it's nothing else that the trade partners are becoming activators, ambassadors, if you like, for promoting RRPs in a given period.

And the last thing, which we're doing, that we're absolutely aware that there is a degree of impact of bad littering on the environment, and we all should be and we are concerned about this culprit. So we're also leveraging our presence in this category to address another issue, which is there, which I mentioned, is about this littering. And so we have a number of these anti-littering initiatives under the umbrella of “Our World Is Not an Ashtray.” Essentially, we're prompting consumers to dispose of the cigarette butt in a very thoughtful manner. I put it into ashtray, put it into the bin. Don't throw it on the street. Don't leave this on the beach, et cetera. So this is another aspect, how we're leveraging the combustible portfolio, not only to continue, obviously, the economics, enjoying the economics of the category, but also how to leverage this to our overarching strategic objective.

So I don't want to repeat too much here. I think, yes, we are focused on the combustible portfolio. We're doing this differently. I have to admit that we used to do it five years ago. We are becoming more focused, learnings, which we have -- internal learnings, the way we organize, et cetera, all of these organizational learnings, which we have learned in the RRP category, we're obviously deploying and we're using for the combustibles. Yes, I mean, with COVID in 2020, it was a very challenging year for us. But I do think there will be recovering.

And I do believe that the portfolio and the few initiatives we have behind us will help me -- help us recover the share without losing the focus on ultimately the most important objective, which is to go free. I mean I don't need to repeat it that the business model for the combustible cigarette is, obviously, for us, target, at least stable, if not growing share, net of cannibalization, and obviously over-weighted with the pricing. So we have a decent contribution from that part of the business. With the help of the digital efficiency and productivity, this part obviously can contribute to the further margin expansion.

And this leads me to the last slide of my presentation. And I'm absolutely shocked because I see on the other screen that I have a 19, 18, 17 seconds left. I think this is the first presentation in my career, which spans almost 30 years, that I delivered such a long presentation on time. So I'm very proud of this. This is a summary of what we're going to do in the near term. And I think this is just the repetitions. I don't think I have to read through the slides or comment on this thing. And the only thing I want to ensure you that we and the entire management will work relentlessly to achieve our visions, which is to go smoke-free.

Thank you very much for your attention.

[Break]

Nicholas Rolli - Philip Morris International Inc. - VP of Investor Relations and Financial Communications

Welcome back to Philip Morris' 2021 Investor Day. Our next presentation will come from Emmanuel Babeau. He's our Chief Financial Officer.

Emmanuel Babeau - Philip Morris International Inc. - CFO

Nick, good morning. Good afternoon, everybody. I'm really thrilled to be with you for the next 30 minutes or so to talk about outlook for our performance. You've been hearing Andre and Jacek talking about strategy, about how we want to continue and, in fact, accelerate our journey to end smoke in the world. They've been mentioning all the very exciting milestone that we have ahead of us. Now let's look at how it translates into outlook for performance, and let's look at what's going to be the driver for the performance of PMI in the coming years.

And I think I have to start by rapidly coming back on 2020 because maybe it was not properly noticed because of the COVID crisis that this has been an absolutely pivotal year for us. And of course, we've been facing very adverse consequences, as we all know. But despite that, we managed to generate a growth of our adjusted EPS, an organic growth, almost in line with the at least 8%, which was our objective until today. And of course, this is not coming from nowhere. This is clearly the success of the development of *IQOS* and what we managed during this year to develop.

A few milestones were reached during 2020. You know them. Q4, we finished with 26% of our revenue based on our RRP business. We've been passing a number of nice milestones in term of reaching 10 countries where our market share for HTU is above 10%. And we have been growing our revenue by more than 30% on *IQOS*. So we are growing rapidly *IQOS* within our business. And as you're going to see, this is going to have a number of very positive impact on the company in the future, although they were already visible in 2020. And if you look at our performance, and here, we are assuming, of course, the guidance that we've been sharing with you for 2021. Well, you can see that during this three-year period, we are actually intending to deliver very close, if not above, the guidance that we have been sharing at the beginning of the '19-'21 period.

In term of net revenue, first, you see that we are targeting to be at 3% to 4%. So we are slightly below the minimum of 5% that we are targeting despite the COVID crisis. That's really important to note. We are very nicely improving our profitability, and we target to have above 190 basis point of margin improvement over the period. And we are targeting, based again on the guidance for 2021, to have a growth on -- an organic growth of our adjusted diluted EPS between 8% and 9%. And we did maintain our objective to be between 90 billion and 100 billion stick on *IQOS* despite the COVID crisis.

And actually, this is, of course, a testament to the strength of our *IQOS* model. And as *IQOS* is growing further in the total of PMI, it enables us to further accelerate our growth and our journey towards a smoke-free world and to increase further our ambition. And here, you have our new set of targets and goals for the '21-'23 period. And you see that on net revenue, we are now targeting to be above 5% organic growth as a CAGR over that period. You see that beyond growing faster revenue, we also want to very nicely improve the profitability of our company, and we target to deliver on average an organic growth of the operating margin of at least 150 basis point per year.

And of course, as we are putting together nice revenue growth and nice margin expansion, we target to deliver above 9% of organic CAGR growth of the adjusted EPS over the period. That's going to be based, of course, on a very nice growth of our *IQOS* business. We are targeting to be in 2023 between 140 billion and 160 billion stick. And as you're going to see, I mean, the more we are growing the weight of *IQOS* in the business, as it keeps growing very fast, of course, it overall improved the growth profile even in term of volume. And we are targeting to be over the three-year period broadly stable, which would be an improvement versus the trend that we have been experiencing in the past few years. And last, but certainly not least, we are targeting to generate an operating cash flow over the three-year period of around $35 billion, and that would be, as you can see, a nice improvement versus the 2019-2021 period.

As I said, the acceleration of our RRP business and the growth on *IQOS* is really a strong generator of this performance and of this performance that we intend to accelerate. And we're going to go through the coming years through two very important milestones for that. The first one is that, by 2023, we are targeting to have revenue on noncombustible business to be around 40%. So that would be a nice improvement versus the 24% of 2020. And then, of course, for 2025, we have this landmark ambition of becoming predominantly a smoke-free company and to have revenue above 50% corresponding to noncombustible business.

That is, of course, a very nice perspective. And I can tell you it's a fantastic push for all energy within the company to get to that very important milestone. And I want to be clear. It's not a kind of remote faraway dream that we would say, one day we'll be above 50% smoke-free business. That is already in the region where we are having a significant presence with *IQOS*. That is already the reality or close to being the reality. Of course, there is one region where we are already above 50%, in East Asia and Australia at 55%. But in Eastern Europe, we have reached already 33%. And in the EU, we are at 25%. And on average, we are at 35%, and six markets are already with revenue corresponding to noncombustible business above 50%.

Now let's dig a little bit further on what is the benefit of having *IQOS* growing. *IQOS* is actually a high-quality business. And when it is growing, it is having, for us, a number of positive consequences. And there is no better example than to take Japan to illustrate that. In Japan, as you can see, we are already at 67% of our sales that are based on RRP. And as you can see on that chart, as we were growing the percentage of revenue corresponding to noncombustible business, we were also nicely improving the margin. And it's, of course, because *IQOS* is intrinsically a business of high quality with potential to deliver even higher-margin than the combustible business.

So I want really to elaborate on that and go through the various reason why *IQOS* is this high-quality business I am describing and why it is having some very positive impact, I would say, throughout the P&L down to the cash flow generation. And here, we are listing all the positive impact that *IQOS* is going to generate. So I'm going to talk, of course, about the nice impact on volume as *IQOS* keep growing fast and with a bigger weight within our portfolio. We will also see that *IQOS* is coming with a nice impact on the revenue growth because it enjoys a higher per stick revenue.

We will see that *IQOS* is also on the consumable, on the HTU business that is presenting a higher gross margin than the combustible business. So as we are growing *IQOS*, we are pushing up the gross margin rate of the company. We will see that we are also, of course, progressing. *IQOS* is still a very young business, but we start to learn, we start to mature in some places, and we are increasing the return on our investment. We're also improving our commercial model, and we will elaborate on the full digital end-to-end model that we are developing. And all these elements put together are designing a very exciting and promising outlook for growth and increased profitability for the coming years.

So let's start now with -- looking at the volume, and Andre has been presenting that chart already. So altogether, for the nicotine industry, we are expecting a yearly decline between minus 1% and minus 2% between 2021 and 2023. But of course, it's going to be quite differentiated before -- between combustible, where we expect a significant continuation of the decrease, and Jacek has been alluding to that. And in front of that, of course, we will see a very nice growth of the noncombustible. And in front of the noncombustible, among the noncombustible, heat-not-burn is going to take the lion's share of the growth and should move from what it was only 1% of the total nicotine industry in 2017 to be, based on our vision, 7% of the total nicotine industry in 2023. And as you can see, when it comes to revenue, it's going to be almost twice the 7% at more than 15%.

That's going to be base for us, of course, and that's -- we're going to be the main contributor to this growth. We are targeting -- with the bracket that we are giving of 140 billion to 160 billion unit, we are targeting a CAGR for our volume between 23% and 28%. And here, you have this very impressive, I would say, ramp up of our growth on *IQOS* and our heat-not-burn business. You see that we are targeting to double up our market share from 3% to 6% between 2020 and 2023. Let's be very clear. In the country where *IQOS* is, I would say, meaningfully present, we are already nicely above 6%, at about 6.7% market share. So in fact, the market share here is not reflecting the real impact of *IQOS* and our heat-not-burn business in the market where we are present. And on the right-hand part of the chart, you see the very nice acceleration of our volume for *IQOS*, and you see this acceleration toward this new objective of 140 billion to 160 billion stick.

So we've seen the very nice impact on our growth profile for volume that is coming from *IQOS* growing fast and, of course, gathering weight in our overall portfolio. Now let's move at the revenue and all the difference -- the positive difference, the additional growth that we're going to be able to put on top of the volume evolution. And here again, the growth of *IQOS* is extremely good news. And the reason why the growth of *IQOS* is extremely good news is that, as you can see on the chart here, we have a higher revenue per stick on *IQOS* versus the average of our combustible portfolio. And this is, on average, 2.4x superior. What does it mean? Well, it means that if you take 10 billion revenue -- 10 billion stick in HTU, it will have the same revenue than 24 billion stick in the CC business. So you can imagine, of course, that as we are growing fast, our volume, I will come back on the volume ambition on *IQOS*, that will be equivalent to a much, much stronger growth if it had been CC volume and, therefore, with a very powerful impact on driving extra revenue growth versus volume growth.

On the left-hand part of this slide, I would just like to draw your attention here on the excise incidents. Of course, one of the reasons why HTU is having this superior per stick revenue is the fact that it's a more premium business on average, a more premium positioning than a lot of our business on CC. And that is, of course, having an impact. And the other reason, as we all know, is that, in many countries, we are enjoying a lower level of excise duty. And Andre, explained why we believe it's going to continue to be the case on the long term.

Here, what we are showing is that, actually, when you look at excise duty on HTU, it's significantly higher than e-vapor. It's about 5x higher in the market where there is a meaningful presence for the two. So what does it mean? I mean, if we believe, as I think it is really the rule normally when it comes to taxation, that you put certain taxes corresponding to certain impact on society or planet. Just to take an example, for the car industry, you put high taxes today on car having a lot of CO_2 emission. And carbon emission is taxed. And when you get to electric vehicle, most of the time, you don't have any taxes. Sometimes you even have an incentive.

It's because you are measuring the impact of one given product or consumption on society and you try to put the tax attached to that. That's for the exact same reason as we know that HTU deserve a lower tax than the combustible because they have a much better impact on society and on the health of the people than combustible. But e-vapor has a similar impact. So one could make the case actually that HTU are actually quite high today in term of taxation, in term of excise duty versus e-vapor for probably a similar broadly impact on public health, and maybe HTU could be lower if it was aligned on the e-vapor reference.

Now I'm coming to the benefit of having this very strong per stick advantage in term of revenue coming from the *IQOS* business. What does it mean? Well, it means that we're going to be flying now on two engines in term of generating extra growth on revenue versus volume. Traditionally, as you all know, we were able to increase price, mainly on CC, and that was still the case in 2018, where really most of the increase on the revenue versus volume was coming from price increase on CC. In the future, we're going to absolutely keep this pricing power. Andre elaborated on the short term, some headwind that we could have on the couple of markets. But nothing is fundamentally changed on the long term. But on top of that, we're going to add this very nice powerful mix impact coming from the growth of *IQOS*.

So as you can see in 2020, we were already nicely flying on these two engines, almost, by the way, for more or less the same impact. And the 6.9% extra growth on the per stick had been generated almost on equal part by increasing price on one side and the positive mix on the other side. Here, we want to just pause for one second to make sure that everybody understands where we are in term of price positioning for the consumable of our heat stick. So of course, *IQOS* and all the consumables that are coming with *IQOS* is a premium business. That's very clear. And the experience -- the overall experience is a very premium experience. But we are benefiting today, as we said, from -- in most countries from a lower excise duty. And that is having two consequences.

Well, the first one is that we managed to have, of course, a retail price that is lower for HTU than premium cigarette. And that's a great way to attract new smokers to switch to HTUs. It's not that it's going to be the only reason for them to switch. It's just an additional on top of all the other benefit that *IQOS* is providing. And what it means as well that being a premium business, which is priced today as something which is closer to medium price positioning, again, on average, well, that means that if there was some excise duty increase, we also have the capacity to price up to absorb this excise duty increase.

And here, I just wanted you to remember and bear in mind that, of course, we retain very nice pricing power and productivity on pricing power. Here, we are taking the example of an increase of $0.10 per pack. You have here the average retail price for a pack for the CC business and for our *IQOS* business. You see that $0.10 is more or less around inflation on average for country. And you see that the two, of course, are delivering very nice productivity on price when it comes to our revenue, plus 6.9% and plus 9% for *IQOS*. But nevertheless, the productivity on *IQOS* is 30%, 3-0%, higher than on cigarettes. So it's also very good news for the future.

I've been talking about positive impact on volume. I've been explaining how *IQOS* on top of prices is going to contribute as well to revenue growth. Now let's move to the margin impact because *IQOS* is also having a great impact on our margin. And I think for the first time, we are disclosing the fact that when it comes to the consumable to our HTUs we are, on average, doing a gross margin rate for our HTUs, which is around 10 percentage point above the one on the CC business on average. So what does it mean? Well, it means that each time that we are growing our consumable on *IQOS*, and you can see that we are growing them rapidly, we are creating a very powerful mix positive for the evolution of the gross margin. And you have started to see that, in 2020, we will continue to see that in the coming years.

The other element when it comes to our *IQOS* business, of course, is the margin that we are making on the devices. Today, let's be very clear. We are having a negative margin on devices. We think that it is extremely important to put the devices in the end of the smoker to convince them to switch. And therefore, we are not targeting on the long-term to have the same kind of gross margin rate on the device and on the consumable, but we are certainly targeting to have a breakeven or slightly positive margin on the long term. And as you can see, reducing the cost of our devices will be one driver to get there.

Note: Edited by Philip Morris International for significant transcription errors

Another very important element when it comes to improving our gross margin rate and our profitability overall will be to generate massive manufacturing productivity. We've been quite good at doing that in 2019 and 2020. And in 2021 to 2023, we are targeting to generate another around $1 billion gross manufacturing productivity that's going to come from procurement, that's going to come from reducing the waste, that's going to come from optimizing our manufacturing footprint. But $1 billion is a very powerful gross productivity. And of course, that will allow us to offset -- more than offset, of course, inflation, investment that we could have to do for regulation or new product launch and generate a very nice net productivity.

So here, it means that we have three drivers to improve gross margin on the medium and on the long term. The first one is the traditional one that you have seen for many years, which is increasing price. And as I said, we retain the same capacity, the same pricing power. The second one is a very nice positive mix impact that is coming from the growth of the *IQOS* business. And the third one is the manufacturing productivity. And therefore, when we look at our ambition to generate, on average, at least 150 basis point organic improvement of our operating margin on a yearly basis, we believe that the gross margin rate improvement should contribute to more than half of this improvement.

Now so we've been talking about gross margin rate improvement. We're going to have a nice second driver to improve profitability. And this is going to be the decrease on an organic basis of our SG&A-to-revenue ratio. And how are we going to generate that? Well, here again, we have a very nice, ambitious, about $1 billion efficiency program on our SG&A. And the fact that we're going to be able to generate this $1 billion efficiency program will allow us to compensate inflation, of course, that we estimate to be between 2.5% and 3%. But at the same time, to continue to massively invest in new growth initiative, innovation, R&D, new launches, consumer program, more digital capacity, you name them, but we are going to build this capacity, while once again still decreasing the SG&A on revenue ratio.

So how do we split the effort? And how are we going to generate this $1 billion saving? Well, we thought it was important to lead you through the detail of our SG&A. So sorry for being a bit didactic here, but I hope it's going to be helpful. We're actually splitting the $7.4 billion between commercial and R&D, about $4 billion; and G&A and other $3.4 billion. On the $4 billion, 1/3 roughly, okay. It's, of course, a rough calculation, 1/3 roughly correspond to the CC business. 2/3 already correspond to the RP and it does include R&D. And 70% of these 2/3 are fixed cost and 30% are variable. And when we talk about variable, that's all the things that are linked with the volume in terms of cultures in terms of call center and everything which is going to be influenced by the volume.

So on this first part, we intend to generate around $0.5 billion. And in one second, I'm going to elaborate on how we intend to do that. And on the G&A, we also intend to generate around $0.5 billion of saving. Here again, I will describe that in a few slides.

So starting with the commercial efficiency. The first element, of course, is that like for all our costs, we're going to generate some operating efficiency. So we keep improving the way we are working. We keep digitizing the way we operate. We are reviewing our processes. We are simplifying things. We are using shared services. So we are working on our fixed cost to reduce them, and that's going to generate part of the $0.5 billion saving.

On top of that, you should also integrate the fact that and Jacek alluded to that. We've been making big investment to launch *IQOS* at the beginning. What we mean by big investment. We've been building the innovation and the product platform. We've been building the commercial infrastructure. And of course, we keep investing on all these fronts. But now that we are accelerating and scaling up our *IQOS* business, these costs are going to grow at a much slower pace than the *IQOS* business, and we're going to generate some efficiency there.

The second driver to decrease our commercial cost and make our growth cheaper, if you want, is the fact that we target to develop, of course, our end-to-end digital model for commercial. We've been learning a lot, sometimes under the pressure, but for that purpose, the pressure was good. And we now have a commercial model that is much more efficient. We are using digital, and it's not only that we intend to reduce our variable cost by 30%. I think we are also achieving through our digital customer experience, a higher level of satisfaction and efficiency in contacting the smoker to teach him about *IQOS* and to share about *IQOS*. And through the journey of the full conversion and building the loyalty for *IQOS*. I think that the overall customer experience is also better. So here, you have the double positive impact of cheaper but also better for our customers.

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So that's for the commercial cost. Now let's move to the G&A. And here again, we are nicely targeting $0.5 billion of savings. I guess, it's going to be the traditional efficiency lever. We are going to simplify a lot of the things we do. We're going to keep overlaps. We digitize. So there is a lot of investment on IT. We standardize. We're going to use much more shared services to generate higher quality and more homogenous type of work, and we are becoming a fully project-based organization that is generating a lot of efficiency.

And here again, with this $1 billion, we're going to be able to generate this nice organic decrease of the SG&A on revenue ratio, while, of course, coping with inflation and reinvesting. When we talk about capacity to reinvest here, we talk about several hundred million dollars that we'll be able to reinvest and still deliver this reduction on the SG&A on revenue ratio in an organic manner.

So just to conclude that part, we are putting together here a very nice ingredient for a strong financial performance. We talk about the volume that we target to be broadly stable. We are having a nice additional growth and nice growth overall on revenue driven by the *IQOS* impact and by the continuation of pricing up. You have seen the two levers for profitability improvement, the gross margin with three pillars, HTU mix impact, pricing and manufacturing productivity. Second driver for improving the profitability of the lower SG&A to sales ratio, and we've been talking about commercial and G&A efficiency. We remain -- we retain the capacity to invest for our future. And of course, all that is going to enable us to deliver on this objective to have at least 150 basis points of improvement on our operating income margin on a per-year basis. This is on an organic basis.

We grow fast revenue. We improve profitability that is, of course, going to deliver a nice growth for the adjusted operating income, the adjusted EPS and the operating cash flow. And precisely rebounding on the operating cash flow, I mentioned to you that we are targeting to generate around $35 billion for the next three years. It's a nice growth versus the previous three-year period. Remind you that we still believe that the capex should stay broadly stable versus what we used to do, so around $0.8 billion. And when it comes to capital allocation, we have to be very clear. The main priority remain the organic investment in our business. You see the potential. We think that we can really deliver a lot of value, and so we'll continue to invest behind the *IQOS* business.

We will invest organically as well on our Beyond Nicotine initiative, and we -- I'm going to come back on that for -- in a couple of minutes. But on that one, it's going to be a lot of organic investment. We just don't discount the possibility that at a certain point in time, a bolt-on acquisition to further accelerate the move could make sense.

Now when it comes to the dividend, we keep our unwavering commitment to the dividend. We absolutely maintain our progressive dividend policy. What does it mean? Well, it means that the dividend cannot be decreased. I want to be very clear on that one. And on the long term, we are targeting a payout ratio of around 75% of our adjusted EPS.

Now when it comes to a buyback program, and provided that the outlook for the year 2021 is confirmed as we progress through the year. Our intention is to launch a three-year program of $5 billion to $7 billion in H2. And to be clear, you should not expect us to be buying the same kind of amount every month. It will be much more tactical and, I would say, opportunistic program based on what is happening in the market.

One word on this Beyond Nicotine ambition. So nothing, of course, in our 2021, 2023, target guidance that we are sharing with you is taking that into account. But -- and I said it, we think that given everything we've been doing and developing in terms of life science, technology, I would say, knowledge, consumer expertise, we are legitimate on at least a couple of areas, certainly on the botanicals, for lifestyle, well-being product, on the respiratory drug delivery. And therefore, we want to make sure that we build on this potential on this capacity that we've been putting together. And we believe that it is reasonable to target at least $1 billion in net revenue by 2025 on this Beyond Nicotine ambition.

Now I'm going to move to what is an essential part of our performance and outlook for the coming years. And I want to be very clear, delivering on our sustainability ambition is both a condition and a consequence of a successful journey in "unsmoking the world." So like everybody, we want to be a best-in-class player in all the ESG parameter. And that's very clear that we want to be having -- we want to have a great impact on the environment. I will come back on some of the target that we have. We certainly want to be seen as a reference when it comes to dealing with society matters, and we want to have an impeccable governance. So you should expect us to deliver best-in-class performance on this front.

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But of course, we have one specificity, and I think we are very proud of the specificity, and that is, I think, animating all of us and driving us. We have a unique duty, we say ambition. I think we feel that is also a duty and something we need to bring to people, which is to create better product, to improve people health and to low the smokers, 1 billion smokers of the planet to go for better alternative for their health. That's when it comes to improving the society, improving the world and, of course, creating better health environment, that's a specific mission that we have. And I want to be very clear, I am not dissociating for 1 second, our financial performance and our performance on delivering sustainability. The way we're going to work on the two is totally entangled, and the two are absolutely connected.

Now the way we want to do it is to start from this, I think, view that we have that to be successful on delivering with all the capacity that we have on all the sustainability dimension we need to onboard all the stakeholders. So we talk, of course, about the government, we talk about the regulators, but we also talk, of course, about investors. And to onboard all these people, we need to have a very solid frame, very clear, very transparent and where people can see very openly and follow what we are doing. So we want to be clear on the why, on the what and on the how.

So why, of course, is why are we starting this journey? Why are we intending to “unsmoke the world” and deliver this smoke-free vision. So this is our statement of purpose and what we think we can deliver through this new product. And we've been sharing that, I think, in a relatively pioneer way with the outside world. But that start -- that put in a very clear manner why we are starting this journey.

Then we want to be clear on the what. What do we want to deliver through this journey, what kind of achievement do we want to bring to the customers through the planet. What are the milestones to get there?

And the third element, which is how. How are we doing in this journey and how are we performing versus our target? And we're going to do that in a very clear, consistent manner, and we think that is the way we're going to be able to have the biggest positive social impact and drive the highest shareholder return.

Here, I'm starting -- I'm sharing, sorry, some of the key milestone for 2020. I'm not going to elaborate on all of them. I'm going to come back more on product in one second. Just in terms of social, I would say, milestone, we indeed have been certified equal pay. I think we are very proud of that. We're also very pleased to have been included in the Bloomberg Gender Equality Index. When it comes to the environment, we are absolutely on track to deliver on the carbon neutrality for 2030. And actually, we are working on ways to further accelerate that, and we are working to see whether we can anticipate this date of 2030.

When it comes to governance, we've been issuing our first integrated report, but I dare to say, I believe it's already a benchmark and a reference in terms of quality of the data that we share and also outlook and perspective that we are giving in terms of our ambition for sustainability.

This one is probably, of course, the one specific and super important for PMI. That is really how we are driving our ambition for a smoke-free world. Let's start, of course, by investing on innovation, almost exclusively, as you can see now, we are virtually at 100% on smoke-free product. You see that today, we are also really focusing our marketing cost 76% on *IQOS*. I've been talking about the growth in net revenue. And of course, 12.7 million people have abandoned smoking to switch to *IQOS*, and we're already very proud of that. But of course, there is still a lot of work to be done, but it's an encouragement to continue and to accelerate.

And now we are working our 2025 and new goal, and you have it for your perusal, so you can, of course, go through it. I'm just going to take a few of them. We want to have by 2023, 100% of our electronic device with a verification -- age-verification technology. So we are working on this road map. When it comes to caring for people, we want to ensure that 100% of our partners, farmers are receiving a living income. And when it comes to protecting the environment, we want by the end of 2025 to have 100% of our smoke-free devices being eco-design certified which, of course, will be a tribute to the impact that we are having on the environment and the fact that we have been greatly improving the impact of our product on the planet.

And last but not least, back on our specific mission when it comes to sustainability, we said it, we want to have more than 50% of our net revenue to be based on noncombustible business by 2025. And that will mean that we are a totally different company at that time.

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But as a conclusion, I think precisely, I really want to conclude on the fact that we are rapidly becoming a fast-growing and increasingly profitable majority smoke-free company. So we're becoming a new animal. I know that we are still called a tobacco company, but I think you see on the ambition that we have that we are evolving very rapidly in new territories. And this ambition, this evolution is going to be driven by the growth of *IQOS* and have been highlighting all the benefit for that. And to this *IQOS* growth, we're going to add up the price excellence and cost efficiency to deliver, we said it, improve volume dynamic, fast-growing revenue, enhance profitability, the two together, generating, of course, strong profit and cash flow growth, and we intend to have a major positive impact on sustainability and society. And by doing that, of course, we believe that we can generate strong, sustainable financial performance and generate superior return for our shareholders.

That concludes my part. Thank you very much. I think we now have a short break and we'll be back probably in 10 minutes for the Q&A session. Thank you very much.

[Break]

Question & Answer Session

Nicholas Rolli - Philip Morris International Inc. - VP of Investor Relations and Financial Communications

Welcome back. It's now time for the Q&A session. We've allocated a little bit more than an hour for this session. And joining Andre, Jacek and Emmanuel will be three members of the senior management team: Suzanne Rich Folsom, our Senior Vice President and General Counsel; Stefano Volpetti, who is our Chief Consumer Officer; and Deepak Mishra, who is our Chief Strategy Officer.

As is our practice with the quarterly results, we have invited sell-side analysts who cover PMI and other institutional shareholders to ask questions live on video or audio in an interactive session. There's also a question box on your screen on the top left-hand corner, if you want to submit a question via e-mail. I'll come back later on in the session. And read several of those questions for the senior management team.

At this time, I'll turn it over to Mark, who's going to moderate the Q&A session. Mark?

Moderator

Thanks, Nick. Welcome, everybody. As Nick just laid out, we're going to do 2 parts. This one is going to be the live interactive on video mostly, maybe a few audio. And then we'll have questions that come in from the Q&A box which is in the upper left-hand corner, as Nick just mentioned. And those will go through by e-mail, and those will be addressed a little bit later. I'll be moderating the raise hand feature for the analysts. We're going to start with 3 sell-side analysts then move to a buy, and we'll move back and forth.

First question of the day will be from Chris Growe from Stifel, and you're welcome to unmute your audio and video, and go ahead. Thank you.

Christopher Growe - Stifel, Nicolaus & Company

I had two questions, if I could, to lead out. And the first one would just be that *IQOS* has been very successful and broaden the number of markets it's in and the regions that are contributing to its growth, it's more balanced. So as I look at your 2023 targets over the next couple of years, is there a region that you think could be a larger contributor to *IQOS*' volume and that should help you achieve your growth. I'm thinking the EU as an example of one area where there seems to be a broader ability to grow in that area. But I'd like to understand your viewpoint on that.

And I could add my second question, and then I can come back to it if you forget it. But just to add to that, you have several new products, new platforms. I guess, I want to understand the demographic profile of the next-generation *IQOS* user. I guess, what I'm thinking is, how does *IQOS ILUMA*, for example, help you attract more consumers or help you convert more consumers versus, say, *IQOS DUO*. And Jacek, I could hear the excitement in your voice when you announced that product.

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Okay. I think probably Jacek could answer these questions.

Jacek Olczak - Philip Morris International Inc. - COO

Yes. I mean, in the European Union, I mean, there are two geographies, sizable geographies, which I believe we should look for bringing *IQOS* to the higher levels, obviously, France and Spain, right? And we have some progress, especially in Spain, Madrid, but this is not, which would satisfy us fully. There is a number of the challenges which we have, one, the most predominant is a very narrow, is bottleneck situation with regards to communication, right? So in France and Spain, we really don't have that much of ability to talk to consumers.

I actually believe if we add *IQOS ILUMA*, which is the much more intuitive almost type of a solution, so you unbox, and very intuitive, very minimal explanations, you know how to use it. I think we can make more significant inroads there. And outside EU, look, I think to Stacey -- sorry, the region which is run by Stacey Kennedy is what I have in mind. So is Indonesia, Philippines, Vietnam, these places. There are a couple of interesting geographies, sizable geographies, and we're working on fine-tuning the right regulatory type of framework. So they are sort of sustainable that we can go with a minimum sort of other communications to consumers. We have opened Philippines, the big word open, I think that 1 almost share point in metro Manila tells us that we got something. Most challenging, to be very frank, will be presumably Indonesia, but we're working on that as well. I don't think it's going to happen in the beginning of this three-year period, but somewhere in a three-year period, we have something more substantial in Indonesia as well. Vietnam is very interesting, right? If you think about it, but we need to overcome a couple of regulatory hurdles there.

The other parts, which are in the region where we have in Japan, Korea, et cetera, are still restricted. So we essentially are not allowed, I should actually put it smokers are not allowed to enjoy the alternatives. But I am cautiously optimistic we can open these geographies. It will be a very nice complement. And I do believe they will have a very strong start from the very beginning. So this is where it's going to come from the sizable geographies.

And the second question was about demographics. Okay. Look, I mean, initially, obviously, you have a bit of this demographics, which is skewed legal age to 30 because there's these generations, they're much more open to experiment with the new things. But as we progress with the time and with the targeting, also geographical targeting, we do see that *IQOS* starts having a more substantial penetrations in a 40-plus or 50-plus.

So this is where you're coming to the core of the smoking population. The product is great. The like -- consumers in this age cohort like *IQOS* taste. There's no questions about this. But all of these things around the blade, which I mentioned in my presentation, the cleaning, it's not a reliability in terms of how do we execute the device. It's the reliability around the blade that incidentally, you may damage, you may break the blade is setting them back.

Some people also forget to clean the device, that impacts the quality of the taste experience, that sort of thing. I actually think that the higher technological advancement of *ILUMA* offer us to go to this more resistant group of smokers because we will give them essentially hassle-free sort of experience while maintaining the great taste profile. So that's my assumptions, but they are not just -- there was a substance behind these assumptions that this should work like it.

I mentioned in my speech that I'm more excited when I look at the consumer feedback from the research. I know it's a research. It is not a commercial setting. But look, I've seen the research on *IQOS DUO*, which really was spectacular and well received, the 3.1 version *DUO*. And I have to tell you the *IQOS ILUMA* blew the chart, it's really there. So people -- it's the best of good thing. It's a hassle-free almost experience. Every stick works from the beginning till the end of the 6-minute experience, which, by the way, is the longest experience anybody is offering in a category today and a consistent experience with the full satisfaction. I think if we, through the technology, address couple of these pain points, I think we really have a wonderful asset on hand.

On the demographics, just to conclude, you may recall, maybe Chris, from the past. We've been underrepresented with female audience, right, this was what -- we have in most of the geographies, essentially, we have closed the gap. *IQOS* today almost starts -- reflects, like it depends on which year you are, was the introduction -- *IQOS* almost started resembling sort of the more natural distributions as you have on the combustible -- in the combustibles.

Moderator

That's great. I think let's move on to the next question. Bonnie Herzog, I see that your camera is lit up. It looks like you're ready to go? Or are you ready to ask the next question? If so, unmute yourself and go ahead.

Bonnie Herzog – Goldman, Sachs & Co.

Sure. So nice to see I just wish it was in person. Okay, next time. I wanted to ask a follow-on question regarding *ILUMA* because Jacek, I think it was great to see how excited you are about this next-generation *IQOS*. Maybe you could give us a little bit more color on where this new technology will be positioned relative to some of the existing *IQOS* platforms that you have in the marketplace. I guess, my assumption would be that it will be premium.

And then I also would love to better understand on the acquisition costs, I believe you talked about that being lower for this *ILUMA*. So can you help us understand how meaningful that could be? Is it quite a bit lower in terms of acquiring new users? And then just your thoughts on how you think about incrementality from this? I assume it could cannibalize, but if it's an up-trade proposition within your portfolio, I would look at that as positive. So just any thoughts on that would be helpful.

Jacek Olczak - Philip Morris International Inc. - COO

Sure. Look, yes, we will have a three values on the three versions of the device, one which is really more of a super-premium. So you may consider this from the device perspective as an up-trade. One which is more or less reflecting the positioning of the 3.1 *DUO*, which we have today in the market and the mono device, which will be a little bit more price accessible. So we also have to say that the innovations, which makes this experience very flawless, simple, also should allow us to penetrate the cohorts, which are around the -- equivalent of the mid or below segment. And obviously, there will be a lineup -- vertical lineup of a consumable.

One thing I said in the remarks, the consumables for *ILUMA* will not work for the *IQOS* blade and *IQOS* blade will not activate the *ILUMA*. We will for a period of time, maintain the technology in the market, right? So you will have *IQOS* blade. And I believe the first group of users who's going to jump really to *ILUMA* recognizing the value of the innovations are existing *IQOS* users. But we know that this may drive them into the better conversion than we have on an *IQOS*. So there is a net gain, not necessarily from a price positioning, but from the even higher loyalty to the product.

I don't know, Stefano is on the call. I mean, like he's also -- *ILUMA* has the few fathers. Andre obviously is the master father of this innovation. This was his idea to put the inductions into the most micro dimensions ever seen in the history. But I mean they can chip in to this one. I think initially, it will go to the *IQOS*. It's going to take the people who try *IQOS* and didn't adopt *IQOS* because they didn't want from this cumbersome process. We can go back after to these consumers. We can now offer them *ILUMA*. I think it's going to help us on acquisitions pretty soon, not from the day one, right? So whatever we start this year, initially, you may take even up to 30% up-trade or change within existing user base, and then we will get the incrementality from the better acquisitions.

Now this drives the cost down because first, on the post-purchase service, handling broken blades, et cetera, reverse logistics, all of these things, we can really start scaling down in these markets fast. And second is, it really doesn't require that much of a handholding during an adoption period, okay? It's so intuitive how to put the stick in. It's so intuitive how to remove the stick after the consumption, after experience. I think a lot of these things are really -- yes, very simple. So I believe this will allow us to reduce the acquisition cost further in addition to what we have achieved already on the current *IQOS* going forward.

Andre Calantzopoulos - Philip Morris International Inc. - CEO

And I would add, but you can also get into more remote geographical areas where you -- because -- can you hear me or...

Bonnie Herzog - Goldman, Sachs & Co.

Yes. We can.

Andre Calantzopoulos - Philip Morris International Inc. - CEO

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Okay. Because today, you need some physical presence to explain to the consumers how to use the product, how to clean it and so on. If the product is intuitive, a little bit like any vapor product, you put the pod in and it works. There you need less infrastructure in the more remote geographical area. So I think we can have an easier expansion at a lower cost.

Now I think the induction is a great technology. And as I said, we may want to keep also a blade type of heating or a pin type of heating, like the *LIL* product or combine the two technologies and IPs into one, if we wish so, and then you have a leg there for -- to go even at a different dimension of market or price positioning. So -- with different consumables. But in reality, the two products will coexists for two, three years because we have a lot of consumers with existing devices of *IQOS*, and some will not trade up immediately. So that's how I see it. And that's why I said, every time we innovate with a major thing, clearly the previous technology is available and may also be available for licensing to others, okay? So because we're -- as we licensed one, I think others can license technology. So that's the way I see it going forward.

Bonnie Lee Herzog - Goldman, Sachs & Co.

Okay. That was really helpful. And if I may just ask 1 other question, and it's more of a big picture question. As I listen to all of you today. Great presentation, a lot of information, exciting because the innovation pipeline seems to be stepping up again as we look into this year and beyond. And as I think about all of that and everything that you guys are trying to execute on, I'd like to ask your confidence level of how you're able to balance all of these different, whether it's new innovation, different initiatives, balance that with the complexities of your organization that seem to be increasing. So if you could touch on that, I think that would be really helpful.

And then a second part of that is, how do you mobilize your employees internally and/or incentivize them behind some of these different technologies and innovations.

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Well, I can start, and I'm sure Jacek can. So I think that first of all, our employees are very excited about the success of *IQOS*. And as you know, success and progress brings excitement. Secondly, we all understand complexity and handling different platforms, both at the consumer contact level, but also with trade and everything. So clearly, there is a lot of infrastructure that can be shared, but also you need dedicated teams to work on your vapor products versus heat-not-burn, also because the problem is we explained is different. In vapor, you need to differentiate your product. And I would say it's more classic marketing. I don't think we have the intention to open a market to RRPs with e-vapor products because we know they don't work as well. As heated tobacco product. So where we go, the categories now.

So it increases complexity at retail level, okay? And I think, however, that the awareness and I would say the respect the trade now has for the success of *IQOS*, will help us, as this is coming from us and under the *IQOS* brand name to also get access to retail easier, I would say than a newcomer would do -- would have. So -- but we are all mindful of the complexity, and that's why also we changed and we are changing completely our ways of work. This is a project-based organization because individual functions cannot handle the complexity. But we also have a lot of subject matter expertise in the company now that can handle these things and digitalization helps.

Jacek Olczak - Philip Morris International Inc. - COO

Andre touched on something important. We never in the calls track between earnings calls and the individual meeting of investors, but even in the time constraint Investors Day like today, whenever we have already had an opportunity to talk about the internal transformation. And people take it for granted. It's very easy to put the one or two or three bullet points on a PowerPoint. But this is enormous effort, right, which we're going through. And I think over the last 5 years, with the revert, I have to admit the -- if I knew, if we knew, five years ago, what we know today, we will be flying in colors but we're learning. This is ours, okay?

We're already flying in colors. But I have to admit, like we had assumptions, which were proven to be wrong. But we learned, and the organization is behind that. And as Andre said, I mean, the prioritizations that in every aspect that we're doing is very important. But we have a very strong governance in the company, how we reorganize ourself completely differently. We're very focused on a product, on a marketing, on the internal processes. So there's a lot of initiatives, but they do have an owner, they do have a leader, they do have a sponsor and dedicated resources to the things which really matter. And you're on. And I think, look, this is not a walk in a park, okay? But I think the motivation is there.

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Andre Calantzopoulos - Philip Morris International Inc. - CEO

Yes, but reality is, as we said many times, Bonnie, and to the benefit of everybody. At the end of the day, technology is a good thing, but brand, equity and organizational knowledge, that's where you get your competitive advantage, at the end of the day. And I think we are ahead of everybody in these two areas because also we started first.

Moderator

Let's do the next question from Gaurav Jain from Barclays. And then Robert Rampton, I see that your video is on, you're going to go after him. Okay. Great. Go ahead.

Gaurav Jain - Barclays

I have a couple of questions. So just trying to understand your guidance over FY'21 to '23 so you are saying that your volume growth will be flat, and you've also highlighted that *IQOS* leads to a positive mix shift of about 4% at that level of growth. And yet the total revenue growth that you're guiding to is only 5%. So above -- pricing is above 5%. But what I'm asking is that, look, if pricing continues to grow on cigarettes and *IQOS* growth will be in EU, which is your higher sort of ASP region on *IQOS*, then aren't you looking at like a 6%, 7% kind of revenue growth rather than 5%?

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Well, I tried to give you all the parameters when I was sitting on this algorithm for a while. Yes, the ambition we have about that. But we are in COVID and I don't know where the rebounds will happen. So I think I gave you which you can calculate, you can do the math your own, you know per unit of *IQOS*, and you know the per unit of cigarettes, okay? So of course, we have to assume some cannibalization is there. And if we want to be conservative, we assume 40%, okay?

So at the end of the day, if you do the math, you're on a 5% to 6.5% based on *IQOS*, okay? Then the whole question is what else is going to come and when? When duty-free is going to come back, when any rebound can happen, and I said that I gave the CAGRs for everyone, right? And then if we take cannibalization out and the COVID effects out, then your normal business, so you can assume 2%, 3% volume decline. We know what CAGR that gives and then pricing compensates and comes on top. So if everything works well, obviously, in a rebound year, you will be well above. If it delays, we wanted to be also cognizant that we are not out of the woods yet. But I gave you all the parameters that can lead you to much higher if the stars align.

Gaurav Jain - Barclays

So sure. That's very helpful. My second question is on just your 2025 ambition, and that 50% plus software revenues will be from *IQOS*. So you will be a smoke-free company. But if I look at the share in units, it will still be around 30%. So from that perspective, you will still largely be a cigarette company even in 2025. And you have announced a share repurchase program today. But do you think you need to go even further than that because we know the continuous pressure from ESG funds who are continuing to pivot away from tobacco. And based on the 2025 projection, that won't change.

Jacek Olczak - Philip Morris International Inc. - COO

We didn't say -- we didn't say or indicated that the '25 is the end of the world and our journey to smoke free. We just picked a moment in time. And there is no magic of 2020 year or '25 other than it is a round date, right? And this is how you set the milestones and we believe that 50% is aspirational, but it's attainable, the directions where we go.

Logic, obviously, dictates that like once we get to the 50% or sort of the revenue, the thing is going to also have a completely different dynamics than the first 50%. I think the directions that they were, the consumer, this is not their world. This is not the industrial manufacturers. The fact that the consumers are looking and deserve and are looking for a better alternative has been all confirmed. The science and the harm reduction strategies, I believe, finally, will reconcile and will go into one direction, is closer, we are not done yet, as Andre and I indicated, but I think we -- every day, every quarter, we're getting closer there. And the consumer is there.

Okay, so as you think that we will go to that level of penetration. And as we measure in dollars revenue to 50%, I think the rest is just -- this is not going to be as challenging as the first 50%. Although, I believe that there will be smokers, and we have

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said it from the very beginning, who will need other set of incentives or disincentives to make the final move. Because we will be confronted and we know it today with the smokers who will never ever, ever stop using cigarettes. So we need to figure it out, other solutions, how to move the last cohort of the combustible smoking into these equations. But I believe we will find, together with our stakeholders, the solutions, which will help everyone to go smoke free. So this is what we believe.

Andre Calantzopoulos - Philip Morris International Inc. - CEO

And as we talk, Gaurav, about ESG. I think everybody needs to understand that first of all, exclusion is not the solution because that's not going to convince any person to stop smoking, as it is not going to convince any person to stop using fossil fuel. I think the key thing here is to say how we can convince, to Jacek's point, people to change behavior. And that's fundamentally an ESG thing. So the fact that if we didn't sell cigarettes because I get this question very often. Let's assume you dispose, you stop your business, whatever. It doesn't change anything from an impact on the planet of the fact that cigarettes do exist. Replace them is the solution. And I think engagement from the ESG investor with us and understand what we're trying to do. Put pressure also on our competitors to do the same. And on regulators coming in and incentivizing the industry to go in that direction. I think that's the right approach to resolve the problem. Otherwise, even if we didn't have cigarettes, somebody else would have them. So the problem is not resolved. So we're trying to resolve the problem, and I think that's why we should be focused.

Moderator

Okay. Robert Rampton, UBS. Are you ready to go?

Robert Rampton - UBS

Yes, ready two questions from me. The first is, could you tell us what the margin profile looks like in Korea? And if you can tell us what you did to defend margins there once the tax get closed? That's my first question.

Andre Calantzopoulos - Philip Morris International Inc. - CEO

You want to take this, I mean, yes, you know the tax structure in Korea, okay? And -- sorry, go ahead.

Emmanuel Babeau - Philip Morris International Inc. - CFO

No, no. I just wanted to say that we don't enter in the elaboration of comment on margin by market. But I mean, I think you were about to say that there has been a significant reduction in the differential on excise duty between CC and heat-not-burn. So the profile today is not materially different between the two, and there is no interest from the local authority today to push better alternatives. So that is certainly paving the way for the CC business to be the one growing and notably with a lot of flavor development in the country.

Jacek Olczak - Philip Morris International Inc. - COO

There was a few percentage points difference between our heat-not-burn taxation and the cigarette taxation. But I guess the question is more about the KT&G at Philip Morris, right?

Robert Rampton - UBS

Okay, fair enough. Just the second question. So on competition, I appreciate that in most of your markets, competition has had a negligible impact. However, peers are coming with better and better products. Can you help us understand how you're thinking about the impact of competition on the various top line and margin drivers in the event it gets more effective? Or is your assumption that your lead on all the fronts you've talked about is too big.

Jacek Olczak - Philip Morris International Inc. - COO

I will take it. And I guess, Andre will finish with this one, okay? Because thanks for the question. So it is not that we are not confronted with the competition, putting a really quite significant resources behind their products to compete with us. If I take Japan, if I take Russia and a few other geographies, it is not that the competition is sleeping. The competition doesn't have an impact on us. We measure this from the fact that we still have a 80-plus percent share of segment. And I took pride that we actually even managed to grow by about 100 basis points our share of segment.

So, so far, the way we're coping with competition very well, but the resources, which the competition have pulled essentially to competitors in some focused markets are seriously very significant. Resources are going, obviously, more into discounting the devices. So we have pretty aggressive schemes, et cetera. But the gain, which makes me very happy is that *IQOS* goes for these rates almost untouched. I remind the high conversion rate. And I said a number of times, that's the key to the right returns while achieving your smoke free future.

Now there are some competitors, and this goes beyond the damage or pressure they put on us from a classical product competition, when unfortunately, they start confusing the regulators about the categories, okay? So if I cannot achieve my commercial success, I am trying to put all other -- pull all other strings in order to pull the leg of *IQOS* of heat-not-burn.

I think personally it is extremely short sighted, because instead of focusing and grab an opportunity which consumers indicates to us, give me good heat-not-burn products or other RRPs, and I will switch. I mean some people, as I said, in the short-sighted type of an approach, are essentially pulling the regulation of the RRPs. I think the strategy, I hope that the strategy will change because it essentially undermines the big purpose of this transformation. And actually, as we have demonstrated ourselves, which is good not only for the smokers and public health but also for investment. I don't understand some of the strategies.

Andre, I think, you want to add something?

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Jacek said, our job is to continue innovating, building our brand and try to be better than the competition. You have to assume the competition will continue improving their product, okay? But -- so we are extremely cognizant of the fact that there will be increasing competition as the segment grows. And we try to get ahead. And I think *ILUMA* is a very good example of us innovating in this category. Ahead of everybody else again. And as I told, Bonnie, I think, as an organization, we've learned a lot, and that's a huge competitive advantage. We had the first-mover advantage with *IQOS*, and it has established credibility.

So I think all this it's fair commercial game for the rest, as Jacek said, I think people should be careful when they go to regulators and say the dividing line in products should be whether they contain tobacco or not. When everybody knows particularly well, it's the absence of combustion that is the issue and not tobacco or non-tobacco. And by the way, that sounds like aligning positions with NGOs and the World Health Organization that are still in the '50s in terms of science. And so I think that's where care should be -- a long-term view should be playing, and not to shoot our foot or a company shooting their foot maybe in some site. I think, as you know, competitors have the right to do whatever they want, and we face this situation increasingly this year. And I don't think I can point to one competitor that had a win in this area.

Moderator

Okay. We're going to try to go to Tom Russo. Tom Russo, if you're available, you can unmute your audio and video, and we'll take a question from you. I think you have multiple questions. So if you can limit it to two, that would be great. If you're ready to go.

Thomas Russo - Gardner Russo & Gardner

I'm all set to go other than the video, I think, is not. But thank you for the chance to address the management team and to thank the management as well as the Board for having had the capacity to suffer through $8 billion worth of investments over the past 10 years to come to this point where you now have such an extraordinary position.

My two questions are, first, just to have a chance to have Andre share with us maybe the role that digital has played in helping you deliver more for less, with more effectiveness and more efficiency across advertising, direct marketing, even auditing your outcomes broadly.

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And then the second question has to do with your priority with the United States as a market. It did not come up in the response to Chris' question about big markets as this was addressed to the EU. But is the U.S. a big market for you? And what are the steps that will be required to begin the process of realizing those values, then?

I'll throw one last question about the capacity to suffer. Do you have any plans to try to commercialize China going forward? That's it actually -- congratulations on a terrific presentation.

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Okay, I'll start. I think in terms of China, I think the intention is always there, but progress is limited for the moment because I don't think the Chinese National Tobacco company, China has decided to, on their domestic market, deploy this project. But we're always hopeful this will happen. I don't think there's much that will happen in the next two, three years. I always remind people that -- how patient we were about certain countries in Eastern Europe opening up and sometimes we waited 15, 20 years until they opened.

Now clearly, on the digital, we are at the beginning, I would say, of the transformation. I think we hinted to both things, how we can use more digital tools, and COVID was an acceleration in the -- all the misfortune surrounding the pandemic. At least everybody was forced and we were forced to even accelerate and try digital tools. So overcame a little bit the reluctance of certain traditionalists, I would say, in our market.

And also now we are standardizing much more our internal processes, as Emmanuel said. And when you standardize, you can obviously digitalize. But to me, this is the beginning of a journey. We're not yet a digital company, I would say, although we sell a physical good. And I think on one side, we look at acquisition and how digital facilitates and reduces cost. But also when we start moving to retention of consumers, which becomes increasingly important as we have a very big number of consumers and competition, then obviously, CRM will take a much bigger base, much more knowledge and data on consumers that we can use obviously to accompany them during the journey, but also eventually offer products and services that can add revenues or loyalty of the consumers. And that's where I think digital will play an important role to have much faster feedback from the market. We have it already, improve the product and what we offer consumers and eventually potentially monetize in a certain way our database and digital knowledge. So that's how I see it.

Now -- sorry, I forgot the third question. I didn't...

Thomas Russo - Gardner Russo & Gardner

It was the expectations of rolling out North America.

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Yes. Look, the potential of the U.S. market is very big, okay. And you know that we have the agreements with Altria. So now we have the authorization for *IQOS 3*. Altria have announced their expansion plans, and the ball is their camp to grow the business in the U.S. So I think that the potential in there. And I hope Altria, with our help, obviously, can materialize this potential as soon as possible.

Moderator

Next, we're going to move on to Adam Spielman from Citi. And Michael Lavery, you're going to be on deck.

Adam Spielman - Citigroup

I'd like to just follow up on that question. So Andre, on Slide 41, you showed -- and I'm talking about the U.S. here. You showed how the markets you've launched in 2019 and 2020 have grown so well. And yet, frankly, it hasn't worked well in the U.S. It's been, in my view, very disappointing. So can you just explain exactly why you think the growth has been so slow in Georgia in the United States relative to Georgia in the former Soviet Union?

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Well, it's difficult to answer this question because we're not doing the commercialization and the marketing of the product. I don't think...

Adam Spielman - Citigroup

But you say you work together closely with them, and they say they work with you.

Andre Calantzopoulos - Philip Morris International Inc. - CEO

They do, but we can only introduce what we think -- we think are appropriate based on our experience, and Altria has to realize certain things. Reality is also that we just got the *IQOS 3* authorization. So I think that will be a boost. And the question is always in certain markets, in how many places do you have to be present before you have the effect?

You see -- if you have a large country like Japan, if I use it as a proxy, Adam. We were in Nagoya, and the brand was at 1%, 1.5%. Because if you are in a city or two, you don't have this feeling that this is a national brand and with big presence. Once we expanded in Japan, the brand grew very rapidly. So I think you need a certain scale also not in a city but across the country in order to get that scale. And Altria has an expansion plan. So we'll see how this, I would say, synergetic effect works.

So just launching in a couple of cities, in my view, based on our experience, is not what maximizes consumer awareness, but also comfort that this is a good product that -- because they don't see it everywhere. So that's how I can explain in part.

And you asked this question in the past, I believe the U.S., obviously, once we go -- Altria expands more is probably not going to be Japan, okay? But it certainly can be close to many European countries. That's my view. But we need to get some scale.

Adam Spielman - Citigroup

Okay. Can I ask about the -- the reason is I was really asking about the 250 billion plus aspiration for 2025, which you've had for a long time. You just obviously announced a target of 140 billion to 160 billion for 2023. But to me, that doesn't fit in with the 250-plus aspiration to '25, which is just -- either that you don't really believe that 250-plus to 2025 or the 140 billion to 160 billion is way too low?

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Well, we should not forget, that we articulated this number in 2018, '19. And I think it's still, in my book, becomes an aspiration, and it remains an aspiration. On the other side, we also have some slowdown based on COVID, okay? And I would like to focus more on getting to 50% of revenues as a benchmark. Sooner or later, we'll get to the 250, okay? If it's a year later or a year earlier, I don't think that should be the criteria. So we try to get some realistic numbers, everybody can put their hands around and their head around. And then once we get to 250, hallelujah. If it's in '26, it would be in '26.

It also assumes in there other -- it's not only hit the tobacco units, other platforms. And there is some degree of assumption in there that regulators will do their job and allowing certain markets a little bit more communication to consumer because it's rather painful and rather expensive to try to be under tobacco law -- cigarette laws, I'm sorry, and try to have rapid expansion. And that's not, as I said in my intervention, much. It's just the ability to talk to people, explain the product and create some awareness and comprehension about the product. So if regulators play in a role, and that was the working assumption by '25, then we can accelerate even further.

Adam Spielman - Citigroup

Can I just follow up on that? I mean, again and again, and I completely understand it, you say you need regulators to play their part. But are there any regulators you can actually point to where things are really changing? I mean, the FDA is where it is. It's been like that, you know, for a while, roughly since 2009. But is there actually any movement that you can point to that has really changed anywhere else?

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Not in big markets. Okay, in Germany, you can communicate with consumers, for example. It's not a big deal. There has been no movement yet in France, which is important. There has been movement in Italy. There is movement in Greece with appropriate legislation. New Zealand changed their laws. And now they authorized this product. So there is movement.

The key to me to have a fast impact is if the World Health Organization and the NGOs and special interests that gravitate around it because it's not -- as you know, it's the framework convention for tobacco control, it's not truly the WHO. Then if they change a little bit their views because they're also influencing politically many countries, I think we can have a major acceleration. And they have to be very conscious, sorry, to use rhetoric here, that by trying to restrict all these things, they perpetuate smoking, and they are accountable for that.

Moderator

Michael Lavery, are you ready to go? And then Owen Bennett, if you'd be ready behind him.

Michael Lavery - Piper Sandler & Co.

I just want to come back to some of your color on the *IQOS* economics. You mentioned the 10 billion sticks would have about 650 million to 700 million -- I believe that's a net contribution. Just want to understand some of that cannibalization -- excuse me?

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Sorry, net revenue, yes.

Michael Lavery - Piper Sandler & Co.

Right. Exactly. And just want to understand some of the assumptions around that. You did -- and if my math is right, about 900 million per 10 billion sticks last year, obviously, that's excluding a cannibalization impact, but that looks like it might imply a 25% cannibalization rate. Is that around the right assumption?

And then also as we look ahead versus history, how much should we try to factor in geographic market mix dilution to pricing or any other variables that would change how you think about the next few years versus the recent past?

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Okay. I'll start and others can chip in. So to me, the way to look at it is -- and we should not forget devices. Okay, devices don't have a positive bottom line, but they contribute to revenue. So you have to add the devices to this calculation. So I mean, you can do the math yourself and you've done it, okay? You take revenues of *IQOS* consumables divided by volume, you have one unit. Then you take cigarettes, and I even took the cigarettes in the markets we're in that are higher than the average. And I -- you can assume between 35% to 40% cannibalization rate, worst-case scenario, okay? That's how you can come to the number I gave. And then you can add 10% to that for devices, can be 12%, as we go higher in pricing in the future with the *IQOS* device. So your numbers are "gross" correct, but you have to take out the volume impact on our own portfolio, not only the others, okay?

And then down the line, as I said, if you apply a 75% margin to what remains, we're between $525 to $550 on the gross profit, which is COGS excluded, okay, net impact to the company, okay. So -- and then Emmanuel gave you the key on how to calculate the variable versus fixed for, obviously, chunks of volume. That's how I would look at it. Emmanuel, can you continue?

Emmanuel Babeau - Philip Morris International Inc. - CFO

Yes. On the second part of your question, Michael, on what you should expect in terms of evolution of the 2.4x multiplier today, I mean, on the foreseeable future, in the 2021, 2023 period, we don't see today a major evolution of that ratio, which is certainly influenced by the mix today. So I think if we were to try to clean that ratio from the mix impact that is coming from exposure to certain markets where *IQOS* is bigger and where the multiplier is higher, at the group level, you would probably get ultimately to a multiplier by about 2x. But again, it's a difficult calculation to make because *IQOS* is not present in all countries. And therefore, it's a kind of rough assumption.

But for the next two to three years, we don't see major evolution on these 2.4x multiplier between CC and HTU per stick revenue.

Andre Calantzopoulos - Philip Morris International Inc. - CEO

And Michael, you can do the math because we give you the regional numbers as well. So it's obvious that it's better in Europe, a bit worse in Japan. And in the middle, in Eastern Europe, okay, by definition because the purchasing powers are different. But you can do the math yourself. If you look at the regions, you can. You have more -- by market, we're not going to give you. It's pretty clear.

Michael Lavery - Piper Sandler & Co.

No. Really helpful detail. And I'll try to get to the math once we finish, I haven't had a chance to run through everything yet. I know even if it goes the way you're aiming for, the non-nicotine piece would be pretty small relative to the rest of the business. But just curious some of the thinking there, maybe two parts. One is just, do you see this more as a growth opportunity sort of proactively? Or is it a little bit of a defensive approach? Just how do you think about that opportunity strategically?

And then I'm sure it's still far enough out. You may not be very specific. But curious when you talk about things like sleep or calm, do you have cannabis derived -- cannabinoids or biomass that you would be putting on your radar? Or is that something you would consider out of the consideration set just because it may be controversial in some markets or whatever else?

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Yes. Well, I see, first of all, adjacencies as an opportunity, okay, because we have -- I mean, adjacency, definition is either you use existing capabilities you have to expand or you use consumer permission to give them more. I explained that part, how you monetize CRM and database, but that's more our consumer, okay? Now that's an opportunity we will not explore because as you get -- you offer something to consumers, you get permission to offer more, and it can be partner products in which you get some margin or something the consumers benefit from. For example, I don't know, we have in Japan many thousands of restaurants that offer *IQOS*. And if you book through our portal, consumers can get a rebate or something. So the consumer benefits because you offer them something they would not otherwise have or something cheaper, but that's pure CRM, okay.

Now if we go to the other categories that I was referring to and Emmanuel elaborated, essentially, I see opportunities in two areas. Something that is not explored by major pharmaceutical companies in this domain, which is respiratory drug delivery, and we have a lot of expertise in this area. And I gave the example of aspirin, which may sound like a stupid example, but this is very important, which is respiratory delivery increases bioavailability and reduces side effects to deliver very rapidly because you can dose less. You have immediate access and effect, and then eventually less damage by using pills and so on because the dose is much higher on the pills without being very technical.

Now the ambition there is not to become pharma. The ambition is we have the clinical, preclinical regulatory approval capability, and then we can outsource or partner for anything else. So we're not going to build the machine. And as we learn, we may also have to make some acquisitions in all this broad area so that we can get scale. But we remain -- we want to be at the -- use our skills at the center of the ecosystem. Now if it's a product that goes to consumers, clearly, we can use our own infrastructure, okay.

Now I guess you refer to botanicals. And I said many times there's two ways to look at these products. The one is a therapeutical medical route, which is pure pharma -- CBD, THC and so on. The other is anything you offer to consumers. And there, you need to evaluate what are the ways of delivery, what warnings you have to give consumers because there may be side effects and so on. So we've looked at CBD, for example. And I'm talking here pure CBD.

First of all, at this stage, there is no, I would say, clinical trial that has proven effects on pain, I don't know, sleep or whatever, okay? And there are also some toxicological concerns because in those who are CBD, pure CBD has efficacy, means it binds with the cannabis receptors, then you start having issues with cytotoxicity and other problems. Now that's embryonic first cut. And we also know from medical studies, because there is one drug for acute epilepsy that is CBD-based -- and then you do have, because of usage, liver effects and other psychiatric effects. So all I'm saying is the product is not purely innocuous. An appropriate warning has to be given to consumers if we have continuous or long-term use. And we're evaluating all these areas, so we understand better. Because we said as a company, we're a science and technology-based company, not a small outfit that just prices under the regulatory radar screen and sells something. So that's all I'm saying. So we're looking at these areas.

We also have an investment in a medical device company, which is Syqe in Israel that have developed a device for pain relief that uses cannabis, THC and CBD combinations, and that's medical route. So we are looking at both categories, but I can't say with determination, we've decided to enter the sector until we have some better understanding of efficacy and side effects.

Moderator

Nick, we have two more with raised hands. It's Owen Bennett will be next, and then Alan Erskine from Credit Suisse, and then maybe go to your Q&A on the toolbar, but I'm also sensitive to the time that you're thinking about. Do you want to limit them to one question each to keep it going? Or how do you want to handle it?

Nicholas Rolli - Philip Morris International Inc. - VP of Investor Relations and Financial Communications

No. Let's go to those two questions. And we have a number of them that come in. Some have already been answered on the email, but I want you to read, yes.

Moderator

Terrific. So Owen Bennett, Jefferies, you're next, then Alan Erskine from Credit Suisse, you'll close out. Part of it, we may come back to the virtual later after Nick gets through some reading of the questions that are on the toolbar.

Owen Bennett - Jefferies

So I had a couple of questions around vapor, please, given the extensive rollout plan during the year. First one around the vapor-specific gross margin economics that you gave, which are better than what we've seen given by certain peers. So just wondering, when you say premium price positioning, is that premium versus over current vapor products or priced the same as premium cigarettes? And then also, within that gross margin, do the manufacturing costs assume full automation?

And then the second question is just around pulling capacity in vapor in terms of refills. What do you think is a realistic ambition for top line contribution from vapor into 2023?

Jacek Olczak - Philip Morris International Inc. - COO

When we talk about the premium positioning, we had more in mind the -- definitely in mind the device because I believe putting some price, which will take the consumers for the serious consideration phase rather than to jump in into something, which is $10 or below and not using this is -- undermines the purpose of the exercise. So the first device, which we've gone through is really a premium device. The cartridges will be competitive but on upper end of the market, okay?

And again, yes, we said that we're going to go to the -- above 20 markets this year, but we actually don't want to change blindly the volumes. We rather want to change the -- chase the consumers from the angle of the full conversion. So however it is complementary conversion where there are dual users between the cigarettes or users of heat-not-burn on some occasions have a need to have a puff on demand, et cetera. So these are complementary to the *IQOS* core proposition. Yes. I mean, this is how we want to take.

With regards to that capacity, we have developed and are in a process of building or developing that capacity, but it's to some extent, is our own in-house capacity. But ultimately, we're going to rely on third-party capacity for the track -- for the cartridges. But obviously, I mean, a proprietary to us, and this is the core of this whole thing is that, well, is the technology is one thing, the *MESH* technology, but the liquid and the compositions, et cetera, which goes into the product.

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Yes. And last thing, Owen, to answer your margin question. The different margins you saw on the slide are -- okay, you are a 50% dual user. Then the rest is you are 100% user at 1.6x combustibles, but that assumes that you consume only one company's or one brand's consumable. And that's the important thing, what I said and Jacek said, is the loyalty. Because if you have seven devices because they were given to you free of charge, and at the same time, you use different consumables on different companies, yes, on aggregate, for a fully -- for a pure user, you get 1.6x, but each individual company gets a fifth or a tenth or a third. And that's where the economy start not being very good because if, on the margin, you are really marginal, and on top of it, you have the infrastructure and the marketing expense to support these products, it's very difficult to make money. So we have the infrastructure.

And our objective, to Jacek's point, is to bring loyalty and trust because of the *IQOS* brand. We will learn, okay? And then we'll take it from there. But the category economics are not bad. It's a fragmentation of the category and very little brand loyalty that consumers have outside the U.S., and that's where improvements can be broad, and that's where we're hopeful we can do better. So that's the analysis, if you wish.

Jacek Olczak - Philip Morris International Inc. - COO

If I may add to this, Owen. I actually think that there is a group of consumers. If you give them, if they haven't had heat-not-burn *IQOS* and have e-vape *IQOS*, they're essentially covering 99%, if not 100% of the daily situational type of needs, okay? Maybe I'm wrong, but this is how we see this whole thing.

Obviously, you have the users who will be 100% on the heat-not-burn, 100% on the vape, and the people who still with the one leg left in the combustibles. But I think delivering something under one umbrella, which is essentially a one-stop shop, right, to solve my smoking problem, I go to the one infrastructure. It's one brand. It's the one contact point. It's -- all of these benefits that I don't have to think about where to go home to choose. I have a brand. It's credible, delivers on a science, deliver technology, delivers on quality. I think there is a winning proposition. I think there might be a winning proposition. But we'll see. We'll go. We will learn. We will confirm.

Owen Bennett - Jefferies

Okay. Just one follow-up there. So on the cost to produce, I remember a couple of years ago, you said once you got to scale on *IQOS*, the consumables were a similar cost to produce as a pack of cigarette. So I'm just wondering when you get to scale on vapor for automation. How would the cost on a pack equivalent basis compare to cigarettes?

Andre Calantzopoulos - Philip Morris International Inc. - CEO

On a pack, it depends on -- okay. If we assume a cartridge is a pack, which is a wild assumption, a cartridge can be between -- if you look at all the competitive landscape between $0.50 per cartridge and $0.80, $0.90 if you have a sophisticated product. Cigarettes are $12 per thousand. So we divide per pack by 50 -- sorry, I'm doing the math with you. So 12 divided by 50, what the heck that is? Sorry, it's late in the day, but that's the comparison.

The difference is taxes on cigarettes are vastly higher, obviously. There is very limited taxes on e-vapor. But a big chunk is the trade margin. It's 30%, 35% compared to 11% for cigarettes on average. So it's kind -- it acts as an ad valorem component in addition to VAT if we take European comp.

So if you sell like EUR 4, you pocket EUR 2, you take 80 cents out, you make EUR 1.20, okay? Still better margin than cigarettes, if I can simplify life for you. Okay. So obviously, we -- and if you stay with the same technology, you will reduce the cost of the cartridges. And I see an opportunity to take the absolute margins at the same level of cigarettes and not having this debilitating ad valorem. That's music of the future. Okay.

Moderator

Note: Edited by Philip Morris International for significant transcription errors

Alan Erskine, Credit Suisse. You're up.

Alan Erskine - Credit Suisse

Just one question for me, really. On the *IQOS ILUMA* consumables, two parts there. One, I think you indicated it was a unique consumable that certainly wasn't interchangeable with the blade device. So my question is, does it require a specific capacity, a dedicated capacity? And if so, how much capacity do you have for this new consumable? And then the second part, I think you indicated that there would be some kind of activation code, which meant that only bona fide consumables could be used in *IQOS ILUMA*. I just wanted to see if you could elaborate on that, and how much protection you have around that?

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Okay. I'll do the -- look, in terms of manufacturing, obviously, there are three parts in the cigarette factory. There is the primary where you prepare the tobacco mixture. There is the making, where you make the sticks, and then the packing. So the sticks machines needs adaptation, okay? That's clear because it's a different process to make it, but all the rest remains the same. And all the transformational cost is in the capex forecast we gave, okay? So of course, we need to build the capacity, and it's not only the capacity in our factories. It's the capacity of the new device and the capacity also of what we call the susceptor, which is induction in the stick, okay? But I think we can satisfy the demand based on our launch plan, and we took this into consideration. That's for the first item.

Yes. Jacek, somebody else wants to answer the second one?

Jacek Olczak - Philip Morris International Inc. - COO

Second one was on the stick activation.

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Well, the -- it's the age verification, okay? We started the age verification with the e-vapor products because it's more sensitive. We are experimenting in New Zealand and in Czech Republic I think.

Jacek Olczak - Philip Morris International Inc. - COO

In New Zealand, we experimented. We passed the experiment. And the technology is, frankly speaking, is comparable like you activate your smartphone. You buy the smartphone, but you need to activate it. So you need to register somewhere. And a part of this registration is, in our case, the age verification. And so we can do it, obviously, in a very, very, very short period of time, this creates a minimal type of disturbance to the consumers. And obviously, consumers cannot just take the product off-the-shelf or buy it for the retailer and start using it. You need to go for the verification.

But I believe with that technology, we master the technology at scale. We're essentially solving the problem of all this unintended use, which might be incidental to create a much bigger problem. So for us, it is very important. As you know, we have said that by 2023, we'll roll out the technology to our devices. So it's not only P4 or electronic cigarettes, but also to *IQOS*, despite the fact that so far, in *IQOS*, we don't observe any unintentional or very minimal unintentional audience, which would be using very much under-age. So this is another thing, which we have not really spent the time today, but being in 64 markets and operating on the scale like this and are not triggering in a youth-related problems, it's -- we can execute this like this. But I think if we go to the locking devices, this really gives you a 99.999% of the assurance that devices are going into the right hands.

Alan Erskine - Credit Suisse

Apologies, I think I misled you. I was -- my question, I thought you said that the *ILUMA* device would only work on a consumable because I think one of the issues or one of the opportunities within *IQOS* is that people could put existing competitor sticks into the product. So I just want to understand how secure you've been able to do this to prevent that happening for *ILUMA*.

Jacek Olczak - Philip Morris International Inc. - COO

Okay. So you never speak of *ILUMA* consumables. You will have what Andre called the susceptor, which is specially designed, developed, manufactured, obviously, with the very low tolerances piece of a metal, if you like, but I oversimplify this whole thing. And Andre got...

Andre Calantzopoulos - Philip Morris International Inc. - CEO

It's a very sophisticated process, but I will not describe it. The reality is the -- when you introduce the HTU in the holder, then the holder recognizes the specific profile of that susceptor and therefore the HTU. So no other product will work in this device because the susceptor has a very specific characteristic that operates in certain temperatures obviously to avoid combustion, and that's the whole secret, if you wish, of the whole innovation.

So competitive products will not operate. If we take an *IQOS* blade product, like the ones we have today, the HTUs, they will not work with that device. That's not the problem because consumer will understand very rapidly. Doing the opposite, taking a HTU from the new device, *ILUMA*, and putting in an existing *IQOS* blade, that's not recommended for consumers because not only it's not going to work, it's going to mess out with their blade. So that's the indication we need at the beginning. But from a protection, clearly, we have the protection we need from third-party devices -- from third-party consumer.

Moderator

Okay. Nick, that concludes everybody with a raised hand. So if you want to take the Q&A from the toolbar, it's all yours.

Nicholas Rolli - Philip Morris International Inc. - VP of Investor Relations and Financial Communications

Thank you very much, Mark. I've got a few questions here that if we can run through before we close today. The first one is on nicotine pouches.

You've highlighted your plan entry into nicotine pouches. What is the strategy for entering this category? Is it through partnership or internal product development?

Andre Calantzopoulos - Philip Morris International Inc. - CEO

It could be both. I cannot disclose. There will be a combination of partnerships and internal development. So we are developing the product, and we think we can be in the market towards the end of this year. But as I said, this is a growing segment, with still very small and very occasional. And everybody has to be also conscious about the same precautions we need to take about nicotine pouches to avoid unintended use by youth, and care in the marketing is very important because technologically, you can get to the product, but we also have some very careful marketing on the product. And that's something to caution everybody in the industry about that to avoid another problem like with e-vapor products in the U.S.

Nicholas Rolli - Philip Morris International Inc. - VP of Investor Relations and Financial Communications

Next question, I think, it's probably for Emmanuel. Can you elaborate on your comment around the opportunistic repurchases versus equal monthly amounts?

Emmanuel Babeau - Philip Morris International Inc. - CFO

Well, I can try. What I meant by that is that companies that sometimes are going for a buyback are saying you split the total amount of the program by the number of months, and more or less, I'm going to be buying that quantity. I think here, we're going to be more opportunistic and certainly take the benefit of weakness on the share price to be more active and more present on the market. And that's why I said don't expect us to go for a kind of regular amount on a monthly basis, but much more to be watching what's happening on the market and come on the market when there will be a situation where we see a good opportunity for us to buy back our share.

Nicholas Rolli - Philip Morris International Inc. - VP of Investor Relations and Financial Communications

The next question is on the litigation with BAT. Can you address what's happening in the current intellectual property litigation? How will it affect your *IQOS* technology? How strong is your patent and other IP protection for all our key markets? So it's kind of an over-encompassing question.

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Yes. Look, I mean, patent law and patent litigation, I think, is very new to our industry, but it's very common in the tech industry, for example. So typically, all these cases are resolved in three possible ways, which are obvious. The one is you litigate to invalidate an asserted claim by a competitor that you are violating their patents or fragments thereof. The second is if there is actually a violation to work around and find a solution to move away from the asserted feature. And the third is to file a modus vivendi between competitors. So I'm stating the obvious.

Now clearly, what is happening is, first of all, our patents are well protected, and we have some claims, as you know, in the past against certain use of elements of our patents by BAT in certain of their products. But the crux of the issue here is what's happening in patent law, and it's new to me, is you can take an existing patent and stretch sometimes beyond imagination to prove that some features in your product are violating -- are violated or vice versa that your patent is violated by some features of your competitor.

The second is take a product of your competitor, analyze it and go and find some patent office that doesn't pay much attention. You call it divisional, an extension on existing patent you have, functioning and nonfunctioning and try after that, once you get the patent granted, and before your competitors invalidate a patent because it's imitating their own feature, and try to get an injunction to put some pressure on your competitor.

And for the injunctions, typically, you're going to use unsophisticated jurisdictions that don't have a history in patent law, trying to get that. And BAT is trying to do all of those. I don't think there is merit in their patents, claims or the assertions they make. But clearly, we do have contingency plans just in case in one country something happens, until we invalidate their patent and work around. So we feel in the long run, we will prevail, but there is always this time between a grant of the patent and the time you can invalidate it over 18 months where there may be somewhere some vulnerability until invalidation happens.

And that's how the things are happening. I think it's a very aggressive strategy, but that's what BAT chose to do, and it's in the general context we are discussing previously also a very shortsighted work with regulators and governments.

So yes, we can all understand that they are not yet breaking through in the heat-not-burn segment, but that's not a reason to use this tactic. Now, I think all these things will unfold in the months to come. But regarding our patents, we're very confident that people are not infringing our patents or can't infringe them.

Nicholas Rolli - Philip Morris International Inc. - VP of Investor Relations and Financial Communications

Question on P2. How important is it for the carbon tip disposable to reach lower income consumers, especially in emerging markets? Does this significantly expand the addressable market for the *IQOS* portfolio?

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Yes. I think it does for more conservative consumers, not necessarily to the lower end of the market because there's not always a correlation between low end of the market and conservative consumers. But yes, for the ritual it's closer there. I think there is potential of this product.

Now as we discussed in the past, we need to get the product right. We had a problem with the tip in certain conditions falling off. I think we fixed that problem. And now we are going to do a test market in Europe on a larger scale to see how consumers react and take it from there.

If you remember the discussion with Bonnie, I think the potential is there, clearly, but we also need to prioritize certain things. So I think *TEEPS* in any significant way after the test market is going to take a year, 1.5 years also to build capacity before we can expand in any significant manner. But we have enough on our plate with what we have today.

Nicholas Rolli - Philip Morris International Inc. - VP of Investor Relations and Financial Communications

Okay, we'll take the last question here before we go to your closing remarks, Andre. When you say the gross margin on HTUs is 10 percentage points higher than combustible cigarettes, is that a like-for-like comparison that reflects combustible cigarettes in your current HTU footprint? Or is it also impacted by the fact that you're not yet selling HTUs in some lower-value combustible markets?

Emmanuel Babeau - Philip Morris International Inc. - CFO

That's a difference that we observe today with the mix that we have. So that's what you can see when you read our full P&L, that's when we observe about 10 percentage point differences.

Nicholas Rolli - Philip Morris International Inc. - VP of Investor Relations and Financial Communications

Well, this concludes the Q&A session. I'll now turn it back to you, Andre, for some closing remarks.

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Sorry, I don't know which button to press here. Any case -- can somebody press the button to -- I don't know.

Nicholas Rolli - Philip Morris International Inc. - VP of Investor Relations and Financial Communications

Yes, you don't have to do anything.

Andre Calantzopoulos - Philip Morris International Inc. - CEO

In any case, I want to thank you all for joining today. I think that we tried to give you as much color about what our plans are, our strategies are in order to get to our 50% ambition for 2025. We explained, I hope, in the most detailed possible manner, the economics of the various platforms.

I think the growth opportunity is real. And yes, we have the uncertainty of the COVID. But certainly, the algorithm we gave you, it's a pretty strong algorithm with more than 5% net revenue growth, more than 9% EPS, and that's before share buybacks, and very strong cash flow of $35 billion. So we're on the right path to achieve a smoke-free vision. A little bit of help from regulators, as I explained, would be very welcome because we can drastically accelerate. And with the right dialogue with governments in various countries, I think there are countries in the world where we can end the sales of cigarettes in 10 to 15 years if we have the right supply-side measures.

So thank you all. And I hope the next investors meeting is going to be with real presence of people so we can have a little bit more time with all of you, but I do appreciate the fact that you joined us today.

Nicholas Rolli - Philip Morris International Inc. - VP of Investor Relations and Financial Communications

Thank you very much, Andre. This -- and thank you all for joining us. This concludes PMI's 2021 Investor Day. You may disconnect now. Thank you.

Andre Calantzopoulos - Philip Morris International Inc. - CEO

Thank you.

Jacek Olczak - Philip Morris International Inc. - COO

Thank you.

Emmanuel Babeau - Philip Morris International Inc. - CFO

Thank you.

Note: Edited by Philip Morris International for significant transcription errors