Principal Group risk factors

Overview

The principal risk factors that may affect the Group are set out on the following pages.

Each risk is considered in the context of the Group's strategy, as set out in this Strategic Report on pages 8 and 9. Following a description of each risk, its potential impact and management by the Group is summarised. Clear accountability is attached to each risk through the risk owner.

The Group has identified risks and is actively monitoring and taking action to manage the risks. This section focuses on those risks that the Directors believe to be the most important after assessment of the likelihood and potential impact on the business. Not all of these risks are within the control of the Group and other factors besides those listed may affect the Group's performance. Some risks may be unknown at present. Other risks, currently regarded as less material, could become material in the future.

The risk factors listed in this section and the activities being undertaken to manage them should be considered in the context of the Group's internal control framework. This is described in the section on risk management and internal control in the corporate governance statement on page 68. This section should also be read in the context of the cautionary statement on page 239.

Assessment of Group risk@

During the year, the Directors have carried out a robust assessment of the principal risks and uncertainties facing the Group, including those that would threaten its business model, future performance, solvency or liquidity.

The principal risks facing the Group have remained broadly unchanged over the past year with regards to Marketplace, Excise and Tax, Operations, Regulation and Litigation risk factors. The Board identified two new principal risks during 2017: the risk related to the development and commercialisation of NGP and the risk associated with the integration of RAI. Due to actions put in place since the closure of the acquisition, the integration of RAI is no longer considered to be a principal risk.

The Directors considered a number of other risks for the Group, and while recognising the risks and monitoring action plans, such risks were not deemed to be principal risks for the Group. A summary of these other risks which are monitored by the Board through the Group's risk register is set out in the Additional disclosures section on pages 226 and 227.

The viability statement below provides a broader assessment of long-term solvency and liquidity. The Directors have considered a number of factors that may affect the resilience of the Group. Except for the risk "Injury, illness or death in the workplace" the Directors have also assessed the potential impact of the principal risks that may impact the Group's viability. This is indicated in the 'impact on viability statement' key under each risk.

Time frame

Short term

Medium term

Long term

Strategic impact

Growth

Productivity

Winning organisation

Sustainability

Considered in viability statement@

Yes

No

@ denotes phrase, paragraph or similar that does not form part of BAT's Annual Report on Form 20-F as filed with the SEC.

Viability statement@

The Directors have assessed the viability of the Group, in accordance with provision C.2.2 of the 2016 revision of the UK Corporate Governance Code. In making this assessment the Directors have considered the Group's continued strong cash generation from operating activities. This assessment included a robust review of the principal risks that may impact the Group's viability (as indicated on pages 49 to 54) which are considered, with the mitigating actions, at least once a year. The Directors also took account of the Group's operational and financial processes, which cover both short-term (1–2 year financial forecasts, 2–3 year capacity plans) and longer-term strategic planning. The assessment included reverse stress testing core drivers that underpin the specific risks to ensure the business is able to continue in operation, while not breaching the required gross interest cover of 4.5 times (see page 38). Each impact would, individually, have to be between 5x and 17x worse than a prudent annual forecast, or would all have to arise simultaneously with no mitigating or corrective actions to affect the Group's ability to meet the liabilities as they fall due.

The Directors noted that the Group would be able to adjust certain capital requirements, including but not limited to the investment in the Group's manufacturing infrastructure in the short term and the £6 billion credit facility (2017: £600 million drawn), to mitigate the impact of the effect of the principal risks, each of which have specific mitigation activities as disclosed on pages 49 to 54.

The Group operates in a unique environment, being subject to inherent uncertainties with regards to regulatory change and litigation, the outcome of which may have a bearing on the Group's viability. The Group maintains, as referred to in note 28 on the Accounts ("Contingent Liabilities and Financial Commitments"), that, while it is impossible to be certain of the outcome of any particular case, the defences of the Group's companies to all the various claims are meritorious on both law and the facts. If an adverse judgment is entered against any of the Group's companies in any case, an appeal will be made, the duration of which can be reasonably expected to last for a number of years.

The Directors have no reason to believe the Group will not be viable over a longer period. However, given the inherent uncertainty involved regarding litigation and regulation, the period over which the Directors consider it possible to form a reasonable expectation as to the Group's longer-term viability, based on the stress testing and scenario planning discussed above, is three years.

Risks

Competition from illicit trade

Increased competition from illicit trade – either local duty evaded, smuggled illicit white cigarettes or counterfeits.

Time frame	Strategic impact	Considered in viability statement@
Long term	Growth	Yes

Impact

Erosion of brand value, with lower volumes and reduced profits.

Reduced ability to take price increases.

Investment in trade marketing and distribution is undermined.

Mitigation activities@

Dedicated Anti-Illicit Trade (AIT) teams operating at global, country levels and internal cross-functional coordination; best practice shared.

Active engagement with key external stakeholders.

Cross-industry and multi-sector cooperation on a range of AIT issues.

Global AIT strategy supported by a research programme to further the understanding of the size and scope of the problem.

AIT Engagement Team (including a dedicated analytical laboratory) works with enforcement agencies in pursuit of priority targets.

Tobacco and nicotine regulation inhibits growth strategy

The enactment of regulation that significantly impairs the Group's ability to communicate, differentiate, market or launch its products.

Time frame	Strategic impact	Considered in viability statement@
Medium term	Growth and Sustainability	Yes

Impact

Erosion of brand value through commoditisation, the inability to launch innovations, differentiate products, maintain or build brand equity and leverage price.

Adverse impact on ability to compete within the legitimate tobacco or nicotine industry and also with increased illicit trade.

Reduced consumer acceptability of new product specifications, leading to consumers seeking alternatives in illicit trade.

Shocks to share price on enactment of restrictive regulation.

Reduced ability to compete in future product categories and make new market entries.

Increased scope and severity of compliance regimes in new regulation leading to higher costs, greater complexity and potential reputational damage or fines for inadvertent breach.

Mitigation activities@

Engagement and litigation strategy coordinated and aligned across the Group to drive a balanced global policy framework for tobacco control.

Stakeholder mapping and prioritisation, developing robust compelling advocacy materials (with supporting evidence and data) and regulatory engagement programmes.

Regulatory risk assessment of marketing plans to ensure decisions are informed by an understanding of the potential regulatory environments.

Advocating the application of our integrated regulatory proposals to governments and public health practitioners based on the harm reduction principles.

Development of an integrated regulatory strategy that spans conventional combustibles and includes Next Generation Products.

Please refer to pages 228 to 231 for details of tobacco and nicotine regulatory regimes under which the Group's businesses operate.

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Principal Group risk factors continued

Risks continued

Significant excise increases or structure changes

The Group is exposed to unexpected and/or significant excise increases or structure changes in key markets.

Time frame	Strategic impact	Considered in viability statement@
Long term	Growth	Yes

Impact

Consumers reject the Group's legitimate tax-paid products for products from illicit sources or cheaper alternatives.

Reduced legal industry volumes.

Reduced sales volume and/or portfolio erosion.

Partial absorption of excise increases.

Mitigation activities@

Requirement for Group companies to have in place formal pricing and excise strategies including contingency plans, with annual risk assessments.

Pricing, excise and trade margin committees in markets, with regional and global support.

Engagement with local tax and customs authorities, where appropriate, in particular in relation to the increased risk to excise revenues from higher illicit trade.

Portfolio reviews to ensure appropriate balance and coverage across price segments.

Monitoring of economic indicators, government revenues and the political situation.

Litigation

Product liability, regulatory or other significant cases may be lost or compromised resulting in a material loss or other consequence.

Time frame	Strategic impact	Considered in viability statement@
Long term	Growth	Yes

Impact

Damages and fines, negative impact on reputation, disruption and loss of focus on the business.

Consolidated results of operations, cash flows and financial position could be materially affected, in a particular fiscal quarter or fiscal year, by region or country, by an unfavourable outcome or settlement of pending or future litigation.

Mitigation activities@

Consistent litigation strategy across the Group.

Expertise and legal talent maintained both within the Group and with our external partners.

Closer integration in Group litigation strategy.

Ongoing monitoring of key legislative, case law and tobacco developments.

Please refer to note 28 in the Notes on the Accounts for details of contingent liabilities applicable to the Group.

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Geopolitical tensions

Geopolitical tensions, social unrest, terrorism and organised crime have the potential to disrupt the Group's business in multiple markets.

Time frame	Strategic impact	Considered in viability statement@
Medium term	Growth	Yes

Impact

Potential loss of life, loss of assets and disruption to normal business processes.

Increased costs due to more complex supply chain arrangements and/or the cost of building new facilities or maintaining inefficient facilities.

Lower volumes as a result of not being able to trade in a country.

Mitigation activities@

Globally integrated sourcing strategy and contingency sourcing arrangements.

Security risk modelling, including external risk assessments and the monitoring of geopolitical and economic policy developments worldwide.

Insurance cover and business continuity planning, including scenario planning and testing, and risk awareness training.

Security controls for field force, direct store sales and supply chain with an emphasis on the protection of Group employees.

Inability to obtain price increases and impact of increases on consumer affordability thresholds

Annual price increases are among the key drivers in increasing the Group's profitability. The Group faces a risk that such price increases will not materialise.

Time frame	Strategic impact	Considered in viability statement@
Short/Medium term	Growth	Yes

Impact

Inability to achieve strategic growth metrics.

Funds to invest in growth opportunities are reduced.

Volumes may reduce faster than anticipated due to accelerated market decline leading to growth of illicit trade.

Mitigation activities@

Key market pricing reviews.

Pricing strategies, excise and trade margin committees exist in all markets with regional and global support.

Robust business cases underpinning key innovative launches.

Clear portfolio and pricing strategies, ensuring a balanced portfolio of strong brands across key segments.

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Principal Group risk factors continued

Risks continued

Disputed taxes, interest and penalties

The Group may face significant financial penalties, including the payment of interest in the event of an unfavourable ruling by a tax authority in a disputed area.

Time frame	Strategic impact	Considered in viability statement@
Short/Medium term	Productivity	Yes

Impact

Significant fines and potential legal penalties.

Disruption and loss of focus on the business due to diversion of management time.

Impact on profit and dividend.

Mitigation activities@

End-market tax committees.

Internal tax function provides dedicated advice and guidance, and external advice sought where needed.

Engagement with tax authorities at Group, regional and individual market level.

Please refer to note 28 in the Notes on the Accounts for details of contingent liabilities applicable to the Group.

Market size reduction and consumer down-trading

The Group is faced with steep excise-led price increases and, due in part to the continuing difficult economic and regulatory environment in many countries, market contraction and consumer down-trading is a risk.

Time frame	Strategic impact	Considered in viability statement@
Short/Medium term	Growth	Yes

Impact

Volume decline and portfolio mix erosion.

Funds to invest in growth opportunities are reduced.

Mitigation activities@

Geographic spread mitigates impact at Group level.

Close monitoring of portfolio and pricing strategies, ensuring balanced portfolio of strong brands across key segments.

Increased focus behind product quality and innovation across all segments to provide tangible differentiation and improve the price–value ratio.

Overlap with many mitigation activities undertaken for other principal risks facing the Group, such as competition from illicit tobacco trade, significant excise increases or structure changes and inability to obtain price increases.

Foreign exchange rate exposures

The Group faces translational and transactional foreign exchange (FX) rate exposure for earnings/cash flows from its global business.

Time frame	Strategic impact	Considered in viability statement@
Short/Medium term	Productivity	Yes

Impact

Fluctuations in FX rates of key currencies against sterling introduce volatility in reported EPS, cash flow and the balance sheet driven by translation into sterling of our financial results and these exposures are not normally hedged.

The dividend may be impacted if the payout ratio is not adjusted.

Differences in translation between earnings and net debt may affect key ratios used by credit rating agencies.

Volatility and/or increased costs in our business, due to transactional FX, may adversely impact financial performance.

Mitigation activities@

While translational FX exposure is not hedged, its impact is identified in results presentations and financial disclosures; earnings are re-stated at constant rates for comparability.

Debt and interest are matched to assets and cash flows to mitigate volatility where possible and economic to do so.

Hedging strategy for transactional FX and framework is defined in the treasury policy, a global policy approved by the Board.

Illiquid currencies of many markets where hedging is either not possible or uneconomic are reviewed on a regular basis.

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Injury, illness or death in the workplace

The risk of injury, death or ill health to employees and those who work with the business is a fundamental concern of the Group and can have a significant effect on its operations.

Time frame	Strategic impact	Considered in viability statement@
Short term	Sustainability	No

Impact

Serious injuries, ill health, disability or loss of life suffered by employees and the people who work with the Group.

Exposure to civil and criminal liability and the risk of prosecution from enforcement bodies and the cost of associated fines and/or penalties.

Interruption of Group operations if issues are not addressed immediately.

High staff turnover or difficulty recruiting employees if perceived to have a poor Environment, Health and Safety (EHS) record.

Reputational damage to the Group.

Mitigation activities@

Risk control systems in place to ensure equipment and infrastructure are provided and maintained.

An EHS strategy ensures that employees at all levels receive appropriate EHS training and information.

Behavioural-based safety programme to drive Operations' safety performance and culture closer to zero accidents.

Analysis of incidents undertaken regionally and globally by a dedicated team to identify increasing incident trends or high potential risks that require coordinated action.

Solvency and liquidity

Liquidity (access to cash and sources of finance) is essential to maintaining the Group as a going concern in the short term (liquidity) and medium term (solvency).

Time frame	Strategic impact	Considered in viability statement@
Short/Medium term	Productivity	Yes

Impact

Inability to fund the business under our current capital structure resulting in missed strategic opportunities or inability to respond to threats.

Decline in our creditworthiness and increased funding costs for the Group.

Requirement to issue equity or seek new sources of capital.

Reputational risk of failure to manage the financial risk profile of the business, resulting in an erosion of shareholder value reflected in an underperforming share price.

Mitigation activities@

Group policies include a set of financing principles and key performance indicators including the monitoring of credit ratings, interest cover, solvency and liquidity with regular reporting to the Board.

The Group targets an average centrally managed debt maturity of at least five years with no more than 20% of centrally managed debt maturing in a single rolling year.

The Group, through B.A.T. International Finance p.l.c., holds a revolving credit facility of £6 billion syndicated across a wide banking group. The facility consists of a £3 billion tranche with a final maturity in May 2021 and a £3 billion tranche with a final maturity in 2018, which can be extended to 2019 by exercising a one-year extension option after which a term out option is available for a further year.

Liquidity pooling structures are in place to ensure that there is maximum mobilisation of cash liquidity within the Group.

The Group has an externally imposed capital requirement for its centrally managed banking facilities of maintaining gross interest cover above 4.5 times. The Group targets a gross interest cover of greater than 5 times.

Going concern and viability support papers are presented to the Board on a regular basis.

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Principal Group risk factors continued

Risks continued

Failure to successfully develop and commercialise Next Generation Products

Risk of not capitalising on the opportunities in developing and commercialising successful and consumer-appealing Next Generation Products.

Time frame	Strategic impact	Considered in viability statement@
Long term	Growth	Yes

Impact

Failure to deliver Group strategic imperative and 2020 growth ambition.

Inability to achieve strategic growth metrics.

Mitigation activities@

Focus on product stewardship to ensure high-quality standards across portfolio.

Development of an integrated marketing activation model, including digital 1-2-1 and retail touch points, roll out plans are aligned and supported by regions and markets.

Open and transparent engagement with all stakeholders; collaboration and participation in workshops to share best practice and publications are made available to all interested stakeholders.

Demand, inventory and capacity is reviewed on a monthly basis to ensure the Group takes advantage of opportunities as they arise.

The Strategic Report was approved by the Board of Directors on 21 February 2018 and signed on its behalf by Paul McCrory, Company Secretary.

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