

SWEDISH MATCH CORP  
Form 20-F  
June 23, 2005  
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As filed with the Securities and Exchange Commission on June 23, 2005

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# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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## FORM 20-F

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**REGISTRATION STATEMENT PURSUANT TO SECTION 12(B) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2004

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-28038

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# Swedish Match AB (publ)

*(Exact name of Registrant as specified in its charter)*

## Swedish Match Corporation

*(Translation of Registrant's name into English)*

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**Kingdom of Sweden**

*(Jurisdiction of incorporation or organization)*

**Rosenlundsgatan 36**

**S-118 85 Stockholm, Sweden**

*(Address of principal executive offices)*

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**Securities registered pursuant to Section 12(b) of the Act:**

**None**

**Securities registered or to be registered pursuant to Section 12(g) of the Act:**

**Shares, nominal value SEK 2.40 per share**

*(Title of Class)*

**Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:**

**None**

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Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:

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Shares, nominal value SEK 2.40 per share 336,596,181

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark which financial statement item the registrant has elected to follow. Item 17  Item 18

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**INTRODUCTION AND USE OF CERTAIN TERMS**

Swedish Match AB (publ) is a public limited liability company incorporated under the laws of the Kingdom of Sweden ( Sweden ). References in this Annual Report on Form 20-F (this Annual Report ) to Swedish Match AB are to Swedish Match AB and its predecessors, and references to Swedish Match , the Group , the Registrant or the Company are to Swedish Match AB and its subsidiaries, unless the context requires otherwise. Swedish Match publishes its consolidated financial statements in Swedish kronor. In this Annual Report, references to SEK or Swedish kronor are to the currency of Sweden, references to EUR or euro are to the currency of the European Monetary Union, references to INR or Indian rupees are to the currency of India and references to U.S. dollars , USD or US\$ are to the currency of the United States (U.S.). On December 31, 2004, the exchange rate between Swedish kronor and U.S. dollars based on the noon buying rate in New York City for cable transfers in foreign currencies as certified for customs purposes by the Federal Reserve Bank of New York (the Noon Buying Rate ) was USD 1.00 = SEK 6.6687. The Noon Buying Rate on June 17, 2005, was USD 1.00 = SEK 7.5270.

The Company s consolidated financial statements are prepared in accordance with generally accepted accounting principles in Sweden ( Swedish GAAP ), which differ in certain respects from generally accepted accounting principles in the U.S. ( U.S. GAAP ). For a narrative discussion of the principal differences between Swedish GAAP as currently in effect and U.S. GAAP, see Note 26 of the Notes to the Consolidated Financial Statements. In 2005, Swedish Match will be required to prepare its financial statements in accordance with International Financial Reporting Standards ( IFRS ).

In 2004, the Company delisted its American Depository Shares (ADS) from the Nasdaq National Market and cancelled its ADS facility program.

Except where otherwise indicated, all references to tobacco, matches and lighters market sizes and market shares are based on Swedish Match management estimates.

The Company is incorporated in Sweden. Its principal executive offices are located at Rosenlundsgatan 36, S-118 85 Stockholm, Sweden, telephone +46-8-658-0200.

**FORWARD-LOOKING STATEMENTS**

Some of the statements in this document that are not historical facts are forward-looking statements, including, without limitation those regarding:

the timing of product deliveries;

the Company s ability to develop new products and technologies;

expectations regarding market growth and developments;

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expectations for growth and profitability; and

statements preceded by believes , expects , anticipates , foresees , hold the view or similar expressions.

Because these statements involve risks and uncertainties, actual results may differ materially from the results that the Company currently expects. Factors that could cause these differences include, but are not limited to:

general economic conditions, such as the rate of economic growth in the Company's principal geographic markets or fluctuation in exchange rates;

industry conditions, such as the strength of product demand, the intensity of competition, pricing pressures, the acceptability of new product introductions;

the availability and pricing of raw materials, and of tobacco in particular;

currency fluctuations;

the commencement or unfavorable outcome of litigation against the Company;

political and economic instability, especially in emerging and developing markets;



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changes in the regulatory environment for tobacco products, including changes in taxes imposed on tobacco products; and

the transition from Swedish GAAP to IFRS

as well as the risk factors specified in this document, including under Item 3.D. Risk Factors .

**Table of Contents****PART I****ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS**

Not applicable.

**ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

Not applicable.

**ITEM 3. KEY INFORMATION****3.A Selected Financial Data**

The financial data set forth below for each of the years in the five-year period ended December 31, 2004 have been derived from the Consolidated Financial Statements of Swedish Match that have been audited by Öhrlings PricewaterhouseCoopers for the four years ended December 31, 2003 and by KPMG Bohlins for the year ended December 31, 2004. Consolidated balance sheets at December 31, 2004 and 2003 and the related consolidated statements of income and of cash flows for the three years ended December 31, 2004 and notes thereto appear elsewhere in this annual report. The Consolidated Financial Statements from which the financial data below were derived were prepared in accordance with Swedish GAAP, which differ in certain respects from U.S. GAAP. See Note 26 of the Notes to Consolidated Financial Statements.

Millions unless otherwise stated	2000	2001	2002	2003	2004	2004
	SEK	SEK	SEK	SEK	SEK	USD <sup>(1)</sup>
<i>Amounts in accordance with Swedish GAAP</i>						
<b>Income statement data</b>						
Net sales	11,533	13,635	13,643	13,036	13,007	1,950
Operating income	1,886	2,113	2,371	2,224	3,370	505
Net income	1,144	1,228	1,429	1,558	1,828	274
<b>Balance sheet data</b>						
Total assets	16,281	16,623	15,447	15,102	14,621	2,192
Share capital	969	892	868	844	808	121
Shareholders' equity	4,584	4,105	4,007	4,010	4,358	654
Bond loans, long - and short-term liabilities to credit institutions	5,699	6,016	5,508	5,381	3,529	529
<b>Per share data</b>						
Basic net income per share, SEK	2.76	3.40	4.10	4.68	5.61	0.84
Diluted net income per share, SEK	2.76	3.38	4.07	4.66	5.59	0.84

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Basic weighted average shares, in thousands	410,177	361,506	348,295	332,679	325,709	
Diluted weighted average shares, in thousands	410,177	363,016	350,894	334,162	327,014	
Cash dividend declared per share, SEK	1.35	1.45	1.60	1.70	1.90	0.28

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Millions unless otherwise stated	2000	2001	2002	2003	2004	2004
	SEK	SEK	SEK	SEK	SEK	USD <sup>(1)</sup>
<i>Amounts in accordance with U.S. GAAP<sup>(2)</sup></i>						
Net income	915	981	1,461	1,680	1,965	295
Shareholders' equity	6,319	5,587	5,391	5,521	6,231	934
Basic net income per share, SEK	2.21	2.71	4.19	5.05	6.03	0.90
Diluted net income per share, SEK	2.21	2.70	4.16	5.03	6.01	0.90

**Notes to Selected Consolidated Financial Data**

- (1) Translated, solely for the convenience of the reader, at the Noon Buying Rate on December 31, 2004 of USD 1.00 = SEK 6.6687.
- (2) See Note 26 of the Notes to Consolidated Financial Statements for a reconciliation of net income and shareholders' equity reported under Swedish GAAP to the corresponding amounts under U.S. GAAP and for a discussion of certain differences between U.S. GAAP and Swedish GAAP.

**Dividends**

The Company considers it desirable that funds not vital for the expansion and consolidation of the Group be transferred to the shareholders in the form of dividends and other forms, such as a share buybacks. Swedish Match policy is that the amount of a dividend should largely follow the trend of the Company's net profit. When establishing a dividend, the size of planned repurchases of shares is also taken into account. It is estimated that the dividend amount will be between 30 percent and 50 percent of net profit. A buyback of shares is, in principle, a reverse new share issue and makes it possible to work continuously to manage the capital structure in the balance sheet. In view of Swedish Match's stable and positive cash flow, the Board of Directors' position with regard to buyback of shares is positive. The size and scope of share buybacks depends on the same factors as the size and the scope of the dividend, namely on Swedish Match's financial position, net profit, anticipated future cash flow, as well as investments and expansion plans and also availability of non-restricted equity. Other factors that affect a repurchase are the price of the shares and the Company's interest and tax expenses.

Dividends are expected to be paid following the end of the relevant financial year, if proposed by the Board and approved by the Company's shareholders at the relevant Annual General Meeting. Subject to the foregoing, and consistent with Swedish practice, the Board would expect to propose only one dividend per year. The Annual General Meeting in April 2005 resolved that shareholders shall receive a dividend of SEK 1.90 per share, for a total amount of approximately SEK 612 million (compared with net income for the year of SEK 1,828 million), and the balance shall be retained in the business.

At the level of dividends proposed in the Board's policy, the Company believes it will have adequate cash flow to fund future anticipated capital expenditures.

The table below shows the amount of dividends paid on each share in respect of each fiscal year indicated, translated into U.S. dollars per ADS on the basis of one ADS for every ten shares and at the Noon Buying Rate on each of the respective payment dates and, in the case of ADSs, after deduction of withholding taxes referred to below and under Item 10.E. Taxation - Taxation of Dividends. No information per ADS is given for dividends for the year 2004 as the ADS program was cancelled prior to the date of payment of dividends.

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	<u>SEK per Share</u>	<u>U.S. dollars per ADS</u>
2000	1.35	1.3
2001	1.45	1.4
2002	1.60	1.4
2003	1.70	1.9
2004 <sup>1)</sup>	1.90	

1) The ADS program was cancelled in 2004

Certain holders of shares may be subject to U.S. federal income tax consequences on dividends paid in respect of shares See Item 10.E. Taxation .

**Exchange Rate Data**

The following table sets forth, for the years and dates indicated, certain information concerning the rate of exchange of the Swedish kronor to the U.S. dollar based on the Noon Buying Rate. The Noon Buying Rate on June 17, 2005, was USD 1.00 = SEK 7.5270.

<u>Year ended December 31,</u>	<u>Period End</u>	<u>Average <sup>(1)</sup></u>	<u>High</u>	<u>Low</u>
2000	9.4440	9.2251	10.3600	8.3530
2001	10.4571	10.4328	11.0270	9.3250
2002	8.6950	9.6570	10.7290	8.6950
2003	7.1950	8.0351	8.7920	7.1950
2004	6.6687	7.3320	7.7725	6.5935
December 2004			6.8043	6.5939
January 2005			7.0069	6.6855
February 2005			7.1114	6.8275
March 2005			7.0716	6.7312
April 2005			7.1627	7.0118
May 2005			7.4108	7.0850
June 2005 (through June 17)			7.7112	7.4373

(1) Represents the average of the exchange rates on the last day of each full month during the year.

**3.B Capitalization and Indebtedness**

Not applicable.

**3.C Reasons for the Offer and Use of Proceeds**

Not applicable.

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### **3.D Risk Factors**

Set forth below is a description of certain risks that may effect the Company's business, financial condition and results of operations from time to time.

See Item 4.B. Business Overview-Regulation .

#### **The Company is affected by legislation relating to tobacco, package labeling, marketing and advertising, smoking bans and trade barriers**

Increasing health concerns related to tobacco smoking followed by increasingly severe restrictions on smoking in public places and in the workplace is evident in most countries where the Group sells its products. For example, countries such as Ireland, Norway, Sweden, Italy and several major U.S. cities and towns have passed laws banning smoking in bars, restaurants and other premises where food or drinks are served. Such bans could have a negative impact on consumption of products that the Company manufactures or distributes and on the Company's results of operations. Furthermore, there is a trend towards increasingly severe regulations related to marketing and advertising of tobacco products, permissible ingredients in tobacco products and the reporting on such ingredients. These restrictions could also have a negative impact on consumption of the Company's products and on its results of operations.

#### **Changes in excise taxes and rules on collection of tobacco tax may reduce the Company's sales and cash flow**

Tobacco products are subject to substantial taxes in most countries where Swedish Match has significant sales. In many of those countries, the taxes on tobacco are generally increasing but the rate of increase varies between different types of tobacco products. Increased excise taxes or changes in relative tax rates for different tobacco products may result in decline in overall sales volume for the Company's products that in turn could adversely affect Swedish Match's results of operations. Changes in rules on the collection of tobacco taxes could negatively affect the Company's cash flow.

#### **The markets for the Company's products are highly competitive**

Swedish Match faces intense competition in each of its geographical markets and for each of its products. In order to be successful it must promote brand equity successfully and anticipate and respond to new customer trends. Restrictions on advertising and promotion may, however, make it more difficult to counteract loss of consumer loyalty to any particular brand or product. There can be no assurance that branding or new product launches by the Company's competitors will not be successful in persuading consumers of the Company's products to switch to competitors' products, which could have a material adverse effect on the Company's results of operations. See Item 4.B Business Overview-Competition .

#### **Some of the Company's businesses are subject to volume decline and price pressure**

Developed markets for many tobacco products, have been generally declining in the past decades. This adverse trend is a result of consistent and substantial increases in the excise duty on tobacco products, increasing governmental regulation, government-funded anti-smoking campaigns and heightened public awareness of smoking-related health concerns. Any future substantial decline in demand could have a materially adverse effect on the Company's operating profits.

The Company is faced with lower volumes and downward pricing pressure in many of its businesses. The lighters and matches businesses in particular are characterized by volume declines, excess production capacity and fierce price competition in many markets. The Company may have to adjust its production capacity to meet declining sales volumes. There can be no assurance that the Company will be able to partly offset volume declines in the future through price increases if at all.

The Company is distributing tobacco products in Sweden for a number of other companies, primarily manufacturers of cigarettes. Three companies account for over 97 percent of tobacco products distributed for third parties. The Company may face downward price pressure for its distribution services or loss of volumes to competing distributors in the future. In addition, the potential decrease in consumption of cigarettes due to laws enacted in certain countries banning smoking in public places and in the workplace may also result in reduction in the volume of products distributed, which could have an adverse impact on the Company's revenues.



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### **Changes in import restrictions could effect the Company's sales negatively**

The Company is selling products in countries where potential competition is barred from entering through import restrictions or import bans. Changes in import or export regulations can negatively affect the Company's sales volumes and prices for its products.

### **Retailer consolidation could cause a decline in the Company's sales and operating results**

In many markets the grocery trade continues to consolidate and as retailers grow larger and become more sophisticated, they demand lower pricing and increased promotional programs. Furthermore, these customers are reducing their inventories and increasing their emphasis on private label products in many product categories. These trends can have an adverse effect on the Company's results of operations.

### **The Company faces litigation in the course of its business**

The Company is involved in a number of legal and regulatory proceedings including pending lawsuits related to intellectual property rights and alleged injuries caused by tobacco products. There can be no assurance that the Company's defenses will be successful in trial and substantial costs may be incurred in defending lawsuits. Although management cannot in any meaningful way estimate the damages that might be awarded, if any, in any ongoing or anticipated disputes these lawsuits individually or in the aggregate, could have an adverse effect on the Company's results of operations.

Swedish Match is not a party to the Master Settlement Agreement or the Smokeless Tobacco Master Settlement Agreement between various U.S. states and certain tobacco companies. To date, neither these settlements nor the legislation enacted as a result of them has had any material effect upon the business activities of Swedish Match in the U.S. The business is being conducted as it has been in the past but there can be no assurance that Swedish Match will not in the future enter into similar agreements that could have material adverse impact on the Company's business.

### **The Company's operations in certain developing countries are susceptible to such countries' political and economic stability**

Swedish Match has substantial operations in emerging or developing markets such as Brazil, the Dominican Republic, India, Indonesia, the Philippines and South Africa. Swedish Match's results of operations and financial condition are influenced by the economic, regulatory and political situations in the countries in which it have operations, which are generally unpredictable and outside the control of the Group. There can be no assurance that political, legal, economic or other developments such as social unrest or terrorism will not have an adverse impact on the Company's investments and businesses or on the Company's consolidated results of operations.

### **The Company may not have adequate insurance**

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Each of Swedish Match's insurance programs have limitations in coverage and there can be no assurance that any insurable damage caused is covered by insurance. Swedish Match has substantial operations in geographic areas where full insurance coverage against property damage resulting from storm and certain other natural disasters may not be obtainable. Swedish Match may not be able to obtain certain types of insurance or extend its existing insurance programs in the in the future.

### **Loss of production capacity could cause a decline in the Company's sales and results of operations**

For product categories where the Company does not have over capacity or where substitution between different production plants is not possible, it may lose market shares and profit in the event of loss of production capacity needed to supply its products.

### **Environmental cost and liabilities could adversely effect the Company's financial condition**

The Company cannot guarantee that it can meet all local environmental controls and regulations or that all such controls and regulations have been met in the past. In the event of changes to local regulations or of the legal environment or in case of accidental environmental pollution, the Company may have to incur additional costs for compliance.

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### **The Company is subject to commodity risks**

The raw materials used in the Group's business, primarily tobacco, splintwood and raw material in various packaging material are commodities that experience price volatility caused by factors including weather conditions, growing conditions, local planting decisions, market fluctuations and changes in agricultural regulations. Commodity price changes beyond the Company's control may result in unexpected increases in raw materials and packaging costs and the Company may be unable to increase its prices to offset these increased costs without suffering reduced volume and revenues.

With respect to the Company's cigar business, unanticipated fluctuations in demand and changes between different years in the quality of tobacco grown require relatively high levels of raw tobacco leaf inventory. In some cases inventory for specific grades or types may be several years supply. In the event of a drop in final demand for finished goods, this inventory may be substantially higher than appropriate levels and lower income due to higher capital costs may result. In some circumstances, some of this inventory may need to be sold at prices below purchase prices or may have to be destroyed which would have a negative impact on the Company's results of operations and cash flows.

### **The Company is exposed to market rate, exchange rate and interest risks**

In the normal course of its business, Swedish Match is exposed to market risk, primarily in the forms of risk associated with changes in foreign exchange rates and interest risk but also in the form of financing, liquidity and credit risk. Swedish Match enters into a variety of financial instruments to the extent judged necessary by management to achieve a desired level of exposure, although the Company cannot assure that these exposures will be reduced to a desired level, if at all.

The Company manages its exposure to changes in interest rates through a mix of fixed rate debt and variable rate debt in its total debt portfolio. To manage this mix, the Company may enter into interest rate swap agreements. There can be no assurance, however, that existing or future swap agreements will manage the interest rate risk successfully, if at all.

Swedish Match has a substantial part of its production and sales in EU member countries, South Africa, Brazil, India and the U.S. Consequently, changes in exchange rates of EUR, South African Rand, Brazilian real, Indian rupees and the U.S. dollar in particular may adversely affect the Company's results of operations, cash flow, financial condition or relative price competitiveness in the future. Such effects may occur both in local currencies and when such local currencies are translated into Swedish currency for purposes of reporting. The financing risk comprises risk arising from large borrowing requirements under austere credit market conditions where the Company may be refused to take up new loans or prolong its loans.

Liquidity and credit risks expose the Company to shortages of cash when such cash is needed in the Company's operations. The Company aims to limit these risks by the Company's policy of investing in instruments with high liquidity and credit worthiness. In addition to bank deposits, investments are mainly concentrated in government treasury bills and bonds with counter parties who have high credit ratings. However, the Company cannot assure that it will successfully invest in such instruments in the future, or that the failure to invest successfully will not have a material adverse effect on the Company's liquidity and credit position.

Furthermore, Swedish Match may show variability in cash flows, due to among others, a changing product portfolio and differing needs for leaf-tobacco, work-in process inventories and finished goods as well as changes in rules on tobacco tax collection.

**The Company could face impairment of goodwill and other fixed assets.**

The value of goodwill and other intangible assets as well as other fixed assets is evaluated regularly to determine whether events or circumstances indicate that the value of the fixed assets are impaired. These evaluations include significant judgments made by management. Future events could cause the Company to conclude that impairment indicators exist and that a fixed asset is impaired. Any resulting impairment loss could have a material adverse impact on the Company's financial condition and results of operations.

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### **Loss of key personnel could have a negative impact on the Company's performance**

The Company relies on a number of highly experienced and/or long standing employees with a detailed knowledge of tobacco and other business related issues. Unanticipated losses of key employees could result in a substantial loss of expertise, which would negatively affect activities and operating performance.

### **There are risks inherent in calculating the Company's provision for pensions and similar obligations**

As of December 31, 2004 the Company had provision for pensions and similar obligations of SEK 739 million. Calculating pension and similar obligations require management to make assumptions on discount rate, expected return on plan assets and rate of compensation increase. Actual results could differ from the assumptions made. The Company may be required to contribute additional amounts to its pension schemes which would have a negative effect on the Company's results of operations. See Item 5.A. Operating Results Critical Accounting Policies Accounting for pensions.

### **The existence of counterfeit products in the marketplace could adversely effect the Company's sales**

Counterfeit products of Swedish Match branded products may be difficult to curb. Sales by others of counterfeit products could have a negative effect on the Company's sales, volumes and brand goodwill.

## **ITEM 4. INFORMATION ON THE COMPANY**

### **4.A History and Development**

Swedish Match AB (publ) was incorporated in 1917 as a limited liability company. In 1995 the Company changed to a public limited liability company with an indefinite duration under the laws of the Kingdom of Sweden. The Company's principal executive office is located at Rosenlundsgatan 36, S-118 85 Stockholm, Sweden and its telephone number is +46-8-658-0200. The agent for the Company in the U.S. is Swedish Match North America, Inc. and its telephone number is +1-804-302-1700.

Swedish Match's two main businesses, tobacco products and lights in the form of matches and disposable lighters, were separately established at the beginning of the century. After a number of transactions the business was acquired by Volvo and since 1994 Swedish Match operated as an independent company within the Volvo Group. In 1996, in line with a new strategic plan at Volvo to concentrate on automotive and transport equipment, Volvo divested the Swedish Match operation by way of a dividend to the Volvo shareholders and in May 1996, after the dividend, Swedish Match's shares were listed on the OMX Stockholmsbörsen, Sweden (the Stockholm Exchange) and its American Depository Shares (ADS) on the Nasdaq National Market (NASDAQ). In 2004 due to the low liquidity of the ADSs these were delisted from NASDAQ. The last day of trading of the ADSs was on October 15, 2004. The Company also cancelled its American Depository Receipts program.

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Swedish Match is a company producing and selling a broad range of market leading brands in the product areas snuff, chewing tobacco, cigars and pipe tobacco niche tobacco products as well as matches and lighters. The Group's global operations generated sales of SEK 13,007 million in more than 150 countries in 2004. Production facilities are located in 15 countries. The average number of employees during 2004 was 15,039.

In January 2004 Swedish Match sold all its advertising textiles business.

In March 2004 Swedish Match settled its claim in *Swedish Match North America, Inc. v. UST* in which the Company was seeking injunction against UST to stop methods aimed at suppressing competition in the American snuff market and compensation for damages. In accordance with the settlement, UST has paid US\$ 200 million to Swedish Match. Furthermore, UST agreed to cause the transfer of its cigar business to Swedish Match, including but not limited to brands, other intellectual property and inventory. Annual sales of the cigar business that was transferred amount to an average of approximately US\$ 11 million.

On March 19, 2004 Lennart Sundén left his position as President and CEO. The Company's Executive Vice President Sven Hindrikes was appointed acting President and CEO and on June 1, 2004 he was appointed President and CEO. Lennart Sundén also resigned from the Board of Directors of Swedish Match as well as all Group companies. Lennart Sundén is entitled to a termination period of 12 months, since the employment was terminated by the Company. Furthermore, Lennart Sundén is entitled to a severance payment corresponding to 24 months salary. The severance pay may be partly reduced by other employment income.

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In April 2005 Swedish Match acquired all of the remaining shares in General Cigars Holdings Inc. General Cigar is the market leader in premium cigars in USA, with well known brands such as Macanudo, Partagas and Punch.

## **Capital Expenditures**

Swedish Match operates primarily in mature markets with limited capital expenditure requirements. Swedish Match's capital expenditures amounted to SEK 486 million in 2004 and were equal to approximately 4 percent of sales. Capital expenditures amounted to SEK 551 million in 2003 and SEK 751 million in 2002. Depreciation of fixed assets amounted to SEK 332 million compared with 346 million in 2003 and SEK 324 million in 2002. Total capital expenditures over the period 2000-2004 were equal to 4.2 percent of total sales during the period.

Apart from necessary investments for replacement purposes, most of the Company's investments involved rationalization measures, such as moving production among the Company's facilities in order to maximize efficiencies and create economies of scale. As a result of increases in snuff sales, particularly sales of portion-packed snuff in Sweden, a new production plant was built in Kungälv, Sweden, near to Gothenburg. The total investment in the plant amounted to SEK 604 million. The plant started production in mid 2003.

Capital expenditure for 2005 is expected to be on the same level or somewhat below 2004. Capital expenditure is expected to be funded primarily through internally generated cash flow. Acquisitions, if any, may be financed through internally generated cash flow or debt financing.

Since Swedish Match manufactures high-turnover consumer products, the Company maintains relatively small inventories of finished products for many of its products.

For more discussion of the Company's principal capital expenditure and divestitures, see [Item 5.A. Operating Results](#).

## **4.B Business Overview**

### **General**

Swedish Match is a Swedish-based international group that produces a broad range of other tobacco products including snuff, chewing tobacco, cigars, and pipe tobacco as well as matches and disposable lighters. Swedish Match products are sold in more than 150 countries. Within the Company's product offering, there are products characterized by strong brand loyalty among consumers (for example, snuff and cigars), as well as products whose trademarks are of lesser importance to the consumer (for example lighters).

By tradition, Swedish Match has its greatest strengths in the Nordic region (primarily Sweden) and the U.S. The Company also has significant cigar and lights (i.e. matches and lighters) operations in Europe, pipe and snuff operations in South Africa and significant lights operations in parts of Asia and Latin America (Brazil).

**Sales by Region**

A breakdown of total revenues by principal geographic market is as follows:

*North America.* Most of the revenues in this region arise from smokeless tobacco and cigar sales in the U.S.

2002: SEK 4,688 million

2003: SEK 4,135 million

2004: SEK 4,036 million

*Nordic region.* Most of the revenues in this region arise from smokeless tobacco sales in Sweden, as well as distribution activities for all tobacco products on the Swedish Market.



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2002: SEK 4,683 million

2003: SEK 4,874 million

2004: SEK 5,087 million

*Europe, excluding Nordic region.* Revenues in this region arise primarily from the sales of cigars, matches, lighters, and pipe tobacco.

2002: SEK 2,214 million

2003: SEK 2,076 million

2004: SEK 1,912 million

*Latin America and Other Geographies.* The single largest source of revenues in this region comes from sales of lighters and matches in Brazil and snuff and pipe tobacco in South Africa.

2002: SEK 2,058 million

2003: SEK 1,951 million

2004: SEK 1,972 million

**Raw Materials**

Raw materials consist primarily of tobacco leaf, which is sourced worldwide with purchase cycle times ranging from several months to several years. Although prices and availability for individual grades of tobacco from individual markets may vary considerably, the volatility is substantially mitigated by the nature of tobacco purchases and the wide geographic availability.

**Marketing Channels**

Swedish Match products are largely intended for individual consumers and are therefore distributed in marketing channels that cater to the local needs of tobacco consumers. The primary classes of trade include but are not limited to (as applicable and allowed by law): food stores, gas stations and convenience stores, mass merchandisers, discount retailers, drug stores, tobacconists, kiosks, hotels and restaurants. Sales methods are standard for the industry and conform to local market norms in the countries where the products are sold.

## General

During 2004, the Swedish Match business structure was composed of four divisions having defined operating responsibility: North Europe, Continental Europe, North America, and Overseas Divisions. General Cigar has been operated as an independent division with its own production and sale of premium cigars. From April 2005, when Swedish Match acquired the remaining 36 percent of General Cigar that it did not own, steps have been taken to further integrate the administration of this business into Swedish Match North America. In 1999 the Company divested its cigarette operations.

Marketing, sales and production of tobacco and lights products are organized in the North Europe, Continental Europe, North America and Overseas Divisions. Lighter sales are coordinated through the Continental Europe Division, while match sales are coordinated through the Overseas Division. General Cigar sells its premium cigars primarily in the U.S. market.

Swedish Match's financial reporting structure follows the six different product areas, Snuff, Chewing Tobacco, Cigars, Pipe Tobacco and Accessories, Matches, Lighters and Other operations.

**Table of Contents****Business - Snuff****Key data**

(SEK millions unless otherwise stated)	2002	2003	2004
Sales	2,788	2,995	3,081
Operating income	1,233	1,386	1,373
Operating margin, %	44.2	46.3	44.6

**Capital expenditures and personnel**

(SEK millions unless otherwise stated)	2002	2003	2004
Capital expenditures in tangible fixed assets	424	219	242
Average number of employees	825	908	924

With restrictions on tobacco smoking and growing health concerns relating to cigarettes, smokeless alternatives have been gaining a greater market potential. Swedish Match is the leading manufacturer of snuff in the Swedish and Norwegian markets and the third largest player in terms of market share in the U.S. Sales in 2004 amounted to SEK 3,081 million (2003: 2,995). Operating income for the year was SEK 1,373 million (2003: 1,386), corresponding to an operating margin of 44.6 percent (2003: 46.3).

Production for the Nordic market takes place at two factories in Sweden, in Gothenburg and in Kungälv (opened in 2003). The production for the American market takes place in Owensboro, Kentucky. Products for the South African market are primarily produced in Johannesburg, South Africa.

Volume in the U.S. grew by approximately 3 percent in 2004, while volume in the Nordic countries grew by slightly more than 1 percent. Overall sales of the Group's snuff business grew by 3 percent during 2004 compared to 2003.

**Snuff market***Sweden and other Nordic countries*

Snuff is a traditional product that has become increasingly socially acceptable. Since snuff can be consumed discreetly in portioned packs, it has become an increasingly popular alternative to cigarettes for both men and women. Approximately 225 million cans of moist snuff are sold annually in the Nordic countries. In Sweden, the largest market, there are more than one million snuff consumers, corresponding to just over 10 percent of the population. Women account for some 20 percent of snuff consumers. Swedish Match has established its own quality standard

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called **GOTHIA TEK**<sup>®</sup> for all of its snuff brands in the Nordic region. Well-known brands in the Swedish and Norwegian markets are Generalsnus, Ettan, Grovsnus, and Catch, which together account for approximately 80 percent of all snuff sales in Sweden and Norway.

Swedish Match has approximately 95 percent of the Swedish snuff market, with a number of smaller competitors, some competing in local or limited markets. The largest competitors are Gallaher, and Fiedler&Lundgren, both with production in Sweden.

Consumption of snuff has been rising most rapidly in metropolitan areas, where population growth is highest and restrictions on smoking are more stringent. Market growth has slowed considerably in Sweden in 2004, and the market is now growing at a rate of 1 - 3 percent per year. Portion-packed snuff's share of the total snuff market is 57 percent, and rising.

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In 2002, the Company launched line extensions to its Catch brand. In April 2003, the Company launched a new range of portion-packed products with a new more appealing appearance and a distinctive functional can lid. In 2004 further line extensions were introduced.

Swedish Match has the largest market share of the limited but growing Norwegian market. Consumption is increasing, with particular emphasis on portion-packed snuff, and was up by more than 20 percent in the Norwegian market in volume terms in 2004.

### *United States*

Approximately 940 million cans of snuff were consumed in the United States in 2004. Consumption has increased at a higher pace in the past two years, after having been growing by about 2 to 3 percent annually for a number of years. The market is estimated to have grown by close to 6 percent, measured in cans, in 2003, and by nearly 7 percent in 2004. Swedish Match's largest competitor is US Smokeless Tobacco Company and its subsidiaries (UST).

Swedish Match's share of the market was for the full year 2004 approximately 8.9 percent down from 9.1 percent, according to AC Nielsen. Consumption volume declined for Timber Wolf, the best selling Swedish Match brand in the U.S. and a leading brand in the low-price segment in an extremely competitive market environment. Offsetting these volume declines, volume grew for a second Swedish Match value priced brand, Longhorn, which was launched in August 2003. The U.S. product range also includes Renegades, a portion-packed snuff. The Company has a limited test launch of a Swedish type of snuff, which is a smokeless tobacco product using the **GOTHIA TEK**<sup>®</sup> process.

### *Other markets*

In the South African market, nasal snuff is the dominant smokeless tobacco product. Swedish Match established operations in the South African market in 1999 through its acquisition of Dingler, with its Taxi brand.

Swedish Match has limited test market and selling activity relating to snuff in Russia, among other markets. At the end of 2004, the Company discontinued its test market activity for snuff in India.

The sale of moist snuff was prohibited in the EU in 1992, mainly because it was assumed that the product was carcinogenic. Sweden was exempted from the ban when entering the EU in 1995. Several studies in Sweden have shown that the assumed carcinogenic effects is lacking in scientific support. Against this background, the European Commission has decided to change the warning labels on packaging for smokeless tobacco, including moist snuff sold in Sweden. The prohibition on the sale of moist snuff throughout the rest of the EU remains in place following the decision by the European Court of Justice in December 2004, that the current ban on the sale of this type of product is not in breach of fundamental EU-law.

Within the EU, Swedish Match sells nasal snuff, under the brands Singleton's, Kensington's, and Rumney's. Nasal snuff accounts for a small portion of total Swedish Match smokeless tobacco sales.

*General*

The Company expects that Sweden, Norway and the U.S. will continue to be the primary markets for Swedish Match's snuff products.

The table below shows the size of the Snuff Business in relation to the Swedish Match Group in 2004.

	<u>Snuff</u>	<u>Swedish Match</u>	<u>Percent</u>
Sales, SEK millions	3,081	13,007	24
Operating income, SEK millions	1,373	3,370	41
Capital expenditures in tangible fixed assets, SEK millions	242	486	50
Average number of employees	924	15,039	6

**Table of Contents****Business - Chewing Tobacco****Key data**

(SEK millions unless otherwise stated)	2002	2003	2004
Sales	1,333	1,146	1,058
Operating income	406	336	304
Operating margin, %	30.4	29.3	28.7

**Capital expenditures and personnel**

(SEK millions unless otherwise stated)	2002	2003	2004
Capital expenditures in tangible fixed assets	42	23	18
Average number of employees	347	346	346

Swedish Match is the market leader in the chewing tobacco business in the U.S. Sales amounted to SEK 1,058 million (2003: 1,146). Operating income amounted to SEK 304 million (2003: 336), a decrease of 10 percent, as measured in Swedish kronor. In local currency (USD) terms, sales and operating income improved versus the previous year. Operating margin was 28.7 percent (2003: 29.3).

Chewing tobacco operations are conducted in the North American market, mainly in the U.S. Well known Swedish Match brands include the Red Man family and Southern Pride. In total, Swedish Match held a market share of approximately 44 percent of consumption volume in 2004.

The headquarters for the chewing tobacco operations are in Richmond, Virginia. Production is carried out in Owensboro, Kentucky.

During the fourth quarter of 2003, Swedish Match launched a new chewing tobacco product into test market in Japan in the Tokyo area. This product, branded Firebreak<sup>®</sup>, is a chewing tobacco in a gum base. The test market continued during 2004.

**Chewing tobacco market***United States*

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The use of chewing tobacco is an old custom in the U.S. Consumption is mainly concentrated in a region comprising the southeastern states. Chewing tobacco is usually associated with outdoor and recreational activities, such as hunting and fishing.

Four major producers dominate the chewing tobacco industry in the U.S. Swedish Match is the market leader with its Red Man family of brands (Red Man, Red Man Golden Blend and Red Man Select). Swedish Match's major competitor is Conwood.

The total U.S. market amounts to approximately SEK 2.6 billion. Consumption of chewing tobacco has been declining by more than 4 percent per year over the past three years, continuing a long-term trend. In 2003 and 2004, the market declined by approximately 5 percent, measured by weight. The reason is primarily demographic, as a result of the increasingly higher average age of consumers and fewer jobs in farming and other outdoor sectors.

### *General*

The market for chewing tobacco is declining in the U.S., but profitability remains strong. Swedish Match's goal is to maintain its market position and to manage capacity utilization in order to control costs and secure profitability.



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The partnership with the retail sector is expanding, with training and support regarding the product range and product merchandising.

The table below shows the size of the Chewing Tobacco Business in relation to the Swedish Match Group in 2004.

	<u>Chewing Tobacco</u>	<u>Swedish Match</u>	<u>Percent</u>
Sales, SEK millions	1,058	13,007	8
Operating income, SEK millions	304	3,370	9
Capital expenditures in tangible fixed assets, SEK millions	18	486	4
Average number of employees	346	15,039	2

**Business Cigars****Key data**

<u>(SEK millions unless otherwise stated)</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
Sales	3,318	3,008	3,171
Operating income <sup>(1)</sup>	472	393	466
Operating margin, %	14.2	13.1	14.7

(1) Includes Swedish Match's 40 percent holding in Arnold André which is reported in accordance with the equity method.

**Capital expenditures and personnel**

<u>(SEK millions unless otherwise stated)</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
Capital expenditures in tangible fixed assets	169	193	128
Average number of employees	6,504	7,148	7,781

Swedish Match is one of the world's largest manufacturers and distributors of cigars and cigarillos, and ranks second in terms of sales in the world cigar market. Including the jointly owned German company, Arnold André (in which Swedish Match holds a 40 percent interest), production amounts to more than one billion cigars per year.

Sales in 2004 grew 5 percent to SEK 3,171 million (2003: 3,008). Swedish Match sales are primarily in the European and in the U.S. mass market and in the U.S. premium cigars market. The growth in sales is primarily attributable to volume gains in the US market. Roughly 62 percent of Swedish Match cigar sales are in the U.S. Operating income was SEK 466 million (2003: 393). The operating margin was 14.7 percent (2003: 13.1).

The Company's main brands include La Paz, Willem II, Garcia Y Vega, La Gloria Cubana, White Owl and Macanudo. In 2000, the Company acquired 64 percent of the shares of General Cigar Holdings, Inc. The remaining 36 percent of the shares were acquired in April 2005. General Cigar is the leading manufacturer of premium cigars in the U.S. and produces the best selling premium cigar brand, Macanudo. As a result of the acquisition, Swedish Match strengthened its position as a leading global cigar company and as a leader in Other Tobacco Products (OTP) (cigars, snuff, pipe tobacco and chewing tobacco) in the U.S.

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Swedish Match manufactures many of the world's best known brands of cigars. The largest markets are Western and Northern Europe, and the U.S. The product range includes all types of cigars and cigarillos, from hand-rolled premium cigars to machine-made cigarillos.

The production plants are located in Houthalen (Belgium) and Pandaan (Indonesia). In 2002 Swedish Match's production in the plant in Overpelt (Belgium) was closed down and moved to other existing Swedish Match plants. Cigars are also produced in Santiago, the Dominican Republic, Danli and Confradia, Honduras, and Dothan, Alabama in the U.S. The Company also has tobacco farms in Jima and Mao in the Dominican Republic and in Connecticut in the U.S. The German company Arnold André with production plants in Bünde and Königslutter (Germany) is 40 percent owned by Swedish Match.

### **Cigar market**

During 2004, the world market for cigars was more than 15 billion cigars with an estimated sales value of SEK 27 billion. More than three-quarters of cigars are sold in North America and Europe.

#### *Europe*

Consumption of cigars was relatively unchanged in Europe during 2004. The strongest market growth was noted in countries such as Spain, France, and Italy, while demand in Germany, Belgium, and the Netherlands was unchanged or lower.

There are a large number of players in the market, with many small local companies operating in parallel with major manufacturers. Production and wholesaling are both being restructured. The players are becoming fewer and larger although merger activity since 2000 has been limited. Swedish Match's market share in Europe is difficult to measure, but roughly amounts to between 10 and 15 percent. Europe accounts for approximately 25 percent of Swedish Match's Cigar Business total sales. The La Paz brand is one of the best selling brands in Europe.

#### *United States*

Until 1997, the U.S. cigar market was characterized by strong growth in the premium segment. In 1998, the very sharp market growth for cigars weakened. Excess inventories had been built up by manufacturers and distributors, and this led to price competition in the premium segment. In 1999 total consumption of cigars stabilized, and large excess inventories of product in the commercial chain reduced somewhat, negatively affecting manufacturers' sales despite stable consumption. In 2000, consumption of mass market cigars increased slightly, while consumption of premium cigars remained flat. There was a substantial reduction of excess inventories of premium cigars in 2000, as a number of lesser-known brands left the market. In 2001, the market for mass market cigars continued to increase slightly, and Swedish Match mass market volumes improved by 11 percent, primarily due to distribution gains. In 2002, the market for mass market cigars continued to grow modestly. However, Swedish Match volumes declined, as did the Company's share of market. The growth in the U.S. market in 2002 came primarily from sweet and flavored cigars, which was not part of Swedish Match's portfolio of products, at the expense of larger, natural cigars. Late in 2002, and during 2003, Swedish Match introduced new flavored cigars, primarily under the White Owl brand, on the U.S. market in order to more fully participate in the growth of the sweet and flavored segment. The market continued to grow in units in 2003, and Swedish Match stabilized its shipment volumes in large part due to flavored product introductions. This trend in market growth, and the trend toward flavored cigars, continued in 2004. Machine-made cigars sold in the U.S. market contributed to approximately 28 percent of Swedish Match's total sales of cigars in 2004, and Swedish Match has a volume market share in the US machine-made cigar market of approximately 7 percent, with growth above market rates.

With General Cigar, Swedish Match is the biggest player in the hand rolled premium cigar segment, with an estimated market share of between 25 and 30 percent. The U.S. premium cigar market is stable. U.S. premium cigars account for approximately 36 percent of total cigar sales for Swedish Match.

*Asia/Australia*

Asia and Australia continue to be characterized as growth markets for cigars. In Asia, Swedish Match uses its base in Hong Kong to develop contacts with mainland China.

**Table of Contents***General*

The world market for cigars has been growing, but with considerable differences between markets. The cigar business has been an important growth area for Swedish Match. The Company aims to capitalize on the growth in cigar consumption in various markets. The Company is continuing efforts to develop its premium cigar business outside of the U.S.

The table below shows the size of the Cigar Business in relation to Swedish Match Group in 2004.

	<u>Cigars</u>	<u>Swedish Match</u>	<u>Percent</u>
Sales, SEK millions	3,171	13,007	24
Operating income, SEK millions	466	3,370	14
Capital expenditures in tangible fixed assets, SEK millions	128	486	26
Average number of employees	7,781	15,039	52

**Business - Pipe Tobacco and Accessories****Key data**

<u>(SEK millions unless otherwise stated)</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
Sales	843	909	901
Operating income	164	201	220
Operating margin, %	19.5	22.1	24.4

**Capital expenditures and personnel**

<u>(SEK millions unless otherwise stated)</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
Capital expenditures in tangible fixed assets	20	15	28
Average number of employees	558	553	527

Swedish Match is a large manufacturer of pipe tobacco. In 2004 sales declined by 1 percent to SEK 901 million (2003: 909) with currency effects, namely the increase in the value of the South African Rand versus the Swedish krona, substantially offsetting declines in most markets. Operating income grew 9 percent to SEK 220 million (2003: 201) largely as an effect of currency fluctuation between the Swedish krona and the South African Rand, as well as by productivity improvements and pricing.

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Swedish Match's best known brands are Borkum Riff, Half and Half, Boxer, Best Blend and Velvet. Borkum Riff is one of the few brands of pipe tobacco sold globally. The main markets are North America, Northern/Western Europe, Southern Africa, and Australia/Japan.

Pipe tobacco is manufactured in Owensboro, Kentucky, and in Boxburg and Rustenburg, South Africa. Part of Swedish Match's pipe tobacco production is subcontracted to MacBaren, a Danish company.

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### **Pipe tobacco market**

The market for pipe tobacco has been declining, by some 10 percent in Europe, and by more than 10 percent annually in volume terms, in North America. The main reason is demographic – the increasing average age of consumers and the weak influx of new buyers. In South Africa, the market in volume terms is also declining in the range of 8 percent per year.

The players in the pipe tobacco industry are mainly large companies, with many other tobacco products in their lines. Most manufacturers employ a defensive strategy, with high sales prices and limited marketing activity.

The largest single market for pipe tobacco is the U.S. Other large markets are Europe, Australia, Japan, Canada, and South Africa.

#### *North America*

Consumption of pipe tobacco in the North American market has been declining by approximately 8 to 12 percent a year for the past several years. This rate of decline is expected to continue over the next several years. Swedish Match is the fourth largest manufacturer in North America, with a market share of approximately 15 percent and a leading position in the premium segment with Borkum Riff. Swedish Match is also strong in the mass-market segment with Half and Half, Velvet and Paladin. The Company's largest competitors are Lane, Middleton, and Altadis.

#### *Western and Northern Europe*

Consumption in Europe has been declining by 6 to 10 percent a year over the past several years. There is a trend toward greater concentration in the retail chain. The competitive situation varies considerably between markets, with few large manufacturers. The exception is Germany, where there are a number of local and international manufacturers. Germany is one of the largest and most profitable markets in Western Europe. Swedish Match has strong positions in Sweden and Finland, as well as in Switzerland and Spain. Swedish Match's market share in Western Europe is under 10 percent, and has been stable.

#### *South Africa*

A marginal decline in demand in South Africa was noted in 2000 following a sharp increase in tobacco tax. With its acquisitions of Leonard Dingler and Brasant, Swedish Match created a solid platform in South Africa. Dingler's brands include Boxer, Nineteen O Four, Black and White, and Giraffe. In February 2001, the Company acquired the South Africa pipe tobacco operations of BAT Rothmans with its Best Blend brand following BAT's merger with Rothmans. In the second half of 2001, the South African Rand depreciated significantly versus most of the world's major currencies. This depreciation accelerated in the final three months of the year, causing commodity prices to increase significantly late in 2001, and especially during the first three months of 2002. This had a negative impact on purchasing power among consumers. Early in 2002 the government of South Africa announced double-digit increases on tobacco taxes. Sales turnover, volume, and earnings were negatively affected in both the final three months of 2001 and for most of 2002. The South African currency began to significantly strengthen versus both

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the U.S. dollar and the Swedish kronor in the second half of 2002. This improved currency effect more than offset modest volume declines of between 3 and 5 percent. During 2003, the South African market declined. However, the strengthening value in the South African Rand provided positive support to both sales and operating income for the business overall. In 2004, the pipe tobacco market declined by approximately 8 percent, and Swedish Match shipment volume declined at similar levels.

### *Other markets*

Swedish Match considers that there may be market potential in Asia, some parts of Eastern Europe and Latin America.

### *General*

Swedish Match is one of the major players in the market for pipe tobacco. The business is global and operating margins in 2004 were 24 percent.



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The table below shows the size of the Pipe Tobacco Business in relation to the Swedish Match Group in 2004.

	<u>Pipe Tobacco</u>	<u>Swedish Match</u>	<u>Percent</u>
Sales, SEK millions	901	13,007	7
Operating income, SEK millions	220	3,370	7
Capital expenditures in tangible fixed assets, SEK millions	28	486	6
Average number of employees	527	15,039	4

**Business Matches****Key data**

<u>(SEK millions unless otherwise stated)</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
Sales	1,648	1,395	1,378
Operating income	221	83	(297)
Operating margin, %	13.4	5.9	neg

**Capital expenditures and personnel**

<u>(SEK millions unless otherwise stated)</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
Capital expenditures in tangible fixed assets	58	81	36
Average number of employees	5,743	5,388	4,746

Swedish Match is a global manufacturer of matches. In 2004, the Match Business had sales of SEK 1,378 million (2003: 1,395). Operating income amounted to SEK -297 million (2003: 83). Operating income includes an impairment charge of SEK 150 million and a provision of SEK 90 million for acquisition for shares in Wimco Ltd. in India.

The Company sells matches to consumers in more than 100 countries under a large number of local brand names. Swedish Match's main markets are Europe, South America (Brazil), and Asia (Indonesia and India, among others). Substantial volumes are also exported to other countries. Operations include Swedish Match Arenco, which manufactures match production and packaging machinery.

Match factories are located in Tidaholm and Vetlanda (Sweden), Curitiba and Pirai (Brazil), Szeged (Hungary) and Orhangazi (Turkey), Bulgaria and India. Swedish Match's holding in the Indian company Wimco Ltd. amounts currently to 74 percent. At the beginning of 2004, the Match Business became part of the Overseas Division, whose head office is in Rio de Janeiro, Brazil. In December 2004, the Company announced closure of the Valencia, Spain match factory.



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### **Match market**

#### *Europe*

The long-term consumption trend in Western and Northern Europe is declining. This downward trend appears to have continued in Western Europe in 2004. In Europe, the market shows a trend toward increased consumption of specialty and high value products (such as barbeque items), even as overall match consumption is flat or declining.

#### *Asia*

The Indian market is stable, as population growth substantially offsets a modest shift away from matches toward utility lighters for cooking, as well as declining smoking rates. The Indian market has become increasingly competitive, and Swedish Match has experienced volume declines in this market.

Swedish Match has a 74 percent interest in Wimco Ltd., one of the world's largest manufacturers of matches, with four production units in India. At the time of the acquisition in 2000, Wimco was active in a number of industries. Since 2001 Wimco's operations have been concentrated to its core business, matches. See Item 8.A Consolidated Statements and other Financial Information for a discussion regarding the Company's requirement to purchase additional shares of Wimco Ltd.

#### *Latin America*

Brazil, where the Group has established operations under well-known brand names such as FIAT LUX, is the focal point for operations in Latin America. The market share in Brazil is approximately 50 percent. In volume terms, the Brazilian market is approximately the same size as Europe, and shows a declining trend. Following the closure of a production plant in São Laurengo, production was concentrated to the plant in Curitiba in Southern Brazil. Locally, prices have increased during the past few years in Brazil, where the product is used mainly for household applications. Part of the output from Swedish Match's plants is exported to neighboring countries.

#### *General*

Swedish Match intends to further consolidate its position in the Match Business by shifting production capabilities among manufacturing facilities in order to maximize Group efficiency and to create economies of scale.

The Group's product strategy includes repositioning brands, updating the product range in some markets, and obtaining better exposure in stores. The Company will continue its efforts in developing higher margin value-added products, such as firelogs and grill and barbeque products.

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Production operations will be further rationalized; however, local production may be required for a presence in certain markets.

The table below shows the size of the Matches Business in relation to the Swedish Match Group in 2004.

	<u>Matches</u>	<u>Swedish Match</u>	<u>Percent</u>
Sales, SEK millions	1,378	13,007	11
Operating income, SEK millions	(297)	3,370	(9)
Capital expenditures in tangible fixed assets, SEK millions	36	486	7
Average number of employees	4,746	15,039	32

**Table of Contents****Business Lighters****Key data**

(SEK millions unless otherwise stated)	2002	2003	2004
Sales	700	599	582
Operating income	56	14	7
Operating margin, %	8.0	2.3	1.2

**Capital expenditures and personnel**

(SEK millions unless otherwise stated)	2002	2003	2004
Capital expenditures in tangible fixed assets	21	11	17
Average number of employees	533	470	460

Swedish Match manufactures disposable lighters, with Cricket as its main brand. Its operations are global, with the largest markets being Europe, parts of Asia, and the U.S. The Cricket lighter is the main brand for Swedish Match. Sales in 2004 amounted to SEK 582 million (2003: 599). Operating income fell to SEK 7 million (2003: 14). The operating margin was 1.2 percent (2003: 2.3).

Production plants are located in Assen (The Netherlands), Manila (Philippines) and Manaus (Brazil). Swedish Match owns 31.9 percent of a company in Malaysia with an assembly plant for semi-finished products.

**Lighter market**

The world market for disposable lighters is relatively stable in volume terms. The rate of growth is higher in many developing countries, where the number of smokers and income per capita are both rising. The market in Europe and the U.S. is declining moderately, in parallel with cigarette consumption. Consumer brand loyalty is low. In most markets, there is increasing competition from lighters made in countries with relatively lower average labor costs, including China and other parts of Asia. Cost-effective production and distribution are thus becoming increasingly important competitive tools.

Bic and Tokai are the Company's largest competitors for branded lighters.

*Western Europe*

Western Europe is a mature market characterized by declining cigarette smoking and growing competition from manufacturers of low-cost lighters in Asia, which has led to declining volumes for higher quality lighters. Swedish Match has noted declining volumes in most Western European countries during recent years.

*Latin America and North America*

The largest markets in the two regions are Brazil and the US. The American market for lighters has decreased in volume terms by 1 to 2 percent in recent years and declines appear to be accelerating, perhaps reaching 5 percent. Swedish Match's share of the market was below 5 percent.

*Eastern Europe*

Swedish Match has a strong position in Eastern Europe. Russia is, one of the more important markets for Swedish Match. Cricket is the leading brand in the Russian market. Much of the Swedish Match lighter volume supplied to Russia is produced in the Assen factory in the Netherlands. As lighters sold into Russia have traditionally been priced in dollars, the business has been hurt by currency transaction effects, and has had difficulty

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in raising local prices to match the increasing value of the Euro versus the U.S. dollar. In 2003, the Eastern European lighter market continued to expand, with Swedish Match, as well as other lighter manufacturers, growing volume. During 2004, volumes for Swedish Match continued to grow in Russia.

*Asia*

Although Swedish Match produces lighters and sources lighter components from Asia, its presence in the Asian market in terms of market share is minimal due to the lack of presence in the substantial Chinese market.

*General*

The table below shows the size of the Lighter Business in relation to the Swedish Match Group in 2004.

	<u>Lighters</u>	<u>Swedish Match</u>	<u>Percent</u>
Sales, SEK millions	582	13,007	4
Operating income, SEK millions	7	3,370	0
Capital expenditures in tangible fixed assets, SEK millions	17	486	3
Average number of employees	460	15,039	3

**Competition***Tobacco*

A few large multinational companies dominate the global tobacco market. The largest multinational tobacco companies include Altria Group, British American Tobacco (BAT), RJ Reynolds, Japan Tobacco and Altadis. All of these manufacturers are heavily dependent on the sale of cigarettes but they also have operations in other fields.

The large tobacco companies compete with Swedish Match in different product areas in different geographic markets, Altadis perhaps being the main competitor in the global cigar business.

The world's largest smokeless tobacco producer is UST of the U.S. (with its Skoal and Copenhagen brands of moist snuff). Swedish Match and Conwood follow in size, producing both moist snuff and chewing tobacco, followed by National Tobacco. Swedish Match's moist snuff business in the U.S. is growing over time but is still relatively small. In Sweden, which is Swedish Match's primary moist snuff market, the Company dominates the market. During the past few years, a number of companies have started manufacturing and marketing snuff products in Sweden.

Competition in the global tobacco market is primarily based on price, quality, distribution and brands

#### *Lighters and Matches*

Swedish Match is a global manufacturer of matches. Generally, the global match industry is fragmented, consisting of local companies that in some cases also have substantial exports.

Bic and Tokai are the Company's largest competitors for branded lighters. In most markets, there is increasing competition from lighters made in countries with relatively lower average labor costs, including China and other parts of Asia.

Competition in the matches and lights markets are primarily based on price, quality and distribution although brands are important for certain products and certain markets.

#### **Production**

Swedish Match manufactures its products at 28 production facilities located in 15 countries.

Swedish Match's chewing tobacco production is located in its production facility in Owensboro, Kentucky and the U.S.



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The production plants are located in Houthalen (Belgium) and Pandaan (Indonesia). In 2002 Swedish Match's production in the plant in Overpelt (Belgium) was closed down and moved to other existing Swedish Match plants. Cigars are also produced in Santiago, the Dominican Republic, Danli and Confradia, Honduras, and Dothan, Alabama in the U.S. The Company also has tobacco farms in Jima and Mao in the Dominican Republic and in Connecticut in the U.S. The German company Arnold André with production plants in Bünde and Königslutter (Germany) is 40 percent owned by Swedish Match.

The Lighter production group has production facilities located in Assen, the Netherlands; Manila, Philippines; and Manaus, Brazil.

Match production facilities are located in Tidaholm and Vetlanda, Sweden; Curitiba, and Pirai, Brazil; Orhangazi, Turkey; and Szeged, Hungary. Production also takes place in Bulgaria and India. In addition, the Company owns a manufacturer of match-making machinery, Swedish Match Arencó, with plants in Kalmar and Halmstad, Sweden and Shanghai, China.

Swedish Match produces pipe tobacco products in Boxburg and Rustenburg, South Africa and in its plant in Owensboro, Kentucky. Further, Swedish Match has a contract manufacturing agreement for pipe tobacco with the Danish company MacBaren.

The snuff product group has production facilities located in Gothenburg and Kungälv, Sweden, Owensboro, Kentucky and Boxburg, South Africa.

Swedish Match is both a producer and a purchaser of raw materials, with matches produced from timber grown by Swedish Match in sustainable forests or purchased on the open market. Tobacco is primarily purchased on the open market. Purchases of raw materials are subject to market supply and demand, and, as such, volatility exists in both tobacco and timber pricing. Swedish Match is also affected by volatility in pricing for cardboard, plastic (used in packaging), nylon (for lighters), and gasoline (for transport/distribution). In the vast majority of cases, Swedish Match does not depend on any single source for tobacco, its main raw material requirement, and tobacco can be bought worldwide and over varying time periods, both reducing pricing volatility. Swedish Match tobacco purchases are almost exclusively made through one or more of the largest tobacco buying groups, which also purchase tobacco for other tobacco companies.

## **Regulation**

The manufacture, marketing and sale of tobacco are highly regulated. A brief summary of the most important legislation that affects the Company in the Swedish, European Union (including Sweden), U.S., and South African markets is given below. Approximately 87 percent of Swedish Match's revenues originate in the European Union, South Africa and the U.S. In these markets, the business in the tobacco segment is subject to a diverse number of restrictions and excise duties. A major risk to the Company's future activities is that the number of restrictions will be increased or that new or higher taxes will be introduced on the Company's products.

### *Sweden*

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*Marketing Act (SFS 1995:450).* The Marketing Act regulates the marketing of all types of products and includes a catalogue of requirements regarding marketing activities. The Marketing Act gives the Consumer Ombudsman (KO) considerable power in his/her role as regulator, including the power of prohibition and information requirements for enterprises.

*Tobacco Act (SFS 1993:581).* The Tobacco Act prohibits smoking in certain areas. From the 1<sup>st</sup> of June 2005 a ban on smoking in restaurants and other premises where food or drinks are served will come into force. Further the Tobacco Act prescribes warning labels and prohibits the use of names, trademarks and figures or other signs suggesting that a particular tobacco product is less harmful than others on the packaging of tobacco products. The Tobacco Act also contains rules on declaration of contents in products in accordance with EU directives and an age limit of 18 years for purchases of tobacco products. Due to the implementation of the WHO Convention for Tobacco Control and EU regulations, amendments to the Tobacco Act will be introduced on the 1<sup>st</sup> of July 2005 resulting in a general ban on advertising and marketing of tobacco products to consumers. This ban covers all kinds of advertising and marketing of tobacco products to consumers in Sweden, except for (i) marketing which is not considered commercial advertising in medias protected by the Swedish Constitution, (ii) the mere sale of tobacco products and (iii) moderate commercial messages at points of sale. Moreover, the amended legislation contains a prohibition for manufacturers, wholesale traders and importers of tobacco products to sponsor events or activities that are open to the general public or which may have cross border effects, if the sponsoring could be considered to have the direct or indirect effect of promoting tobacco products.

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*The Swedish Board for Consumer Policies (KOVFS 1998:7)*. This ordinance sets forth the particular requirements on marketing of tobacco products under the present legislation.

*The National Institute on Public Health (FHIFS 2001:2)*. This ordinance sets forth the specific labeling requirements on tobacco products in Sweden.

*Ordinance covering the banning of exports of moist snuff (SFS 1994:1266)*. This ordinance implements the EU directive prohibiting the export of certain oral tobacco products (including snus) to EU countries that have introduced bans on the sale of such products.

*Tobacco Tax Act (SFS 1994:1563)*. The Tobacco Tax Act regulates Swedish tobacco taxes including tax rates. This act also provides that individual consumers may only import to Sweden quantities of alcohol and tobacco for their own and their family's private consumption.

*Tobacco Tax Ordinance (SFS 1994:1613)*. The Tobacco Tax Ordinance contains definitions of the various tobacco products.

*Tax Payment Act (SFS 1997:483)*. This act regulates payment conditions for tobacco excise taxes.

## *European Union*

*Council Directive 89/552/EEC*. This directive provides for a complete ban on tobacco advertising and tobacco sponsorship on television. This directive was amended by Directive 97/35/EC of the European Parliament and of the Council of June 30, 1997 on the coordination of certain provisions laid down by law, regulation or administrative action in Member States concerning the pursuit of television broadcasting activities.

*Council Directive 2003/33/EC*. This directive provides for a ban, with few limited exceptions, of tobacco advertising in printed media, radio broadcasting and information society services, as well as on sponsorship of events with cross-border effects with the aim of promoting tobacco products. The directive came into force in June 2003 and must be implemented by the Member States by July 31, 2005.

*Council Directive 2001/37/EC*. This directive sets forth the labelling requirements for all tobacco products sold in the European Union. Through the directive the strong warning for smokeless tobacco causes cancer was changed to the more general warning text This product can damage your health and is addictive. For other tobacco products there are two new general warnings: Smoking kills / Smoking can kill and Smoking seriously harms you and others around you and a list of additional warnings. The size for the general warnings and the warning for smokeless tobacco at the respective surface of the pack is now required to be 30 percent and 32 percent (2 languages) and 35 percent (three languages). For certain products, such as cigar boxes there are special conditions as to the size of the health warning. The directive requires a batch number on the tobacco product for proper identification. Member states will require manufacturers and importers of tobacco products to submit to them a list of all ingredients, and quantities thereof, used in the manufacture of those tobacco products by brand name and type. This information will be submitted on a yearly basis. By December 31, 2004, the Commission should propose a common list of ingredients to be used in tobacco products but no such proposal has been made yet. Effective September 30, 2003, texts, names, trademarks and figurative or other signs suggesting that a particular tobacco product is less harmful than others are forbidden on the packaging of tobacco products (descriptors, such as light and mild).

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The Commission will regularly report on any new scientific and technological developments to the Member States with a view to keep the Directive up to date. The marketing of certain forms of tobacco for oral use (including moist snuff) is still prohibited, without prejudice to article 151 of the Act of Accession of Austria, Finland and Sweden. No later than December 31, 2004, and every two years thereafter, the Commission should submit to the European Parliament, the Council and the Economic and Social Committee a report on the application of this Directive. On submission of the first report, the Commission should indicate in particular the features, which should be reviewed or developed in the light of developments in scientific and technical knowledge. In this report an evaluation should be made of tobacco products which may have the potential to reduce harm. So far the Commission still has not published this report.

*Council Recommendation 2003/54/EC* recommends a number of restrictions to be adopted by the Member States. Such restrictions include that vendors will be obliged to verify the age of consumers purchasing tobacco products, that tobacco products will be removed from self-service displays, that access to vending machines shall be

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restricted and that sale of cigarettes in packages of less than 19 cigarettes will be prohibited. Furthermore the recommendation includes restrictions on tobacco distance sales for general retail (including sales via the Internet) to adults by using adequate technical means, a prohibition against selling sweets and toys resembling a tobacco product, a prohibition on the use of tobacco brand names on non-tobacco products and services, as well as on the use of promotional items, free gifts, indoor and outdoor billboards and posters and use of advertising in cinemas. The recommendation is intended to supplement a number of Community measures on tobacco control, notably the tobacco labelling Directive and the Directive on tobacco advertising and sponsorship, by addressing aspects of tobacco control which are the responsibility of the Member States. Member States must inform the Commission every two years of action taken in response to this recommendation.

*Commission Decision (2003/641/EC)* on the use of colour photographs or other illustrations as health warnings on tobacco packages. Member States can decide whether these kind of graphic health warnings or photographs are required. The Decision establishes rules for the use of colour photographs/graphic warnings on tobacco packages. By September 30, 2004 at the latest, the Commission will provide a library of pre-tested source documents in order to make available a choice of several photographs or other illustrations for each of the additional warnings listed in Annex I to Directive 2001/37/EC. The Commission will make the source documents available on request. Where Member States require health warnings in the form of colour photographs or other illustrations, tobacco packages for which such photographs are required must carry a combined warning taken exclusively from the source documents provided by the Commission, without any changes to any of its components. Member States may choose the source document best adapted to consumers in their countries. This decision does not apply to smokeless tobacco products.

*Council Directive 2002/10/EEC* regulates the structure and rates of excise duties that are applied on manufactured tobacco products, amending directives 92/79/EEC, 92/80/EEC and 95/59/EEC. The EU's Member States were required to implement this directive by July 1, 2002 at the latest, but derogations from this deadline were given to Germany, Spain and Greece. The Directive stipulates that the definition of cigars and cigarillos as set out in Council Directive 95/59/EC on taxes other than turnover taxes which affect the consumption of manufactured tobacco should be adapted so that a type of cigar which is similar to a cigarette is treated as a cigarette for excise purposes.

*International Framework Convention on Tobacco Control* On June 16, 2003, the EU signed the WHO's International Framework Convention on Tobacco Control. On May 3, 2005, 169 countries had signed and 63 had ratified the Treaty.

### *United States*

The U.S. Federal Trade Commission (the FTC) and the Department of Justice regulate the US. tobacco industry. The smokeless portion of the U.S. tobacco market is regulated by the Comprehensive Smokeless Tobacco Health Education Act of 1986, which is enforced by the FTC. This legislation requires that, among other things, warning texts be prominently displayed on products, packaging, advertising and advertising articles. Advertising smokeless tobacco products via electronic media (radio and television) is prohibited. Swedish Match North America is also subject to an FTC Order that is aimed at television and radio transmissions of events sponsored by the Company.

In addition, the FTC, by consent decree, regulates the packaging and advertising of cigars, requiring that warning texts must be prominently displayed on all cigar product packaging and marketing materials. The federal authorities have not adopted any packaging or advertising regulations covering pipe tobacco, although packaging and advertising regulations are currently under consideration by the FTC. Many states have adopted stricter legislation covering advertising, coupon offers and sampling of smokeless tobacco products. In addition, the minimum age for the purchase and use of the division's products, such as chewing tobacco, is 18 years in most states.

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Chewing tobacco, moist snuff, cigars and pipe tobacco are all subject to excise taxes at the federal and state levels. Federal excise taxes are based on weight whereas state excise taxes are generally expressed as a percentage of the manufacturer's list or wholesale prices. State excise taxes vary from state to state and from product to product. These taxes vary from a low of zero in one state plus the District of Columbia to a high of 75 percent in Alaska and the State of Washington. Otherwise, excise taxes are on average in the range of 25-35 percent.

In the Fall of 2004, the U.S. Senate considered legislation that would grant the FDA authority to regulate tobacco products. Among other things, the legislation called for the prohibition of free samples and self-service displays. The proposed legislation also limited certain advertising and labeling to a text only format and called for a

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ban on the sale or distribution of non-tobacco items that bear tobacco brand names, such as hats and t-shirts, and would have restricted sponsorship of events to corporate name only. In addition, the FDA was to be empowered to adopt rules regarding the manufacture, ingredient content, and pre-approval of tobacco products. The proposed legislation passed the US Senate, but failed to garner sufficient support in the House of Representatives and was not enacted into law. There remains uncertainty as to whether the U.S. Congress can gain passage of legislation in the future to permit the FDA to regulate tobacco as outlined above or to permit the FDA to regulate tobacco in a different manner.

In 2004, Congress passed legislation to eliminate the federal price support system for tobacco farmers and, in its place, provided an estimated US\$10.1 billion buy out of tobacco farmers over the next 10 years. The buy out will be funded by quarterly assessments on tobacco manufacturers. Cigarette manufacturers will pay 96.331 percent of the buy out; cigar manufacturers will pay 2.783 percent; moist snuff manufacturers will pay 0.539 percent; roll-your-own manufacturers will pay 0.171 percent; chewing tobacco manufacturers will pay 0.111 percent; and, manufacturers of pipe tobacco will pay .066 percent. Within each category, an individual company's assessment is based upon its market share. The 2005 payments will be based upon 2004 market shares, 2006 payments will be based upon 2005 market shares, etc. It is estimated that SMNA's share will be approximately US\$3 million per year.

As opposed to the strict regulatory regimes for tobacco products, legislation requiring that lighters sold in the U.S. be child-resistant is the only special legislation affecting the match and lighter business.

### *South Africa*

In South Africa the consumption and promotion of tobacco products is regulated and controlled by Parliament (the Supreme Authority) in terms of legislative enactment known as the Tobacco Products Control Act No. 83 of 1993 (as amended), and the regulations promulgated thereunder. The main thrust of the legislation prohibits or restricts smoking in public places, regulates the sale and advertising of tobacco products and prescribes the health messages that are to be reflected on packages. Highlights from the Tobacco Products Control Act include: the prohibition of smoking tobacco products in any public place, the complete ban on the advertising and promotion of tobacco products, the restriction of the sale of tobacco products except in packages bearing the prescribed health warning, the prohibition of the sale of tobacco products to persons under the age of 16 years and the prohibition on the distribution and supply of tobacco products for free, or at a reduced price, or coupled to any reward, such as gifts, cash rebates or rights to participate in contests.

Regulations made in terms of the Act deal with maximum tar and nicotine yield, permissible public smoking areas, point of sale of tobacco products (e.g. signage), exemption from unintended consequences of the legislation and the phasing out of existing sponsorship and contractual obligations. Excise duties including VAT on smoking pipe tobacco products in South Africa are levied at the current uniform rate of 52 percent of the manufacturers suggested retail price.

The South African Minister of Health has proposed a bill of amendment of the Act. The bill has not yet been enacted by the Parliament. The proposed changes would restrict further the way tobacco business may be undertaken in South Africa mainly by restricting the display of tobacco products at sale, requiring extensive warning labels to be borne by tobacco products, limiting the means of distribution of tobacco products, increasing tax rates and penalties for breaches of the act and prohibiting tax- and duty-free tobacco products.

### **Seasonality**

There is no material seasonality in the consumption of Swedish Match products. There are some quarterly variations in shipments, especially for premium cigars, with heavier purchases by wholesalers and retailers in anticipation of the Christmas/New Year selling season.

#### **Patents and licenses**

Swedish Match holds or licenses a number of significant trademarks and other intellectual property rights to the products marketed by the Group wherever such protection is available. In view of the significance of tobacco and lights brand awareness among consumers, it is management's opinion that the Group's trademark and other intellectual property rights must have sufficient protection. Despite the steps that the Company has taken to protect its intellectual property rights, the Company cannot be certain that any rights or pending applications will be granted or that the rights granted in connection with any current or future patents or trademarks are sufficiently broad to protect its technology and trademarks. Any patents and trademarks that are granted to the Company may be challenged, invalidated or circumvented, and any right granted under the Company's patents or trademarks may not provide competitive advantages for the Company.



**Table of Contents****4.C Organizational Structure**

The following is a list of the Company's significant subsidiaries as of June 1, 2005:

<u>Company</u>	<u>Country of Incorporation</u>	<u>Swedish Match Ownership Interest (%)</u>	<u>Swedish Match Voting Interest (%)</u>
Swedish Match North Europe AB	Sweden	100	100
Swedish Match Distribution AB	Sweden	100	100
Intermatch Sweden AB	Sweden	100	100
Swedish Match Industries AB	Sweden	100	100
Swedish Match Arenco AB	Sweden	100	100
Svenska tändsticksbolaget försäljningsaktiebolag	Sweden	100	100
Swedish Match North America Inc.	United States	100	100
General Cigar Holdings, Inc.	United States	100	100
Swedish Match Group BV	The Netherlands	100	100
Swedish Match Cigars BV	The Netherlands	100	100
Swedish Match Cigars NV	Belgium	100	100
Swedish Match Lighters BV	The Netherlands	100	100
Swedish Match UK Ltd	United Kingdom	100	100
Swedish Match Nederland BV	The Netherlands	100	100
Swedish Match France SARL	France	100	100
Swedish Match Ireland Ltd	Ireland	100	100
Swedish Match Fosforos Espana SA	Spain	100	100
Swedish Match Kibrit ve Cakmak ve Endustri AS	Turkey	100	100
Swedish Match do Brazil SA	Brazil	98	98
Wimco Ltd	India	74	74
Leonard Dingler (Pty) Ltd	South Africa	100	100
Best Blend (Pty) Ltd	South Africa	100	100
Swedish Match Philippines Inc.	Philippines	100	100

**4.D Property, Plants and Equipment**

Swedish Match manufactures its products at 28 production facilities located in 15 countries. The output of a number of the Company's plants is limited by the environment permits issued.

The Chewing Tobacco product group has one production facility located in Owensboro, Kentucky.

The production plants are located in Houthalen (Belgium) and Pandaan (Indonesia). In 2002 Swedish Match's production in the plant in Overpelt (Belgium) was closed down and moved to other existing Swedish Match plants. Cigars are also produced in Santiago, the Dominican Republic, Danli and Confradia, Honduras, and Dothan, Alabama in the U.S. The Company also has tobacco farms in Jima and Mao in the Dominican Republic and in Connecticut in the U.S.

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The Lighter Product group has production facilities located in Assen, the Netherlands; Manila, Philippines; and Manaus, Brazil.

The Match Product group has production facilities located in Tidaholm and Vetlanda, Sweden; Curitiba and Pirai, Brazil; Orhangazi, Turkey; Szeged, Hungary and also in Bulgaria and India. In addition, the Company owns a manufacturer of match-making and packaging machinery, Swedish Match Arenco, with plants in Kalmar and Halmstad, Sweden and Shanghai, China.

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Swedish Match produces pipe tobacco products in Boxburg and Rustenburg, South Africa and Owensboro, Kentucky. Further, Swedish Match has a contract manufacturing agreement for pipe tobacco with the Danish company MacBaren.

The Snuff product group has production facilities located in Gothenburg and Kungälv, Sweden. The production for the American market takes place in Owensboro, Kentucky. With the acquisition of Leonard Dingler, the group has production facilities in South Africa.

## **ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

### **5.A Operating Results**

The discussion and analysis by management of the financial condition and results of operations of the Group that follows should be read together with the Selected Financial Data, the Consolidated Financial Statements and the Notes thereto that appear elsewhere herein.

The Group's Consolidated Financial Statements have been prepared in accordance with Swedish GAAP, which differs in certain respects from generally accepted accounting principles applied in the U.S. For a discussion of certain differences between Swedish GAAP and U.S. GAAP and a reconciliation of the Group's shareholders' equity at December 31, 2003 and 2004 and net income for the years ended December 31, 2002, 2003, and 2004, see Note 26 of the Notes to the Consolidated Financial Statements.

### **Overview**

Swedish Match is a Swedish-based international group that produces a broad range of other tobacco products including snuff, chewing tobacco, cigars and pipe tobacco as well as matches and disposable lighters. Swedish Match products are sold in more than 150 countries. Within the Company's product offering, there are products characterized by very strong brand loyalty among consumers (for example, snuff and cigars), as well as products whose trademarks are of lesser importance to the consumer (for example lighters). A common characteristic of these products is that the consumer demands a high degree of accessibility to the products.

Several general factors, as discussed below, have affected the Group's results during the periods under review.

Consolidated sales for 2004 reached SEK 13,007 million compared with SEK 13,036 million in 2003. Sales increased in the snuff and cigars product areas whereas sales decreased in all other product areas. Income after financial items increased to SEK 3,206 million in 2004 from SEK 2,174 million in 2003. Operating income in 2004 was positively affected by a settlement with UST of SEK 1,521 million between Swedish Match North America and UST. According to the settlement, Swedish Match received a cash payment of USD 200 million and UST transferred its cigar operations to Swedish Match. Operating income also includes an impairment charge of SEK 150 million relating to the match operations and provisions for the acquisition of shares in Wimco Ltd. in India of SEK 90 million. Excluding these items operating income decreased by 6 percent.

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In 2004 net income per share amounted to SEK 5.61 from which a dividend payment of SEK 1.90 was paid in May 2005.

### *Business environment*

The Group's pipe- and chewing tobacco businesses have generally been characterized by declining volumes over recent years due in part to demographic changes and in part to regulations and health concerns in the industrialized countries that comprise the Group's primary markets. Snuff and cigars have increased in volume. Regulations have limited the consumption of smoking products by imposing bans on smoking in public areas and in the workplace. Taxes have made smoking products increasingly expensive. Individuals have given up smoking due to health concerns or generally changing habits.

In response to the declining demand for cigarettes, as of July 1, 1999 the Company sold its cigarette business to Austria Tabak. In addition, management has had three other principal responses to operating in an environment of declining volumes for certain smoking products and chewing tobacco with a view to maintaining or increasing profitability.

First, as the tobacco industry, including Swedish Match, has generally been characterized by overcapacity, management has continued to implement cost-saving measures through consolidating production, closing plants, reducing personnel, developing more efficient manufacturing processes and, in relation to the cigar business with certain acquisitions and has developed more highly automated production.

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Second, the Group has generally been able to effect price increases that compensate or occasionally more than compensate for volume declines. Price increases are aided by the fact that the price charged by a manufacturer is a relatively small percentage of the consumer price due to high taxes. However, there can be no assurance that the Group will be able to continue to effect price increases as it has in the past.

Third, the Group has introduced new brands and product variants, and to some extent, expanded its markets geographically, as well as increased sales of certain existing products. The Company's most important product category moist snuff often serves as a cigarette alternative product in some markets and thus enjoys a growth potential as cigarette consumers opt to switch to moist snuff.

In most of the important markets in which the Company sells matches there has also been a general decline in the volumes of matches sold due to declining volumes of smoking products in industrialized countries, to the substitution of matches by disposable lighters and to increased electrification worldwide. The match and lighter markets are characterized by production overcapacity. Management has sought to introduce price increases and to rationalize operations while also seeking new markets in Europe and elsewhere. Rationalization measures have included consolidating operations through reduction of production capacity and reducing the number of product variants.

### *Tobacco taxes*

Taxes generally represent a significant percentage of the consumer price of tobacco products and have been steadily increased by governments in many of Swedish Match's markets.

### *Currency*

Certain of the Group's product areas are significantly affected by fluctuations in foreign currency exchange rates.

In the Chewing Tobacco product area and the U.S. part of the Snuff and Cigar product areas, changes in the U.S. dollar against the Swedish krona exchange rate have a translation impact on net income.

In the Swedish part of the Snuff product area, currency movements have had a fairly limited effect on results and are mainly restricted to the U.S. dollar exposure on purchases of leaf tobacco.

In the Cigar product area, the plants in Belgium, Holland and Germany export to other countries outside the European Monetary Union countries, including Sweden and Australia. Hence, changes in the exchange rate between the invoicing currency and the currency used in the financial statements of the producing company will have a transaction effect. Additionally, changes between the reporting currency of the local company and the Swedish krona will have a translation effect on net income when the local results of operations are translated into Swedish kronor.

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In the Lighters product area approximately 40 percent of Swedish Match's lighters sales are invoiced in U.S. dollars, with results affected by changes in the U.S. dollar against the euro and the Philippine peso, the two currencies in which the major part of production costs are incurred.

In the Match product area, Swedish Match operates production facilities in Brazil, throughout Europe and in India. Results are affected by movements between the Swedish krona and local currencies.

### *Country risks*

The Company maintains a large global presence, primarily through its matches and lighters operations, and these operations can be significantly and adversely affected by political and economic instability in developing world countries. The Company believes that its future results of operations and financial condition will be affected by the economic, regulatory and political situations in the countries in which it conducts its operations, which situations are generally unpredictable and outside the control of the Company. For further information concerning the Company's trend information see Item 5. D Trend Information .

### **Critical Accounting Policies**

Swedish Match's consolidated financial statements are prepared in accordance with Swedish GAAP, which requires management to make estimates and assumptions that affect amounts reported in the financial statements and related notes. Swedish GAAP differs in certain significant respects from U.S. GAAP. Accordingly, the Company

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has prepared a description of the significant differences and a reconciliation of consolidated net income and stockholders' equity from Swedish GAAP to U.S. GAAP in Note 26 of the Notes to the Consolidated Financial Statements. In preparing these financial statements, the Company's management has made its best estimates and judgments of certain amounts, giving due consideration to materiality. Swedish GAAP is to adopt the accounting principles issued by the International Accounting Standards Board in full as from January 1, 2005. The adoption of new accounting standards will have a significant impact on the Company's financial statements in the year of change as well as in future years.

Management believes the following represents Swedish Match's critical accounting policies under Swedish GAAP and U.S. GAAP. For a further discussion of the application of these and other accounting policies, see Note 1 and Note 26 of the Notes to the Consolidated Financial Statements.

*Intangible assets*

Goodwill is normally amortized on a straight-line basis over 5 to 20 years. Goodwill in larger subsidiaries that have been operating for more than 20 years and have strong brands and a good market position is amortized over 20 years. Acquired trademarks are amortized over 20 years if similar conditions exist. The value of goodwill and other intangible assets is evaluated regularly to determine whether events or circumstances indicate that the value of the intangible asset is impaired. These evaluations necessarily include significant judgments made by management. Future events could cause management to conclude that impairment indicators exist and that an intangible asset is impaired. Any resulting impairment loss could have a material adverse impact on the financial condition and results of operations. Under Swedish GAAP, the Company's intangible assets amounted to SEK 3,285 million in 2004 compared with SEK 3,648 million in 2003. Amortization in 2004 amounted to SEK 322 million compared with SEK 319 million in 2003 under Swedish GAAP. Under U.S. GAAP, the Company's intangible assets amounted to SEK 5,147 million in 2004 compared with SEK 5,352 million in 2003. Amortization under U.S. GAAP amounted to SEK 147 million in 2004 compared with SEK 107 million in 2003. The higher amount for goodwill under U.S. GAAP is due to goodwill not having been amortized during 2002, 2003 and 2004 in accordance with FAS 142 and "push down goodwill" from Volvo's acquisition of Swedish Match in 1994. U.S. GAAP requires that "push down" accounting be applied for independent annual reports of wholly owned subsidiaries if the ownership is 95 percent or more, which was the case of Volvo's acquisition in 1994. Consequently, the adjustment made in accordance with the purchase method by Volvo, pertaining to Swedish Match, began being reported for U.S. GAAP purposes by Swedish Match in June 1994.

According to Swedish accounting principles, goodwill is to be amortized in a systematic manner over its useful life. The useful life for goodwill is always limited. In accordance with the U.S. accounting principles FAS 142, "Goodwill and Other Intangible Assets", which applies from January 1, 2002, goodwill and intangible assets that have a indefinite useful lives are no longer amortized. Instead, an impairment test shall be made in connection with the transition to FAS 142, and then on an annual basis. As a consequence, the goodwill amortizations made during 2002, 2003 and 2004 in accordance with Swedish accounting principles, SEK 208 million, SEK 212 million and SEK 175 million respectively, were reversed for U.S. GAAP purposes. According to FAS 142, potential impairment arises if the book value of a reporting unit exceeds its fair value. The implied value of goodwill shall be determined in the same manner as the amount of goodwill recognized in a business combination is determined. The excess of the fair value of a reporting unit over the amounts assigned to its assets and liabilities is the implied fair value of goodwill. With the transition to FAS 142, an impairment test of goodwill was made January 1, 2002. This resulted in a goodwill write-down in accordance with U.S. GAAP of SEK 206 million in pipe tobacco operations in northern Europe. The fair value of the operations was calculated as the present value of the estimated future payments which the operations can be expected to give rise to. The Group does not have any intangible assets with an indefinite life other than goodwill.

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### *Deferred taxes*

Deferred taxes are recognized for temporary differences which arise between the tax and book value of assets and liabilities as well as for unutilized tax losses carry-forwards to the extent that it is probable that future taxable profits will be available against which the unused tax losses can be utilized. Deferred tax assets for unutilized tax losses amounted to SEK 13 million in 2004. Uncertainty in the future outlook for the economy or other failure to estimate future profit accurately could result in lower taxable income in the future in the subsidiaries where deferred tax assets for tax losses are at hand. As a consequence the actual utilization of deferred tax assets may differ from expected utilization and therefore may affect future earnings.

Under U.S. GAAP deferred taxes are recognized for virtually temporary differences and a valuation allowance is established to the extent that it is more likely than not that a deferred tax asset will not be realized. The accounting policies under Swedish GAAP and U.S. GAAP have not given rise to any GAAP differences related to deferred tax assets.

### *Legal proceedings*

As discussed in Item 8 and Note 22 of the Notes to the Consolidated Financial Statements, Swedish Match is currently involved in certain legal proceedings. Management holds the view that there are good defenses against all the claims and each case will be defended vigorously, and the Company has not provided any amounts in the Consolidated Financial Statements for unfavorable outcomes. It is possible that the Company's business, results of operations, cash flows or financial position could be materially affected by an unfavorable outcome of certain pending litigation.

### *Accounting for pensions*

As from January 1, 2004 the Company has adopted a new accounting standard, RR 29, which requires an enterprise to recognize a liability when an employee has provided service in exchange for employee benefits to be paid in the future, and expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits. The benefit obligations of the Company's defined benefit plans were estimated to exceed the fair value of plan assets with SEK 257 million net after taxes. The deficit was charged to opening equity on January 1, 2004 in accordance with RR 29. In accordance with the transition rules for the standard no restatements for prior years were made. Calculating pension obligations require management to make assumptions on discount rate, expected return on plan assets and rate of compensation increase. Actual results could differ from the assumptions made.

Under U.S. GAAP, pensions are accounted for in accordance with FAS No. 87 *Employers' Accounting for Pensions*. The Group has estimated the effect on net income and shareholders' equity assuming FAS No. 87 provisions would be applied as set forth in Note 26 to the Consolidated Financial Statements.



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The following table sets forth the net sales and operating profit by product for the periods indicated.

	<b>For the years ended December 31,</b>		
	<b>2002</b>	<b>2003</b>	<b>2004</b>
	(SEK millions unless otherwise stated)		
<b>Snuff</b>			
Sales	2,788	2,995	3,081
Operating income	1,233	1,386	1,373
Operating margin, %	44.2	46.3	44.6
<b>Chewing Tobacco</b>			
Sales	1,333	1,146	1,058
Operating income	406	336	304
Operating margin, %	30.5	29.3	28.7
<b>Cigars</b>			
Sales	3,318	3,008	3,171
Operating income	472	393	466
Operating margin, %	14.2	13.1	14.7
<b>Pipe Tobacco &amp; Accessories</b>			
Sales	843	909	901
Operating income	164	201	220
Operating margin, %	19.5	22.1	24.4
<b>Matches</b>			
Sales	1,648	1,395	1,378
Operating income	221	83	(297) <sup>1</sup>
Operating margin, %	13.4	5.9	(4.1)
<b>Lighters</b>			
Sales	700	599	582
Operating income	56	14	7
Operating margin, %	8.0	2.3	1.2
<b>Other operations</b>			
Sales	3,013	2,984	2,836
Operating income	(181)	(189)	(224)
Income from settlement with UST			1,521
<b>Group Total</b>			
Sales	13,643	13,036	13,007
Operating income	2,371	2,224	3,370
Operating margin, %	17.4	17.1	25.9

1) Including an impairment charge of SEK 150 mill