

TRANSLATION
ORIGINAL LETTER SENT IN FRENCH

July 27, 1994

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Purdy Crawford
Chairman and
Chief Executive Officer

Dear Professor Lauzon:

I am writing concerning your recently released socio-economic impact study on the Canadian tobacco industry. As the industry leader, Imasco's Imperial Tobacco featured prominently in the study, and a central conclusion was that Canadian tobacco companies, Imperial Tobacco included, are poor corporate citizens. Others in the industry may have their own reactions. My purpose is to go on record and disagree strongly with your assessments of Imperial Tobacco and Imasco.

The Canadian tobacco industry is not monolithic. It is well known in the business world that Imasco's structure, corporate strategy, and profile are fundamentally different from other participants in the Canadian tobacco industry. This point was not made clear in the study and, with the greatest respect, I also question some of your other findings and the assumptions on which they are based. In more detail, my comments are as follows:

The Canadian tobacco industry is concentrated but still highly competitive

As the study points out, the Canadian tobacco industry is concentrated, with three major participants. However, it is wrong to conclude that the industry is not competitive. Because consumption has been declining for many years, the most promising source of volume growth is market share gains. The stakes are large and the competition is intense. To suggest that the Canadian tobacco industry is a cartel is provocative and totally unwarranted.

If the level of competition is not obvious to the public at large, governments may be partly to blame. Key strategies adopted to discourage tobacco use have tended to be anti-competitive in nature. For example, trademark advertising of Canadian tobacco products was banned in 1989, and enormous tax increases in the late 80s and early 90s virtually eliminated price as a competitive tool. Currently, the federal government is considering mandatory plain packaging which would remove another marketing tool that companies use to compete amongst themselves.

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The consistent strategy of Imperial Tobacco has been to focus on increasing its share of the domestic market. As the share data and the financial results cited in the study clearly demonstrate, this strategy has been successfully executed, and the company has profited accordingly.

Neither Imperial Tobacco nor Imasco is "controlled" by B.A.T Industries, p.l.c.

B.A.T Industries, p.l.c. owns approximately 40.5% of Imasco's common shares. The balance is widely held, for the most part by Canadians and Canadian institutions. The ultimate responsibility for the management of Imasco lies with its Board of Directors which is entirely made up of Canadian and American citizens. No current Board member is connected to B.A.T, and B.A.T has not had a representative on the Imasco Board for more than forty years. Imasco's independence has been evaluated and confirmed by two separate federal government agencies, Investment Canada and the Superintendent of Financial Institutions.

Imperial Tobacco did limit its exports in support of government efforts to control smuggling

From April 1992 until March 1993, Imperial Tobacco voluntarily limited its exports in support of government initiatives to control tobacco smuggling. Surprisingly, there is no mention of this in the study but it can easily be demonstrated with information found in Imasco's annual report. Exported cigarettes and cigarette equivalents by Imperial Tobacco were 2.8 billion units in 1992 compared with 4.0 billion units in 1991, a decrease of 30%. Over the same period, the forensic accounting firm Linquist Avey MacDonald Baskerville, found that the contraband market continued to grow at a rapid pace.

The limits on exports had a significant negative impact on Imperial Tobacco's revenues, market share, and profits. Unfortunately, there was no corresponding decline in the contraband activities. The contraband tobacco market responds freely to the law of supply and demand. The demand for reasonably priced tobacco products was substantial, and other sources of supply (not necessarily Canadian) were tapped by smugglers to fill the void created by Imperial's brands being unavailable. In other words, Imperial's restraint, while costly to the company, had no effect on the growth of the contraband market. After providing this assessment to government authorities, in late March of 1993, Imperial Tobacco began responding to actual demand on the export market.

One hypothesis of your study is that Canadian tobacco companies intentionally created the contraband market by making massive exports. This

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is depicted as a tactical move in the industry's efforts to achieve an overall tobacco tax reduction in Canada. The suggestion, therefore, is that exports somehow created domestic demand. Smugglers understood that it was very high tobacco taxes in Canada that created the demand. It was high taxes that led millions of smokers to seek more reasonably priced cigarettes. If Canadian products were not available, the contraband market drew from other sources. This is exactly what happened in the early 1950s when high cigarette taxes caused an enormous smuggling problem. At that time, the contraband products were virtually all American brands.

All of this explains why the federal government suspended its 1992 export tax after only eight weeks. It was not, as has often been stated, a case of the government caving in to the "powerful tobacco lobby". Rather, it was a decision based on common sense and basic economics. The export tax served to eliminate but one source of supply, it had no impact on demand. The export tax could never have been expected to close down the contraband market and yet it clearly put the Canadian tobacco industry and thousands of jobs at risk.

The investing public receives dividends from Imasco, not Imperial Tobacco

Your study includes estimated dividends paid from Imperial Tobacco's earnings to foreign investors. No such dividends are paid. Investors receive dividends from Imasco, and information on the actual amounts paid is provided in the annual report. For the seven year period, the total dividends paid by Imasco to foreign investors from consolidated earnings (all sources) was \$426.6 million as opposed to the \$433.4 million attributed solely to Imperial Tobacco in the study. More significant was the \$589.3 million that Imasco paid out to Canadian investors in the same period. These funds are either used to purchase goods and services or reinvested. This is an enormous benefit to the Canadian economy and it was not even mentioned in the study.

The study is also critical of the level of tobacco industry reinvestment which it shows as \$286.0 million from 1987 to 1993, or 17.3% of estimated industry net profits. If reinvestments in tobacco assets have been relatively modest, this should surprise no one. The tobacco industry in Canada is mature, and it is subject to policies through which governments hope to accelerate its rate of decline. There is certainly no call for increased capacity. In so far as Imperial Tobacco and Imasco are concerned, continuing tobacco investments have been substantial (\$176.5 million in the period studied) and have generally been to improve efficiency and enhance competitiveness. However, substantial additional funds are generated by Imperial Tobacco, and Imasco is able to invest this money in other businesses. In fact, that is the very reason Imasco was created: to grow by investing the strong cash flow of Imperial Tobacco.

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Once again, there are significant benefits to the economy. In the period covered by your study, additions to Imasco's consolidated capital assets were nearly \$2.5 billion.

The socio-economic analysis

I am not qualified to comment on the socio-economic analysis in any detail, and I therefore asked Montréal economist Jean-Pierre Vidal to do so. Mr. Vidal has done extensive work in this area and his conclusion is as follows:

Lauzon's main conclusion, i.e. that tobacco production has a largely negative impact on society, is in no way proved by his analysis. In general, he disregards the appropriate methodology. The figures added up as social benefits are not always benefits, and the most significant benefits are not included. In addition, there is no explanation why the tax figures are underestimated by half. Lastly, health costs are estimated at \$9.7 billion, whereas Health and Welfare Canada provides a figure of \$2.9 billion, and the only reference offered for the \$9.7 billion figure is a telephone conversation.

In summary, and after scratching the surface only lightly, it becomes apparent that significant parts of your study and several, if not all, of its conclusions cannot be supported. In the circumstances, it is lamentable that the report has been made public and received media attention. More lamentable still is that the reputations of Imperial Tobacco and Imasco have been unjustly tarnished in the process.

Yours truly,

Purdy Crawford
Encl.

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