

Extract from BAT Industries
- 6 - April 1993 Future Business
Environment paper.

3. Tobacco

3.1 Sales Volume Growth

- 3.1.1 World cigarette sales volume (Table 6) is forecast to grow at 1% p.a. over the five years to 1997, having grown at 0.6% p.a. over the past five years. Recent growth has been reduced by the effects of the recession.
- 3.1.2 Growth rates will vary markedly between regions. The fastest rates of population growth, and the fastest increases in GDP per capita, are in the developing countries. Therefore the fastest projected increases in cigarette volumes are also in these countries. The fastest growth rates are expected in China 2.5% p.a., Far East (excluding China) 2% p.a., Indian sub-continent 1.7% p.a. and Latin America 1.1% p.a.
- 3.1.3 Volumes are expected to decline over the medium term in North America by 2.6% p.a. and Western Europe by 0.8% p.a.
- 3.1.4 It is assumed that increased import and license penetration of the monopoly markets (Table 7), including China, will continue over the medium term.
- 3.1.5 Volume growth in International Filter Brands (IFBs) (Table 8) is forecast at 4.7% p.a., with US IFBs growing more quickly than UK IFBs, and with particularly high IFB growth in the ex-Communist countries.

3.2 Key Tobacco Market Issues

- 3.2.1 **Anti-smoking pressures:** Anti-smoking pressures are expected to increase in the US, as a result of the change in administration. They are expected to remain intense in Canada. The Canadian Tobacco Products Control Act is likely to be enforced, and possible other restrictions to be introduced such as where tobacco products can be sold and what packaging is allowed. Anti-smoking pressures are increasing in the EC, where there is a significant risk that a ban on tobacco advertising will be imposed. They are also very high in Australia and New Zealand. Over the medium term, pressures are expected to increase in other more sophisticated markets, and longer term to spread to less sophisticated markets.
- 3.2.2 **Litigation:** This has been mainly of concern in the US where the Tobacco industry is expected to continue to win litigation cases. However it is now spreading to other countries, and there is a risk that decisions will be political rather than judicial.
- 3.2.3 **Excise rates:** US Excise rates are expected to rise progressively in real terms. Excise rates in Canada are expected to remain penal, encouraging transit trade. In general, excise rates around the world are expected to rise more quickly than inflation as this is a politically "acceptable" way for governments to raise revenue, and to discourage smoking where this is an objective.

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- 3.2.4 **Counterfeit:** Counterfeiting and the abuse of trademarks by third parties is increasing, and greater vigilance will be needed to track and stop its sources.
- 3.2.5 **Transit:** A significant proportion of the world export trade is transit. It is impossible to determine its exact size and it is very unpredictable. It exists wherever there are widely different excise rates and trade restrictions, and is expected to continue where these conditions exist.
- 3.2.6 **New markets:** Many of the opportunities for volume growth are in new markets, such as East Europe, the CIS and the Far East, where monopolies are being broken up or where ex-communist governments are opening their markets to imports. It will probably be necessary to make investments in order to participate in these markets, although investments will typically have long paybacks. There is much competition among the major manufacturers for these opportunities which will result in some high prices being paid. The resulting earnings may be lower quality as they may be less remittable and some of the regimes under which they are earned are unstable.
- 3.2.7 **Value for money:** A progressive increase in Federal Excise Tax could encourage the mix change to VFM in the US to continue or accelerate. Excise, VAT and manufacturers price increases in Germany will make smoking more expensive in real terms, encouraging the shift to lower price brands. Tobacco rolls will continue beyond 1994 in Germany as a low price alternative although at a reduced price differential. The shift to VFM world-wide has been hastened by the recession, but it has also resulted from consumers perceiving that VFM products really are good value for money. Manufacturers are expected to seek ways to differentiate their full revenue products so that they offer more added value for the customer. Excessive RONAs can give weaker competitors an opportunity to take profitable market share with VFM products.
- 3.2.8 **Profitability:** It is difficult to generalise about trends in profitability as it tends to reflect local competitive conditions. Prices in the US had been expected to continue to rise more quickly than inflation as a result of the profit growth objectives of the main competitors. However the picture following the Philip Morris announcement is unclear. There is also a danger that the overall profitability of the US industry could fall because of the mix change. The profitability of the Canadian industry is expected to remain high as prices are expected to rise more closely in line with excise rates and hence faster than inflation. There is a risk that German competitors could use price to defend, and to try to increase, market share, resulting in lower profitability. Brazilian prices in US\$ per pack are expected to rise slowly from the current level, allowing market volumes to increase slowly, and improved profitability to be maintained.

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- 3.2.9 **Packaging:** The environmental lobby is pressing in Germany for the introduction of regulations which would limit the number of packaging layers, as a product leaves a supermarket, to one. A carton of cigarettes currently has five layers (cellophane, carton, cellophane, pack, foil), with product freshness as well as brand information purposes. Although the lobby is unlikely to achieve its ultimate objective, it is likely to lead to the need for radical packaging redesign.
- 3.2.10 **Hinged lid:** Hinged lid boxes are perceived as desirable by consumers. Where they have been introduced at a small or no price premium they have quickly increased their market share. This has been particularly true recently in Japan and Brazil, and has caused manufacturing capacity problems. The major manufacturers are expected to introduce additional hinged lid capacity in further markets in an attempt to gain competitive advantage and increase market share.
- 3.2.11 **Manufacturing:** The economies of scale from manufacturing encourage fewer, larger factories. This leads to increasing risk as a result of high dependence on these units, with a need for catastrophe plans. It also conflicts with the desire of many governments to encourage local manufacturing, and hence jobs. Whilst there are opportunities for cost reduction from factory rationalisation, they will have to be balanced against the ability to export freely to target markets.
- 3.2.12 **Competitors:** "Big 4" will continue to dominate the world cigarette market over the medium term. Their share of the world market is forecast to rise from 31.5% in 1992 to 35.5% in 1997 (Table 9). Philip Morris' market share will grow most quickly, and they, BAT and JTI are expected to take market share from Rothmans and the smaller competitors, while R.J. Reynolds is expected to hold market share. It will become increasingly difficult to improve profitability (Table 10) as mix changes offset price increases and productivity improvements.
- 3.2.13 **Leaf:** Supply of tobacco leaf is expected to continue to outstrip demand and hence prices are unlikely to rise in real terms. There will nevertheless be good opportunities for sales growth for high quality producers as customers demand higher quality cigarettes, and as a result of the switch to IFBs. The merger of Standard Commercial and Dibbrell may mean that our relationship with Standard Commercial may have to change.

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Table 6

World Cigarette Sales Volume

	Total Sales (bn)				Growth Rate (%)			BAT Share (%)		
	1987	1991	1992	1997 (d)	'87-92	'91-92	'92-97 (d)	1987	1992	1997 (d)
World	5149	5292	5296	5557	0.6	0.08	1.0	10.4	10.9	12.7
North America	632	559	544	478	-3.0	-2.6	-2.6	14.6	15.5	18.4
Western Europe	767	762	734	706	-0.9	-3.7	-0.8	9.5	9.9	11.2
Central Europe/CIS	700	658	664	667	-1.1	0.9	0.1	0.3	2.2	2.5
Latin America(a)	377	372	346	366	-1.7	-6.8	1.1	57.8	47.1	55.3
China	1454	1649	1705	1929	3.2	3.3	2.5	0.4	2.4	3.3
Far East (b)	769	838	848	926	2.1	1.1	2.0	7.8	8.0	7.6
Indian Sub-Continent	138	138	138	150	0.1	0.07	1.7	61.9	67.3	70.0
Middle East	102	104	105	106	0.6	0.96	0.3	10.2	21.2	21.0
Africa	211	208	209	215	-0.2	0.09	0.6	16.1	15.0	15.6
Memo: Kretek	109	132	132	163	3.9	0.03	4.3	-	-	-
Memo: Open Markets	1898	1843	782	1761	-1.3	-3.3	-0.2	27.9	27.1	33.0
Monopolies (c)	3251	3449	3514	3796	1.6	1.9	1.6	1.1	2.6	3.2

- (a) Includes Cuba
(b) Includes Australasia and Kreteks
(c) Includes Communist and ex-Communist
(d) Forecast

World total may differ from sum of regions due to rounding.

Source: BATCo

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Table 7

Import and License Penetration of Monopoly Markets 1987 - 1992

	Market (hns)		Growth %	Imports and Licenses (hns)			Growth %	Import Share %		BAT Import Share %	
	1987	1992	% p.a.	1987	1992	% p.a.	1987	1992	1987	1992	
China	1454	1705	3.2	14.9	70.0	36.3	1.0	4.1			
Japan	308	329	1.4	27.4	60.7	17.2	8.9	18.4	22.6	21.2	
S. Korea	82	102	4.5	-	5.3	-	-	5.2	-	9.6	
Taiwan	34	36	1.3	5.6	6.0	1.4	16.5	16.7	23.1	24.8	
France	94	96	0.5	43.0	52.4	4.0	45.7	54.6	3.4	2.8	
Italy	99	93	-1.3	38.5	45.4	3.4	38.9	48.8	6.7	5.7	

Source: BATCo

Table 8

International Brands

	Sales (hn)				Growth (%)			Share of World (%)			
	1987	1991	1992	1997	'87-'92	'91-'92	'92-'97	1987	1991	1992	1997
USIB	318	445	464	602	7.9	4.2	5.3	6.1	8.4	8.7	10.8
UKIB	121	135	140	158	3.0	3.7	2.4	2.3	2.5	2.6	2.8
Total	439	580	605	761	6.6	4.3	4.7	8.5	10.9	11.4	13.6

Source: BATCo

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Table 9

Market Shares

	1987	1988	1989	1990	1991	1992	1997(n)
BAT	10.9	10.7	10.3	10.4	10.8	10.8	12.7
PM	10.0	10.2	10.7	11.5	12.2	12.5	14.9
RJR	5.5	5.5	5.1	5.4	5.2	5.0	5.0
ROTH	3.2	3.2	3.1	3.2	3.2	3.1	2.9
TOTAL	29.1	29.1	29.2	30.5	31.4	31.5	35.5

Table 10

Tobacco Profitability For 'Big 4'

Profits/Net Sales (%)		BAT	PM	RJR	ROTH
US	1987	35.8	45.8	32.8	-
	1988	34.9	45.7	31.7	-
	1989	35.1	46.6	34.3	-
	1990	36.0	48.9	39.9	-
	1991	33.0	50.8	38.1	-
	1992	28.5			
Rest of World	1987	-	15.8	15.6	-
	1988	-	17.8	14.1	-
	1989	19.6	21.1	15.9	-
	1990	20.6	23.1	18.3	-
	1991	24.5	24.5	18.7	-
	1992	25.9			
Total	1987	-	34.3	28.6	12.6
	1988	-	34.8	27.1	16.5
	1989	24.5	36.9	28.8	17.8
	1990	24.7	38.3	33.9	16.9
	1991	27.0	39.7	31.9	17.1
	1992	26.9			
Return on Total Assets (%)		BAT	PM	RJR	ROTH
	1987	31.9	51.0	N/A	N/A
	1988	30.2	64.3	N/A	N/A
	1989	30.7	67.1	N/A	N/A
	1990	33.5	72.1	N/A	N/A
	1991	34.1	74.9	N/A	N/A
	1992	34.3			

Source: BATCo.

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