

RATIONALISATION OF PACK SIZES

1. INTRODUCTION

This note indicates specific areas where progress is being made towards the conclusions outlined in the previous paper on this subject:-

- Where opportunities exist, companies should move King Size Hinge Lid production to one of the three major pack sizes:

BATCo	Compact
B&W	Compressed
BATCF	Super Compact

- Acquisition of change parts to provide source flexibility in a crisis.
- Digitising art work to allow rapid material redesigning where this is necessary.

2. STRATEGY FOR PACK SIZE RATIONALISATION

The approach which is being taken is to treat pack size rationalisation as one factor in the overall issues of greater flexibility in Group product sourcing and maximising the use of production assets.

Currently a key restriction in the progress of this strategy is the different pack sizes at major plants.

The continuing marketing view is that there are certain sensitive export markets (e.g. Hong Kong exports, West Africa) where pack size change is not possible. This applies particularly where counterfeit cigarettes are a threat.

In addition to this marketing limitation, there are physical restrictions to pack size change in some domestic markets, e.g. Vending Packs in Germany and Tax Stamping in U.S. Souza Cruz also has specific cost constraints, since a change in cigarette specification to international dimensions would increase variable costs by around £4.5 million per year.

It is accepted at this time that these factors limit opportunities to increase sourcing flexibility, but they will continue to be challenged.

However, there are some export markets, e.g. CIS, Eastern Europe, and some domestic markets, e.g. Finland, Benelux, where there are opportunities to increase sourcing flexibility.

For these markets, there are four instances where re-sourcing of manufacture can be used either to rationalise pack sizes or to increase production flexibility:-

- * Where there is a shortfall in forecast non source specific capacity at an operating company which can be met by manufacture elsewhere.
- * Factory closure
- * Cost or market pressures which require a change in product sourcing
- * Short term demand due to opportunity business or a crisis at a major plant.

Where any of these situations arise, the following alternatives are examined to determine which provides superior return to the Group

- * Switch manufacture to a source with surplus capacity and accept a different pack size
- * Switch manufacture and acquire change parts in order to maintain the source pack size

3. RATIONALISATION OPPORTUNITIES

3.1 Plant Capacity

Taking King Size Hinge Lid as the key area, current forecasts show that there is unlikely to be any shortfall in major plant production capacity compared to requirements throughout the plan period

	1994	1995	1996	1997	1998
20KSHL					
B&W					
Requirement	30.1	35.8	40.4	45.3	51.6
Capacity	35.5	44.2	46.6	51.3	52.0
Souza Cruz					
Requirement	25.0	28.7	30.5	31.9	33.5
Capacity	42.5	42.5	42.5	42.5	42.5
BATCF					
Requirement	15.0	16.7	18.1	19.4	20.7
Capacity	17.8	21.7	21.4	21.4	22.7

Southampton					
Requirement	34.8	39.4	47.9	54.9	62.4
Capacity	36.7	39.8	49.6	54.9	63.3
Singapore					
Requirement	7.1	9.4	7.8	7.8	7.8
Capacity	9.0	10.0	10.0	10.0	10.0
Imperial					
Requirement	1.9	1.9	1.9	1.8	1.7
Capacity	3.7	3.7	3.7	3.8	3.9

Note: Requirement is sales forecast plus contingency of at least 10%.

Since each major location can meet its production requirement there is no need at this time to re-source any production volume on purely capacity grounds. However, this will be kept under review as forecasts and production requirements change.

4.2 FACTORY RATIONALISATION

The key area is Europe and the potential closures of Brussels and Finland.

4.2.1 Closure of Brussels

This is being examined as part of the European flexible manufacture study. There are two possible sources for Brussels KS HL Compact manufacture:

- Southampton. Compact. There are no pack size implications for this alternative.
- BATCF. Standard and Super Compact. The alternatives which are being studied are:-

Supply Super Compact. This would mean changing BATCo pack size in EC and Scandinavia. However, this change could be seen as a move towards a European Super Compact standard, but this standard would inhibit Southampton production for Europe in the future. The marketing implications of this change are being further studied.

Supply Compact. This would involve movement of machinery from Brussels or changing existing BATCF machines to Compact (approximate cost £300,000). Either case would cause some reduction in operational flexibility at BATCF, though this is not likely to be significant.

4.2.2 Closure of Finland

Due to EFTA tariff barriers, Switzerland (Super Compact) may prove to be the most cost effective alternative source. Indications are that Super Compact would be acceptable for the Finnish domestic market, where competitors have a similar pack size, but the implications for export markets, such as Norway, are being further examined.

However, if the financial implications of Swiss manufacture or the move to Super Compact prove to be unacceptable, then other alternatives are to:-

- Source from Brussels (Compact pack size), working to minimise the tariff implications until Finland joins the Common Market. The costs of this option are being studied.
- Change to Compact at BAT Suisse at a cost of approximately £350,000 and an increase in variable material costs of around £25,000 per year. If Compact were market acceptable in Switzerland, this would increase BATCo sourcing flexibility in Europe in the short term and could also facilitate closure of BAT Suisse in the longer term.

4.2.3 Other Factory Closures

Factory rationalisation is also under review in Brazil, Germany, Caribbean, Nigeria, Pakistan and Central America. Since these are either internal or within a region with consistent pack size, there are unlikely to provide opportunities for pack size rationalisation.

4.3 COST BASED PRODUCT SOURCING

Where pressure to reduce product cost cannot be satisfied at the existing source, transfer of manufacture to a lower cost source will be studied.

Within BATCo, Hilton sourcing in the longer term is under review in order to meet forecast demand at minimum cost. Currently Southampton sourcing is planned but, amongst other options, the potential to source Hilton from Brazil is being studied. Hilton is a market sensitive product where change to the pack size is not acceptable and thus the cost of change parts to BATCo standard specification for Souza Cruz machinery and the operational implications to Souza Cruz manufacture will be taken into consideration.

B&W have had exploratory discussions with Souza Cruz as an alternative source for that part of B&W manufacture for export which is not source sensitive. Provision would need to be made at Souza Cruz to match B&W specifications, but this would also have the benefit of increasing overall Group sourcing flexibility.

If these options prove to be viable, Souza Cruz would have the facility to produce their own size, BATCo Compact and B & W Compressed, which would significantly increase Group sourcing flexibility.

4.4 SHORT TERM DEMAND CHANGE

4.4.1 Opportunity Markets

Opportunity markets are frequently source and pack size flexible. Given this flexibility, there is considered to be sufficient King Size Hinge Lid capacity within the Group to respond to potential opportunity markets. Thus, there is at present the following surplus capacity:-

		<u>Billion</u> <u>Cigarettes</u>
BATCo	Compact	13
BATCF	Standard/Super Compact	2
B & W	Compressed	5
Souza Cruz		17

Note: BATCo surplus capacity is for all plants.

Souza Cruz have increased their sourcing flexibility further through an exercise with Malaysian Tobacco Co. MTC have successfully produced 9 million Hollywood for a Souza Cruz export market and are now established as a potential source where market demand allows a Compact Pack to be used.

4.4.2 Crisis Sourcing

The marketing view is that in a crisis, change in pack size is generally preferable to failure to supply the market. However, provision should be made for appropriate market communication, e.g. through pack inserts.

Group Disaster Recovery sourcing is currently under review by B&W. The two key areas are Macon and Southampton, since other major sources e.g. Brazil, Singapore and Germany, can be covered for key brands either internally or by other sources with the same pack size. At Macon and Southampton,

product is market sensitive to size and in Southampton's case it is also source sensitive.

For Macon, there are agreements in place with two competitors in US for sourcing of key brands. These are currently under review to strengthen them and explore the potential to extend them to a third source. Discussions have also started with Souza Cruz for sourcing of other brands, which would include provision of change parts to bring Souza Cruz manufacture in line with Macon.

At Southampton, the potential to enter into similar agreements with the UK competitors is under review. When the volume which could be sourced from UK in a crisis has been established, it can be determined the extent to which the remaining volume required can be sourced within BATCo without pack size implications.

5. DIGITAL ARTWORK

Considerable progress has now been made amongst Group companies, most notably by B&W. An agreement has now been reached on the hardware platform, Apple Macintosh, and there is a trend to adopt the B&W process system.

The progress towards completion made by each Group company is estimated to be as follows:

B&W	95%
BATCF	25%
BATCo	5% (20% in Europe)
Souza Cruz	Not yet started
Imperial	Not yet started

This measure is based on BAT control of the process from origination to printer. However, in addition there are many instances where printers locally have independently digitised artwork.

All companies are working towards digitising all new artwork, though the process of retrospective digitising of all old artwork could take several years.

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