Imasco Plan Preview 1994-1998

A CEC meeting to discuss the Preview of the Imasco Plan for 1994-1998 was held on 20th October 1993 in Montreal.

Present: Mr M F Broughton, Mr U G V Herter, Mr D P Allvey, Mr P Crawford, Mr B L Levitt, Mr R Guyatt, Miss H C Barton (Secretary)

1993 Forecast

1. The Quarter 3 result to be published on 29th October will show earnings per share up 7% year to date. This is at the top end of the expected range and will result in more pressure on the full year forecast. The cash flow is strong.

Canada Trust

2. Much work has been done in Canada Trust (CT) on cost control and productivity. There are fewer staff now than there were two years ago and numbers will continue to be driven down in 1994. So far, the staff reduction has been achieved through natural wastage but it is possible that there may need to be a managed voluntary redundancy and early retirement programme soon. Any one-off cost of such a programme is not included in the Preview figures. The on-going cost savings from the staff number reduction is being used to fund growth, for example, 20 new branches have been opened and telebanking introduced.

3. The Canadian trust industry has been consolidating and it is assumed that Montreal Trust (MT) and National Trust (NT) will be sold at some time in the future.

4. Imasco has studied MT but concluded that the business is unlikely to be worth much more than C$200m, although Bell has invested C$1bn in it. MT's main franchise is the corporate trust business which is not very profitable and which was sold to MT by CT. MT has 60 branches with little deposit business outside Montreal and is therefore of little interest to CT.

5. NT's franchise is in smaller towns and therefore it has low growth prospects. It has a good name in the personal wealth trustee business. The business does not have sufficient scale as a stand-alone operation, and it has not invested in information technology. However it does not have asset quality problems. The acquisition of NT would build CT's market share, presence and scale in Ontario particularly and also in Alberta and British Colombia. There would be cost reduction and synergy opportunities. It is probably worth C$800m to C$900m for C$15bn assets. NT is owned by Mr Jackman, the Lieutenant-General of Ontario, who may be interested in selling NT for a mixture of cash and Imasco equity, and may possibly be interested in having a seat on the board of Imasco.

6. Imasco tried to acquire bank status for CT but withdrew in the face of government opposition. CT is already a primary clearer and part of the banking establishment, however it does not suffer from the generally negative consumer perception of banks. Imasco is aware of at least two banks which would be interested in acquiring CT if it were for sale.

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7. CT is refocusing on its core retail banking business and getting out of some peripheral businesses, such as property. In 1992 CT updated its marketing approach based on customer segmentation, and now it is maintaining its market share having lost share for the past three years. It has been successful in attracting cheque accounts. Commercial lending is also being de-emphasised with a move to statistical assessment rather than credit assessment.

8. Sales of mutual funds have been good. CT's mutual funds invest in equities and bonds rather than mortgages and money market instruments. They are "bought" rather than "sold" products, and the role of the branch staff, reinforced by their incentives, is to provide service and information. The mutual funds are "no load" products with ½% fee. Guaranteed return products are also sold which guarantee a 3% return plus ½ of any equity gain.

9. CT has a pensions custody business which will probably not be competitive in the future with the global custodians. The other large Canadian custodian is Royal Trust. CT will put together a proposal over the next few months to merge their business with that of Royal Trust in order to create a business of global scale.

10. Telebanking is working well and there are now about 25,000 customers. There is a plan to open a second centre in New Brunswick which will provide disaster recovery and has the advantage of bi-lingual employees. Mr Crawford will send to Mr Broughton a report on the investment and returns from this project when it is available.

11. The level of non-performing loans is reducing and the large cases have been resolved. The pattern of provisions in 1993 is C$45m in Q1, C$45m in Q2 and C$40m in Q3. Imasco is much more confident about the projected $125m provision in the 1994 Preview than it was about the C$100m provision in the 1993 Plan, and it does not expect the 1995 provision to be higher than 1994.

12. In summary, the underlying trends for CT are positive: provisions are expected to be lower, expenses will be lower, the economy will be recovering and the mortgage market is likely to improve. However a growth target of 15% may be unrealistic with low levels of inflation.

<u>First Federal</u>

13. First Federal (FF) has been reoriented from survival to growth. It has always had tight expense control and is now considering its positioning, segmentation, and which customers are being lost and why. The mortgage portfolio has recently been churning at 30% p.a. as customers refinance their borrowings at lower interest rates. Bad debt experience since 1989 has been good.

14. The only other Canadian bank that is expanding its US presence is Bank of Montreal. FF's expansion into the US is important to Imasco because there is scope for growth. FF is seeking to strengthen its position in New York State. Buying branches means buying premises, staff and deposits. It is not a major drawback when buying branches if the IT systems are not the same. This is more important if whole companies are being bought.

15. Imasco is not interested in acquiring Confederation Life's business in Canada. It has a lot of real estate, is under-reserved, has no sales force, and is dependent on large group cases that are low margin and volatile.

Genstar

16. The earnings of Genstar are very difficult to forecast. It is a long cycle business, the results this year depend on decisions made at least five years ago. The long term growth prospects are reasonably good rather than exciting. It has a balanced portfolio and the plans are constructed on a very conservative basis. It is a very focused, stand-alone business with 70 employees. It provides a good return, only once in the last six years has it been cash negative. It is no distraction to Imasco's management, and it is unlikely that it could be sold for its true value.

17. The pensions litigation case has been settled. Imasco has provided C$50m pre-tax, C$42 net of tax, which may be on the high side. This provision was taken as a prior year adjustment in BAT's 1992 Accounts.

UCS

18. UCS has 500 locations (150 of which are called Woolco, and there is a variety of other names, including "Transit") which sell tobacco, magazines, T-shirts, etc. Tobacco is a decreasing proportion of the business as a result of the growth of transit. Costs have been reduced through reorganisation, "shrink" has been tackled, and stores which lose money are being closed. Den for Men, which is responsible for approximately C$2m of the total UCS loss of C$2.3m forecast for 1993, will be closed as soon as possible. Duty Free business is being built up, with a shop opening in Vancouver airport later in 1993.

Shoppers Drug Mart

19. The sales mix is changing as Tobacco sales fall as a result of the growth of transit. Prescriptions account for about 30% of sales and are increasing by about 1 percentage point per annum. Shoppers is the only national brand in healthcare. However, there are severe margin pressures on the prescription business. 40% is government funded and a high proportion of the remainder is funded by companies. Both the government and companies are seeking to reduce their costs in this area. Shoppers has locations near most employers and is considering the introduction of a management service for employers to help them to control the drugs cost for their employees.

20. Non-performing stores, in malls and free-standing, are being closed. New locations and independent stores are being acquired. Post Offices are being opened within stores. The direct profit on this is small but the main objective is to increase the traffic in the stores and the challenge is to generate extra profits from this traffic.

21. Shoppers is the biggest retailer of cosmetics in Canada by far, hence the shops are oriented towards women. Building on this, convenience foods have been added and hours have been extended.

22. The introduction of private label has been successful, though Life more so than Realto. Private label is much less important in Canada than it is in UK supermarkets. Shoppers aim is to carry the two top brands and one private label.

23. Point of sale technology is complex because of the 700 franchise units. Where it has been installed, margins and labour costs have been improved. However it will not be rolled out quickly until the strategic review has been completed.

24. The objective of the strategic review is to make the existing business more productive and efficient, with respect to the buying, distribution and organisation of the stores. The operations are currently decentralised, including the book-keeping and the buying. The review is being conducted with Monitor and is due to be completed Q2 1994.

<u>Imperial Tobacco</u>

25. The underlying long term decline in smoking in Canada mirrors that in the US, overlaid with one-off dips from tax increases followed by a gradual recovery. Smuggling is close to 50% of the market in some areas. In Ontario it is 25% and growing. Imperial Tobacco (ITL) has been explaining to the Liberals the problems arising from the growth of the underground economy and has been lobbying them to roll back tobacco taxes. However tobacco taxes are an extremely important part of government revenue, and in view of the deficits of the federal and provincial governments, are unlikely to be reduced. The main problem is the differential between US and Canadian taxes. Therefore the situation in Canada will be improved if US tobacco taxes are increased, although a 75 cent increase would be too small to make very much difference.

26. ITL was pleased to obtain leave to appeal against the Tobacco Product Control Act. However a decision is needed soon, or ITL will start to incur cost on the changes that are needed by next March.

27. ITL is forecasting that it will achieve plan in 1993 as its share of export business has risen from 30% to 50%, although this is still lower than its domestic market share. A 7% price increase was taken in 1993. A further 4% to 5% is planned for 1194 against an inflation forecast of 1½%. Mr Herter commented that this pricing strategy might be dangerous as it might drive more people to buy transit products.

28. ITL will be conducting a major strategic review over the first half of 1994. Since ITL's dominant preoccupation has always been market share, this review will focus on costs, for example, cost by product and distribution costs. It will also consider the profitability of the smaller products and whether it is necessary to keep open the second manufacturing plant to produce them.

29. The other major issue in ITL is its culture and management process. The functional organisation has been fairly slow to respond in the past and has forced all trade-off decisions to the top. As the market is moving more quickly now and the situation is more complicated, the process needs to be changed so that the whole senior management team is involved in major decisions.

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30. The DIET plant has been suspended as the market demand has fallen with the growth of transit products. It may be resurrected at some point in the future to provide product for all the Canadian manufacturers but only if there is a good financial case for this. ITL has just made an investment in its leaf processing plant. Mr Herter noted that there is spare capacity in the very modern plant in Wilson which may be of use to ITL.

Hardees

31. Hardees has outperformed Imasco's expectations in 1993, with additional contribution from new products and reduced corporate overhead costs, although the gross margin in the restaurants is down.

32. Imasco considers that there is still potential to improve Hardees profits from approximately C$100m to C$150m over the next two years. A segmentation exercise is being carried out to enable more sophisticated marketing to be used as a result of a better understanding of the target customers. In addition work will be done in the first half of 1994 on costs, production methods and locations. The proposals from this work will be tested in the second half of 1994 and rolled out in 1995. This should provide a lift to the profits.

33. 29% of restaurants are co-owned, the rest are franchised. It may be possible to sell the co-owned restaurants to the franchisees and invest the capital released where penetration is low.

34. FFM produces a consistent profit and return. It has highly efficient distribution and manufactures in three plants. It may be possible in the future to outsource and release capital from these plants. It may be possible to split distribution from manufacturing and sell both parts of the business separately, with a commitment from the restaurants.

Progress against long term objectives

35. Imasco continues to outperform its benchmarks for shareholder return. It is expected that the dividend will continue to increase at least as fast as the consumer price index. Mr Broughton commented that this objective is less demanding than BAT's dividend objective. The target 15% growth in earnings per share will not be achieve in 1993 but 14% is projected for 1994 and 17% for 1995. 15% is challenging at low levels of inflation. It may be better to set a "real" objective. It is expected that the cash flow objective will be achieved in 1993 and 1994. The debt/equity ratio tends to improve each year towards its target, but occasionally to be set back again by a management action such as an acquisition. Progress will be made towards the 15% return on equity target during 1994 and it is expected that it will be achieved by the end of 1995.

H C Barton
4th November 1993

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