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Minutes of a meeting held in Windsor House on Thursday 12th August 1993 to discuss cost reduction opportunities in the Tobacco business.

Present: Mr U G V Herter, Mr D P Allvey, Mr B D Bramley, Mr D Brown (part of the meeting), Mr A Monteiro de Castro, Mr E E Ettedgui, Mr E E Kohnhorst, Mr C Schoenbachler, Dr B Schweitzer, Miss H C Barton

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1. Mr Herter introduced the meeting by saying that he had called for the meeting as a result of the price war in the US, which could develop into a wider issue with competitors cutting prices to regain market share in similar situations in other countries. BAT can survive a price war only if we are the low cost provider. In addition we have a commitment to shareholders to grow profits by cutting costs wherever possible.

2. All members commented that there are numerous case studies of price wars in different countries around the world from which we could learn. It was also agreed that we should be pro-active in identifying markets at danger from price wars in order to take proactive steps if possible. Miss Barton will work with Mr Bingham to produce a paper for the TSG in December, setting out case histories and lessons to be learned from them, and analysing potential areas of risk.

3. Mr Schoenbachler explained the background to the developments in the US market since "Marlboro Friday". VFM market share had accelerated from 30% at the end of 1992 to 40% by May 1993. The actions since then have completely changed this trend, which is now flat at best. Marlboro has increased its market share by 3 or 4 share points. Winston picked up slightly but in general the weaker brands have either not gained or have lost market share.

4. In the period from late March to late May, Basic gained market share by being heavily promoted and discounted with a wide margin for distributors.

5. The brand which has gained most from the price cut is Marlboro, and Philip Morris has gained 1.43% net market share increase. The main brand losers were private label, Cambridge, Best Value, Merit and Virginia Slims. B&W, Liggett and Lorillard have all lost net market share.

6. There is now a two tier market with list prices of $10.79 and $8.09. By announcing and then reversing a decision to reduce VFM prices by $1.15, Philip Morris have demonstrated that they will take whatever actions are necessary to defend their market share. Therefore it is expected that if the level of discounting, and the share of VFM, increase, PM will react forcibly.

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7. Other price wars appear to happen where the differential between FR and VFM is too wide, or where the rate of return is too high, or where a competitor wants to gain market share. For example, duty free is vulnerable because margins are very high.

8. Each market has its own perception of the acceptable margin which depends on the absolute price level, the competitive environment, and whether the economy is in recession.

Profit Outlook for 1993

9. Mr Bramley reported that the July forecast for BATCo would be available next week. The June forecast of £584m PBIT has downsides of about £20m (Asia Pacific North, property sales, Spain), and some possible upsides.

10. Dr Schweitzer reported that the BATCF budget of DM 269.6m had been reduced in two stages. In the first stage the fall in volumes resulted in DM 88m lower profits, offset by DM 49.5m cost reductions. In the second stage, volumes fell further to reduce profits by an additional DM 81m offset by cost reductions of DM 35.7m. Therefore the latest forecast is DM 185.5m. DM 38m of the cost reduction is from Marketing.

11. On top of this, there are downsides of DM 8m from the forecast 2bn sales to Iran, an additional DM 2.5m costs for opening up East Europe, DM 12m accounts receivable at risk in Iran, and the weakness of the Italian lira. A small offset is DM 2m reduced depreciation on lower capital expenditure.

12. BATCF's market share is steady but the market is down as a result of rolls and transit (estimated at 15bn, 12% market share and growing). Generics are not growing as consumers still prefer brands.

13. Dr Schweitzer reported the rumoured possibility of the launch of a Camel refill pack for a re-usable plastic box. This would have the advantage of appealing to environmental concerns and allow a lower price equivalent to that of West (which would not be fully justified by the lower costs). It would be difficult for vending machines (30% of the market) and food stores, but would work in tobacconists.

14. Mr Castro reported that the latest forecast for Souza Cruz is expected to be $270m, which is $2m lower than the last forecast but $2m higher than budget. The improvements of $20m for prices of 84c vs. 82c, $12m from taxes not being raised, $4m from a 2 month delay in the transition tax and $2m additional cost reductions, are offset by lower domestic and export cigarette volumes and lower Leaf exports at lower prices.

15. Mr Schoenbachler reported that the latest forecast for B&W was likely to fall from $369.5m to $367.4m (against $887m in 1992). The $520m year on year decline is due to $274m from eliminating the trade load, $50m increase in Marketing, $25m

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increase in selling field, and approximately $170m from lower US domestic volumes and poorer mix.

16. After declining by 25% in the second half of 1992, Kool has held market share, or even slightly increased share in the first half of 1993 as a result of its support. There could be some upside in the domestic forecasts for Kool and GPC.

Cost Reduction Programmes

17. Dr Schweitzer reported that the guideline to return to 1992 profit levels i.e. DM 228m. adjusted for DM 27m from B&H, was very challenging. 1992 was exceptionally good for exports and the Iran business and benefitted from DM 20m Berlin preference. There is a risk of a price war in Germany as Reynolds and Rothmans are both losing share.

18. New cost reduction programmes include:

   - outsourcing some of the jobs in the field force such as checking vending machines, simple mechandising. This could also increase efficiency by concentrating the field force on selling. It should save DM 10m p.a. from 1995 onwards. In Germany, Proctor & Gamble are experimenting with outsourcing the whole field force by selling it to a merchandiser and leasing it back on better terms. These could be interesting ideas for BATCo in Europe;

   - integrating R&D into Beyreuth;

   - considering closing Berlin and putting the production into Beyreuth. This would make sense only if volume projections were below 55bn and depends on the outcome of the European Manufacturing Location Strategy.

19. The possibility of moving the head quarters from Hamburg to Beyreuth was discussed but felt to be a lower priority for consideration as Beyreuth has poor transport connections and would not be attractive to top quality Marketing staff.

20. Mr Castro reported that the head count in Souza Cruz has fallen from 18,297 in December 1990 to 15,918 in December 1992 and is projected to fall to 13,881 by December 1993. Three plants have been closed, Pirahy has been focused on cigarette paper, sales depots have been centralised and the head count in Leaf and Finance departments has been reduced. Mr Castro believes that it will be possible to reduce the head count to below 10,000 in 2 to 3 years.

21. Future cost reduction opportunities include closing another plant and rationalising head quarters.

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22. Mr Kohnhorst reported on the progress made on the review of research resources. Our R&D resource is not out of line with that of our competitors. There is good short term co-ordination through the world-wide best programme which is Marketing driven. There is also an integrated approach to technological developments. However there are still areas which remain uncoordinated.

23. Mr Schoenbachler explained that McKinseys are about to start the performance diagnostic element of an organisation structure and efficiency review. This will cover:

    - the gap between B&W's performance, that of competitors, and shareholder expectations;

    - sales and marketing, for example, the efficiency and effectiveness of paying for space in stores, sales force calls, HQ support;

    - operations, including manufacturing productivity, logistics and overheads;

    - corporate HQ.

    As well as a functional review, cross functional opportunities will be sought. The diagnostic will use approximately 8 B&W and 8 McKinsey staff and will take 3½ months and the implementation 6 to 18 months. McKinsey estimate as a rough order of magnitude, based on similar projects, that there could be savings in excess of $100m.

24. Mr Kohnhorst presented Project Core which is looking for breakthrough product cost reductions, by challenging conventional thinking while maintaining smoking quality and consumer acceptance. Initiatives are expected to reduce costs cumulatively by $200m over the next four years.

25. Mr Brown expressed the opinion that the US Leaf ~~import restrictions~~ are contrary to GATT and NAFTA. There is a possibility that they were included in the Budget package for political reasons and will not be applied.

26. Imperial Tobacco is forecasting to be C$14m below plan in 1993, and to come back to plan in 1994, although with a wide range of uncertainty. The market is very close to a price war over re-imports. The legislative reaction to tax avoidance is difficult to predict. Mr Bramley will investigate the possibility of manufacturing for the Canadian market in Southampton.

27. Imperial Tobacco is down to two manufacturing plants, one efficient and one less efficient as a result of its mix of production. Plans are being made to take advantage of the likely attrition of 100 people p.a. The number of brands and brand packs is being reviewed. Two thirds of advertising costs are sponsorship and this is being

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reduced carefully to the level necessary to maintain/grow market share. A.T. Kearney are investigating the costs of logistics.

28. Mr Bramley reported that BATCo have the objective of reducing the fixed and semi-variable costs per mille (excluding depreciation and advertising) by 5% p.a. in real terms, and the plans show that this will be achieved. His main concern is the cost of headquarters (Millbank costs £60m p.a.) and there may be lessons to be learned from B&W here. This will be addressed when Project Rubicon has settled down.

29. There are cost reduction opportunities in the rationalisation of Central American Leaf operations and factories. A strategy paper is being prepared on the Caribbean but the opportunities would require a change of policy by B.A.T Industries. This also applies to factory rationalisation in Africa. The smaller plants in Europe (Brussels, Cyprus, Canaries and Finland) are being examined, as are possible rationalisations between BAT China and Hong Kong, and countries where we have adjacent GLT plants.

30. It may be cost effective to exit from Leaf in some markets. There could be opportunities by making more Group purchases through Millbank. There are many markets where our facilities could be down-sized, for example, Argentina, Venezuela, Asia Pacific, Australia and the Sub-Continent and work has already started in some of these areas.

31. BATCo has £500m margin between the factory and the retailer, some of which it may be possible to claw back, for example, by having fewer distributors. In Australia warehousing, delivery and cars are being contracted out. Surplus assets could be sold.

32. There are some opportunities which should be discussed at the September meeting, for example, that there are more management layers above than below the GMs, and the duplication of export offices.

33. Mr Herter summarised by saying that he was reassured by ~~the level of attention~~ being paid to costs. There are no taboos and opportunities must be identified across the Group not just within the Operating Groups. If we can make cost savings by reorganising this will be discussed in September.

Capital Expenditure

34. Mr Herter explained that it was necessary to re-examine our capital expenditure particularly for increased capacity in the light of lower domestic market and export growth projections.

35. Mr Kohnhorst showed the B&W latest volume forecast for 1998 of 117.5bn, which is well below last year's plan. Hence the capital expenditure priorities are to achieve maximum flexibility at minimum cost, to phase expenditure and to make contingency

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plans. The key mix issues of box, menthol/redried and export/domestic are being addressed, and cost reduction is being accelerated.

36. The costs of phase 1 of the Macon expansion have been cut by $20-25m, the capacity has been reduced by 25bn to 130-135bn (expandable to 165bn) and product advantages (redrying leading to greater uniformity, lower foreign matter, and less downtime for cleaning) have been achieved.

37. The total cost for all four phases has been reduced from $342.7m to $257.3m.

38. ELT does not run 24 hours, 3 shifts. It could have surplus capacity by extending hours with some changes to manning levels. Monk in Guatemala ships dried whole Leaf to US for GLT. This may be an opportunity for BAT. There may be surplus capacity between ELT and Souza Cruz. Mr Bramley will ask Mr Snowden to investigate this with Mr Harrison and Mr Benneman.

39. Mr Castro reported that $24m capital expenditure in Souza Cruz has been postponed in 1993 because of lower volume projections both in the domestic and export markets. At least $10m will also be postponed in 1994. Souza Cruz has excess capacity today such that it could operate solely with Uberlandia. Closing additional plants is politically difficult and therefore excess capacity is likely to continue for some time.

40. Dr Schweitzer reported that DM 68m capital expenditure in BATCF was for rationalisation and automation projects and not for increased capacity. Some capital expenditure decisions have been deferred and are now currently on two shifts, and capacity could be increased further by moving to three shifts.

41. Mr Bramley reported that the sales forecasts for the Southampton factory are well down and not just for Asia Pacific North. Various options are being considered, such as the phasing of capital expenditure in Southampton or closing other plants more quickly. The blended line has been delayed by two years, although this may need to be brought forward again if other plants are closed, or if some Virginia brands move more to a blended product. Mr Herter stressed that we would need to look across the Group for blended capacity before investing in Southampton.

42. Mr Herter asked Mr Kohnhorst to update the Group view of capacity as quickly as possible and at the latest for the TSG meeting in December. This is needed to review the individual Operating Group plans. Mr Kohnhorst said that this was already being prepared as part of the disaster recovery exercise, but it will be accelerated.

43. Mr Bramley will ask Mr Davis to update, in parallel, the work on the standardisation of production particularly of IBs. This needs to be a joint Manufacturing/Marketing initiative, and the proposal is not to change everything now but to move towards standardisation. Mr Bramley will also ask Mr Beck whether the procedures for Group ordering of machinery from major suppliers is working satisfactorily.

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Accounts Receivable and Inventories

44. Mr Bramley reported that BATCo's Debtors and Stocks increased from £0.88bn at the end of 1991 to £1.18bn at the end of 1992. The increase of £300m was made up of: £119m currency movements; £123m stocks (new companies, closing factories, leaf stocks for export, correct leaf durations and raw materials for exports); and £58m debtors (VAT, new companies, increased cigarette prices), i.e. nothing particularly unusual.

45. The major item is Stocks which are expected to be only 1% higher in 1993 than 1992 and are likely to fall next year. Stock turnover is forecast to increase from 2.7 in 1992 to 3.1 in 1993, and debtor turnover to improve from 5.9 to 8.0.

46. Dr Schweitzer reported that BATCF was cutting down Leaf purchases to bring duration back to 12 months. Finished goods stocks stand at 14 days as usual and A/R at 48 hours. All exports are for cash up front with the exception of the DM 12m debt in Iran.

47. Mr Castro reported no problems with debtors in Souza Cruz which stand at about 4 days. However there is a huge problem with Leaf, with increased Leaf production, lower domestic cigarette sales and lower Leaf exports. The latest crop was 240k tonnes against the 226k tonnes planned, however the price paid was that contracted for 226k tonnes. The duration has moved from less than 12 months in 1991 to 24 months now.

48. Souza Cruz is contracted to buy 179k tonnes in 1994 which has resulted in many complaints, but this will bring the duration back to only 21 months. There is a danger that farmers who stop growing Tobacco will not start again even if it is needed in the future.

49. Mr Bramley will ask Mr Snowden to review the forecasts for real demand for Leaf in order to give better central guidance. In addition the Leaf Directors will be asked to review how much Tobacco is being brought from outside the Group, and the prices being charged to Group as opposed to third party customers.

50. Mr Schoenbachler explained that B&W must declare its domestic Tobacco purchase requirements one year ahead. It then has to buy 90% of its forecast or pay a penalty. B&W is currently evaluating the financial effects of buying 90% or paying the penalty. It is also evaluating reducing its duration and taking the risk on being able to buy Leaf as necessary from dealers.

51. B&W's A/R are forecast to fall from above $200m at the end of 1992 to $50m at the end of 1993 as a result of the de-loading in the domestic market. ½% discount is given for paying within 2 weeks. This is expensive but it reduces the risk from the trade which is in financial difficulties. $131m of the $154m international A/R is with

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Sumitomo in Japan. This could be reduced but only by selling less in Japan. $10m A/R translates into $5m trading profit.

52. Mr Herter summarised the meeting by saying that he believed that there was much value from the cross-fertilisation of ideas. It may be possible to use the McKinsey approach in other parts of the Group. There may be further scope for capital expenditure reductions as volume projections are still high. It was confirmed that there will be a TSG meeting in September to discuss further the Group co-ordination issues.

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