<u>NO COPIES MAY BE MADE</u> <u>SECRET</u>

<u>Tobacco Strategy Group</u>

A meeting of the Tobacco Strategy Group was held on Wednesday, 2nd December, 1992.

Present: Mr U.G.V. Herter, Mr D.P. Allvey (morning only), Mr B.D. Bramley, Mr D. Brown, Mr A. Monteiro de Castro, Mr J-L. Mercier, Mr R.J. Pritchard, Mr T.E. Sandefur, Dr B. Schweitzer, Miss H.C. Barton (Secretary).

Mr F. de Andrade was present throughout the meeting. Mr D.G. Stevens was present for items 4 to 6, Mr N.G. Brookes for items 15 to 21 and 41 to 44, Mr K. Dunt for items 30 to 35, Mr N. Davis for items 45 to 47, and Mr S.P. Chalfen for items 48 and 49.

<u>Minutes of the Previous Meeting/Matters Arising</u>

1. Mr Herter welcomed Mr Brown as a new member of the Tobacco Strategy Group (TSG), and Mr Andrade who would present the Conference on Sales and Distribution.

2. All matters arising were covered on the Agenda except:
   - France (minute 7) - Mr Rembiszewski will reassess the approach to France once the outcome of project Talisman is clear;
   - Leaf Trading Project (minute 33) - Mr Pritchard will report on this project at the next TSG meeting in February;
   - Manufacturing Quality Control (minute 40) and R&D/Technology (minute 41) - Mr Kohnhorst will make proposals at the next TSG meeting;
   - Appraisal systems (minute 51) - Mr Stevens will report at the next TSG meeting.

3. Mr Bramley noted some amendments to the previous minutes:
   - minute 14 - Mr Rembiszewski is not a member of the senior international managers group;
   - minute 32 - BATCo does not have a paper on counterfeit;
   - minute 46 - Leaf contract guidelines have been produced but not yet issued;
   - minute 49 - Mr Bramley remarked on the higher proportion of young managers in the inter-company <u>transfer scheme.</u> need [illegible]

4. Management Development and Training: Mr Stevens reported on the first Leaf Core (Level II) and Production (Level I) programmes which had been very successful, and the preparations for the first Marketing (Level I) and Finance (Level I) programmes which were well advanced.

5. Only four nominations have been received so far for the various Leaf modules (Level I) commencing in 1993. Mr Herter asked all members to remind their managers to make nominations direct to Brazil by 1st February 1993.

502578690

6. Mr Herter proposed that:
   - Induction training should be given within the Operating Groups;
   - The four functional training programmes should be supported and developed at Levels I and II since they are Tobacco specific;
   - Mr Stevens should assess the appropriateness and feasibility of using parts of the functional programmes for other specialists;
   - Mr Bramley should address the training of Personnel specialists through the annual Human Resources meeting;
   - Functional programmes at Level III are not necessary since they would be too repetitive;
   - Level III should be an SMP/MDP combined programme, addressing the whole business, covering all disciplines, Tobacco-oriented, giving a Group-wide perspective, to be used as the foundation for future general managers and senior functional specialists;
   - Mr Stevens should make a proposal on design and content of the Level III programme to the next TSG meeting, to be announced in mid-1993 for implementation in early 1994.

7. High Leaf Costs: Mr Castro presented a cost comparison of Brazilian and Chilean Burley tobacco. This showed that the average export prices of lamina plus stem were within 5% of one another.

8. Career Development for Blenders: Mr Sandefur reported that the benchmarking with tea blenders had shown a high correlation but few lessons had been learned since in general Tobacco blending was more sophisticated. Cocoa will be benchmarked next. Mr Mercier suggested that benchmarking against wine/champagne would be useful. Mr Herter commented that as we have few blenders for the size of Group, it is important not to lose those we have. He asked all members to ensure that:
   - if there are no career opportunities for them, blenders are paid well as specialists;
   - they should be seen more as product developers and have a much better knowledge of the total product including R&D;
   - where there are no or few blenders in the training phase, a long term recruitment plan must be drawn up.

9. Review of Tobacco Results and 1992 Forecast: Mr Allvey presented the actual results for the first three quarters and the results that must be achieved in the fourth quarter if the full year forecast is to be achieved. Brown & Williamson, BATCo and ITL were fairly confident of achieving the forecast. BATCF may be slightly below forecast. However, forecasting in Germany is particularly difficult at the moment due to the uncertainties arising from the recent price rise, the imminent launch of tobacco rolls, the tax increase in January, the price reduction of Winston, the recently ended strike in Italy and a possible slowing in exports to Eastern Europe. The Souza Cruz profit forecast is expected to be achieved despite the Brazilian market shrinking by even more than forecast.

<u>Progress Reports</u>

10. Competitors: Mr Brown reported that Philip Morris is rumoured to be very disenchanted with Rothmans in Canada, and Mr Sandefur reported a major rift between Philip Morris and Rothmans in Malaysia.

502578691

11. In Brazil, Mr Castro reported that L&M Lights had achieved a market share of 5.7% by the end of September. Viceroy Box was launched at the end of October. Philip Morris are trying to reduce the price categories of both Marlboro and L&M, meanwhile the prices of all categories are rising. Their strategy seems to be to win market share by positioning their brands in low price categories but meanwhile pricing up the whole market.

12. Mr Bramley reported that L&M had been launched in both Venezuela and Argentina.

13. In the US domestic market, Mr Sandefur reported that Philip Morris are pursuing higher margins in the full revenue segment but are aggressively seeking market share in VFM. The list price is misleading since the use of money-off coupons is accelerating again. Marlboro Medium has achieved a market share of 1.4% but more than 80% is cannibalisation. Marlboro total is expected to lose 0.9% market share in 1992. He believes that there is an opportunity for Marlboro Medium in Germany to fill a product gap.

14. Dr Schweitzer reported that R.J. Reynolds are being aggressive on price in Germany, although they have not been successful to date. They are promoting Salem in the Far East and low margin brands in Eastern Europe. Mr Sandefur believes that they will continue to use the Joe Camel advertisements in the US, that Camel Wides have not been a success in the US, and that Camel Milds have not been a success in Germany.

15. New Markets: Mr Brookes outlined the resources available within the New Business Development (NBD) team and the considerable range and scale of opportunities that they are trying to cover. The policy is to keep the Windsor House team, which assesses the opportunities, small and to call on resources from the Operating Groups to take the projects through. These resources are very stretched especially in BATCF, and more and higher quality support is needed for NBD.

16. The ideal situation is for there to be a team of approximately five top quality, experienced BAT managers (general manager, production, marketing, sales, finance) for each project. The team would make a detailed evaluation of the opportunity very quickly and then manage the investment if it goes ahead. In practice this is extremely difficult to achieve since it is very difficult to extract key managers at short notice without knowing whether they need to be replaced permanently. ~~In the immediate future,~~ Mr Bramley will provide a team to evaluate the opportunity in Kazakhstan.

17. Mr Brookes reported progress in the priority markets.

18. Cuba: Mr Castro reported that two trips had been made to Cuba and support had been offered on Leaf and production. Two Cubans are currently visiting Souza Cruz.

19. Philippines: Mr Pritchard reported plans to develop soft cup offerings. The possibility of acquiring all or part of a local manufacturer will be revisited.

20. Iran: Dr Schweitzer reported on the proposal that has been approved by the CPC. Representatives of the Iranian monopoly will be at BATCF later this week.

502578692

21. **Exports to Central/Eastern Europe:** Dr Schweitzer reported that the fall in value of the rouble against the dollar was resulting in a slow down of German exports to Russia. Orders are still being received but payment is slower. Brown & Williamson and Souza Cruz have not observed a slow down, but Souza Cruz is constrained by box capacity for Hollywood.

22. **USTB and UKIB:** These reports were taken as read. Questions should be addressed to Mr Pritchard or Mr Bramley.

Marketing

23. **Competitor Analysis:** Mr Allvey's proposal was accepted with a few minor modifications. The responsibility for Greece will switch to BATCF. The Andean Pact and Mercosur markets should be covered. Mr Allvey will consider whether the responsibility for the regional analysis for Europe should switch to BATCF. Reemtsma is regionally important. Whether it is important enough to be included in this analysis should be reconsidered next year. Scandinavia should be included, with BATCo having the responsibility. Seita and Tabacalera should be included in less detail, and the Italian monopoly should be covered as part of Italy.

DAH review

24. **Study of Export Profitability:** Mr Allvey tabled a detailed report on export profitability. This information is not readily available and different definitions are used. He cautioned that the figures have not been adjusted to a common basis, and the report does not cover the whole of the Group. However the report still gives an extremely useful insight into export profitability and pointers to more detailed examination.

25. The report shows that some exports are made at a loss, others at contribution per mille of less than $1, and others at a contribution that would not cover any fixed cost allocation. Exports have now become too large a part of our total business to be conducted generally on a marginal basis. There may be justified cases where we are investing in a market or where the business can only be achieved at marginal prices, provided that they are profitable on this basis. Each market must be assessed individually and strategies put in place to improve profitability where possible. In some markets, low price brands may be necessary as part of a "basket" including high price brands. In general where brands have been introduced at a low price it has proved more difficult than expected to increase the price at a later date. If business can be done only on a ~~marginal basis,~~ the business must be managed on a marginal basis, with no fixed costs. Mr Herter pointed out that investment in manufacturing capacity was unlikely to be justified for sales at $10/mille.

26. Mr Herter proposed that;
   - all members should study the report, discuss it in their Operating Groups and give to Mr Allvey their ideas for future improvements/analysis/focus;
   - Mr Allvey should refine the report to include these ideas, make the figures more consistent, and add information on the investment behind each brand;
   - the report should be updated annually.

502578693

27. **Dr Schweitzer** asked for guidance on which export markets were available for BATCF exports. **Mr Herter** said that, with respect to exports to China, Korea and Taiwan, BATCF must go through the BATCo/Brown & Williamson organisation that has just been set up there, who would evaluate whether there were opportunities for BATCF brands. It was agreed that, as far as export growth is concerned, the Guidelines would have to be more specifically tailored to each operating Group. The starting point should be an analysis of and plan for each market, setting out the best use of Group resources. A plan for the profitability of each market would then assist in agreeing the brand strategy for that market. The objectives, strategies, plans and forecasts for each market can then be fed back into the Operating Group Guidelines and Plans. **Mr Herter** suggested that the Guidelines and Plans should be constructed this way in 1993.

28. **Brand Evaluation Model:** Mr Bramley reported that the seminar on Brand Evaluation had been successful. All companies will use the technique during 1993, and in the 199~~6~~ 4 1998 Plan.

29. **Excise Strategy:** The Excise Taxation manual will be distributed to all members as soon as it is completed which will be before the next TSG meeting.

30. **Andean Pact:** Mr Dunt made a presentation on the opportunities for BAT in the Andean Pact territories. He reported that Venezuela and Colombia are moving faster than Ecuador, Bolivia and Peru to lower tariffs. In his opinion the Andean Pact Common Market will only be operational in the medium term between Venezuela and Colombia, with a subsequent agreement being signed with Mexico as a further step in the G3 grouping. As BAT has a company in Venezuela, the main immediate focus for the Group must be Colombia. The Colombian market is by far the largest in the Andean Pact at 31.2bn and a very high proportion is Duty Not Paid. BAT has a near 10% market share in the Andean Pact net of Venezuela, PM 13% and local manufacturers 77%. This market share presence can be improved upon. The possibilities of acquiring either Protabaco in Colombia or El Progreso in Ecuador are a secondary priority after focusing the Group's brand portfolio and efforts in a more concerted fashion.

31. It was agreed that:
    - the approach to the Andean Pact markets must be brand/market driven not manufacturer driven;
    - the brand portfolio needs to be more focused: High price - Lucky ~~Strike, Kent~~, Kool; Medium price - Hollywood, Belmont, Viceroy; Low price - Minister, and Consul if necessary;
    - the trademark problems must be resolved. The action being taken is endorsed;
    - the group manufacturers must share a common infrastructure;
    - one person must be accountable for the Colombian market. A joint proposal is to be made to the next TSG meeting supported by BATCo, Brown & Williamson and Souza Cruz.

32. **Mercosul/Uruguay:** The possible acquisition of Monte Paz in Uruguay was discussed. It was agreed that BAT did not need the manufacturing capacity (the closure of which might cause political problems) and therefore what would be bought is local brands and distribution. Citibank valued the business at $55m assuming the continuation of current profit levels and including Leaf inventory and a printing company that are not needed. The value of the business should be recalculated in the light of Mercosul and compared with increasing exports of BAT's own brands into Uruguay. Monte Paz owns many Souza Cruz brands in Uruguay. It is not yet clear whether they will be able to export these brands from Uruguay to Brazil within Mercosul. If this is possible it will be a real threat to Souza Cruz.

33. Booz Allen made recommendations about rationalisation opportunities between Souza Cruz and Nobleza-Piccardo. Task forces have been set up to validate the figures behind these recommendations. There are opportunities to sell Souza Cruz brands in Argentina and Nobleza-Piccardo brands in Brazil, but it is a higher priority for both companies to address the challenge from Philip Morris. The unsatisfactory trademark position is being worked on. A progress report will be made to the TSG meeting in May 1993.

34. **NAFTA:** Mr Pritchard reported that NAFTA is expected to come into force on 1st January 1994 as scheduled. The US and Mexican negotiators reached agreement on the cigarette rule of origin which requires that the cost of offshore tobacco including oriental not exceed 9% of the declared export value. Even with the 50% tariff (declining gradually to zero over 10 years), B&W export cigarettes should be able to compete with the premium brands in Mexico. However it is a large market and early entry and considerable investment will be needed, therefore it is not expected that significant profits will be made for eight or nine years. Mr Sandefur will report to the next TSG meeting on the preparations being made by B&W.

35. Mr Mercier pointed out that the trademark position needs to be resolved as ITL owns the Marlboro, Lucky Strike and Pall Mall brands in Canada. Mr Brown pointed out that there could be an opportunity for ITL to manufacture BAT trademarks for Mexico since it is in NAFTA but not in the US. A possible longer term threat may be that, under Mexican law, a manufacturer who owns a trademark in Mexico may export a product to any country. Mr Pritchard will report on the position with respect to intellectual property rights within NAFTA and Mr Bramley on trademarks in US/Canada/Mexico at the next TSG meeting.

36. **Lucky Strike pricing:** Mr Pritchard presented a proposal, which was agreed, that:
    - FESU's price to the HKDF trade would be raised to $15.50 per mille in mid-1993;
    - the world-wide benchmark price for Lucky Strike would be set at $15 per mille;
    - action will be taken where GEX product is currently sold below benchmark;
    - certain DP markets will continue to be below benchmark price where the product carries local government health clausing and re-export is not a problem;
    - the retail pricing strategy for Lucky Strike is to be one or two (small) price points below Marlboro, except in those markets where low price positioning is detrimental to the brand's image where it will be priced at parity to Marlboro;
    - action is planned in those markets where pricing is out of strategy.

37. **Pall Mall:** Mr Pritchard reported that Pall Mall is being developed to bring it up-to-date and to make it into a strategic core brand.

502578695

38. **John Player Special:** Mr Bramley will present a more detailed plan for the strategy for this brand to the next TSG meeting.

39. **Consumer attitudes to Marlboro:** It was agreed that Philip Morris' changed strategy with respect to Marlboro gave a good opportunity to BAT.

Conference on Sales and Distribution

40. Mr Andrade presented his proposals for a conference on sales and distribution. It was agreed that the subject of the conference is worthwhile. However it may not be possible to compress the material into the three days suggested and there is probably insufficient time for adequate preparation for a conference in May. Therefore it was agreed that a more detailed conference plan should be drawn up for the next TSG meeting. The conference will then be planned in detail and held in Rio next autumn. Dr Schweitzer believed that only common subjects should be addressed so that the outcome will be of practical benefit to all participants. Mr Herter asked him to pass his ideas on this to Mr Andrade and agreed that Mr Andrade could gather together the contributors to the conference for a planning meeting.

Central/Eastern Europe/CIS

41. **Marketing plans:** Dr Schweitzer reported on the last quarterly meeting between Mr Whitehair, Mr Tomat, Mr Pereira and Mr Andrade. They discussed the pricing structure agreed at the last TSG meeting, but considered that it might take some time to increase prices where they are currently lower than the structure agreed. This particularly impacts Souza Cruz. The next meeting of the group will be before the next TSG meeting. Mr Herter asked that specific plans to achieve the agreed pricing structure should be presented to the next TSG meeting.

42. **Organisation in Russia:** Dr Schweitzer reported that the same group of international managers had agreed that while conditions in Russia where so chaotic, they should exploit the opportunities through individual approaches. Mr Sandefur said that he disagreed with this recommendation. He believes that one person should be made accountable for exports to Russia. Mr Herter said that he thought that within a year one person should have this accountability but until then, the current structure would continue, providing that all the companies operated out of the same offices and not different offices. Mr Herter asked Dr Schweitzer to find as soon as possible one office in Moscow that could accommodate all the Operating Group and NBD representatives. In future where an office is opened it must be large enough for all Operating Groups and NBD.

43. Dr Schweitzer reported that the group had also added Embassy to the list of economy brands. Mr Herter said that this should be removed as it is not necessary as we already have Hollywood and Viceroy.

44. Mr Andrade reported that it had been agreed at the meeting that each Operating Group would continue to offer its own range of products. Mr Herter pointed out that it had been agreed at the last TSG meeting that each Operating Group should offer the whole range of BAT products.

502573696

European Manufacturing Location Strategy

45. Mr Davis presented the key points that have emerged so far from the study of European manufacturing strategy. There are considerable opportunities for economies of scale - only Southampton will have, after Test Phase II, an output at optimum scale level. Complexity of product range increases costs significantly and sometimes results in products not recovering their fully loaded costs. In comparison with Philip Morris in Europe, BATCo has disadvantages from economies of scale and complexity, but gains from better operating practices. Labour productivity can be expected to be made uniform across Europe and complexity is a matter of choice. This means that labour rates become a key factor in achieving lowest cost production. The UK ACT situation makes UK manufacture effectively cheaper than other sources (including many outside Europe) where costs are otherwise lower.

46. The next steps are to:
- move our present factories to best practice operation;
- manage down the complexity of the product range in consultation with Marketing;
- work towards increasing the capacity of the Southampton factory by means which minimise the associated investment, i.e. through 3-shift working;
- monitor developments which could make feasible the consolidation of continental European manufacturing;
- include data from BATCF;
- in the longer term, expand the work to encompass other BAT manufacturing operations.

A full report will be made to the next TSG meeting.

47. Rationalisation of pack sizes: Mr Davis reported on this study. Total rationalisation of pack sizes would be very difficult and would still not allow the Group to cope with a major disaster at one of its main sites. Rationalising to three sizes (Compact, Compressed and Super Compact) could be done with minimum disruption and would allow enough flexibility to cope with foreseeable "disaster" situations. It is the view of marketing departments around the Group that an emergency pack size change would be easier to handle than an on-going change.

Flexibility could be enhanced further by investing around £2m in change parts and a smaller amount in coupon insert equipment as well as by digitising art work. These recommendations were accepted.

Legal/Regulatory Issues

48. Counterfeit: Mr Chalfen presented a policy statement which was accepted. He reported that very little of the effort involved in minimising counterfeit can be effectively centralised at this stage. However there is a newly recognised need for active co-operation between the Operating Groups. He will report back to the TSG on progress in one year's time.

502578697

49. **Trademarks**: Mr Chalfen reported that, as a result of the problem in GIPS, the Raleigh trademark had been lost in Russia and probably Czechoslovakia. He also reported on the development of the computer system. One lawyer from each Operating Group will assist GIPS to verify the integrity of their group's database held on the GIPS computer. All Operating Groups will have efficient access to the database on a read-only basis by March 1993. The next phase to update the computer system will take about a year, and only verified data will be transferred to the new system.

50. **ETS**: Mr Pritchard reported that a negative report is likely to be published this month.

51. **Fire-Safe Cigarettes**: Mr Pritchard will make use of the know-how available within BATCo to propose an alternative testing methodology. It is possible that the proposed methodologies could be different for blended and Virginia cigarettes.

52. **Advertising restrictions**: Mr Herter asked all members to update him immediately if they became aware of developments rather than waiting for the next TSG meeting.

53. **Leaf contracts**: Mr Bramley reported that a draft leaf contract had been reviewed by Standard Commercial and was now with the Operating Groups for review.

54. **Distributors' contracts**: Mr Bramley reported that the draft contract had been discussed with Mr Walzer and now needed to be progressed.

<u>90th Anniversary Conference</u>

55. Mr Herter thanked all members for their contributions to a very successful and enjoyable conference.

HCB
10th December 1992

502578698