

NO COPIES MAY BE MADESECRETTobacco Strategy Group

A meeting of the Tobacco Strategy Group was held on Thursday 3rd September, 1992.

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

Mr. E.E. Kohnhorst was present throughout the meeting, Mr. S.P. Chalfen was present for items 48 and 49, and Mr. D.G. Stevens for items 50 to 54.

Apologies were received from Mr. Brown of Imasco.

Minutes of the Previous Meeting/Matters Arising

1. Mr. Herter welcomed the members to the first meeting of the renamed Tobacco Strategy Group, particularly the new members Mr. Allvey and Dr. Schweitzer. The matters arising not otherwise included in the Agenda were discussed.
2. Conference on Sales and Distribution : A possible Conference on Sales and Distribution was discussed. It was agreed that, since this is a strategic issue, conditions are changing quickly, and there are wide differences between the markets, a high level conference with a limited number of participants in the Spring of 1993 would be valuable. Mr. de Castro will ask Mr. Andrade to draft a proposal for a conference concentrating on strategic issues but not ignoring the benefits that may be obtained from covering operational issues. Mr. Andrade will draw on the expertise of a group including Mr. Niedermann, Mr. Fitzmaurice and a BATCF delegate to be advised by Dr. Schweitzer. The proposal will be discussed at the next TSG meeting on 2nd December.
3. Excise : Mr. Herter has asked Mr. Bingham to prepare a strategy paper on Excise, which can be used in discussion with different Governments, to be discussed at the next TSG meeting.
4. New Markets Meeting : A date for the next New Markets meeting will be discussed with the Chairman or at the latest at the next TSG meeting.

Marketing

5. Brand Valuation : Mr. Bramley reported that the BATCo document on Brand Valuation would be published by the end of September. A BATCo seminar is being arranged for key Marketing and Finance staff in early October in order to implement this new tool in the larger companies. It was agreed that one Marketing and one Finance representative from each of Brown & Williamson, BATCF and Souza Cruz would be involved in that meeting so that they can introduce the methodology in parallel with BATCo. This should enable it to be applied to all key brands in key countries in 1993. Mr. Bramley will confirm the date of the meeting in the week commencing 7th September.

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6. **Competitor Cost Model, Analysis and Activity :** Mr. Allvey explained that the CPC had requested a shareholder perspective on the main tobacco competitors, which would require an understanding of their whole business. The concept of a "model" was a common approach to analysing competitors. Brown & Williamson already have a model of the impact of price increases on Philip Morris' results which they use as input to their own pricing decisions, and BATCO use similar models. Mr. Eckmann's paper was a useful summary of the information and analysis needed by market. A view will then be needed of how the corporate centres will react. This will require knowledge of the organisations and personalities. Mr. Allvey will co-ordinate the production of a paper to be discussed at the next TSG to set out the format, frequency and coverage of an annual competitor review, as part of the planning cycle, with quarterly updates, for example, covering product launches. He will involve Mr. Eckmann, Mr. Blingham, and similar staff from the other companies. It was agreed that JTI should be added to the competitors to be analysed by Brown & Williamson.
7. **France :** The competitive situation in France and the strategy of Seita, in France, the rest of Europe and Africa, were discussed. It was agreed that in view of the size and importance of the French market in the middle of Europe and BAT's lack of success there, Mr. Bramley would ask Mr. Rembiszewski to reassess our approach to France and to propose for the next TSG meeting a strategy.
8. **Germany :** BATCF have a contingency plan in the event that a price war is initiated by another competitor. The fear is that a competitor such as Rothmans may introduce cheaper brands. Reemtsma is unlikely to initiate lower prices since their low price brand has the highest market share and is progressive, but they would probably follow if prices were lowered. If other companies raise prices this might well encourage the current down-trading to tobacco rolls and promote an increase in border trade which sell for about half price. The same pressures are limiting BATCF's ability to increase prices. Philip Morris appears to be under considerable pressure for profit and thus seems to be likely to want to push its prices higher.
9. **Brazil :** The Government's decision to merge price categories III and IV is excellent for Souza Cruz since they will not need to lower their prices and L&M loses its advantage. Philip Morris are threatening to sue the Brazilian government over the decision. The price categories could disappear within 3 to 6 months. Souza Cruz have contingency plans for this, including launching Viceroy from Brown & Williamson. Mr. Bramley commented that L&M appears to be becoming Philip Morris' low price brand in Latin America, Middle East, Japan and China. Mr. de Castro reported a rumour that R.J. Reynolds are thinking of returning to Brazil.
10. **JTI :** Mr. Bramley reported that JTI give three reasons for their purchase of Manchester Tobacco:- experience with Virginia; opportunities for own label in Europe; and the relative ease of exporting to Taiwan from UK rather than Japan. They are also negotiating with R.J. Reynolds to licence brands.
11. **International Cigarette Marketing Information System :** Mr. Bramley reported that the development is complete, a pilot is now running, and it should go live in early October.

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12. 90th Anniversary Tobacco Conference : Most guests have accepted their invitations. All speakers are aware of their topics. Miss Black will communicate a common format for slides.

Key Markets

13. Exports to Central/Eastern Europe : Dr. Schweitzer reported that sales are nearly double those for the same period last year. In the year to the end of July, the highest sales are to Romania. This will change in August due to high shipments from BATCF (700 million) and Brown & Williamson (250 million) to Russia. Orders currently exceed production capability (manning) in BATCF. Brown & Williamson have orders awaiting money. Souza Cruz have received money for 250 million cigarettes for Russia and Ukraine and have a letter of credit for 250 million more.
14. Mr. Herter raised the issue of brands and prices in these new markets. He pointed out that our export margins are going down and suggested that we are pricing too low at the low end of the market. It was established that a variety of brands is being sold at prices ranging from \$9 to \$27, with the bulk at \$15. In some cases the same agent is dealing with three or more BAT companies and is able to play them off against one another. It was agreed that the brands offered would be restricted to State Express at \$27.50, Kent at \$20, HB, Pall Mall and Lucky Strike at \$15, and Hollywood and Viceroy at about \$10. This list may be further restricted when the markets are more developed. It was agreed that BAT contacts with one agent should be funnelled through one BAT representative. The senior Operating Group managers, Mr. Whitehair, Mr. Tomat, Mr. Pereira and Mr. Rembliszewski, already meet quarterly. Mr. Herter will ask them, at their next meeting, to draw up a plan for Central and Eastern Europe, covering brands, prices and advertising, and to recommend the organisation required to make the above guidelines work.
15. Group organisation for Russia : Mr. Herter reported that the sales office in Moscow mainly covered the Moscow region, and the country is so vast that more offices would be needed. It was agreed that BAT should have one organisation in Russia which should expand as quickly as possible. Mr. Herter will ask Mr. Tomat and Mr. Macdonald to propose a plan for this.
16. New Markets : Mr. Herter reported on the progress made with respect to new markets.
17. Uruguay : Mr. de Castro reported that he expects in the near future a report from Citibank on a major tobacco company in Uruguay.
18. Cuba : Mr. de Castro will visit Cuba in September to establish links with the monopoly. A similar approach had been made by Philip Morris, but technicians from Cuba had not been granted visas to visit Philip Morris in the US.
19. Mercosur : Booz Allen's final report is due at Souza Cruz on 14th September. Mr. Herter, Mr. Bramley and Mr. Dunt will be in Argentina on the 14th, 15th and 16th October. Mr. Bramley will agree with Mr. de Castro when will be convenient for him to come to Argentina during those three days for Booz Allen to present their findings to the whole group. /...

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20. **Argentina** : Mr. Branley reported a problem with Ritz undercutting Derby in Argentina. It was agreed that the policy of brands not being exported into domestic markets without prior consultation with the regional and local management on pricing, brands, and competitive implications, would be reinforced.
21. **Philippines** : Mr. Pritchard reported on talks with the third largest player in the market (64% owned by Rothmans, Australia), to contract manufacture and distribute our products.
22. **Iran** : Dr. Schweitzer reported that BATCF has shipped 3.5 billion cigarettes to Iran in the year to date and expect to ship another 500 million. The plan for 1993 is 3 billion. The Iranian monopoly has approached BAT with a proposal for a joint venture to construct a factory capable of producing 20 to 22 billion cigarettes (in a market of 30 billion), with a 25% to 30% participation for BAT. Exports into Iran of 5 to 8 billion a year for 8 years would be included in the deal.
23. **Andean Pact** : Mr. Dunt is meeting Mr. de Castro in the week commencing 7th September to resolve differences of opinion. A report will be presented to the next TSG meeting.

US International Brands

24. **Kent** is below budget because of the adjustment in Hong Kong but is up on last year. It is doing very well in Japan because of the box styles. Mr. Pritchard believes that there is a message here for all markets, that boxes will come to predominate all over the world. The US Domestic market is moving to boxes and China is moving very quickly. This could be an opportunity for the Group. Capacity on the box lines is a major constraint in Brown & Williamson. The proposal for 3 combinations was not enough and a new proposal will be made as quickly as possible.
25. **Lucky Strike** has a new gold standard which is believed to be better than Marlboro. The prices must now be worked up. Mr. Branley and Mr. Pritchard will discuss the co-ordination of price increases in China and make a proposal to the next TSG meeting. Mr. Herter asked Mr. Pritchard to prepare a market by market assessment of pricing position for the next TSG meeting. The use of the US and European advertising campaigns was discussed. Mr. Herter believes that each market should use whichever campaign sells more cigarettes. It is not a free choice as it must be one of the two campaigns, with the only deviations being for language. The two campaigns achieve brand integrity by being consistent with one another, because one is pack based while the other is image based.
26. **Barelay** : Mr. Pritchard reported that the margin for distribution through Tiedemanns in Norway of \$11.26/mille is believed to be adequate. The problem is that the effort is going behind Prince. Progress in France is on hold pending the outcome of Talisman. A test for Germany is being prepared for 1993. Formula One sponsorship will end at the end of 1993.
27. **Pall Mall** : Mr. Pritchard will report to the next TSG meeting on the developments that would be necessary to make Pall Mall into a strategic core brand. /...

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UK International Brands

28. State Express 555 is selling well in China. More marketing spend would be desirable in China but this will be assessed against the below budget profit forecast. The dependence on State Express in China is still being discussed. Mr. Bramley reported that BATCo.'s Marketing department believes that US International Brands provide support and that there is no need for another UKIB. Mr. Herter will discuss this issue further with Mr. Brunley, Mr. Adams and Mr. Rembiszewski following his visit to the Far East.
29. Benson & Hedges has problems in New Zealand (with the movement to RYO), Australia, Nigeria and Malaysia. The quality of the product is being reviewed.
30. Players Gold Leaf is progressive. The quality has been improved and there is now a major review of the packs, advertising campaigns and blends.
31. John Player Special is being used tactically, for example, as a low price brand in Malaysia. The brand ownership is complicated with Imperial owning it in the EC (and licensing it to Reemtsma in some markets), and BAT in EFTA. Mr. Bramley will ask Mr. Rembiszewski to propose a strategy for this brand for the next TSG meeting.
32. Philip Morris in China : Mr. Bramley reported that Philip Morris is not expected to introduce a low price brand in China in the near future. Marlboro's share of imports is lower than that of State Express. Philip Morris is spending heavily. The support for Marlboro in 1992 is believed to be more than \$20m which is more than BAT will spend on its four major brands in total. Philip Morris has had problems with CMTC and with counterfeits. Mr. Bramley will distribute copies of BATCo.'s paper on the latter subject to the members of the TSG. Mr. Sandefur believes that the longer term opportunity in China is for Lucky Strike rather than Kent, since it is full flavoured. The money allocated to supporting it has never been spent. Mr. Herter and Mr. Bramley will review the position in Hong Kong on 7th September.

Leaf

33. Leaf Trading Project : Mr. Pritchard will head up a team including Mr. Benneman, Mr. Hensman, Mr. Snowden, Mr. Harrison and Mr. Bruce-Miller. The brief will include evaluation of the opportunity as well as implementation. The report to the next TSG meeting ~~should~~ address questions such as who are the competitors, who will be the customers, will the fact that BAT is likely to be a competitor be an impediment, and what return is expected (their accounts show that some of the current competitors make low returns).
34. High Leaf Costs : Mr. de Castro reported that Brazilian Burley is more expensive than Chilean because of higher productivity per hectare based on irrigation in Chile. The quality of the Chilean leaf is close to that of Brazilian but it needs to establish itself. Mr. Pritchard recommended that the comparison should be of in-blend cost rather than the price to farmers in order to take account of the cost of technical support, sorting, etc. Mr. de Castro will produce fuller cost numbers on this basis for the next TSG meeting.

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35. **Training in blending :** Mr. Kohnhorst reported on a meeting of senior blenders who identified the desirable qualities of, sources of, and training for future blenders. The next steps are to complete the design of the training programme, assess the current blenders and design a training programme for each blender. The assessment is expected to show that BAT has many blenders at levels 1 and 2 and very few at level 4. In view of the 10 year time scale to train up to level 4, there could be a need to recruit experienced blenders from competitors or from best practice companies such as coffee and tea companies. One problem has been that there was no career path for blenders and their importance was not recognised in pay and status. Mr. Kohnhorst was asked to make a recommendation to the next TSG meeting on how to provide a career and the right pay and status for blenders.

Smoking Quality

36. **Smoking Quality Study :** Mr. Kohnhorst reported that two good new products have been developed and extremely valuable work is available on the characteristics of Marlboro and Philip Morris' smoking quality strategy. Marlboro has the same product characteristics around the world, and nicotine per puff is similar even where the tar levels are very different. Mr. Herter asked all members to ask the participants in the study to brief their Marketing colleagues. In particular BATCo should be more involved, since the knowledge to improve blended products could be used in many of their companies. Mr. Bramley will ask Mr. Reid to conduct a similar study for Virginia using the methodology developed for this study.
37. **Masurable Smoking Quality Indicators :** This has been included in the Plan Guidelines. The testing method developed by the Smoking Quality Study Team should be implemented by all companies.

Production

38. **Production and Reserve Capacity Review :** Brown & Williamson's projections show that they will run out of box and primary capacity in 1994. If GPC were to be redried, they would already have run out of capacity. Hence an extension is needed at Macon. Production capacity at Southampton will start to be tight if the growth to China continues, even with production being moved from Southampton to Europe where possible. Extending production capacity in the UK would have ACT advantages. Mr. Pritchard pointed out that Imperial probably has surplus capacity in the UK which could give BAT the opportunity to acquire one of their purpose-built single-floor factories. BATCF has no reserve box capacity on two shifts. The reserve capacity comes from the potential for a third shift or Saturday working, where the problem would be lack of trained staff. With Uberlandia working 7 days a week, and new machinery, Souza Cruz has spare capacity, although this could change if the domestic market switches to box very quickly. Mr. Herter stated that reserve capacity must take account of a reasonable amount of overtime.

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39. **Manufacturing Location Strategy for next 10 years** : The Group agreed with Mr. Allvey that a 10 year view should start with an assessment of the markets and trading blocks before considering how many factories were needed, where and at what size. It was agreed that this should be studied on a regional basis, starting with Europe. Mr. Bramley will liaise with Dr. Schweitzer on a European study and report back to the next TSG meeting.
40. **Manufacturing Quality Control** : Mr. Kohnhorst presented an analysis of the causes of complaints at Brown & Williamson and BATCF. With very few exceptions (stale cigarettes being the only notable one), the distribution of manufacturing faults was remarkably similar between the two companies. It is likely that this is true throughout the rest of the Group. Therefore, it should be possible to develop a co-ordinated Group approach to reducing the number of faults and hence complaints. Therefore, the next step is to broaden the Group involvement and co-ordinate work on major defects. It was agreed that Mr. Kohnhorst would pull together a team to co-ordinate this Group work and also to make a proposal to the TSG meeting in February 1993 on whether the Group should pursue an ISO 9000 accreditation.

R&D/Technology

41. Mr. Kohnhorst reported that several areas of mutual interest had been established. He will circulate the programme for these to the TSG members and make a proposal to the TSG meeting in February 1993 on how this is to be taken forward.

Review of Trading Results

42. Mr. Allvey will speak to each of the operating Groups individually about their results and forecast. In particular he will ensure that there is a coherent Group approach to the translation and transaction problems arising from the current exchange rate movements.

Regulatory and Legal Issues

43. **ETS** : Mr. Pritchard reported that the science has not improved in the latest report, and Brown & Williamson will continue its watching brief.
44. **Fire-Safe Cigarettes** : Mr. Pritchard reported that a testing methodology needs to be accepted by August 1993. The only factor which has so far been proved to reduce the propensity to burn is circumference.
45. **Advertising Restrictions** : The NMA is lobbying the EC over the proposed advertising ban.
46. **Leaf Contracts** : Mr. Bramley reported that Guidelines have been issued, and a draft has been given to Standard Commercial for comment.
47. **Distributors Contracts** : Mr. Bramley reported that some work still remained to check whether there were any differences between the BATCo and Brown & Williamson contracts. Mr. Walzer will be asked to review the proposed contract from the point of view of EC Legislation. /...

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48. Trademarks : Mr. Chalfen pointed out that the paper presented was a legal review but not a marketing review. It was agreed that the role of Group International Property Services (GIPS) should be developed as proposed and the Tobacco Trade Mark Team should be established as proposed. One topic for technical review by the Team should be whether or not to recommend for marketing consideration, the establishment of a single trademark company, and Mr. Chalfen should report back to the TSG in February 1993. Benchmarking of GIPS' operations has started and he will also report this to the TSG in February 1993. It was agreed, in principle, that there should be a single trademark company for future registrations, which would all be carried out through GIPS, since this would have no cost, give the potential to maximise UK income, eliminate confusion and obtain maximum flexibility from comprehensive licensing : Mr. Chalfen will report to the TSG in December 1992 on this. Mr. Chalfen also reported a problem in GIPS which resulted in many trademarks renewals not being made, particularly for Barclay. The position is being recovered, the computer programme has been amended to eliminate this risk in future, and the processes and procedures should be audited.

Human Resources

49. Inter-Company Transfers : Mr. Bramley remarked on the high proportion of younger managers in the scheme. For it to be successful with more senior managers, the support of the TSG is needed. Mr. Stevens said that balance should be adjusted if possible to avoid the current predominance of Sales and Marketing staff.
50. Functional Training : Mr. Stevens reported that all the pilot programmes were established starting in October and running through 1993. He suggested that we should consider the resources required in 1994 onwards when the programme will be rolled out, since the staff running the programmes also have full-time jobs.
51. Appraisal Systems : It was agreed that Mr. Stevens would discuss the future development of appraisal systems with the Operating Groups, with a view to ensuring that they produced meaningful development plans for appraisees. He will make an interim report to the TSG meeting in February 1993.
52. Management Development Announcement : Mr. Stevens reported that since the 1993 programme for Chelwood has been announced it would be preferable to defer further announcements until the functional training programme is well established. Mr. Stevens would report on the Leaf and Production pilot programmes due to be held in October 1992 at the next TSG meeting. He would also recommend to the TSG the form of the 1993 transitional arrangements which would ensure that the new arrangements were fully established, communicated and in operation from 1994 onwards.

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53. **Benchmarking** : Mr. Stevens will circulate the summary paper on benchmarking produced by Brown & Williamson. The exercise was very beneficial and will be repeated and expanded. The overall conclusion was that Brown & Williamson need to upgrade significantly the entry grade managers and to formalise the management development programmes. Mr. Bramley will apply the methodology in BATCo and report to the Chairman.

Any Other Business

54. **Agenda for Next Meeting** : Counterfeit will be added to the next Agenda which will be much pruned. Miss Barton will telephone members about 6 weeks before the meeting to ask for items for the Agenda.

HCB
21st September 1992

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