Secret

Note to: D P Allvey
E E Entedgui

cc: D C Potter

From: D W Surdeau

Date: December 12, 1994

Subject: **BATCo Profit Target 1995**

Following the discussion of the BATCo Plan this note seeks to summarise the issues in respect of the BATCo profit target for 1995.

1. Group Plan Preview

The consolidated Preview of 1995 tobacco trading profit gave 10% growth on a 1994 base of £1176mn. Exchange rates used were forecast average for 1994 as follows:

US$ 1.530
DMK 2.481
CAN$ 2.080

2. BATCo Trading Profit Target

At the meeting between the CEC and the BATCo Board to consider key issues arising from the BATCo Plan for 1995-1999, guidance was sought on the acceptable level of trading profit for 1995. After subsequent discussion a target of £620mn tobacco trading profit was set being BATCo's contribution to the attainment of 10% growth on the revised 1994 base of £1184mn for the Group. The new base reflected the October Update, on an R&A basis, with exchange rates as above.

3. Group Plan

In the appendix to this note the latest estimate is presented based on the following:

3.1 Latest forecast for 1994 being the November Update on an R&A basis.

3.2 Forecast average exchange rates for 1994 of:

US$ 1.542
DMK 2.483
CAN$ 2.099

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3.3 1995 figures from Company Plans with adjustment for BATCo, which was based on a US$ rate of 1.63, on the basis of the US$ sensitivity identified in the Plan for both transaction and translation.

3.4 Other tobacco trading profit in line with the Preview.

On the basis of the above assumptions tobacco trading profit growth in 1995 is 5%. Attainment of the 10% target would require another £54mn trading profit.

4. Underlying BATCo Profit Growth

In my note commenting on the BATCo Plan I analysed how BATCo arrived at their estimate of 5% underlying profit growth in 1995. Many of the reconciling items could be challenged since BATCo is a holding company with a portfolio of businesses which will require continuing review involving restructuring of existing operations and investment in new markets. Nevertheless the figures provided could be instructive in understanding the challenge represented by the £620mn profit target.

Tobacco Trading Profit £mn	1994	1995	% chg
Company Plan	578	521	-10%
Exchange (1.63 to 1.54)		36	
	578	557	-4%
Stretch		63	
	578	620	7%
Special Costs	25	73	
	603	693	15%

The table above assumes all rationalisation costs relate to tobacco. Using the BATCo methodology the underlying profit growth is 15% which is clearly very challenging and, in view of the updated figures from other Operating Groups, may not be required.

Possible improvements to 1995 profit are likely to come from the following:

- cuts in brand spend
- review of price increase assumptions
- additional cost cutting

BATCo are to review each of the above categories. However with a cut of 10% of brand support expenditure providing £35mn and the need to protect spend on national and regional brands the £63mn profit enhancement required to deliver the £620mn target looks unrealistic.

5. Attainment of Profit Target

Three alternatives are identified on the attached appendix which give some indication of how profit growth could be improved at consistent exchange rates. These are:

5.1 **Alternative 1:** Other Operating Groups remain as they are with BATCo's underlying rate increasing to 10%. In view of the comments above this could be seen as a stretched but obtainable target.

Tobacco Trading Profit £mn	1994	1995	% chg
Company Plan	578	521	-10%
Exchange		36	
	578	557	-4%
Stretch		33	
	578	590	2%
Special Costs	25	73	
	603	663	10%

This alternative generates a growth in tobacco trading profit of 8% in 1995 for the Group.

5.2 **Alternative 2:** Other Operating Groups remain as they are with BATCo's underlying rate increasing to 12% as follows:

Tobacco Trading Profit £mn	1994	1995	% chg
Company Plan	578 585	521	-10%
Exchange		36	
	578	557	-4%
Stretch		45 50	
	578	602	2%
Special Costs	25	73	
	603 610	~~675~~ 680	12%

This alternative generates a growth in tobacco trading profit of 9% in 1995 for the Group.

5.3 **Alternative 3:** Underlying profit growth at 12% for BATCo and stretched profit targets for the remaining subsidiaries as follows:

B&W	Additional $10mn giving a total growth of 10% on the present 1994 base.
BATCF	Additional DM 24mn from cost cutting and international spend as discussed at Plan review meetings.
Souza Cruz	No change due to continued volatility of Brazilian economy.

Assuming no adjustment for Imperial this would provide tobacco trading profit of £1303mn representing 11% growth on 1994.

6. Conclusion

The above suggests that a target of underlying growth of 12% for BATCo (equivalent to £45mn additional profit) using consistent exchange rates will be required together with stretched targets for BATCF and B&W in order to deliver the required Group performance. The incremental profit on this basis will be derived as follows:

	£mn	
BATCo	45	50
B&W	6	
BATCF	10	
Total	61	

Thus the above measures, if achieved, would deliver £7mn in excess of the requirement which offers some limited protection to the forecast.

Please advise what further work you require.

SC upsides excluded

D W Surdeau
o/dws/batco/lea/pn

20.12.94 DPM

1. 94 R&A LAE 1196 (→ 177)
Batco 585 (+8)
BatcF 58 (+7 ... ... not. prov.)

2. 10% target for 1995 (1196 x 1.10) = 1316

3. Batco 95 target should be £608 (ie 50m£)
Fit ... in any upside for SC

4. B&W £395m → £435 (not 423m)
(exc. ATCo) 670m $ 652m $

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Tobacco Group Trading Profit 1995 (£mn)

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Group Plan Preview	Actual 1993	Estimate 1994	Preview 1995	% inc. 95 vs 94
B&W	205	385	422	10%
BATCo	559	580	614	6%
BATCF	58	51	46	-10%
Souza Cruz	143	62	89	44%
Imasco	92	109	119	9%
Other	153	-11	1	-109%
Tobacco Trading Profit	1210	1176	1291	10%
US$	1.502	1.530	1.530	
DMK	2.484	2.481	2.481	
CAN$	1.938	2.080	2.080	

Latest Estimate	Actual 1993	Nov Update 1994 R&A Basis	(+)		Plan 1995	% inc. 95 vs 94
B&W	205	390	5	395	422	8%
BATCo	559	578	7	585	557	-4%
BATCF	58	51	7	52	50	-3%
Souza Cruz	143	62			91	47%
Imasco	92	108			120	11%
Other	153	-12				-108%
Tobacco Trading Profit	1210	1177	+19		1241	5%
US$	1.502	1.542	11%		1.542	
DMK	2.484	2.483			2.483	
CAN$	1.938	2.099			2.099	

Alternative 1	Actual 1993	Nov Update 1994 R&A Basis	Plan 1995	% inc. 95 vs 94
B&W	205	390	422	8%
BATCo	559	578	590	2%
BATCF	58	51	50	-2%
Souza Cruz	143	62	91	47%
Imasco	92	108	120	11%
Other	153	-12		-108%
Tobacco Trading Profit	1210	1177	1275	8%

Alternative 2	Actual 1993	Nov Update 1994 R&A Basis	Plan 1995	% inc. 95 vs 94
B&W	205	390	422	8%
BATCo	559	578	602	4%
BATCF	58	51	50	-2%
Souza Cruz	143	62	91	47%
Imasco	92	108	120	11%
Other	153	-12		-108%
Tobacco Trading Profit	1210	1177	1287	9%

Alternative 3	Actual 1993	Nov Update 1994 R&A Basis	Plan 1995	% inc. 95 vs 94	
B&W	205	390	429	10%	435
BATCo	559	578	602	4%	608
BATCF	58	51	60	17%	60
Souza Cruz	143	62	91	47%	91
Imasco	92	108	120	11%	120
Other	153	-12	1	-108%	1
Tobacco Trading Profit	1210	1177	1303	11%	1315
		1196	1316	10%	

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