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TOBACCO STRATEGY REVIEW TEAM

A meeting of the Tobacco Strategy Review Team was held on 6th September, 1991.

Present: Sir Patrick Sheehy, Mr. M. F. Broughton, Mr. B. D. Bramley, Mr. R. J. Pritchard, Mr. U. G. V. Herter, Mr. A Monteiro de Castro, Dr. R. Salter (Secretary)

Mr. J.-L. Mercier was unable to attend

In Attendance: Mr. T. J. Wylie, Mr. E. Kohnhorst

Minutes of the Previous Meeting/Matters Arising

1. The minutes of the meeting held on 30th May were agreed.
2. **R&D Funding Arrangements.** Mr. Broughton reported that the allocation of the costs of the fundamental research programme had now been agreed.

It was noted that Mr. Castro will draw up with BAT Industries legal department, an agreement through which Souza Cruz will pay for research results and technology passed to them. Souza Cruz will then need to obtain approval from the INPI in Brazil in order to be able to make payments under the agreement. Although, initially, these payments may be relatively modest, it is felt to be important to establish the principle that Souza Cruz should make a financial contribution to the research programme.

Marketing Issues

3. **November Marketing Seminar:** It was noted that invitations had been sent to everyone who had been nominated to attend the conference. However, following the resignation of Mr. Hazel, his place will now be taken by Mr. Norman Davis.
4. Mr. Pritchard will agree with the Chairman a final programme for the conference and this will then be sent out to delegates. It was noted that the speakers will also act as chairmen for their sessions except where there are several speakers, in which case a separate chairman will be nominated. The Chairman emphasised the importance of encouraging discussion and suggested that this should be impressed on Professor Quelch, whose first session should set the pattern for the whole seminar. He also suggested that the timing of the afternoon sessions should be flexible, with provision for these to over-run the scheduled time, if required.

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5. **Marketing Information Systems:** Mr Bramley's proposals for setting up a modified Group data-base, showing cigarette sales worldwide was accepted but it was suggested that its implementation should be accelerated, aiming to complete this during 1992.

It was noted that the person responsible for setting-up and managing the system would be Ian Ross. It was suggested that Souza Cruz should contact him to ensure that they have full access to the system.

6. It was noted that the system would be based on sales to final consumers rather than shipments. While it was agreed that this was the most useful measure, it was asked that there should also be a reconciliation relating these figures to shipments, which are the basis of the financial reporting system.
7. **TV Screening of Motor Sports:** Mr. Herter presented a paper summarising the position on possible restrictions on the screening on TV of Motor Sports sponsored by cigarette manufacturers. The current view is that this should continue to be allowed. However, it was noted that the European Commission take a different view. In view of this uncertainty, it would be important to have escape clauses in any contracts, allowing cancellation if a ban is imposed.
8. **Competitor Activity:** It was noted that Brown and Williamson had recently completed their periodic review of competitor activity and copies of this would be distributed to all members of the team.
9. Mr. Pritchard reported that Philip Morris had completed their management re-organisation and were continuing to act aggressively, especially in trying to replace R. J. Reynolds in-store in retail outlets. Marlboro-medium had been launched, apparently aiming for the segment of the market which wants a lighter cigarette but which is unwilling to convert to Marlboro Lights. It is too early to judge the success of this initiative.
10. In the US domestic market, Philip Morris increased prices in March and June and are rumoured to be seeking a further increase in September. Prices are being increased more rapidly on the cheaper brands, narrowing the gap to the full-price segment. At the lower end of the market, Bristol and Bucks are being pushed harder than Cambridge.
11. Overseas, Philip Morris are managing food and tobacco together in Brazil and the rest of Latin America but elsewhere the two activities appear to be managed separately. Other developments have been attempts to influence excise in Argentina and Singapore (asking for an increase in the proportion of specific tax) and a strong promotion of Belmont-Ultra in an attempt to pre-empt the expansion of Barclay.

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12. R. J. Reynolds' strategies continue to be heavily influenced by their financial structure with an apparent emphasis on quality, efficiency and profit margins ahead of market share. However, there is some evidence that the loss of market share in Canada may be damaging profits and market share may again receive more emphasis in the longer term.
13. Rothmans appear to have strengthened control from the centre. Innovative products (sticks) have been introduced in Canada as a means of overcoming the problems of high excise, while in Germany there is evidence of a push for share at the expense of profits, which could lead to the introduction of a lower price category.
14. Reemtsma, which is a family business and more able, therefore, to accommodate short-term reductions in profits may also be tempted to introduce low-price brands in Germany in an attempt to recover share.
15. American Brands, Lorillard and Ligetts, all continue to earn good profits. American Brands has been successful in the USA with the low priced Montclair and Misty Slims, which could be a threat to Capri. For Lorillard, Newport is no longer gaining market share and although Kent has been relaunched it has made little impact. Ligetts has a range of private label business but is losing market share. However, they appear to be involved in a project to rebuild a cigarette factory in Russia.
16. It was agreed that a review of competitor activity should be a regular feature of Tobacco Strategy Review Team meetings and the Chairman asked that greater priority should be given to this item. It was also asked that members should provide information and views for the next meeting on how the new Philip Morris organisation is working in their territory and how they are financing promotion, especially in Latin America.

Key Markets

17. Eastern Europe: Mr. Herter reported continuing good progress with exports to Eastern Europe. Although the political situation could effect sales to Yugoslavia, there were good prospects elsewhere for a further increase in exports in the second half of the year.
18. Representatives have been appointed for Poland, Bulgaria and Czechoslovakia. An office has also been set up in Russia and candidates for the job of running this are being interviewed.
19. The Chairman believed that there was a need to accelerate the development of contacts in Russia and the other former Soviet republics, possibly in conjunction with another company. He is due to visit Russia during September and will arrange a meeting to progress this.

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20. Hungary: It was noted that BATCo were still negotiating with the SPA for the purchase of a shareholding in the Pecs1 Tobacco company.
21. Romania: Mr. Pritchard's review of the Romanian market was noted and it was agreed that although there were limited opportunities for development at present, contacts should be maintained.
22. France: It was noted that the study of the potential for acquiring the rights to Lucky Strike in France had now been extended and the possibility of acquiring the rights to the brand worldwide in exchange for the rights to Benson and Hedges in Europe (excluding Duty free) was now being considered. The Chairman intends to discuss this possibility with the Chairman of American Brands during his forthcoming visit to the USA.
23. The possibility of licencing SEITA to manufacture and sell all BAT brands in France will also be considered.
24. UK: It was agreed that no further action would be taken at present to investigate the potential for BAT in the UK market, apart from ensuring the continuing availability in the London area of Lucky Strike imported from Germany.
25. China: It was noted that following further investigation of the implications of the proposed re-organisation of the companies serving the China market, Mr. Bramley was preparing a ~~revised proposal for presentation to the CPC.~~
26. Mexico: It was noted that although contacts would be maintained, it was not expected that significant progress could be made in becoming re-established in Mexico until it became part of the North American Free Trade Area. In the meantime, it was noted that the licence for Kent would not be renewed beyond its current term, which expires in November.
27. Turkey: It was noted that Philip Morris had announced a \$480m investment in a 30bn capacity manufacturing plant. Mr. Bramley reported that a ~~BAT investment proposal was in preparation and would be presented to the CPC during September.~~ Mr. Watterton would be responsible for the further development of this project.
28. Thailand: Mr. Pritchard reported that although locally produced cigarettes still had a substantial price advantage over imports, it was still hoped to sell 1 billion into the Thai market in 1992. Shipments will start in the Autumn of 1991 and, including pipelining, should total 0.3 billion during the rest of the year.

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29. Contacts are being maintained in Burma and a strategy paper was being prepared covering Vietnam.
30. Colombia: It was noted that the development of Group sales in the Colombian market were being co-ordinated by Brown and Williamson. The next meeting to progress this was scheduled for November.
31. South Cone: Mr. Broughton reported that a meeting would be held in Brazil in September to set up a project to study possible implications for the Group of the proposed free trade agreement between Brazil, Argentina, Paraguay and Uruguay (Mercosul).

#### US International Brands

32. Overall Performance: Mr. Pritchard reported that although total volumes to end-June were 2% ahead of 1990 they were 10% below budget. However, this shortfall was expected to be largely eliminated during the second half, leaving full year sales over 9% up on 1990 and only 0.4% below budget.
33. Kent: Shipments have been affected by ~~interceptions to~~ ~~customs in~~ ~~China~~. However, in-market data suggest that sales to final consumers are still increasing and a team is investigating ways to overcome the problems with shipments.
34. It was noted that Kent sponsorship in the Far East is to be rationalised, focussing on a \$2.7m Golf promotion. Experience gained in the Far East may then be applied more widely.
35. It was noted that Kent is being launched in Munich and a launch in Benelux is also being considered. The Chairman suggested that Brown and Williamson should consider putting more impetus behind the development of Kent in Europe.
36. Lucky Strike was continuing to make good progress in Germany and had been introduced successfully into Brazil. However, progress had been disappointing in Italy and Switzerland. The Chairman emphasised the need to achieve comparable or better quality (e.g. by using more imported leaf) and to reduce the price differential to Marlboro, aiming to achieve the target of not being more than one price point below Marlboro in all markets by end - 1992.
37. It was noted that the other US brands were continuing to make satisfactory progress with significant increases for Hilton, Pall Mall, Viceroy and Barclay.

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UK International Brands

38. **Overall Performance:** Mr. Bramley reported that sales of UK International Brands to end June were 8.5% ahead of 1990 but 0.7% below budget. For the full year, sales are expected to be 11.7% greater than in 1990 and 0.8% ahead of budget.
39. **State Express 555** was progressing well. BATCo's new marketing director had been reviewing the promotion and sponsorship for this brand and would be presenting his proposals on this in October. The Chairman suggested that in developing the plans for the brand, consideration should be given to the potential for a Lights version.
40. **Benson and Hedges** had been disappointing but market shares were being maintained and some improvement is expected in the second half of the year. It was noted that B&H Special Mild had shown a significant increase in volume in 1991. However, doubts were expressed about the attractiveness of Benson and Hedges Golden Mild with its mixed US and Virginia taste.
41. **Players Gold Leaf** continues to be progressive but BATCo are reviewing the positioning of JPS as an international brand.
42. The Chairman emphasised the importance of quality and asked for a formal review of this to be included in the next progress report on UK International Brands.

Manufacturing Issues

43. **Production Capacity:** Mr. Kohnhorst reported that ~~including the proposed expansion of Southampton, the planned manufacturing capacity in the Group for 1995 exceeds the objective that this should exceed the sales forecasts by a margin of at least 15%.~~
44. **Conversion Costs:** Mr. Kohnhorst presented an analysis and comparison of production costs in the UK, USA, Germany and Brazil. This showed ~~that conversion costs in the USA are 61% of those in the UK, while in Germany and Brazil they are less than half those in the UK.~~
45. It was noted that there had been an increase in the cost of equipment relative to labour. As a result, ~~that equipment had become more expensive than expanding capacity. Large capacity plants were also significantly more economical than small plants and a 150 billion capacity plant might be very attractive from this point of view.~~
46. Mr. Kohnhorst will send copies of the slides used during his presentations on manufacturing capacity and conversion costs to all members of the team.

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47. **Upgrading Manufacturing in Brazil:** Mr. Castro was asked to arrange for Mr. Saboia to investigate further whether there could be an advantage to Souza Cruz in importing second-hand equipment from the USA. Although old, this could still represent a significant advance on some of the equipment currently installed in Brazil.

Leaf

48. **Leaf Processing Meeting:** Mr. Pritchard reported that a seminar to discuss and exchange information on leaf processing had been arranged for November. Messrs. Bramley, Herter, Castro and Mercier were being asked to nominate attendees.
49. **Leaf Rationalisation Scheme:** Mr. Pritchard reported that following the introduction of the leaf rationalisation scheme, there had been a significant increase in the movement of stocks from one company to another. Visits to the USA by Group Leaf buyers had also decreased from 35 in 1989 to 11 in 1990, representing a substantial saving in costs.
50. **Leaf Supply Position:** Mr. Bramley presented a paper reviewing the leaf supply position in the BATCo operating companies. It was noted that this still showed a number of companies which were either below or above the agreed stock duration targets and the Chairman asked for further pressure to be applied to improve this situation. Further consideration should also be given to the opportunities for expanding leaf exports (e.g. from Central America).

Smoking Quality

51. **Report by Study Group:** Mr. Kohnhorst reported that a study group of himself, Mr. Ross (BATCo) Dr. Kausch (BATCF) and Mr. Andrade (Souza Cruz) had been set up:-
- (a) To establish a better interchange of experience on smoking quality testing within the Group;
  - (b) To recommend action to improve the effectiveness with which quality is measured and monitored.
52. The proposals to collect examples of best practice were accepted and it was suggested that Bigott in Venezuela should be one of the companies to be visited.

The study group was asked to report back with its recommendations at the meeting of the team arranged for 26th February 1992.

Management Development

53. **Review Report:** Mr. Broughton reviewed the results of the study of management training and development in the tobacco business which had been presented to the CPC.

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62. It was suggested that there could still be a need for centralised research on regulatory and health issues but the Chairman questioned how much value past research in this field had been in enabling the company to win arguments with its critics.
63. It was noted that one of the subjects for discussion would be whether or not there was a need to appoint a new Research Co-ordinator to replace Mr. Heard, who is leaving the company.
64. It was also noted that in view of the current uncertainties about the future organisation and programme for R&D Mr. Bramley will inform Mr. Heard that the Research Conference arranged for November should be cancelled.

#### Technology Reviews

65. Team members presented summaries of the reviews of technology which had been prepared for the BAT Industries Board meeting in October, when each of the Group's businesses is asked to assess where it stands relative to competition in the application of technology.
66. It was noted that the assessments showed an improvement in product quality relative to competition but primary manufacture and leaf processing were seen as continuing areas of weakness.
67. The Chairman emphasised the importance of using I.T. to improve the effectiveness of the field sales-force and Mr. Pritchard agreed to organise a meeting to exchange experience in the application of I.T. to selling.

#### Technical Issues

68. **Reduced Sidestream:** It was agreed that although low sidestream might be part of the specification for a new product, attempts to reduce sidestream in existing products did not appear to be worthwhile since the methods for achieving this appeared to result in no net gain in the overall attractiveness of the product.
69. **Y-1 Tobacco:** It was noted that tests of cigarettes incorporating Y-1 tobacco were continuing in the US, Germany and Brazil.
70. **Decomposition Products of Ammoniated Tobacco:** Mr Bramley reported that analysis of the decomposition products of cigarettes made from ammoniated tobacco had suggested that use of the ammonia process in manufacturing has little effect on the composition of the smoke from the cigarettes produced. Further work is in hand to try to discover the reason for the observed improvement in smoking quality.

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71. **Use of Reconstituted Stem:** It was noted that using the Band Cast system, Brown and Williamson were able to incorporate stem in blended products. They also used Paper Reconstituted Tobacco (PRT) made for them under contract.
72. Influenced by the lower capital cost, Souza Cruz were evaluating the DEER process. However, although this might be acceptable as a short term solution it was suggested that the Band Cast process should also be evaluated. In addition they might also consider taking a licence for the PRT process with a view to exporting the product from Pirahy.
73. It was noted that Imperial and BATCF were also evaluating processes for incorporating increased amounts of stem and while BATCo had found this to cause irritation in Virginia brands, further evaluations would be made on blended products.

#### Regulatory Issues

74. **ETS:** Mr. Pritchard reported that the draft reports by the US Environmental Protection Agency (EPA) on Health Effects of Passive Smoking and Environmental Tobacco Smoking in Workplaces would not be published or given official endorsement. While individual researchers could still publish their work this would reduce any impact which it might have.
75. **Fire-safe Products:** The Congressional task force set up to develop a standard for fire-safe cigarettes has met and will continue with its work. However, they have not yet established an acceptable test method and progress has been slow. The situation on this will continue to be monitored.
76. **Additives Register:** Mr. Bramley reported that the additives register is now complete and is operating satisfactorily.
77. **Smoking Compendiums:** Mr. Bramley reported that updated versions of the smoking compendiums have been distributed.
78. **Environmental Charter:** Mr. Broughton reported that the Group's environmental policy was due to be reviewed at the October meeting of the BAT Industries Board. Since it was clear that tobacco companies could not subscribe to either the ICC Environmental Charter or to the Valdez Principles, it was likely that BAT Industries would continue to have its own Environmental Policy, worded in a way which was appropriate to the specific circumstances of the Group's businesses.

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Operating Results

79. **Financial Results:** Mr. Broughton reviewed the results for the half year. The importance of achieving the full year forecasts was stressed and it was noted that there had been a good increase in sales volumes in July.

Future Meetings

80. The next meeting will be on Monday, 2nd December and meetings in 1992 have been arranged for Wednesday, 26th February, Friday, 29th May and Wednesday, 2nd December. A further meeting will be held at the beginning of September but the date for this has still to be arranged.

RS/cp  
13th September 1991

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