

**PRESENTATION BY ULRICH HERTER
AT 1995 BATCO GMs CONFERENCE**

Good morning everyone and thank you, Barry, for asking me to talk about B.A.T Industries' strategy for tobacco. The findings from the first round of management interviews conducted in the course of Project Battalion revealed a considerable degree of concern about the Group's apparent lack of strategy.

Let me say, right away, that I do not accept this criticism about our lack of strategy. What I do accept is that we have not communicated our strategy clearly enough in the past. This is therefore a good opportunity for me to explain what we are trying to do and why.

I am going to concentrate almost entirely on our tobacco strategy, since Martin Broughton will be covering the role that tobacco is expected to play in the future development of B.A.T Industries, and the strategy for the Group as a whole, on the final day of this conference.

As Keith Dunt will be giving you an update on Project Battalion after this, I don't want to say much more than that both Martin and I are totally committed to the radical change that Battalion will involve. Battalion follows on logically from the move to end market control and it is about nothing less than the requirement to change the structure of our organisation so that tobacco can be managed as one worldwide business.

204554890

This does not, however, mean that we intend to become a company with rigid central control. Our aim is to preserve our decentralised culture because it provides us with an important competitive edge. Our ambition is to achieve the greatest possible degree of delegation, with absolutely clear accountability.

The new structure will, at the same time, provide for clear strategic direction and will also incorporate very clear decision processes for those issues which cannot, or should not, be left to end markets. Two good examples are international brands and product sourcing, within which I also include manufacturing strategy. That's all on Battalion for now.

Our objectives for both B.A.T Industries and tobacco are very focused. The primary objective for B.A.T Industries is to provide our shareholders, over the long term, with a total return above the average of the companies making up the FT All-Share Index. Total return measures capital growth and dividend income and is therefore appropriate for a group, like BAT, that is committed to dividend increases significantly in excess of the rate of inflation.

BAT's objective for tobacco is to regain our position as the world's number one tobacco business within 10 years and thereby deliver strong profit growth. I believe that this objective is stretching but achievable in volume terms but I do accept that it is unrealistic in profit terms.

It will, however, maximise the profit and cash flow to the Group from the tobacco business over the long term, without jeopardising our short term profit targets. In the long term, there will be a virtuous circle of rising value share, as well as rising volume share and the objective of being number one in profit terms will be met.

204554891

We will grow our value share in those markets where we already have a large volume share, and we will grow our volume in other markets. We will also invest in new markets and expand through acquisitions, if they make financial and strategic sense. Last year's acquisition of American Tobacco sets a very high standard for a developed world deal.

In our assessment, there are a number of things that we must achieve if we are to regain the number one position in volume terms in 10 years:

- maintain volume in the shrinking US market, building on the American Tobacco acquisition and the success of Kool, GPC, Misty and Carlton;
- maintain share in the growing Brazilian and Indian markets;
- continue to grow share in Japan;
- achieve a significant position in China;
- establish the joint venture in Turkey;
- build on the investments in Russia and Eastern Europe.

As well as these specific targets, there are also six strategic imperatives.

204554892

Develop a focused, segmented and differentiated brand portfolio

First, we have to develop our international brands to generate future profit and cash flow. I know that, in the past, there has seemed to be an endless debate about which of our brands actually qualified as international. Our criteria for the selection of international brands are that they should be seen by the consumer as international and that they should have critical mass. On this basis, our international brands are: Lucky Strike, Kent, Pall Mall, Viceroy, State Express 555, Benson & Hedges, John Player Gold Leaf, Barclay and Hollywood. Carlton and Silk Cut are two new possibilities available to us since we made the deal with American Brands. End of debate!

Each of these international brands must be consistent on a worldwide basis, something I accept that we have been weak at in the past. If we are not to confuse our consumers, we must have consistency in the product itself, in its communications, its pricing and its packaging. However, consistency does not mean that everything has to be the same in every place.

Looking at the international brands segment in more detail, both the value-for-money and premium segments are growing, although value-for-money is growing more quickly. BAT has a much higher volume share in the value-for-money segment than in the premium segment, which is why our international brand profitability is so much lower than Philip Morris'. Together with their dominance of the US market, this is the main reason why it is unrealistic for us to expect to match Philip Morris in profit terms in 10 years.

204554893

Our premium international brands are Benson & Hedges, State Express 555, Carlton and Barclay. In the mid to high price segment we have Kent and Lucky Strike, with Viceroy, Pall Mall, John Player Gold Leaf and Hollywood at the value-for-money level.

Our strategy is to build on the strength of our high share in the fast growing value segment, as well as ensuring that we are better placed to cater for the consumer who wishes to trade up.

We expect the switch from local brands to international brands to be a general trend, although it is one which will happen more quickly in some markets than in others. The speed of switch can sometimes be slowed by strong support for local brands where we are strong but we must accept that international brands will dominate in the end, even though it may take some time. Of course, local brands may still hold significant market positions if they have been managed well and have at least developed into regional brands.

And talking of regional brands, we must obviously maintain our strong position by supporting selected brands. There's not quite such an intense discussion here but our most important brands are: Kool and GPC in the US; HB, Prince and kim in Europe; Hilton in Asia Pacific; Belmont, Derby and Free in Latin America; Embassy and Sportsman in Africa; and Wills Gold Flake, Scissors, Bristol and Wills Navy Cut in the Indian Sub-Continent.

The priority for regional and local brands is to generate current profits and cash flow, while maintaining brand loyalty and our corporate market share. Success with regional brands is what will enable us to invest further in our international brands.

204554894

Some of our regional and local brands are in vulnerable positions with old or weak campaigns, so we are revitalising the communications for brands like Kool and HB, and must continue to do so, to maintain our market share.

BAT also needs to take advantage of the opportunity to develop a free standing Lights brand, so that we can take a strong position in the growing Lights segment, where our two main candidates are Kent and Barclay. We also have opportunities with Carlton and Silk Cut, so we are well placed to capitalise on the world market's gradual shift to lower tar and nicotine levels.

In our assessment, there is a limit to how far a full flavour brand can be stretched. Philip Morris, for example, have not yet succeeded with Marlboro Ultra Lights in the US, despite many years of testing. This really should give BAT the opportunity to develop a brand against which Marlboro can't currently compete very well.

We need to focus our research and development on improving product and smoking quality, as well as generating genuine innovations which can be used to gain a competitive advantage. In the Lights and Ultra Lights segment, for example, it must be our aim to achieve greater consumer satisfaction than can be offered by our competitors' brands.

In order to drive our brand portfolio, we obviously have to improve the effectiveness of our marketing spend. As an example of what not to do, I need do no more than mention the inconsistent level of support for Lucky Strike over time, along with its various campaigns.

204554895

Another instance of our willingness to embrace what might appear to be a cultural change, in BAT's terms, can be seen in the fact that we are now prepared to enter contract manufacturing agreements and even to license our trademarks, if joint ventures or other entry routes to new markets are not feasible, for the time being. The examples here are Poland, Turkey and China. I accept that these arrangements will generate lower absolute levels of profit than full scale operations, but they should still produce very attractive returns on our investment and provide the base for us to reach our ultimate objective of establishing fully fledged joint ventures.

Have an excellent trade marketing and distribution capability in the end markets

Moving beyond the brand portfolio, we must focus on gaining advantage from trade marketing and distribution. All of you who have heard Hans Niedermann on the subject should not need me to persuade you that this is an easier area than some where gaining a competitive advantage is concerned. Furthermore, where media is not available, trade marketing is the only tool that can be used to build our brands.

Minimise supply chain costs within the constraints of the marketing objectives

The efficiencies we can achieve through trade marketing must be reinforced by a continuous reduction in our unit costs. I accept that, with our wide range of brands and larger number of factories, we do not have the economies of scale to be the lowest cost provider, worldwide, in the short to medium term. But think of the opportunity!

204554896

That is why sourcing decisions cannot be left simply to the discretion of end-market managers. They have to be decided centrally so that our sourcing, and following on from those, capacity and expenditure decisions, can be optimised, worldwide, in terms of cost, quality and the marketing aspects of "Made in England" or "Made in the USA".

Our marketing strategy will mean supporting fewer brands and styles in future, although a brand or style will only be dropped completely if it is not profitable. The development of free trade will increasingly allow us to supply one market from a factory in another market, even though there will still be some regions where the best low cost option will still be to have local factories, so that we can avoid high import tariffs.

We also need to ensure that we achieve a competitive advantage from our position in Leaf. There is some evidence that the edge provided by Leaf is less than it used to be, so we need to decide whether the business should be continued on the basis of minimum time and maximum profit, or even whether it should still be part of the Group's core business.

Establish leading positions in priority markets where we are not already strong

Leaf has certainly given us an advantage in some of the new business development markets, where tobacco is an important crop, and we have already achieved investments in many of our priority markets, particularly in Eastern Europe and the former Soviet Union. The remaining top priority markets are China, Turkey, Poland and Vietnam.

204554897

We are also under represented in many of the world's largest and most profitable markets, such as Italy, France, Spain and the UK. In all of these, the only realistic way to achieve a major position in a relatively short time scale would be to make an acquisition but any acquisition has to make strategic and financial sense.

Last year's American Tobacco transaction is a good example of how expansion in developed markets can balance the risk of investing in developing markets, particularly where payback periods and remittable earnings are concerned.

Support consumers' freedom of choice to smoke

One of the strategic imperatives that inevitably involves a longer payback period is our commitment to support consumers' freedom of choice to smoke. We do intend to take a higher profile position internationally and attempt to "get science back into the debate".

The World Health Organisation's Beijing conference in 1997 will probably target the activities of tobacco multinationals in developing markets. We clearly need to do whatever we can to minimise any risk that the conference might damage our business, particularly in China.

We will also continue to lobby against excise tax increases wherever possible, so as to support our consumers and, particularly in the European Union, work for a tax structure which would diminish the price difference between local and international brands.

204554898

Ensure managers in key functions are first class

Just as important as supporting our consumers is ensuring that we, ourselves, have first class people in our key functions. In particular, we must continue to strengthen our marketing skills so that a state-of-the-art brand management capability can be developed.

We do need, however, to recognise that some of our operations will be orientated towards low growth and cost reduction and that the skills needed for them will be different, although no less important.

Conclusion

I believe that these eight strategic imperatives simply must be met, if we are to achieve our objective of becoming the world's number one tobacco company within 10 years. I do not expect everyone to agree with every detail but I very much hope that the broad thrust is not only clear but acceptable. Before I hand over to Keith, I just want to make one last remark to make it absolutely clear that we have a strategy and explain how you "come in" and can contribute to our vision of regaining the number one position worldwide.

Last year, the centre provided four acquisitions which will contribute some 50 billion sticks to our total Group volume this year. We are looking for your contribution and help in increasing market share and volume in our existing markets, as well as, of course, in exports. Without your contribution we will not achieve our overall objective. Let's be absolutely clear about that:

204554899

Now over to Keith, who is going to give you an update on the progress of Project Battalion, after which he and I will both be happy to answer your questions, whether they're on the tobacco strategy or on Project Battalion. They are both equally important, because Battalion is very much the key to the successful execution of what I believe is a coherent and ambitious strategy, reflecting the vital importance that B.A.T Industries attaches to the tobacco business.

204554900