

SECRET

BATCO OPERATING GROUP

KEY AREA - FINANCE

Changes from 1991 Key Area Paper are indicated by double lines in right hand margin.

INTRODUCTION

This paper seeks to establish the financial priorities of BATCo. and to confirm the minimum levels of financial performance acceptable for BATCo. and its Operating Companies. It incorporates the July 1991 financial guidelines from BAT Industries and the financial issues arising from the BATCo. 5 year plan 1992 - 1996, together with the expectations from the BATCo. operating companies to be reflected in their 1993 - 1997 company plans.

The financial performance targeted for BATCo. should be set against the objectives of BAT Industries, which include:-

"Provide an above-average return to shareholders through dividends and capital appreciation based on a sustained trend of above-average growth in Earnings Per Share, achieved by developing and expanding the Group's activities in Tobacco and Financial Services.

However, emphasis will also need to be given to improving profitability, to reducing costs and to improving asset productivity, ensuring that each activity within the Group achieves a return on assets which will generate a net cash flow sufficient to pay a dividend and to fund the investment necessary to support above-average growth".

The following areas are covered:

- (i) Growth in Profitability.
- (ii) Return on Net Operating Assets (Historical only).
- (iii) Interest Cover and Debt Management
- (iv) Taxation Management.
- (v) Return on Shareholders' Equity.
- (vi) Cash Management and Cash Generation to BATCo.
- (vii) Standard Finance Policies Applicable to Operating Companies and Finance Directors' Checklist.

BATCo's Financial Position 1988 - 1996 is summarised in Appendix I.

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(i) Growth in Profitability

The current BATCo. plan projects sterling pre-tax profit growth of 10.8% 1993 over 1992 and 10.6% over the period. To meet the aspirations of BAT Industries, profit growth of 15% p.a. in sterling is required from the 1992 base. Certain companies will be unable to achieve this every year, but it should be targeted, particularly for 1993, except where it puts at risk the longer term viability of the company. In practice BATCo. seeks to achieve this growth level on a published quarterly basis.

In targeting individual company profit growth, consideration should be given to the following:-

- (1) Those companies that have the potential to produce cost savings, better asset utilisation and efficiencies, and disposal of non or under performing assets. One of the key BATCo. objectives is to be the lowest cost producer in each of the markets where we operate. A 5% p.a. real reduction in General Administration costs should be targeted.
- (2) A major determinant of profitability is the level of factory selling prices and companies should ensure that as a general rule cigarettes do not become cheaper in real terms.
- (3) Excise is the largest single item of cost and companies should regularly review their excise systems with a view to ensuring the key objectives of all interested parties are being achieved. Where this is not the case consideration should be given to pursuing a more proactive approach with the authorities to improve the overall position. It is suggested companies should address the overall subject of excise as a separate issue in the company plan. An Excise Key Area Paper is also available as a reference.
- (4) The financial position and marketing activities of the competition and how it is likely to impact on the operating company forecasts.

(ii) Return on Net Operating Assets (Historical basis)

The July 1991 Guidelines received from BAT Industries stated that:- "BATCo. should aim to achieve a historic cost return of at least 40% for the Operating Group as a whole with each individual business achieving at least 25%."

Appendix II highlights those companies where the historical RONA is below 25% and where the forecast 1993 return is lower than the 1991 actual or 1992 budget.

It is suggested Territorial Directors and Finance Advisers target individual company historical RONA's based upon current forecasts and known improvement opportunities.

While specific references to CCA returns and targets have been excluded, those companies operating in territories prone to inflation and devaluation must continue to constantly monitor their performance so that there is no overall deterioration of the business in real terms. CCA may need to be continued in certain circumstances and other management measurement and monitoring techniques include effective use of replacement costing for managing price increases and tight cash control and cash flow management. Territorial Directors and Finance Advisers should target those companies that are vulnerable and ensure proper management controls are in place.

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The developments at BAT Industries regarding changes in accounting for the Group's Brazilian interests will be monitored to see if they are applicable to BATCo.

(iii) Interest Cover and Debt Management

All companies should seek to limit interest cover to not less than 7 times. The situation giving rise to low interest cover in Indonesia, Panama, Cameroun, South Africa Foods and Chile Agribusiness should be examined to ensure we are continuing to structure debt in the most cost effective manner.

Many Operating Companies still have potential for increasing their local borrowing without reducing interest cover to below 7 times. Where appropriate and particularly if the flow of funds to the shareholders can be increased, a higher level of local borrowing and lower level of interest cover should be pursued. However, the impact of any significant non-forecast expenditure on the BATCo. group debt/equity position will need to be considered before approval. Within this framework, individual company Debt/Equity ratios of 50%, and even higher in short term instances, are acceptable and, within this criteria, there is great potential for further increasing dividend flows.

Companies where the interest cover is higher than 12 times and can be classified as having surplus financial resources include Costa Rica, Honduras (1993 onwards), Malawi, Mauritius, Wills PNG (1993 onwards), Wills (New Zealand), Singapore. Companies with virtually no interest paid also include BAT Suisse, BAT Nederland, Nicaragua, Nigeria, BAT Zimbabwe, Uganda, Malaysia and Barbados.

Local remittance problems should not prohibit maximum permissible dividend declarations.

(iv) Taxation Management

In 1992 the BATCo Group will suffer corporate taxes of £113mn of which over 80% arises outside the UK.

The Group effective tax rate has improved from 27.8% in 1990 to 25% in 1991 and is forecast at 22.5% in 1992. Thereafter the forecast rate deteriorates to 24% in 1996.

Tax management papers issued to all companies remain relevant. Attention is particularly drawn to:

- a) The UK Inland Revenue's contention that BATCo is recovering insufficient costs from its operating companies in respect of T & A fees and R & D recoveries. All efforts should be made to increase direct income flows to the UK and reduce Millbank exposure in this area.
- b) The effective UK tax rate of 8% means that the Group's overall tax efficiency improves by the maximisation of local borrowings and the minimisation of shareholders funds through high dividend distributions and the consideration of capital reduction schemes.

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(v) Return on Shareholders' Funds

The BATCo. Group historical return on Profit After Tax to Shareholders' Funds improved to 29.2% in 1991 and is forecast to rise to 32.1% in 1992 and to 32.8% in 1993.

To enable the Group's cash generation objectives to be met, the overall key financial criteria must be regarded as profit after tax return on shareholders funds. This also encompasses debt, cash, and taxation management from the profits angle and the quantum of dividend, capital reductions and retentions in the business from the shareholders' funds level.

The objective must be for the return on shareholders funds to increase at a faster rate than RONA. However, the following companies have a static/falling return on shareholders equity:-

|                 |                   |
|-----------------|-------------------|
| Spain (1993)    | Export Leaf       |
| Cyprus (1994)   | Cameroun          |
| Nobleza         | Uganda            |
| Republic (1994) | Singapore (1993)  |
| Suriname        | Pakistan (1993)   |
| Nigeria (1994)  | Bangladesh (1994) |

The following companies have a return below 20%:-

|                        |                           |
|------------------------|---------------------------|
| Wills (Australia)      | S.A. Food (up to 1994)    |
| Malaysia               | S.A. Tobacco (up to 1993) |
| Indonesia              | Suriname (1993 onwards)   |
| Pakistan (1993 - 1995) | Spain (1992 onwards)      |
| Bangladesh             | Suomen (1992)             |
| Export Leaf            | Cyprus (1992)             |

The following companies have a return on equity growing slower than RONA (over the period 1991 - 1994):-

|             |                   |
|-------------|-------------------|
| Spain       | Aureol            |
| Chile Group | Export Leaf       |
| Republic    | Cameroun          |
| Honduras    | Uganda            |
| Morazan     | Wills (Australia) |
| Barbados    | Wills (PNG)       |
| Nigeria     | Malaysia          |
| Kenya       | Indonesia         |
| SA Tobacco  | Singapore         |
| SA Food     | Bangladesh        |
| Malawi      | Ceylon            |

Strategies should be developed with the operating companies that over a period of time reverse the declining trends and improve the return on shareholders funds both in quantum terms and at a faster rate than RONA.

(vi) Cash Management and Cash Generation to BATCo.

Sound cash management, together with risk adverse Treasury management and the maximum generation of cash by operating companies and remittances to BATCo. should be regarded as a key area for inclusion in all company Guidelines.

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The Manageable Cash Flow figure in the new Cash Flow reporting is likely to become the basis for future guidelines and it is suggested an appreciation of this area is targeted.

A. From Operating Companies to BATCo.

This is reflected in the minimum dividend declarations required by BAT Industries from BATCo. which increase at 12% reflecting net interest growing at a lower rate than trading profit.

The improving RONA returns, the limited use of debt within the majority of the BATCo. businesses and the trends in the returns on shareholders funds indicate substantial amounts of cash within certain companies that are basically surplus to requirements for the ongoing size of the existing tobacco operations.

Following the BATCo. dividend requirements and unique tax position of UK income, guidelines to operating companies should emphasise the need for maximising UK remittances via the UK companies, ie. BATCo. BAT (UK & E) or Henri Wintermans UK. The following specific issues should be addressed:-

- (a) Dividends should be maximised and local constraints challenged. Surplus cash and under-utilised borrowing potential within companies is basically financially inefficient from an overall BAT Group position. In particular any forecast cash build up should be addressed via the guidelines.
- (b) Payments by Operating Companies for specific expenses such as royalty, T & A Fees, R & D, insurance placed with TIC, etc. are highly tax efficient as they are generally allowed for tax in the operating company and subject to low tax in the UK. Purchase of operating company trade marks by the centre could be financially attractive where it provides tax efficient UK royalty income and provides the companies with cash which can eventually be repatriated as dividends.
- (c) The use of capital reduction schemes. This is particularly attractive following the removal of pre 1.4.1982 gains from UK Capital Gains Tax. This option should be explored with all companies that have surplus financial resources. A paper on Capital Reductions is available.
- (d) For companies in Central America, Caribbean and Africa, continuing efforts should be made to release BATCo. blocked funds which at December 1991 has a nominal book value of £14.5 mn. comprising mainly of invisibles, eg. Dividends, T & A Fees and Royalties. Such income is only taken to BATCo. profits when received.

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While encouraging progress has been made, principal amounts outstanding and possible value that could be realised given the opportunity include:-

|              | Local<br>Currency<br>Based | Sterling<br>Based | Total<br>£ 000's | Potential<br>Value<br>£ 000's |
|--------------|----------------------------|-------------------|------------------|-------------------------------|
| Nigeria      | -                          | 1,778             | 1,778            | -                             |
| Ghana        | 875                        | 69                | 944              | 900                           |
| Sierra Leone | 542                        | 2,449             | 2,991            | 750                           |
| Uganda       | 1,117                      | 308               | 1,425            | 1,400                         |
| Nicaragua    | 582                        | -                 | 582              | 550                           |
| Suriname     | 1,576                      | 540               | 2,116            | 500                           |
| Demerara     | 30                         | 2,587             | 2,617            | 2,600                         |
| Zaire        | 20                         | 852               | 872              | 600                           |
|              |                            |                   |                  | <u>7,300</u>                  |

All legal methods of extracting blocked funds should be examined, including debt swaps, counter-trading and other methods including charitable donations, which have tax advantages. A policy statement on Swaps was issued in 1989.

Where it is not possible to organise the immediate release of blocked funds, then arrangements should be made to ensure that they are invested in such a way as to maintain their value in real terms, normally in a readily realisable form so that repatriation can take place immediately any opportunity arises.

B. Within Operating Companies

With the increased emphasis on cash and asset management it may be appropriate, particularly in high inflation territories, to set a year end cash balance objective.

Companies should aim to bring their expertise in cash flow management and forecasting to the same general level of accuracy as reflected in profit management. The recently introduced Quarterly Cash Flow reporting should now be used to ensure this happens and to identify immediately those companies that have a negative cash flow or are generating less cash than budgeted so that corrective action can be taken.

Guidelines to Operating Companies should make reference to the "asset turnover ratio" required as an overall measurement of efficiency of asset management and targets set where rates are unacceptable or declining. Appendix III highlights those areas where the Asset turnover is below the group average or declining.

With volume growth opportunities, largely through exports, now emerging in several companies, extra vigilance is required to guard against over stocking and subsequent asset turnover ratio declines.

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The recent asset productivity exercise provided the opportunity for a thorough and ongoing review of all non and under performing assets and methods of improving the balance sheet ratios, liquidity, asset utilisation and the asset turnover ratio. There are many remaining disposal opportunities that should be taken as soon as practical.

Investment levels in Fixed and Current Assets are largely governed by volumes, and so the accuracy of sales forecasting is very relevant. This is generally accepted by most companies, but it may be appropriate to emphasise that where sales forecasts are not being achieved it is important to react quickly to adjust stock levels.

Capital expenditure recommended by the Operating Companies should be reviewed by Territorial Directors before inclusion in the BATCo. Company Plan, and the principles outlined in the paper "Financial Return on New Investment" should be followed in operating companies when evaluating proposals.

(vii) Standard Finance Policies Applicable to Operating Companies and Finance Director's Checklist.

In view of the high profile of the group, its activity in various financial markets and as a pre-requisite to BATCo. being a well managed group of companies it is vital that these disciplines are adhered to at all times. Territorial Directors, Finance Advisers, Operating Company No.1's and their Finance Directors and staff must ensure, particularly where staff changes occur, that awareness and implementation of these policies is maintained at all times. Unfortunately, serious lapses continue and compliance with these procedures at all times must be re-emphasised continually. Coverage of such issues as dividend levels, borrowing arrangements, new company formations, etc. in Company Plans does not remove the requirement for specific approval at the actual time of implementation.

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