

SECRET

BATCo OPERATING GROUP

KEY AREA - FINANCE

Major changes from 1994 Key Area Paper are indicated by double lines in right hand margin.

BACKGROUND

During 1994 BATCo Finance Department adopted the Mission Statement:

With world class people and standards, to proactively manage the BATCo Group's profits and cash to ensure our individual market and overall financial performances are at a level of definite competitive advantage.

A common set of financial Key Result Areas were developed for all Finance Directors and Regional Finance Controllers in the drive for more consistent focus and prioritisation of major issues.

The Finance function seeks to add value to the business process by understanding the key business issues, challenging the effectiveness of the allocation of scarce financial resources and playing a leading role in the achievement of both the short and long term profit and cash objectives of BATCo.

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 operations. It incorporates the June 1994 financial guidelines from BAT Industries and the financial issues arising from the BATCo, 5 year plan 1995 - 1999, together with the expectations from the BATCo, operations to be reflected in their 3 year 1996 - 1998 plans.

The Key Area Paper covers the following areas:

- (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, Manageable Cash Flow and Cash Generation to BATCo.
- (vii) Export Business Financial Performance.
- (viii) UK Costs and Southampton operations.
- (ix) Standard Finance Policies Applicable to operations and Finance Directors' Checklist.

BATCo's Financial Position 1991 - 1998 is summarised in Appendix I.

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(ii) Growth in Profitability

The revised Group profit budget for 1995 should be used as the basis for growth guidelines for future years, as the original plan profit for 1995 was not acceptable. However, for certain companies/markets, the revised 1995 profit base is probably unacceptably low and individual profit growth guidelines need to take this into account. Overall profit growth in constant terms of at least 12.5% p.a. in line with BAT Industries expectations is considered to be achievable based upon 1995 - 99 plan projections and the opportunities for profit enhancement available. Prioritisation of resource allocation between markets and brands is essential if the profit growth targets are going to be achieved. In practice BATCo. seeks to achieve the profit growth targets on a published quarterly basis. These profit growth expectations exclude any significant restructuring costs and the local results of the new businesses in Russia and Uzbekistan.

The present cost structure of the BATCo group puts BATCo at a competitive disadvantage and more radical ways of structuring and managing the business need to be developed.

In targeting individual company and export market profit growth and attributable brand earnings growth, consideration should be given to the following:-

- (1) Consistency with international brand and market share objectives.
- (2) Commitment to the implementation of the 'Pink Book' which should provide a key mechanism for the improvement of profit and management of the trade.
- (3) A major determinant of profitability is the level of selling prices. Export Managers and companies should ensure that as a general rule cigarettes do not become cheaper in real terms, and with increasing leaf and WMS prices and pressure on brand support costs, realistic costing and forecasting is essential in determining future pricing levels.
- (4) Those operations that have the potential to produce cost savings, better asset utilisation and efficiencies, and disposal of non or under performing assets.
- (5) Excise is the largest single item of cost and excise systems in all markets should be kept under constant review to ensure the key objectives of all interested parties are being achieved. BATCo should never be at a competitive disadvantage because of an excise structure.
- (6) The financial position and marketing activities of the competition and how it is likely to impact on individual market forecasts and pricing levels.

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

The June 1994 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%."

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Appendix II highlights those companies where the historical RONA is below 25% and where the forecast 1996 return is lower than the 1994 actual or 1995 revised budget. Appendix III highlights those areas where the Trading margin is below group average or declining.

It is suggested Regional Directors and Finance Controllers target individual company historical RONA's and export markets contribution to admin based upon current forecasts and known improvement opportunities.

Those operations 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. Current Cost Accounting 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. Regional Directors and Finance Controllers should target those operations that are vulnerable and ensure proper management controls are in place.

The methodology for understanding and enhancing Brand Value should be implemented and the results evaluated. However, this is a separate management exercise to improve our understanding of brand value and is not intended to form part of the Balance Sheet.

(iii) Interest Cover and Debt Management

BAT Industries are looking to BATCo. to reduce its debt equity ratio over the plan period - no specific targets are set - except to the extent that U.K. income can be enhanced via increased local borrowings.

Appendix IV highlights companies with interest cover falling within the following bands -

- a) Below 7 times
- b) In excess of 12 times

In the case of the (a) band the profitability of the end market and structure of the debt should be examined to ensure we are financially geared in the most effective manner from a tax and U.K. income angle.

Companies falling within the (b) band can be classified as having surplus financial resources and all ways of improving U.K. income and group tax efficiency must be explored

There may be group tax advantages if borrowings can be channelled via Hamburg Investment Trust or the Belgian Co-ordination Centre and these opportunities should be explored before new local borrowings are taken out or when existing facilities are due for renewal. Discussions with both Treasury and Taxation are required when such facilities are used.

Local remittance problems should not prohibit maximum permissible dividend declarations

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(iv) Taxation Management

In 1995 the BATCo Group will suffer corporate taxes of £141 mn of which only 26% arises on UK profits which represent 48% of the Group total profit.

The Group effective tax rate has improved from 25.2% in 1991 to 22.7% in 1994 and is forecast at around 24% for 1995.

The UK Government has introduced Foreign Income Dividend (F.I.D.) legislation which can reduce the UK tax payable on dividends paid by BAT Industries where the dividends are funded from overseas earnings. The introduction of this legislation does not alter the objectives of reducing the taxation paid by operating companies and of maximising the opportunities for increasing UK income - the UK marginal tax rate for 1995 and beyond remains at 13%.

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 subsidiaries and, more importantly associated 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 marginal UK tax rate of 13.0% in 1995 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.
- c) The low UK tax rate also means that BATUKE is a very tax efficient vehicle for exports. By carefully structuring operating company export operations via BAT(UK&E) the Group can capitalise on this situation.

(v) Return on Shareholders' Funds

The BATCo Group historical return on Profit After Tax to Shareholders' Funds is forecast at 31.5% in 1995 and to 36.2% in 1996.

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. Appendix V sets out those companies that have:

- a) a static/falling return on shareholders equity
- b) a return below 20%
- c) a return on equity growing slower than RONA (over the period 1994 - 1997)

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Appendix V highlights that most companies fall under c) above and strategies must 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. The level indicated points to dividend declarations being too low.

(vi) Cash Management, Manageable Cash Flow and Cash Generation to BATCo.

Our policy revolves around sound cash management, together with risk averse Treasury management and the maximum generation of cash by operating companies and remittances to BATCo.

A new Treasury policy is due to be issued in the first half of this year. This will combine all the various current policies that are at present contained in numerous guidelines and instructions.

Banking Relationships, Local Borrowing Requirements, Foreign Currency Management and Netting are four key areas where we will be seeking to gain extra value for the Group during the next 18 months. In each of these areas, specific attention should be paid not only to the new policy and procedures, but also the work and direction that has been and will be emanating from the BATCo Group Treasury during the next few months.

The Manageable Cash Flow figures by operations are detailed in Appendix VI. These should form the basis of targets for individual operations and should be monitored on a quarterly basis via the QPR and QBS during the budget year to improve overall cash management. BAT Industries have set a target of manageable cash flow growth (excluding capital expenditure) increasing at 2% above trading profit growth to reflect control of working capital.

A. From Operating Companies to BATCo.

This is reflected in the minimum dividend declarations required by BAT Industries from BATCo, in 1996 to 1998 which increase by 15% p.a.

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, i.e. BATCo. or BAT (UK & E). 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.

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- (b) Payments by Operating Companies for specific justifiable and arms length 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.
- (d) Continuing efforts should be made to release BATCo blocked funds.

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. Manageable cash flow growth should exceed trading profit growth.

Companies must bring their expertise in cash flow management and forecasting to the same general level of accuracy as reflected in profit management. The monitoring of the Manageable Cash Flow via the Quarterly Cash Flow reporting should 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 VII highlights those areas where the Asset turnover is below the group average or declining.

With volume growth opportunities, largely through exports which tend to be more volatile, emerging in many markets, extra vigilance is required to guard against over stocking and subsequent asset turnover rate declines.

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

There are many remaining disposal opportunities for non and under performing assets that should be taken as soon as practical.

Proposed capital expenditure should be reviewed by Regional 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. Reference should also be made to the Group manufacturing capacity data base held by PP&D before recommending or agreeing a new investment.

Use should be made of post audit reviews covering all areas of the business e.g. investment appraisals, price increases, new brand launches, etc with a view to improving controls and learning from past experiences to assist the quality of future decision making.

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(vii) Export Business Financial Performance

Appendix VIII shows contribution to admin from the major markets and growth rates. The same principles for the operating companies are relevant - maintaining price levels and margins consistent with costs and international brand and market share objectives; cost, credit and stock control; and cash management.

Complexity costs, the level of unallocated overheads and financing costs must be taken into account when fixing prices and considering contribution to admin figures. As well as absolute currency values relevant ratios for each market, e.g. contribution to admin as % of net turnover and contribution to admin per mille also need to be considered for each market.

Southampton site costs will be allocated to exports on a budgeted per mille cost which will be determined when the impact of the Project Stern (cost - 10%) formula is fully evaluated.

(viii) UK Costs and Southampton Operations

The management of all UK costs is becoming a major issue with Southampton failing to meet its original Project Test conversion cost levels and the majority of Staines and Woking department cost centres looking for cost increases way ahead of the rate of inflation and the general level of cost increases accepted in the overseas operations. Southampton should pursue its Class A status objectives while Head Office costs are unlikely to be aggressively tackled until the outcome of Project Battalion is known.

(ix) Standard Finance Policies Applicable to Operations 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. Regional Directors, Regional Finance Controllers, 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. There have been serious lapses in the past 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 Plans does not remove the requirement for specific approval prior to the time of implementation.

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