1995 KEY AREA PAPER: SECURITY AND ECONOMY OF LEAF SUPPLIES

Mission Statement

Growing: **To produce a domestic crop of tobacco of acceptable quality with a lower in stock cost than comparable grades of imported tobaccos and thereby provide a distinct competitive edge.**

Exports: **To secure long term profitability of the business; protect BAT's sources of supply; and ensure a cost advantage to BAT vis a vis the competition.**

Purchasing: **To coordinate all buying to ensure security of supply; and equal or lower cost than the competition (grade for grade).**

Blending **To ensure superior smoking quality of our blends compared to competition; that leaf stock durations meet security of supply and ageing requirements; to have professional and well trained blending specialists for the future.**

Overall: **To protect and use our No 1 position in leaf worldwide to leverage the business to our advantage and wherever possible to place our competition at a disadvantage vis a vis security of supply, quality and price.**

1. Domestic Tobacco Production

1.1 **Quantity:** Plans for domestic crop must reflect the Operating Companies requirements for domestic use (based upon the individual Operating Company duration policy) and for exports (see later section on exports). Uncontrolled expansion with "the hope" of exporting any surpluses (ie no commitment) is not acceptable.

1.2 **Quality:** Plans must show quality improvements and how these will be obtained, particularly with regard to improving grade turnout.

1.3 **Yield:** Minimum target yields/ha must be set for the next crop (1996) for each type grown. Yields must show progressive improvement. However, these must not be to the detriment of quality.

1.4 **Price:** annual cost of production surveys (tobacco and competing crops) must be carried out to establish realistic and competitive purchase prices so that farmers' returns stimulate the required production without adversely affecting essential food crop production. Export pricing implications must also be considered.

Net returns to farmers should be competitive with returns achievable from non-tobacco crops. Returns should be increased by a combination of improved yields, reduced real cost of inputs/labour etc (ie efficiency) rather than having to

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resort to automatic price increases; our farmer base and hence our key source of raw material must be protected and managed effectively and efficiently.

You should compare the cost of your domestic tobaccos to the cost of comparable quality leaf available from the International market.

Your objective must be "to produce a domestic crop of tobacco with an in stock/in warehouse cost (per kg) lower than imported tobaccos of comparable quality" - otherwise why grow when you could buy tobacco from outside cheaper. However, care must be taken not to over-react to the volatile world market situation by looking at your position over the medium term (ie five years).

(Obviously freight/duty/exchange rates/forex availability have to be taken into consideration and it should also be remembered that International prices are now beginning to rise over the Plan period, as previously forecast.)

1.5 **Master Farmer Schemes:** Each Operating Company must have an established scheme for identifying and rewarding (prizes, greater range of crop inputs available, etc) the better farmers. It is appreciated that these farmers will have higher yields and better grade outturn. Plans must clearly show your scheme (Master farmer, category A farmers, etc), how you intend to identify these farmers and actions to support and motivate them to achieve better quality and to provide a greater percentage of your purchases.

1.6 **Afforestation:** Every Operating Company using woodfuel (for all or part of the curing - flue/fire - and for barn construction, etc) must have an afforestation programme with the objectives of achieving self sufficiency in wood supply over the shortest realistic time period. Plans must show target dates for self sufficiency The BATCo Policy on Afforestation must be adhered to.

Afforestation schemes should be based around farmer plantings, and where feasible, be supplemented by company managed plantations. Improvements in specific fuel consumption (amount of fuel used to cure one kg of tobacco) must be achieved. ie targets set and actions shown.

Alternative Fuels - Each Operating Company must review the use of alternative fuels to ensure that opportunities are not lost in terms of cost/efficiency and/or replacement of woodfuel to ease the pressure on afforestation issues. Plans must reflect current situation and plans for alternative fuels if applicable.

1.7 **Crop Chemicals:** The selection of and need for crop chemicals must be critically evaluated and updated. BATCo policy on safety in the use and storage of such crop chemicals must be stringently followed.

1.8 **Food Crops:** Tobacco production must not affect food crop production but should also seek to enhance it through increased yields from residual fertilisers, rotations, improved agricultural techniques etc.

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1.9 **Crop Expenses:** Must be monitored and controlled effectively. Increases in crop expenses (on a per kg green weight basis) should be less than domestic inflation (ie real savings). These can be achieved by, for example, reduced manning levels, improved loan recovery, improved yields and perhaps even reorganisation of the extension function to achieve same or better coverage. However, tobacco quality must not be prejudiced.

Crop expansion automatically reduces crop expenses (on a per kg basis) which can sometimes hide inefficiencies. It is therefore extremely important to obtain real savings and to ensure that we are competitive even without any crop expansion.

1.10 **Crop Advances and Capital Loans:** Many Operating Companies still fund crop inputs and cash advances themselves and/or guarantee local bank advances. The objective should be to not only utilise bank loans and do away with the guarantee, but also to reduce and eventually eliminate loans to farmers. It is fully appreciated that this is not currently feasible in all operations, but you must seriously investigate how far you can go to meeting these objectives and to clearly state what you intend to do and by when.

Crop inputs/cash advances and capital loans to farmers can, depending on the type of growing programme, vary from 10% of the value of tobacco to be purchased up to 60%. There have been cases in the past where this was even higher and the growing programme almost collapsed with excessive debts and demotivation of farmers. Each company growing tobacco must clearly state in their plan outstanding loans/debts carried forward from previous crops, planned advances/loans for the budget year, the value of these loans as a percentage of the value of the crop to be purchased and recovery targets. (Further details will be forwarded with each Company's specific Guidelines.) The objective must be to reduce advances/loans (as a % of the value of the crop to be purchased) to reduce risk. Targets and actions required should be clearly stated.

1.11 **Safety:** Agricultural/extension safety is a key issue (eg chemical use, tractors, storage etc) and BATCo's policy on safety must be stringently followed. A zero accident target must be set and will become part of the normal performance appraisal assessment.

2. <u>Export of Domestic Tobaccos</u>

2.1 **Quantity:** Domestic requirement must first be fully met. Quantities grown/ produced for export should be based on firm indications from dealers/ customers (these should be written indications in which case they may not be legally binding, or part of the contractual agreement in which case they could be considered legally binding). Any production over and above firm indicated orders must be approved by Leaf Department and the RBU. It is therefore extremely important to know your customers and have tight contracts with dealers. With the new scenario on world supply (shortage developing) and prices (increasing) there is an opportunity to consolidate and recover export markets

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and profitability. This must be well managed with the objective of securing long term sales.

2.2 **Run of Crop:** Exports should be run of crop otherwise there is a danger of debasing your domestic cigarette quality which is unacceptable in any market and even more serious in a competitive market. If exports are not run of crop it is difficult to truly cost these exports and we would question your profit figures.

2.3 **Price/Profitability:** Exports must be profitable on the accounting basis established by BATCo Finance (paper circulated December 1991), unless there is an overriding need for forex earnings, however if the latter is the case this must be clearly stated in the plans and agreed by your Regional Director. Exports must be profitable even without any local currency devaluations. Devaluations are a bonus and not a realistic reason for pushing exports.

The "BATCo Leaf Export Policy", circulated to all exporting Companies on September 1 1993, clearly states the direction the Group is taking with regard to exports. The policy must be followed and any exceptions can only be approved by Leaf Department and the RBU.

Margins in a normal year should be sufficiently large enough to cater for fluctuating export prices (ie the world tobacco surplus depressed prices in 1994 - the 1995 recovery is expected to carry on through to the 1996 crop - for 1997 we will have to assess the reaction to increased prices on crop volumes and supply/demand.

2.4 **Other Factors:** Tobacco quality must be acceptable, continuity of supply must be assured, crop chemical residues must be below permitted levels, processing specifications must be met, and infestation controls well established.

2.5 **Export Contracts:** Leaf Export Contract Guidelines have been circulated. Each Company must incorporate the recommendations/points made in these Guidelines when their respective Export Contracts are next renewed (usually every year). Again it is important to take advantage of a rising export market to negotiate longer term sales security to protect our business if and when the next downturn occurs.

3. <u>GLT Processing</u>

3.1 **Quality Control Protocols:** All Operating Companies have already received the new quality control protocols (ie methods for measuring processing specifications). These must be implemented so that you/we have confidence in the various specification measurements reported and that the figures are comparable over our industry. The new International Coresta screens must be used as they are an integral part of the protocol, and a BAT QC Audit Team has been formed to ensure compliance.

3.2 **Processing Specifications:** All Operating Companies will be receiving the updated processing specification targets (move to redried targets with upper and

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lower limits to achieve uniformity/minimise variability). Whilst these are for tobaccos purchased internationally by the total BAT Group, they should be used as a standard by all Operating Companies. Most companies must plan to meet and even exceed these standards and the targets must be clearly shown in the forthcoming Company Plans. Some companies, with older equipment, may have difficulties in the short term. However, in these cases, progressive improvements must be shown/stated, actions required to achieve this improvement and a target date set for meeting/exceeding BAT standards.

Export customers processing specifications must be met.

It is important to remember that the domestic cigarette factory is also a customer just like any export customer.

3.3 **Processing Costs:** Whilst it is fully appreciated that we need to upgrade plant and equipment with the knock-on effect of depreciation increasing processing costs, we must remain fully competitive. Processing costs in some operations are still too high and every effort must be made to reduce these, targets must be shown and actions clearly stated to achieve these targets.

3.4 **Infestation Control:** Good housekeeping and cleanliness are the basis of good infestation control. The selection, use and storage of infestation control chemicals must be strictly in accordance with BATCo policy (issued February 1992 with updated additions).

4. <u>Imported Tobaccos</u>

4.1 **Purchase Requirements:** All orders/requirements for imported tobaccos must be placed through BATCo Leaf Department, Woking, who are responsible for coordinating, supervising and negotiating prices for Group purchases.

4.2 **Buying Commission:** The BATCo Board have agreed to a standardised worldwide buying commission of 3% which is now applicable to all tobaccos from all supply sources. Wherever possible the commission will be built into the agreed prices to allow proper comparisons to be made. Otherwise it will be charged directly to the customer.

4.3 **Import Restrictions:** Where imported tobaccos are essential to enhance the smoking quality of domestic tobaccos and thus provide a competitive advantage, Government pressure to reduce/eliminate imports must be resisted.

4.4 **World Supply/Stocks:** With the end of the world surplus situation in sight, a dramatic shift to a shortage position is imminent for all types of tobacco. Prices reached their low point in 1994 and an upturn, necessary to support and stimulate the farmer and tobacco production, is now in progress. However, the dramatic change in the economic situation in Brazil (a major player/supplier to the world market) is exacerbating the price scenario; the exceptions are those sources with a market support system (eg USA, Canada).

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Most major supply countries cut production in 1994 and have not increased 1995 production to force the sale of surplus stocks and revitalise the world market. As a result, the quantity to be traded in 1995 is not likely to change and therefore may well be below world trade requirements.

1996 production of all types is likely to increase in response to this shift in overall supply and reaction to higher prices. However, due to the lead time of an agricultural crop, major supply problems could be prevalent in 1996 forcing prices to increase further.

It is essential to protect the supply of the raw material and green leaf prices can be expected to increase. Suppliers/dealers margins are also expected to be forced up as they try to compensate for losses/low profitability of 1993/1994.

Together these factors will have a major influence on prices in 1996. The fear is what will happen in 1997/1998 if proper and sensible management of this situation does not occur.

The situation continues to be volatile and BATCo Leaf Department will provide updated information through their quarterly review.

4.5 **Visits:** BATCo Leaf Department have to approve and coordinate all visits from BATCo Operating Companies to major producing areas.

5. <u>Stock Duration Policy/Stock Registers</u>

5.1 **Durations:** BATCo Operating Companies must establish stock duration levels within the policy guidelines given by the BATCo Board, recognising the intrinsic differences between "filler" and "flavour" tobaccos, the ageing period required and the use of two crop blending for flavour grades - essential contributors to smoking quality and hence consumer acceptance.

However, given the volatile nature of sales in certain markets and the tobacco supply scenario (see above), BATCo Operating Companies should work <u>within the flexibility given in the guidelines</u>, to maintain higher than normal stock durations of those imported tobaccos considered to be at risk or to take advantage of attractively priced tobaccos.

Any decision to purchase extra tobaccos at attractive prices against future years requirements must be first approved by BATCo Leaf Department and the Regional Director.

5.2 **Stock Registers:** Both the Imported Tobacco Stock Register and a Domestic Stock Register are now operational. BATCo Operating Companies are required to participate in returning information for these schemes so that better control and potential movement of stocks can be organised within the Group.

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6. **Functional Expertise**

6.1 **Recruitment:** BATCo Operating Companies must continue to recruit high calibre, high potential local national leaf staff. Particular emphasis must be given to recruitment for leaf blending and product development.

6.2 **Training:** Training/development programmes must be drawn up and carried through for all managers identified as having high potential with particular emphasis on the Leaf Functional Training Courses being offered by Souza Cruz, the Oriental Courses being offered by BATCo, the Blending Courses being offered by BATCo and a GLT training/development programme currently being developed by a subcommittee of the LTG (Leaf Trading Group). All leaf managers should at some stage of their career attend a detailed finance course and need to be fully aware of the financial impact of their decisions on the Company as a whole. All requests for training must be channelled through BATCo Leaf Department who will approve and assist companies with their training requirements.

6.3 **Regional Blenders:** BATCo Operating Companies should maintain close liaison with their Regional Blender, calling on his services when required.

6.4 **Blenders:** The TSG initiative on Career Development for blenders emphasises the need to reward blenders and product managers as specialists.

6.5 **New Business Developments:** The current initiatives into Eastern Europe/the Former Soviet Union and the Far East could well result in an increased requirement for experienced leaf personnel. These will first be sourced internally from within the Group. It is therefore imperative that you train and develop high fliers as quickly as possible and that you have succession plans in place to allow the Group to call upon Operating Companies to provide leaf personnel (International staff and local staff for ± 2 year attachments) if and when required.

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