PHILIP MORRIS U.S.A.

INTER-OFFICE CORRESPONDENCE

Richmond, Virginia

To: Steve Darrah

Date: June 2, 1992

From: Mark Kilpatrick

Subject: Rothman's B&H of Canada

The following outlines the current situation between Philip Morris and Rothman's regarding possible U.S. manufacturing:

Canadian Tax Situation

- The Canadian government increased the cigarette tax in Canada and as a result Canadians began to cross the border to buy their cigarettes in the U.S.
- Canadian cigarette manufacturers then began to increase their distribution of cigarettes along the border within the U.S.
- The Canadian government then enacted an Export Tax of $8.00/carton. This led Canadian manufacturers to seek alternative sources of supply outside Canada.
- The export tax has since been rescinded by the government in return for industry cooperation in fighting smuggling.

As a result of our investigating the possibility of establishing a Joint Venture with Rothman's to produce their cigarettes in the U.S., we discovered that there were opportunities to reformulate the relationship to our advantage.

Philip Morris - Rothman's Relationship

- Rothman's B&H (RBH) of Canada is 40% owned by Philip Morris USA and 60% owned by Rothman's (Canada). Rothman's (Canada) in turn is 71% owned by Rothman's (UK) the parent company and 29% publicly owned.

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- Philip Morris owns the rights to market the majority of the RBH brands in the United States but sublicensed this right back to Rothman's. Some of these brands are Belvidere, Cravin A, and Number 7 (these may be misspelled). We can terminate our sublicensing of the rights to market these products in the U.S. by providing 6 months notice to RBH.

- Distribution and sales of RBH products are handled in the U.S. by Tobacco Exporters International (TEI). TEI is 100% owned by Rothman's (UK).

- Rothman's (UK) has established a low transfer price from RBH to TEI. TEI then adds a large markup at retail which directly flows to Rothman's (UK). This arrangement in affect results in Rothman's (UK) making about $36 per thousand gross margin and Philip Morris making $4 per thousand on these products.

- The brands which we have sublicensed back to RBH have grown to about 1 billion units in U.S. sales and continue to grow rapidly.

Recognizing that there was an opportunity to capture the growing 1 billion unit market which would result in $35 to $40 million in additional revenue, Philip Morris gave notice to RBH on May 18th that we would be taking back our right to sell these products within the U.S. effective November 18th of this year.

To date, there has been one round of formal negotiations between Philip Morris and Rothman's (UK) surrounding the contract manufacture of these products in Canada by RBH for sale by Philip Morris. The result of this round being that the two parties are still very far apart. Further negotiations will be conducted both with Rothman's (UK) and directly with RBH. The alternative, if no acceptable contract manufacturing arrangement is reached, is that Philip Morris would need to be ready to manufacture these products.

<u>Philip Morris Manufacturing Plans</u>

Key product elements:

- These products use all Canadian tobacco to which no humectant is added. Issues exist concerning our ability to procure these tobaccos and our ability to control contamination in our primaries. The use of no humectants is a result of strict ingredient labeling laws in Canada.

- These products use a shell and slide type pack. Prior to this project we did not have equipment to produce these packs. Since, we have acquired 7 used packers and 6 wrappers from a dealer in Holland.

At the time a joint venture was being discussed with RBH to avoid the export tax, a preliminary proposal was made to manufacture these products in the Ashland warehouse with our only role being to sublease the warehouse (See attachment).

In approximately the April/May time frame a preliminary plan was put together to manufacture these products by Philip Morris pending a notification to RBH that we were cancelling the sublicensing arrangement. This plan called for cut filler to be made at Stockton Street and the cigarettes to be manufactured in Ashland. Our ability to meet a 1992 startup hinged on the contamination issue and whether Stockton Street would be successful or a new primary would be required. (See attached plan).

Since the notification was made to RBH, we have purchased the 7 packers and 6 wrappers as mentioned above. These machines are scheduled to arrive here this month and be stored at 1600 Jefferson Davis Highway. No further plans have been initiated to do anything further with this equipment which is of 1950-60's vintage.

In regard to Leaf, Bill Campbell has said that we should identify from where we could obtain the leaf, but should not purchase any at this time.

Tim Beane of Financial Planning in New York, who has been in charge of coordinating these efforts to date, indicated that in light of the unsuccessful first round of negotiations, we need to begin firming our plans to manufacture these products, both to meet the November 18th date and longer term. Plans required to meet the November 18th date should indicate the key decision points required.

Tim said that Bill Campbell is fully up to speed on all elements of this project. He also indicated that he would be in the office from 7:30 am tomorrow and could be reached at ext. 2116 if he could help you further.

If I can clarify any items please let me know.

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