2. Tobacco Group Strategic Review

2.1 Tobacco Environmental Trends

The most significant environmental trends with long-term impacts to the Tobacco industry are social and political. Future events in these arenas imply an environment which remains highly profitable, although significantly challenging in which to operate. Population represents another major environmental trend affecting the industry's outlook.

Social/Political

- Social pressure

  Anti-smokers continue to campaign for tax increases, for smoke-free environments in the workplace and other public places and for a ban on advertising. This heightened level of anti-smoking media tends to reinforce these efforts.

- Health

  The general health consciousness of the American public has increased. The primary focus of the health issue attack continues to be the use of scare techniques. Most recent attacks have been broadened to include the issue of the dangers of passive smoke.

- Litigation

  Litigation alleging that smoking has caused lung or cardiovascular diseases continues to increase with the involvement of more skilled and specialized law firms.

The foregoing areas are ones which the industry and Brown & Williamson have been vigorously and successfully defending in the past and every effort will be expended in the future to protect B&W's and the industry's position.

- Advertising

  In 1984, Congress enacted legislation requiring the use of four alternating health warnings on cigarette packages with the intent to strengthen anti-smokers' negative health claims.

  Similar health warnings will probably be required on smokeless products and it is expected that smokeless manufacturers will agree to forgo broadcast advertising.

- Taxation

  It is expected that either the federal excise tax of 16¢ per pack sunset provision will be superseded or a new tax enacted to maintain the current level. Longer term, cigarettes remain a revenue raising target for government at all levels.

- Tobacco support

  It is projected that either a stabilization buyout by major manufacturers will occur or the federal Tobacco support programs will be eliminated as the U.S. government extends its free market, nongovernment intervention movement. Longer term, either change has potentially positive cost implications for the industry; however, some short-term disruptions could arise during the transition phase.

Population

The population of the U.S. is aging as the "baby boomer" generation grows older and elderly people continue to live longer. Fewer young people and a reduced smoking incidence among younger Americans, implies the number of smokers ten years hence could be approximately 3 million lower. However, in total, the number of smokers will remain a very sizable market in the range of 50-52 million.

With a higher quit rate among better educated, upper income individuals, smoking is becoming more concentrated among the lower socioeconomic population. With minorities expected to account for 28% of the U.S. population by the year 2000, versus a 1980 level of 18%, the minority segment represents an attractive growing target segment for brand development.

2.2 Tobacco Environmental Implications

- A combination of the above environmental factors and the tobacco industry's maturity suggest a continuation of the industry trends currently in place. Volume is estimated to decline approximately .5% annually.

- A slowly declining, but highly profitable market will continue to generate intensified competition. Increased segmentation will result. Price, package size, geography and ethnic group will be used as a means of new differentiation, as well as, traditional cigarette market segmentation. Minority groups could become the target for more new product offerings. The pricing structure that has been a trademark of the industry is expected to continue tiering with the evolution of more price points likely.

- Modification or deregulation of the Tobacco Support Program produces a mix of potentially favorable and unfavorable results. The positive impacts include a reduction in leaf prices, an increase in U.S. leaf production and longer term, an increase in exports. Potential negative consequences could include such as disruption of the present market system as a new system (contract growing or Maryland-type auction) evolves, and longer company leaf durations required due to reduced pool stocks.

  The overall trend should increase the opportunity for ELT to sell worldwide.

- Overall, cigarette selling prices are expected to continue to increase at a rate slightly less than the average urban consumer price increase. However, aggressive pricing on branded products by major competitors is possible and could intensify price tiering activities. It is assumed that the "value for money", generic and other new segments can provide potential profitable opportunities as price tiering continues, but the rate and timing of these segments' growth will evolve as the marketing environment changes.

- Over the last five years, consolidation of the distributors has begun, resulting in the initial development of some "super" distributors. For example, three distributors now handle approximately ten percent of B&W's shipments. To negate this increasing power, manufacturers may be required to move to employment of their own distribution networks in the future.

- The environmental development with the greatest potential impact on the industry outlook and on company strategies would be significantly restricted advertising. Under this scenario, the use of various forms of media would be prohibited.

  Implementation of such restrictions would make new brand introduction more difficult and could further the market and product trends currently in place. Strategies to alter these trends would be more limited. However, manufacturers who develop strong innovative/alternative methods of communications and/or relationships with the retailers could still achieve share gains.

2.3 Tobacco Competitor Analysis

The competitive environment in tobacco will likely intensify. Philip Morris and R. J. Reynolds, the two dominant companies, may take different paths. Philip Morris is expected to continue to focus on extending its momentum in the full price area, while R. J. Reynolds will focus on protecting volume.

Both Philip Morris and R. J. Reynolds are expected to continue to invest significant sums in manufacturing equipment and research and development to enhance their position as low cost quality producers.

American Brands is forecast to continue its expressed policy of harvesting its tobacco business, while Lorillard, likewise, appears to be moving to a cash maximization strategy.

Grand Metropolitan's interest in selling Liggett & Myers through a leverage buyout no longer appears viable. The possibility of a vertical integration between distributors and Liggett & Myers remains a possible Grand Metropolitan strategy.

2.4 Tobacco Strategies

Brown & Williamson's long-term strategies remain essentially unchanged from a year ago:

Emphasis on quality: Ensuring that B&W's products maintain or exceed competitive standards of physical quality and taste remain the highest priority. This commitment extends to include achievement of high quality in all aspects of product design, manufacturing and packaging.

Allocate resources strategically with the intent of husbanding funds for new brand introduction: B&W will continue to allocate the necessary resources for KOOL and BARCLAY while maximizing resource productivity on the other established brands to generate enhanced cash flow. New brand development will continue to be pursued aggressively so as to position B&W to compete in all viable segments. An increased emphasis will be placed on new high margin brand development. Recognizing the high costs of a national brand launch, B&W intends to continue geographic rollouts where appropriate.

In addition, B&W will continue to pursue the "value for money" segment via RICHLAND 250's and other opportunities for brands positioned for growth as price tiering accelerates. Thus, new brand positioning (e.g., premium priced products), not possible a couple of years ago, could allow B&W to gain share from its competitors.

Maintain volume and share position through generics and the employment of defensive brands if required: B&W remains committed to volume maintenance through generics and its goal is to improve profits from this segment. Once it is expected that the volume target will be attained, B&W will pursue a price increase. This action in conjunction with significant cost reductions will enhance generics' profitability.

RALEIGH/BELAIR could be moved to mid-point or generic pricing if required to ensure volume and share targets.

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Remain committed to being a low-cost producer as well as matching manufacturing and distribution to product mix and volume: Matching manufacturing and distribution strategies to product mix and volume remains an ongoing process. A single manufacturing facility with a no strike labor agreement protects the execution of our strategic plans. To remain a low-cost, high quality competitor, state of the art manufacturing equipment and processes will continue to be emphasized.

Improving asset management and corporate productivity continues as a high priority objective.

Competitive emphasis on Philip Morris (Marlboro): B&W intends to target specific share gains from Philip Morris through its new products program using a well defined niche strategy. Initial examples of this include brands that are targeted to attract young adult male starters, and others targeted to gain share from PM's historically strong box and 100mm styles and the female segment. Because the Marlboro franchise has the largest number of female smokers, new female entries, such as VISA and Kim, can be positioned to gain share from Marlboro.

In addition, B&W intends to capitalize on PM's traditional reluctance to make any price concessions, via RICHLAND "value for money" offerings targeted against specific segments of the growing Marlboro franchise.

Emphasis on innovation: B&W remains committed to devoting resources to develop technologically-based new products. This will be accomplished through a broadened development scope including product, blend, flavor and delivery technologies. To support these actions, operations in all areas will be structured to enhance creativity and there will be a continuing R&D emphasis.

Develop the International business by selective investment: B&W will continue to emphasize increased penetration in targeted markets which show continued export potential, such as Japan.

Assistance in improving the Group's share and contribution level remains a high priority. Strategies include using strategic brands such as KENT, BARCLAY, LUCKY STRIKE and KOOL in certain markets as well as employment of tactical brands such as VICEROY and PALL MALL.

Continue attention on enhancing Non-Cigarette Products (NCP): B&W continues to focus on maximizing the benefits, particularly cash flow, from its NCP business in the near term. Longer term, B&W will evaluate ways of either enhancing its NCP business through new product introductions, or acquisitions, or alternatively will consider redeploying the assets currently invested in NCP.

2.5 Tobacco Performance Projection

As a consequence of the strategies outlined above, B&W is optimistic it can improve its volume and share levels to generate real trading profit growth, particularly in the last five years of the view period. B&W's domestic volume is predicted to grow from 68 billion units in 1984 to 78 billion in 1994 and share increases from 11.3% in 1984 to 13.6% in 1989 and 13.9% in 1994. Existing brands are forecast to decline from 10.9% market share in 1984 to 7.1% in 1994, while new products and generics exhibit a more than offsetting share increase. These actions translate into trading profit growth in excess of 5% during 1984 to 1989 and 8.0% from 1989 to 1994 while RONA increases to almost 90% by 1994.

Tobacco Group Baseline Projections
($ Millions)

	1984	1989	1994	CGR% 1984-1989	CGR% 1989-1994
Sales	2251	2933	3639	5.4	4.4
Trading Profit	432	561	825	5.4	8.0
RONA (%)	52.1	68.6	89.7	-	-

2.6 Tobacco Strategic Conclusion

The tobacco industry is highly profitable but mature, with increasingly challenging competitive pressures which are causing an unsettled marketplace. However, this turbulence provides new opportunities for BATUS. B&W's longer term strategies remain to conserve resources and provide a high level of financial performance, while taking advantage of the changing marketplace to build new volume.

The established strategies for developing new innovative products concentrate B&W's efforts in the key areas of quality and domestic market segmentation. Combined with careful evaluation of test markets and roll out introductions, these strategies provide the greatest potential for improving the long term profit and cash generation from the business. This will be reinforced by the approach discussed earlier for improving margins and returns from "value for money" products and generics, and ongoing efforts to enhance the performance of established brands.

By 1994, new products (including Richland and generics) are expected to account for almost 50% of B&W's volume. Excluding Richland and generics, the new products consist predominantly of full margin brands designed to substain B&W's long-term profit and cash flow. Generics will be utilized to ensure volume but will be deemphasized as full margins brands grow. Kool will remain the cornerstone of the 50% of volume to be accounted for by existing brands and will require continued

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investment to protect that core position. Altering Barclay's trend performance is dependent first on product refinement, thereafter supported by marketing. Other existing brands are expected to continue to decline in market share.

Because of its dependence upon new products, B&W's strategy can be characterized as a high risk, high reward approach. Because of the risk inherent in a forecast so dependent upon new product success, a reduced performance scenario for Tobacco has been included in the consolidated BATUS Risk Forecast.