1993

PM Companies Worldwide Leadership Conference -- PM-USA Presentation
W. I. Campbell

Thank you _______. Good morning.

Last year I spoke about the dramatic changes taking place in our industry regarding discount products. More importantly, I detailed a number of strategic initiatives that PM-USA was undertaking to deal with these changes and to reinforce our leadership position in the marketplace.

Our primary objective last year was to strengthen the performance of our most profitable asset: our premium brands. As part of this plan, we initiated a number of strategic brand launches and a major retail merchandising program.

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Last February, we introduced Ultima, a super ultra light addition to the Merit family. Ultima is performing well and is one of the reasons the Merit franchise showed dramatic improvement in 1992. Merit unit volume declined only 2.7% in 1992 versus 13.8% in 1991. Latest Nielsen data indicate that Ultima has a respectable 0.4% market share.

We rolled out Marlboro Medium 100's in May, one year after the successful introduction of Medium Kings which established a legitimate, unique category in the industry and currently holds a 1.4% market share. Medium 100's will help build Marlboro share in the 100's segment where we are currently underdeveloped relative to our share in the king size segment. So far,

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100's is performing up to expectations, -- attaining a 0.3 share per Nielsen through November.

We launched Benson and Hedges Kings in August. The brand serves the dual purpose of increasing B&H's relevance to adult smokers under 35 and providing PM-USA with a vehicle to increase its share of the menthol market. Although we are not satisfied with the results so far, -- the brand is showing some encouraging results in key urban ethnic markets where PM has been traditionally underdeveloped. For 1993, we'll be re-focusing our marketing efforts on gaining distribution and increasing consumer awareness of the brand.

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PM-USA's successful market performance has been accomplished despite a competitive disadvantage at retail due to product clutter and RJR's merchandising strength. To correct the situation, we implemented Retail Masters in 1992,-- a performance based merchandising program designed to incent retailers to promote PM's premium brands. We've signed over 100,000 accounts representing over half of industry volume.

An important benefit of the program is that it forms the foundation at retail that allows us to launch major promotional programs like the Marlboro Adventure Team that I'll tell you more about it in a few minutes.

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No one, -- especially George Bush, would dispute that 1992 was an exceedingly difficult year. However, despite the lingering recession, PM-USA was able to report respectable operating performance.

Our operating revenues grew to $12.0 billion in 1992 from $11.6 billion in 1991, an increase of 3.6%. Operating income increased 8.6% to $5.2 billion. Our operating margin excluding FET increased 4.1 points to 54.9%. Our cash flow increased 15.8% to almost $3.0 billion.

Before I get into specifics about our objectives and strategies for 1993, I'd like to give you some background on the industry and the growth of the discount segment.

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Since its 1981 peak of 626 billion units, industry volume has fallen by about two percent annually, a total decline through 1991 of 117 billion units.

Despite the volume decline, industry income climbed steadily and reached $9 billion by 1991.

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Virtually, all of the volume loss has come from our competitors, and their premium or full price losses have been even greater. In 1981, our competitors sold 424 billion premium units. In 1991, they sold 199 billion -- a loss of 225 billion premium units. Attempting to offset these premium volume losses was probably their primary motivation for the launch of discount brands.

Yet for all the volume loss and mix shift into less profitable discount brands, our competitors are still making handsome incomes by any business standard. Since 1982, our income has more than quadrupled to $5.2 billion, while we estimate our competitors' combined incomes have more than doubled to $4.3 billion. Aggressive pricing in the premium segment has enabled them to

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more than double their income on just two-thirds the volume and has opened a large margin umbrella for the promotion of discount products.

The profit margin on premium brands has grown from $10.49 per thousand in 1982 to $42.40 in 1992, while margins at the lowest price tier have only grown from $3.80 to $4.50 during this same period.

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All our competitors can fund modest income growth from premium price increases which more than offset their premium volume losses. They can then compensate for volume declines by expanding their discount sales which are only moderately profitable. This strategy avoids losing share in a declining market.

However, the cumulative impact of premium brand price increases is taking a toll on consumers. Since 1982 the portion of a household's disposable income needed to smoke Marlboro on a regular basis has risen from two to 3.3 percent, while it still takes only two percent of disposable income to smoke a lowest price brand. This economic pressure is at the heart of the Discount category's growth.

The Discount category has developed in four distinct phases.

During the period from 1981-88, discount grew moderately at about 1.4 share points each year, finally reaching 11 percent of the market in 1988. Since 1988, discount has tended to grow for a while and then subside as retail prices and profits rose.

During the period January 1989 through May 1991, competition intensified as manufacturers introduced or extended new packings into the discount segment. Discount growth accelerated to an annual rate of 5 share points, and the category comprised 24% of the market by May 1991.

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Then in mid-1991 a series of manufacturers' price increases raised Discount prices and profitability. As a result, annualized discount growth slowed to 3 share points, taking the category to a 27 share by May of 1992.

The most recent phase began last June. RJR aggressively drove for lowest price volume using their sales force to gain distribution for Monarch -- their new branded deep discount product. The competition has been particularly fierce in pack outlets, Marlboro's stronghold. In convenience stores, Marlboro now sells for over $2.00 per pack while lowest priced cigarettes are often sold for 99 cents or less.

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As the price gap has widened to 89%, the annual growth rate of discount has more than quadrupled annually to 12 share points.
--We define the price gap as the dollar difference divided by the lowest price. --
At the rate discount is now growing, it will rise from 30 percent to over 40 percent of the market by the end of 1993.

The threat posed by Deep Discount products is clear when you look at their impact on profitability. Every share point they take from premium or full priced brands reduces industry income by $180 million. In 1992, the discount segment has taken five share points and with that share loss 900 million dollars of industry profits have evaporated.

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The most recent phase of discount growth caused major dislocations in the marketplace last year. In 1992, Premium volume fell 28.2 billion units, with PM-USA losing 10.3 billion and 17.9 billion units coming from competitors. While we command nearly 50 percent of the premium business, most of our competitors are losing their premium volume at more than one and a half times the rate we are. Our premium brands are weakening. Except for RJR's Camel and Lorillard's Newport, their brands are collapsing. This is both our strength and our weakness. As our Premium brands outperform theirs, they strike back with their only weapon -- price.

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Industry discount volume grew 25.8 billion units in 1992.

PM-USA gained 3.9 billion and our competitors captured the remaining 21.9 billion units, which were almost all low margin, deep discount products.

These dislocations have also dramatically affected the industry's financial situation. In the period 1982 through 1990, total industry operating income grew at 12.8% compounded annually. PM grew at 16.3% and our competitors about 10%. In 1991, total industry operating income growth fell to 7.7%. PM was still strong at 13.5% and the competition at only 1.9%.

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The intense price competition in 1992 has reduced industry profit growth even further to an estimated 4.7%, with PM down to 8.6% growth and the balance of the industry at only 0.4%. The dramatic acceleration in discount growth this year accounts for the reduction in our income growth from 12.7% at Original Budget to our actual performance of 8.6%.

We made a decision last year to take a moderate approach to gaining discount unit volume. We didn't pursue the discount category with the same intensity as some of our competition did. RJR has been very aggressive and Brown & Williamson, a traditional force in this segment, has intensified its efforts.

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The business implications of this industry analysis are clear.

First, our competitors apparently view discounted cigarettes as an opportunity to stabilize their overall share in light of their weaker positions in the premium segment.

Second, due to premium margins, they <u>have</u> funds available to price promote their discount brands and accept smaller margins on low end products.

Third, the fact that discount entries eventually become profitable gives our competitors an incentive to periodically launch new products at the lowest selling price they can legally execute.

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The long standing incentive for our competitors to periodically pursue volume growth in discount will not change. Thus we believe discount will continue to grow.

However, we do see encouraging signs that the rapid growth of the discount segment will slow somewhat.

Since last October, manufacturers have raised deep discount prices three times and reduced trade allowances. In all the prices of deep discount products have increased over $7.00 per thousand -- 50% greater than the increase in premium prices over the same period.

Incidence of 99¢ pricing peaked in mid-November at 35%, in stores with at least one Deep Discount product. Since then, the impact of list price increases has driven retail prices up and the incidence of 99¢ cigarettes down. Currently incidence is 24% in stores that carry Deep Discount.

In late 1992 the distribution of deep discount cigarettes reached virtually 100% of outlets. With the market saturated, retailers are more likely to focus on profitability rather than attract volume with bargain basement prices.

Finally, the current pursuit of volume at almost any cost is significantly reducing the levels of profit for our competitors and their shareholders.

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This brings me to our strategic objectives for 1993.

First, we must enhance the trademark equities in our premium brands.

Second, we must capture a share of the discount category growth equal to our market share to sustain our momentum.

Third, we must continue to seek profitability in our discount products and inject trademark value into them.

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Finally, to insure we are efficient in execution, we must reduce our cost base and improve the effectiveness of the marketing and sales dollars we spend.

If we achieve these strategic objectives, we believe we can continue to grow our income and market share.

I will now take you through the plans we have developed to reach our objectives.

To protect our premium volume we plan to focus marketing support and retail sales efforts on Marlboro. The emphasis on Marlboro is obvious. It is the crown jewel of our portfolio due to its position as the world's most profitable trademark. Its younger smoker base also means that its profit stream has a longer time horizon than our other brands. Finally, because Marlboro is the focus of the financial community's attention, we cannot let its performance weaken.

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While Marlboro's shipments dropped 5.6% last year partially due to inventory adjustments, its retail take-away volume is down only 2.5%. That 2.5% decline is still unprecedented and reflects the huge price gap between Marlboro and discount cigarettes. To address this price gap we intend to raise the level of volume sold on promotion from 15% to 26%.

We will use the size of our sales force, the scale of our merchandising programs, especially Retail Masters, and persistent promotion from January through August.

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The centerpiece of our promotional activity is the new, image extending Marlboro Adventure Team. Adventure Team has been designed to appeal to and create excitement among young adult male smokers.

Adventure Team is also a continuity promotion. Consumers can save symbols on Marlboro packs to redeem for specially designed, high quality adventure gear such as jackets, watches, and sleeping bags. This continuity program seeks to reduce the alternate purchasing of discounted cigarettes by Marlboro smokers, which accounted for 12 billion lost units in 1992.

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To attract price sensitive smokers of Marlboro and competitive brands, we will aggressively use price off specials at retail and deliver coupons through free standing inserts and direct mail. During the first six months of 1993, we will offer more than 200 million deals to Marlboro and competitive smokers.

You will find a pleasant surprise when you return to your room this afternoon, compliments of the Marlboro Adventure Team.

To protect equities in our <u>other premium brands</u>, B&H 100's, Merit, Virginia Slims and Parliament, we will bypass retail and go directly to the consumer. Direct mail and free standing insert coupons will address the price gap and encourage loyalty among current and

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occasional users. This approach will continue the successful strategy we began this year. In 1992, we were able to cut the decline rate of these brands in half, from 11.8% down to 5.8%.

For Virginia Slims we will offer young adult female smokers an opportunity to collect pack UPC's for V-Wear -- a street-wise style of clothing.

Parliament will offer smokers a chance to win "the perfect get-a-way car" and acquire "perfect recess" merchandise.

Benson & Hedges 100's will continue utilizing the popular Signature Collection to reward and maintain their loyal franchise.

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The newest B&H entry, Special Kings, is important because of its potential to grow our share of menthol, where we have always under performed, and because it provides us with another king sized full-flavor, non-menthol entry besides Marlboro. The B&H Kings program includes traditional trial generating retail activities, product mailings to Newport smokers, and special promotional efforts in urban menthol markets.

Merit will pursue its new direct marketing program -- The Lighter Side of Merit. Merit Ultima will be incorporated into the continuity and coupon programs to expand the growth of this successful entry into the lowest tar segment.

In total during 1993, we will spend $300 million in traditional equity building activities and $800 million in price and continuity promotions for all our Premium brands.

In our discount brand plan we will concentrate on two trademarks, Cambridge and Basic. Step one will be the restoration of Cambridge as a viable mid-price discount trademark through aggressive couponing and pulsed promotion. We will be very competitive with Doral's coupon values and incidence. These actions will grow Cambridge and draw volume away from unbranded lowest price products. Importantly, promoting Cambridge's growth will <u>not</u> widen the highest to lowest price gap at retail.

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We will use Basic to inject trademark equity into the lowest priced segment. Basic's packaging will be changed to make it competitive with RJR's Monarch. It will be positioned as "your everyday cigarette." Larry Wexler, our Vice President of Marketing, will fill you in on the details of our Discount strategy this afternoon.

The final element of our strategic response to the new marketplace is reducing our cost base. In 1992, we cut manufacturing and overhead by $171 million. Our 1993 budget calls for cuts of an additional $309 million. Cumulatively, this $480 million reduction equals 10% of our cost base.

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We have also been pursuing reductions in headcount, with hourly cuts of 406 in 1992 and another 595 in 1993 through an early retirement program.

In the salaried headcount area we have been equally aggressive. In 1992, we eliminated 771 positions and in 1993 we will reduce salaried headcount by another 179. Over the two years, our total headcount reduction will reach almost two thousand people -- 10 percent of the 1991 PM-USA workforce.

While we envision no significant increase in our marketing spending, we will not cut marketing dollars. Our objective is to continue improving our marketing effectiveness relative to the competition. Because of our scale, we estimate that PM-USA spends 25% less per thousand than our competitors on marketing.

This brings me to our 1993 budget goals.

PM-USA's share of the Premium segment will be up 2.1 share points to 50.9%. Our Premium volume will be 159.2 billion units, down 7.9%. Our Discount volume will reach 52.3 billion units, up 26%. This will give us a 29.5 share of Discount, up 2.4 points. Our

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total share of market will reach 43.1%, an increase of 0.8 share points. PM-USA's total volume will be 211.5 billion units, a decline of 1.3%.

These volume and share targets will deliver $5.6 billion dollars in income from operations, an increase of 9.0% over 1992.

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Turning to the legislative front, there are two issues that affect the entire cigarette industry that I'd like to talk about.

The first issue is the continuing threat of higher federal and state excise taxes on cigarettes to compensate for the weakened economy and budget deficits. The federal excise tax rose 4 cents per

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The second issue is smoking restrictions. Undoubtedly you all heard last week's EPA announcements regarding environmental tobacco smoke (ETS). As you know, we strongly question the report's scientific validity. The agency has combined data from several widely different studies, ignored the National Cancer Institute's most recent study on ETS because the study did not support the EPA's conclusions, and lowered its own official standards for establishing statistically significant risk in order to make the case against environmental tobacco smoke. In addition, the EPA report did not offer any new findings, as it largely echoed the findings of the Surgeon General's report of 1986.

We expect that this will result in further restrictions on smoking, and that means that we will become even more aggressive in our defense of smokers rights. Part of our efforts focus on businesses that serve the public, such as resturants and bars, to ensure that both smokers and non-smokers are accomodated.

As in previous years, 1993 will see other media-promoted proposals about tobacco regulation. Nonetheless, we do not anticipate that the EPA report or any other federal or state action will meaningfully affect the character or profitability of the cigarette industry.

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I want to conclude by listing the reasons why PM-USA can continue to enhance the profitability of our products in all price categories in 1993 and beyond. My optimism for our future is rooted in six facts:

Fact 1: Despite a decade of pressure from anti smoking interests the industry decline rate has remained stable at 2 to 3 percent annually. At this rate, we will still have a US. cigarette market of over 400 billion units and 40 million smokers in the year 2000 -- the largest market behind China and the most profitable.

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Fact 4: The average age of adults who smoke our brands is seven years younger than the average age of our competitors' smokers. That means our trademark franchises have a long future. You should also know the smokers who switch to discount brands tend to be older, which partially explains why our competitors are losing almost twice the premium volume we are.

Fact 5: We have grown our share of the premium cigarette segment every year for over thirty years. Through scores of attacks by anti-smoking groups, tax increases, smoking restrictions and marketplace shifts, our premium trademarks have survived and prospered because of superior product quality, innovation and astute marketing.

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Fact 6: Even as we move to protect our trademarks' profitability, we are aggressively cutting costs and bureaucracy. Our cost base will not encumber our ability to compete profitably and effectively in the discount segment.

These facts reinforce my prediction that PM-USA will continue to achieve success in 1993. We will focus on profitability, but we will not allow any competitor to gain sustained advantage over us in the marketplace. That determination is how we became number one and it is how we will remain number one.

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In summary, for 1993 and over the long term, PM-USA has the trademarks and market expertise to outperform the industry and deliver profitable growth, while at the same time providing substantial cash flows to the corporation. Thank you.

And now I would like to introduce Geoff Bible.

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