MARKETING REPORT

UZBEKISTAN

FIELD VISIT 6/10/93 TO 15/10/93

From: D.R.J.B.SIMS

Circulation

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NB Photographs of market are available

Physical brand samples will be available as of 24/10/93.

* Missing

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1. OUTLINE OF REPORT OBJECTIVES

Originally, the brief for this report was to make a more detailed evaluation and analysis of the sales and distribution systems in the Uzbekistan market further to M.Marr's field visit of 26/7/ to 30/7.

The prevailing status quo within the market on arrival and subsequent discussions with JRR/NBM in situ, necessitated a more wide ranging marketing evaluation and recommendation on both the overall investment strategy and both the short and mid term marketing strategy irrespective of the final structure of BAT's investment within this market.

This is set in the context of the signing of the MOU on 4/10/93 and the prevailing marketing scenario.

The report reflects some discussions and contributions from JRR and was intended to form part of a more complete investment and strategy recommendation to be put to NB and the main board. However as the conclusions state, the need for expediency is critical.

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2. PRINCIPAL CONCLUSIONS AND RECOMMENDATIONS

(A) The market in Uzbekistan represents a ver significant commercial opportunity.

(B) The opportunity in Uzbekistan can be won or lost in the next 45 days. Expediency is critical.

(C) The opportunity in Uzbekistan is pivotal on

(i) our ability to secure the guarantees outlined in point 2 (E) (i) and (ii).

(ii) An appreciation of the PMI strategy and the speed at which they can apply their strategy.

(D) Winning or losing now in Uzbekistan will dictate our opportunities in Central Asia for the next 10 years. It is a key market.

(E) No JV with TFF is of any value whatsoever unless they can guarantee, absolutely either one of the following two points and preferably both:-

(i) Exclusive BAT Group supply to Bakalea for at least the next five years irrespective cf the % split between locally manufactured product or imports from various BAT Group companies. (NB the intention will be to move totally to local sourcing when capacity/product quality allow.)

(ii) The rapid application and enforcement of import duties on imported cigarettes. These duties need not be draconian and 20% to 25% is recommended. Higher levels of taxes would induce DNP trade. The above stated levels are sufficient (even with some DNP leakage) to assure a significant BAT competitive advantage in the

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sensitive pricing environment.

An accompanying 3 year indemnity for BAT Group imports while production is expanded and developed locally is also a prerequisite.

In addition:-

- A further non essential but desirable guarantee is that of a restriction free advertising environment that will allow brand creation and establishment. Legislation should also indemnify and protect the JV through higher fiscal taxes on advertising of imported products.

- Minor packaging legislation such as country of origin identification etc. is also requisite).

- The successful negotiation of Part E (1) would create an immediate 12 billion p.a. volume for the BAT Group albeit that brand pricing would be from $60/mille to $100/mille to meet pricing requirements in line with the level of disposable income.

  In this respect the achievement of the MOU is extremely significant but it must be immediately established what it is that this guarantee is.

  It must be absolutely clear that what we wish to buy is not manufacturing assets or brands but an opportunity to dominate the. market .

  The TTF assets and brands are worthless without the above guarantees. The potential leaf export business is fragile at best and long term.

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With these guarantees it could emmerge as one of the most significant and lucrative Group investments in tobacco in the last twenty years. The impact on Group profits could be considerable.

No effort or avenue should be ignored to try to achieve the above guarantees but this must be immediate. This may require unorthodox arrangements to be made with the decision makers but this will have to be weighed against the scope of the opportunity.

(F) BAT have viewed the Uzbekistan opportunity erroneously as an independent investment. It is probable that PMI have viewed the surrounding republics of Kirgistan and Turkmanistan as one investment opportunity together with Uzbekistan and Khazahistan.

It is also probable that PMI have evaluated this investment opportunity view the achievement of the prerequisite guarantees under Part (E) as unobtainable. Their move to acquire a 30% stake in TTF was probably an insurance policy or blocking manoeuvre.

It is probable in view of this that PMI made a very substantially higher offer for the tender in Khazakistan viewing it as crucial to the whole region and giving them the possibility to dominate the region and move first in terms of marketing initiatives.

(G) The clarification of our position under Part (E) must be immediate and at most within 30 days. The successful acquisition of this opportunity will enable us to retain a key market in our global brand strategy that is trying to link the Far East with Europe.

(H) If it becomes clear that none of the guarantees in Part (E) are realistically achievable we should drop any intention of a JV.

(I) If we withdraw from a JV project, we should view any Green Field Site alternative in the context of Kergistan and Turkmanistan and not in isolation. Under these circumstances we may already have lost the initiative to PMI. We believe PMI are in the process of setting up a regional office and will shortly launch a coordinated and supported market initiative.

(J) In the immediate short term and irrespective of the outcome of the above points it is necessary to rationalise short term group exports to Uzoekistan. A strategy on brands, pricing, sourcing and management control must also be harmonised within 45 days at the latest. Again it is probable that e have lost the initiative to PMI and possibly RJR. Brand pricing will be in the range indicated above (viz $6/mille upwards). This in itself will narrow the options on brand choice and sourcing. We cannot rely on IFB's alone. Volumes could be very substantial but we may be too late to associate ourselves with the limited solvent trade groups available. Preferably the

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brand choice would have more widespread regional synergy and mid long term strategic importance. The brands needed are not jus IFB1's and IFB3's but VFM brands.

Trademark complications, and group structure will inhibit the rational harmonisation of such a co-ordinated strategy. This point should not be lost as an example to avoiding similar circumstances elsewhere in the future.

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3. RECOMMENDATIONS ON MARKETING STRATEGIES

Irrespective of how our investment (or lack of) in Uzbekistan finally emerges the marketing requirements remain virtually identical. A successful JV under the right conditions would make Uzbekistan a highly profitable market. Volumes and profitability would be very significant even to Group level.

(a) In the event that we acquired TTF our policies on brands would need to embrace the following broad strategies:-

(i) withdraw Ragistan, Tashkent and Kosmos which are worthless brands in terms of profits, profitability or trademark.

(ii) Reprice Astra and Uzbekistan at 250 rubles and 500 rubles respectively (current pricing) in enhanced packaging and with improved product. They should not be supported. The brands have no development potential and should be treated as cash cows.

(iii) Introduce a brand at US$0.3 (per 20's pack) retail price currently 700 roubles! This can initially be imported (assuming all guarantees are negotiated as specified). CIF price to ODESA would be approximately $6/mille possibly as high as $7.50/mille. If import duties were levied and we were given an indemnity and also if we distribute via Backalea. A possible brand could be Continental from Souza Cruz. This should be nationally supported. This would eventually be manufactured locally.

(iv) One (at least) IFB3 introduced at approximately $15.0/mille CID ODESA under the right conditions should be introduced. IFB3's should be the category of brand. Options are Pall Mall, Hollywood, Viceroy, Gold Leaf, JPS. There are a multitude of considerations to be reviewed for the choice of the IFB3 brand(s).

(v) Several IFB1's should be similarly imported at lower levels initially and marketed in strategic locations (Tashkent and high visibility /high prestige outlets). Possible invoice pricing could be $19./mille CIF ODESA. Again under the right conditions.

These brands should embrace LSF, Kent and possibly HB and 555.

(vi) A menthol brand at both IFB3 and a VFM level is also required. For IFB3 this could be Kim with a market variant of whatever national brand at VFM level.

It would be several years before any IFB could be manufactured in situ and even for the national brand the cut rag would need to be imported initially until our investment programme in leaf and machinery was complete.

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(b) In the event that we do not acquire TTF, points a (iii) (vi) still apply but this must be co-ordinated in a quickly agreed Group strategy on brands, sourcing, pricing, control and distributor appointment.

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4. RATIONALE

The following observations and analyses serve as rationale for the preceding conclusions and recommendations.

a) Executive Summary

For background country information and initial marketing analysis refer to Appendix 4.

b) Brand Evaluation TTF brands

Evaluation of TTF Brands

There remain questions about the availability of brands ex TTF. Production figures show only three brands, Uzbekistan, Astra and Ragistan but a fourth (Tashkent) was seen under production the factory. It is believed that the figures for Tashkent are included with the Uzbekistan figures.

Production figures for 1993 show a nine month MMA of 255 millions giving an annual production total of 3.2 billion. This contradicts earlier production claims of 5 billion +. The 255 million MMA is split approximately:

Uzbekistan	40 million
Astra	200 million
Ragistan	15 million

There was no production in July due to annual maintenance and a shortfall of WMS and there has been an unexplained 20% decline in average production figures over the preceding quarter

Product

In terms of product offers the brands have very limited current or future value. The tobacco is below all acceptable standards of quality and packaging presentability is equally dire.

- Uzbekistan sells purely on price as the cheapest available KSFB
- Astra has a core franchise of smokers due to price and some (limited) product style preference. This franchise will certainly dwindle (it has an old age profile and is only smoked by younger smokers at the extremely low end of income levels).
- Registan has a minority product type franchise and absolutely no future value.

Image

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- In terms of image all brands have no value. They are consistently appalling in their product smoking characteristics packaging and inconsistency of supply. No brand name is worth salvaging.

Financial Value

In terms of financial value the brands also have little inherent value. Using the 1993 production figures and black market retail values* (see note), the following brand values can be calculated:

Uzbekistan:-
(+ Tashkent)

- 480 million per annum
- Retail price US$8.00/mille less 40% distribution costs and 25% tax
- Net ex factory price approx., US$4.55/mille
- Assuming material and conversion costs of $3.00/mille, gross annual contribution would only be approximately US$750,000 before any contributions to overhead.

Astra

- Similar to above calculations:-
- 2400 millions per annum
- Retail price US$ 5.0/mille less 40% distribution and 25% tax.
- Net ex factory price approximately $2.86/mille.
- Contributions on this level must be less than US$0.50c/mille giving approximately US$1.200000 annual gross contribution before contribution to overheads.

Registren

- Totally valueless.

* NOTE: It must also be noted that the above contributions are calculated using very conservative estimates on material/conversion rates. They were also calculated using black free market retail prices and not the official ex factory prices currently achieved through the state distribution system.

Their actual value using the prevailing official prices is completely worthless since they sell ex factory at prices of:-
Uzbekistan US$1.10/mille
Astra US$0.80/mille.

There is no guarantee that we could even achieve current volumes if we applied current black market pricing before any possible

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product/packaging enhancement work) which would reduce contribution further and no account has been taken of increased material costs arising from any packaging enhancement programme.

c) General observations on brand availability and consumer attitudes

- Young people aspire strongly to western brands.
- There is an awareness of IFB1's and 3's but confused perceptions of value over VFM or low price offers
- There have been sufficient imported brands on the market for people to differentiate between product smoking quality.
- Consumers are aware that bright coloured, relatively well packaged brands offering western (particulary US) style imagery are not a guarantee of quality. There have been numerous cases of dumped/aged stock which has provoked a healthy tendency to discern products but a growing cynicism towards inconsistently supplied brand offers. (We should use this growing cynicism positively).
- Brands originally from the USA/Europe have higher value perceptions than brands from FSU states or the sub continent. The absence of country of origin requirements mean that manufacturers (especially sub continent/independents) can play on this ambiguity producing brands appearing to be made in the USA due to their packaging/imagery. There are some overt cases of this with designs using stars and stripes and brand names such as New York, Liberty, President, Texas, Manhattan etc.

- Historically, local products have been too strong to attract large numbers of female smokers. Female smoking is now more socially acceptable and females can be drawn into the market via menthol offers or lighter brands (see also comments below).

- There is most definitely an opportunity for menthol brands.

- There is no real understanding of tar/nicotine levels and subsequently no understanding of the positioning of "lights" variant offers.
- For the moment there is no real appreciation of longer length VFM (100*) offers but this could be used and developed later although local production constraints may inhibit this marketing lead product variation.
- There is little awareness of the smoking and health issue. More than 60% of the brands carry health warnings in a variety of languages/formats. The smoking and health issue could easily be provoked through irresponsible advertising/promotional activities (see also communications).
- A small upward turn in disposable income could have a disproportionately positive effect on the incidence of smoking.

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Smoking remains one of the cheapest and easily accessible ways in which to embrace western culture and protract this personal image.

- Equally, per capita consumption by smokers could grow rapidly and exceed many western economies.
- Populated demographics indicate very favourable age profiles over the long term (5 - 15 years) with good total market growth prospects in volumes nd profitability..

(d) Market Analysis & Forecast

- M.Marr's report (appendix 4) makes some segment analysis and forecasts.
- Volume information remains totally inadequate. A partially better understanding should be available by the week commencing 24/10 resulting from information gleaned from follow up action (Appendix 1).
- My opinion is that the market is smaller than estimated (viz 22 billion per annum) comprised of:-

	No.Billions
TTF	3.5
Imports via Bakalea (+A/P society?)	8.5
General imports	10.0
	22.0

No evidence of this sort of volume has yet been encountered due to an absence of a private wholesaler network.

The volume is only achieved through the volume of state outlets which number +/- 10,000 nationally.

Papiros	0.5
NFB's (Low low quality)	4.0
NFB's ex FSU states	3.0
FB's (ex FSU/sub continent)	5.5
Other FB's (multi source)	6.5
IFB's	2.5
	22.0

In particular I would make an unsubstantiated estimate that PMI were selling +/- 550 million Marlboro per annum.

- Due to regular supply and pricing a clutch of brands are now establishing themselves. There are pricing and positioning/ perception anomalies inconsistent with other markets that is a reflection of consumer/trade naivity and historical isolation.

Of the brands establishing themselves the following are notable:-

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IFB1	Marlboro, Kent, Rothmans, Winston, LSF, Camel, Salem
IFB3	Pall Mall, Hollywood, Gold Leaf, L & M.
Mid (VFM)	Magna, Bel Air, American Kings, Monte Carlo, Montana, Bond Street, West,
Low 1	Peter Johnson, Memphis, Manhattan, Spirit of America, Milde Sorte
Low 2	New York, Real, Liberty, South Congress, Richman, Polo, Tokat
Low 3	(Bulgerian brands) TU 134, Rodopi, Opal, Beta
Low 4	TTF and ex FSU brands

- No brand can yet claim to have any critical mass or national distribution due also to the virtually unpromoted environment (see communications) which are very short term.

- There seem to be a proliferation of RJRbrands (under the Alexander Field name) particularly in Bukhara.

e) Pricing

- The market is fragmented into about seven clear price segments.

- It will remain a multi price segmented market and the management of these price segments will be key.

- The multi segment scenario will remain for at least 2 years before contracting over the mid term.

- The consumer needs to be progressively drawn up the pricing board to higher real priced brands in a manner commensurate with his increasing disposable income.

- Concentration on IFB1's or IFB3's will leave the market open to low priced quasi international offers which is where the highest weighting of volume will remain. We cannot ignore this market.

- The differentiation between segments will be narrow but the controlled management of consumers' uptrading aspiration will result in best volume/profit results.

The real values of price segments is as follows:

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CATEGORY	20's pack price in Rubles	Example Brands Based on active Price Positioning not conventional positioning	20's pack price in dollars
IFB1	(1800/2000)	Marlboro, Winston, Kent, Salem, Rothman	$0.72 to $0.80
1FB2	(1500/1600)	LSF, Hollywood, Pall Mall, Camel	$0.60 to $0.64
IFB3	(1200/1400)	West, Gold Leaf	$0.48 to $0.56
Mid	(1000)	Magna, Bel Air, Bond Street, Monte Carlo, Milde Sorte	$0.40
Low 1	(800/900)	Memphis, Pete Johnson, Spirit of America	$0.32 $o.36
Low 2	(650/750)	New York, South, Liberty, Texas	$0.26 $0.30
Low 3	(500)	Opal, Beta, Rodopi, TU134	$0.20
Low 4	Below 500	TTF brands and low quality ex FSU brands	$0.10c to $0.16c

f) Blends

Any marketing possibilities other than imports (i.e. arising from local manufacture) will be restricted by the availability of American (style) blends.

GRR's report of 2/8/93 covers this subject in detail (Appendix 5) and is key to our marketing options, as it is in the overall approach to our investment.

It is unlikely that product technology using the various available parameters can overcome the very low quality (quasi) oriental leaf that in itself is appalling in quality and further is contrary to consumer needs.

This situation can realistically only be changed significantly for year 3 onwards (at

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earliest) in any JV with TTF.

Any other local manufacturing option must consider imported cut rag (initially) progressing to imported leaf on construction of a GLT/PMD.

(g) Communications

- The Uzbekistan market must be unique in the world in terms of its singularly unexploited advertising and promotional environment. Virtually no active communications whatsoever are apparent.

- The entire advertising environment is very primitive/non existent but it is astonishing given the three years since independence, that there is so little brand support for any FMCG or other products.

- There is limited infrastructure available in terms of Uzbekistan TV, radio, printed material and points of sale. The media channels are crude and low quality but the opportunity to construct quality outdoor advertising, introduce electronic media and commence P.O.S activities exists all at reasonably low cost. Despite the fact that these materials would need to be imported there is currently no (little) tax implication.

- There is cortradictory information about a legislated, or soon tc be legislated, total ban on alcohol and tobacco advertising.

  Appendix 2 details the points of uncertainty that are necessry to clarify.

- I am at a loss to explain why even the most basic P.O.S. materials are not in evidence. It is certain that container fulls will soon appear (ex PMI and RJR). In a community starved of this sort of material for so long, trade and consumer loyalty could be quickly achieved and the difficulty/cost of establishing brands thereafter exacerbated.

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- There is currently an open opportunity to establish critical early brand loyalty in several price segments given regularity of supply, good distribution, correct pricing and some basic P.O.S. activities.

- Moscow T.V. is received within Uzbekistan and IFB awareness is growing.

- No advertising agencies in the true sense of the word exist locally. All creativity and printing must be sourced externally. However the limited number of people currently working in this field exercise disproportionate influence and as with financially stable distributors, we should tie them up with exclusive contracts now.

- I visited an "agency" from which it became clear that there will be a considerable bureaucratic power struggle for control of various media channels and there will be complex regulations.

- We were informed that a large scale PMI campaign to support a low price offer (Appollo) will start in October. They are organising a regional office and (surely) locally sales promoters

- A threat exists that a deluge of advertising will provoke a total ban and raise the smoking and helth issue.
- Advertising costs will be cheap enough to allow multinationals almost unrestricted marketing spend which will make our industry over visible.

- I estimate that as little as $450,000 would be sufficient to support a brand nationally with a good spread of communications activity (current costs for one year).

I would envisage total marketing investment levels under a JV scenario (with the appropriate guarantees) as approximately $2 million split.

Nat brand (VFM) 0.5m

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IFB3	0.8m
IFB1's	0.5m
	0.2m
	2.0m

- In the competitive rush to acquire positions throughout the FSU and Central Asia it is unlikely that any workable inter-industry agreement on advertising could be reached.

h) Distribution & Trade

- Appendices 3(a) and 3(b) explain the dynamics of trade flow for both imported products and those produced by TTF. The flow diagrams also illustrate trade margins. It appears that 20% is ubiquitously used as a margin at every trade step irrespective of volume or product type.

  This is a reflection of the embryonic private retail sector. It also explains inconsistency in retail prices. Both will stabilise in the future.

- There are very few serious FMCG trading or distribution groups in evidence.

- Smaller trading companies are emerging and forming into groups.

- The proliferation and relative financial limitations of these entrepreneurs explains the corresponding proliferation of brands. The volume of imports entering via the 'ant operation' of individuals travelling to Moscow should not be underestimated.

- Clearly Forex is hard to acquire.

- Understanding of commercial management of inflation is poor. This has lead to serious trading problems elsewhere in the FSU, particularly

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Moscow.

- The lack of Forex means that many trading groups seek merchandise in Moscow where they can buy for roubles. There is an opportunity for us to liquidate the stockpile of some Group brands by making short term agreements with our distributors in Moscow.

- Future trading conditions look favourable with limited need for credit or deviatioin of credit if sales ex our any factory are in local currency.

- The state distribution organisation Bakalea sources product offshore to fulfil the shortfall of local production.

The acquisition of exclusivity for the Group (through imports and/or local production) in whatever balance in the short/medium term) is the key to our investment decision. We could instantly gain volume of 12 billion per annum for the group if UPP can deliver this exclusivity. Without it even the existing volume of TTF is perilous since we would need to raise prices to black market rates. Under this scenario Backala may also reduce or entirely refuse to take our products.

TTF have no private distribution network (?) and the products have very limited consumer appeal (see above).

The whole rationale for purchasing TTF turns on this last point which is brought out in the conclusions

j) Competition Activity

- TTF claim to have received two alternative offers for a JV from PMI and a German group (Reelsme?)

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- Makmudov claims that both PMI and the Germans were prepared to settle for a 30% and 35% shareholding respectively.

- Macmudov also announced that a Chinese consortium were building a factory on a GFS 400 Km from Tashkent. This is unconfirmed but provokes a multitude of questions about the integrity of the "monopoly" status that UPP purport to be selling, and the validity of any hope we have of achieving the guarantees stated in the conclusion section of this report.

PMI invoicing could be as low as $5.50/mille to importers to position the brand at 700 roubles (per 20) and put pressure on ourselves.

- It is clear that having secured a JV in Khazakistan PMI have evolved a Central Asia marketing strategy that will use this plant as a source to cover Uzbekistan, Turkmanistan and Kirgistan.

They are probably making the assumption (correctly) that none of these territories will successfully be able to impose any fiscal duty on imports or prejudice their own nationally made products through other protectionist measures such as advertising restrictions, packaging requirements etc. This may also explain why their tender for Khazakistan was considerably in excess of our own as they were viewing it as the lynch pin to the whole region.

It is equally clear that having secured the JV in Khazakistan they will quickly move to establish some specifically chosen low price offers as the initial marketing assault on the high volume quasi international American blend segment. I would expect a progressive introduction of more expensive brands until this reaches IFB's. (L&M, Marlboro)

In the meantime they will position and support their IFB1's and 3's with a longer term view.

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We can expect that their investment in the initial low price offer will be disproportionate due to the wide open marketing opportunity. They could tie up all the key players in distribution, trade and advertising very quickly.

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