October 16, 1992

NEGOTIATING STUDY #2

- RBH fees for manufacturing are based on PM's net price less FET and duty. RBH fee is 50% of this amount.

- Initial fees -- (per M, US$)

	RBH 2nd Proposal	PM Offer	Difference
Domestic	$30.24	$28.90	($1.34)
Duty Free	$27.22	$15.40	($11.82)
Other Duty Free	$28.77	$15.40	($13.37)

(This contemplates one fee for duty free. We could offer a higher fee for other duty free--$19.00 based on current $38.00 net price--assuming that we are willing to separate duty free into components and that we can agree on an ordering mechanism).

- Future fee increases
  - Adjusted semi-annually on January 1st and July 1st based on PM's net price less FET and duty as of that date. Adjustments can begin in 1993.

- Contract term of 10 years. (We will have termination language which would let us out earlier if necessary).

- RBH's prices to other customers TEI cannot be lower than their price to PM.

- RBH provides us with license on Belvedere.

- PM pays duties to FET.

- Marketing costs incurred by PM are shared with RBH on a 50/50 basis.

- Production of other PM brands (B&H, Mark 10, etc.) will be done by RBH for the same 10 year period on the same terms.

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October 16, 1992

NEGOTIATING STRATEGY #1

- RBH fees for manufacturing are consistent with their second proposal but slightly more favorable for PM duty free.

- Initial fees -- (per M, US$)

Counter offer.

	RBH 2nd Proposal	PM Offer	Difference
Domestic	$30.24	$30.00	($0.24)
Duty Free	$27.22	$24.00	($3.22)
Other Duty Free	$28.77	$27.00	($1.77)

(One issue is how we will distinguish between the duty free components when ordering product from RBH. To avoid this, we could go with one fee for all duty free of $26.00).

- Future fee increases
  - -- Adjusted annually on January 1st beginning on 1/1/94.
  - -- Increase amount determined solely by PM but not less than increase in RBH's per 1000 manufacturing costs.

- Contract term of 3 years with PM's right to renew on an annual basis. No RBH right to refuse renewal.

- RBH's prices to other customers (TEI) for other cigarette brands cannot be lower than their price to PM.

- RBH provides us with license on Belvedere.

- PM pays duties and FET.

- Marketing costs incurred by PM are shared with RBH on a 50/50 basis.

- Production of other PM brands (B&H, Mark 10, etc.) will be considered.

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October 16, 1992

RBH NEGOTIATING STRATEGY

The two principle negotiating strategies open to PM-USA differ in the degree to which we want to keep RBH "whole" in the short term versus allowing them to benefit from future price increases in the U.S. market.

The first negotiating strategy would offer RBH a fee for manufacturing duty paid and duty free product which is similar to their second proposal to us. While this would lower our initial profitability, we could limit RBH's future fee increases to accelerate our profit generation.

The second negotiating strategy would not keep RBH whole in the short run, but would give them a greater long term potential by allowing them to share equally with PM in future margin growth. Given expected price increases, they would experience considerable fee growth and, by the mid 1990's, they could have higher fees than they would have realized in the first strategy.

This strategy offers two additional advantages for PM-USA.

- It should enhance PM's ability to implement our pricing strategy since RBH would have a shared interest in boosting duty paid and duty free margins.
- Since RBH would get higher fees for duty paid (domestic U.S.) business, it would encourage RBH to support our efforts to migrate the business from duty free to duty paid channels.

Must spread share around

We can further enhance the attractiveness of the second approach to RBH by offering a longer contract term of say 10 years versus a 3-5 year term for the first approach. The stability gained by RBH should be of some value to them and could be a good selling point to the RBH board.

The key points of each negotiating strategy is attached.

October 16, 1992

TEI OFFER AND PM'S COUNTER PROPOSAL

TEI's offer to license Craven to PM along the border in exchange for keeping the existing TEI in U.S., Central and South America "as is" has the following disadvantages for PM.

- Loss of units which would probably be offset by the Craven volume, but not definitely.

- It would limit our ability to develop a national market for Canadian brands.

- TEI could potentially undercut PM and service non-border customers who, in turn, could compete with us for border business. They may be doing this now.

Non border domestic

If we do nothing with TEI, we must assume that they will use the Craven brand to compete with us in the domestic and dutyfree markets. While domestic retailers may consolidate pricing on Canadian brands such that Craven will not be able to sustain a retail price advantage, the same may not be true in some areas of dutyfree.

If possible, we should gain control over the Craven trademark for the U.S. domestic and dutyfree market to maximize our unit volume and profit potential.

Counter Proposal

- PM is granted a license for Craven in the U.S. domestic and dutyfree markets. PM will retain 10% of our net price less FET and duty as profit and the remainder will be split between RBH as a contract manufacturing fee and TEI (or the trademark owner) as a royalty payment.

- need mutual agreement.

  PM is allowed to terminate the Cartier contract with Inter-Euro on 12/31/92. PM will provide TEI with the equipment necessary to continue Cartier production at a price determined by the book value of the equipment. (Feasibility of the equipment sale needs to be researched.)

- In exchange for a royalty payment equal to 5% of the net price less FET and duty, PM will allow TEI to continue to market Peter Stuyvesant and St. Moritz as is in the U.S., Central and South America so long as the volumes do not exceed 75 million units annually.

- PM will allow TEI to continue to market Rothmans in Central and South America as is so long as the volumes do not exceed 200 million units annually.

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October 16, 1992

- In the non-border U.S. domestic and dutyfree markets, TEI will be allowed to assist in PM sales efforts by serving as a sales agent for PM for Rothmans, Craven and other RBH brands. For services to be negotiated, TEI will be paid a fee equal to 5% of these brands' net price less FET and duty.

- PM will determine pricing for the non-border duty paid and dutyfree markets for Rothmans, Craven and other RBH brands.

Note:

This counter proposal has not been discussed with PMI. I do not know if they will agree with the proposal.

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October 16, 1992

POTENTIAL RBH FEE GROWTH
(Per 1000 US$)

	Initial	1993	1994	1995	1996	1997
Domestic						
Strategy 1*	$30.00	$30.00	$30.60	$31.24	$31.91	$32.62
Strategy 2	28.90	31.97	35.03	38.35	41.69	45.05
2 versus 1	(1.10)	1.97	4.43	7.11	9.78	12.43
Dutyfree**						
Strategy 1*	$24.00	$24.00	$24.60	$25.24	$25.91	$26.62
Strategy 2	15.40	18.39	21.35	24.56	27.77	30.98
2 versus 1	(8.60)	(5.61)	(3.25)	(0.68)	1.86	4.36
Other Dutyfree***						
Strategy 1*	$27.00	$27.00	$27.60	$28.24	$28.91	$29.62
Strategy 2	19.00	21.97	24.93	28.14	31.35	34.56
2 versus 1	(8.00)	(5.03)	(2.67)	(0.10)	2.44	4.94

* Assumes RBH's manufacturing costs of about $10.00 grows 6% annually.

** Assumes duty free prices increase at same rate as U.S. domestic.

*** Assumes PM is willing to separate the duty free components and future price increases are in line with U.S. domestic.