PHILIP MORRIS U.S.A. INTER-OFFICE CORRESPONDENCE

120 PARK AVENUE, NEW YORK, N.Y. 10017

TO: William I. Campbell DATE: September 24, 1993

FROM: B. A. Reuter

SUBJECT: Status of Canadian Tobacco Export Business

Responding to the growth in demand for Canadian cigarettes and fine cut in the United States, Philip Morris U.S.A. negotiated distribution agreements for selected brands with Imperial Tobacco Ltd. and Rothmans, Benson & Hedges, Inc. The agreements required domestic Canadian manufacture of the products with marketing and sales executed by Philip Morris in the States.

In 1993, year-to-date sales volume of all Canadian cigarettes sold by PM have nearly reached 2 billion units, with another billion in sales projected through the end of the year. The 1993 income contribution is expected to reach $28 million. Almost all of the unit volume is sold through U.S.A Duty Free sales (which became part of PMI in 1978 when it was given to International to help seed that operating company's growth).

The duty free special market business has taken off because the Canadian consumer is turning to imported product which is readily available in alternative Canadian outlets at a lower price point, $3.50 versus $6.50/pack or $22 versus $48/cartons for regular domestic products sold through traditional tobacco outlets. Thus, the special market product available in Canada is priced almost as low as the Canadian duty paid product we are selling on the American side of the border.

As a result, there is very little demand for the duty paid products PM USA has available for sale. The sales volume duty·free has achieved, has happened at the expense of duty paid PM USA sales, suggesting two possible corporate solutions.

<u>One solution</u> is to consolidate the business in one operating company, either PMI or PM USA. PM USA is probably the most logical company for the reasons listed below. Although, PMI could manage both duty paid and duty free.

- Sales are made in the U.S. in dollars
- Other PMI regions manage their duty free
  - Synergies of management/warehousing/marketing materials and sales support are realized.
- Contract arrangements on Canadian Exports are with PM USA
- US marketing and sales activity reside in PM USA
- Product, packaging and distribution are all done in PM USA

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The second solution, if the Canadian business is not consolidated, would be to charge International for the market presence PM USA is creating along the border and in key vacation markets for Canadian tobacco exports, both duty paid and duty free.

In conclusion, as you can see by the trends in our 1993 budgeted and actual Canadian volume, Duty Free sales have captured the market, while Duty Paid sales have not materialized.

(million units)	1993 OB	1993 2nd RF	1993 3rd RF	1993 Actual Jan-Sept 17
Duty Paid	1,500	750	161	117
Duty Free	280	1,245	3,230	1,967

This ironical turn of events is primarily due to:

- Duty Free special market activity was originally limited by Imperials' reluctance to participate; this changed as the year progressed.
- Duty Free negotiated their agreement with Rothmans after the Duty Paid business began. Thus, Rothmans volume was excluded from the Original Budget.

Consequently, PM USA resources are being used to distribute product and create a market presence that delivers minimal sales. But, it does provide marketing activity that reinforces the development of the duty free business. It follows that PMI be asked to compensate PM USA for our marketing efforts through a charge-back arrangement.

Please let me know your thoughts on this matter as the direction we take will impact the Original Budget for 1994.

cc: R. King
S. Reich

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