DRAFT

I. THE IMPORTANCE OF YOUNGER ADULTS

Within five years, younger adults (18-24) will drop from 18% to 15% of the total adult population (18+). They will continue to decline in numbers until at least 1995, as the crest of the Baby Bubble pushes farther past age 25.

This shift in the population will cause smokers aged 18-24 to fall from 16% to 14% of all smokers by 1988. Even 13% would not be surprising, since smoking incidence has been declining more rapidly among younger adults than any other age group in recent years (see Appendix A).

Why, then, are younger adult smokers important to RJR?

1. VOLUME

Younger adults are the only source of replacement smokers. Repeated government studies (Appendix B) have shown that:

- Less than one-third of smokers (31%) start after age 18.
- Only 5% of smokers start after age 24.

Thus, today's younger adult smoking behavior will largely determine the trend of Industry volume over the next several decades. If younger adults turn away from smoking, the Industry must decline, just as a population which does not give birth will eventually dwindle. In such an environment, a positive RJR sales trend would require disproportionate share gains and/or steep price increases (which could depress volume).

2. MARKET SHARE -- THE "FIRST BRAND" ADVANTAGE

A. ANNUAL GAINS FROM THE "NEW" MARKET

"New" 18-year-old smokers in the 1983 market were worth 1.6 points of total smokers.* By capturing half of these, Marlboro gained .8 points of total smokers without needing to attract a single brand switcher. This gain was the equivalent of a successful two-style new brand introduction, with no cannibalization and no development/introductory costs.

As a company, Philip Morris held more than 60% of these 18-year-olds in 1983 versus RJR's 15-20%, yielding PM a .5 point in-going SOM advantage due only to "new" smokers.

* This assumes 18-year-olds are 10% of the 18-24 group rather than a "fair share" of 14% because of population decline and the fact that some smokers start after age 18.

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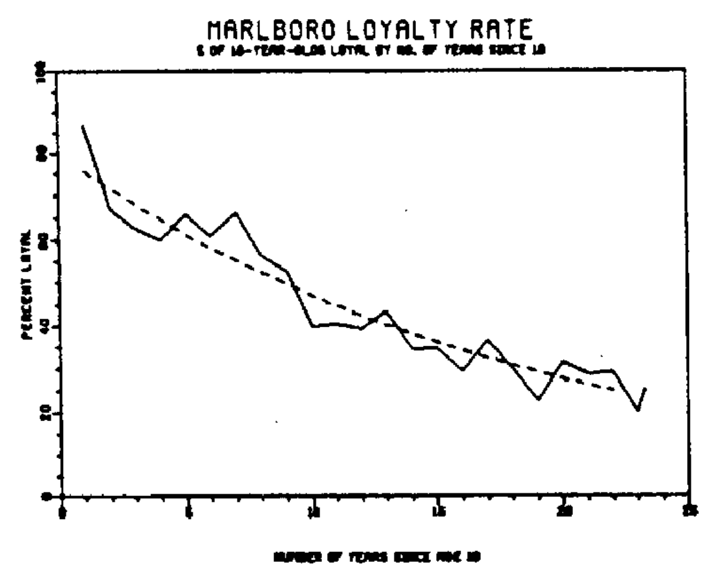
2. MARKET SHARE -- THE "FIRST BRAND" ADVANTAGE (Cont.)

B. THE COMPETITIVE SQUEEZE

This influx of 18-year-olds causes the pre-existing smoker market to shrink in share value: smokers who were worth 100.0% of the market at the beginning of 1983 were worth only 98.4% by year end. Thus, a brand which had a 10.0% smoker share going into 1983 and did not attract any 18-year-olds would drop to 9.9% even if it kept every member of its franchise. This means that <u>any brand/company which is underdeveloped among 18-year-olds must achieve net switching gains just to break even.</u>

In contrast, a brand which is strong among 18-year-olds can have net switching losses and still hold/gain share. The graph below shows loyalty rates from the 1983 SDS, i.e., the percentage of smokers who smoked Marlboro at age 18 and still do, after one to twenty-plus years. These loyalty rates show that Marlboro loses about 25% of its 18-year-olds by age 20 and another 15% by age 24 -- a total loss of 40% over the six years between ages 18 and 24. Translating this to share points, Marlboro would be expected to lose .3 points of its .8 points of 18-year-olds between ages 18-24. This is, in fact, about the annual total NFO switching loss found for Marlboro in recent years. (See Appendix C.)

However, since Marlboro gained .8 by becoming their "first brand", it can afford the .3 switching loss and still come out .5 points ahead.



C. MOMENTUM FROM AGING

Once a brand becomes well-developed among younger adults, aging and brand loyalty will eventually transmit that strength to older age brackets.

2. MARKET SHARE -- THE "FIRST BRAND" ADVANTAGE

C.. MOMENTUM FROM AGING (Cont.)

An analysis of Tracker shares from 1979-83 (see Appendix D) shows that, apart from short term fluctuations:

- Incoming 18-year-olds and the movement of its existing franchise into older age brackets can explain all of Marlboro's smoker share gains in the past four years. Among smokers 25+, all of Marlboro's gains are attributable to this aging movement -- switching appears to have had no net long term effect.

  Even if Marlboro makes no further gains among younger adults in the next five years, it is likely to gain at least 3 points of smoker share due to the aging movement of its present smokers (assuming its switching is no worse than in 1980-83). If Marlboro continues to gain share among younger adults at its present rate, its overall smoker share could easily increase by a total of 5 points, from 19% in 1983 to 24% by 1988.

- Newport's growth can also be entirely explained by its younger adult strength and aging. Over the next five years, Newport is likely to gain .8 points of total smokers without any additional growth among younger adults. If its younger adult gains also continue, it could exceed a 4% total smoker share by 1988, a gain of about 1.5 points over 1983.

These examples demonstrate the momentum younger adults give a brand. Although a competitor could slow this momentum by attracting switchers, the "first brand" would hold the high ground of brand loyalty in such a battle.

D. LONG-TERM DIVIDENDS -- RATE PER DAY

Government and RJR studies spanning several decades have shown that smokers increase their consumption as they age. The chart below shows that smokers 25+ consumed 22% more than smokers 18-24 on average during 1980-82.

	RATE PER DAY (1980-82 AVG.)		
AGE	Cigts.	% Increase Vs. 18-24	Index vs. Total
18-24	26.2		85
25-34	30.6	+ 17%	99
35-49	34.1	+ 30%	110
50+	31.2	+ 19%	101
Total 25+	32.0	+ 22%	103
TOTAL	31.0	+ 18%	100

Source: Incidence/Rate Report, Year 1982.

2. MARKET SHARE -- THE "FIRST BRAND" ADVANTAGE

D. LONG-TERM DIVIDENDS -- RATE PER DAY (Cont.)

Thus, the 18-year-olds who were worth 1.6 points of smoker share in 1983 were worth only 1.4 points of market share, since their consumption was below average (index of 85). However, by ages 35-49 they will be worth 1.8 points of SOM -- a 30% dividend on their original market share value. This consumption increase is the difference between having smokers 35-49 and having smokers who will age to 35-49.

E. EXTENDED BRAND LIFE CYCLE

The combination of brand loyalty, aging, and increasing usage tend to provide "life insurance" for brands which skew, or have skewed, younger adult.

For example, we have seen that Marlboro relies heavily on 18-year-olds for its share growth. But if, from 1984 on, no 18-year-olds ever smoked Marlboro again, aging could let Marlboro hold its market share for five more years. The left side of the table below shows Marlboro's current smoker share by age group and what those shares would be in 1988 if Marlboro got no more 18-year-olds and merely moved smokers to older age brackets. On the right side of the table, the smoker shares are translated to market share, by factoring in rate per day. The bottom line shows it is possible Marlboro could even continue to grow without 18-year-olds, but much more slowly than in the past.

	SMOKER SHARE			MARKET SHARE VALUE		
	1983 TRACKER		1988 PROJECTION	1983 EST.		1988 PROJECTION
18-24	41.2	←	17.6	6.7	←	2.4
25-34	24.7		28.4	7.1		8.0
35-49	13.5		18.4	4.5		8.4
50+	6.3		7.7	2.2		2.5
TOTAL	18.9	←	17.8	*20.5		21.3

*Jan.-Nov., 1983 MSA.

Thus, even if a brand falls from favor among younger adults, the younger adults it attracted in earlier years and their increasing consumption can carry the brand's market share for years, significantly extending its overall life cycle.

3. SWITCHING OPPORTUNITY

Younger adults are more likely to switch brands than any other smoker group, i.e., they are a concentrated switching target. Their very high propensity to also switch styles within their brand suggests the latent potential for even higher rates of brand switching.

	PROBABILITY OF SWITCHING IN 6 MO.			
	BRAND FAMILY		STYLE IN BRAND	
	%	INDEX	%	INDEX
18-24	16.6%	126	21.5%	178
25-34	13.4	102	12.8	106
35-49	12.1	92	10.4	86
50+	13.2	100	11.1	92
TOTAL	13.2	100	12.1	100

Source: NFO, 1981-1983 (first half).

Younger adult brand switchers (who then remain loyal) can also contribute the major portion of their aging benefits, including increased usage, to their second brand. Thus, switching by smokers 18-24 can yield a significant part, but not all, of the share advantages associated with a "first brand". Older switchers confer less, or none, of these benefits.

THE IMPORTANCE OF YOUNGER ADULTS

KEY POINTS

Though decreasing in number, younger adult smokers are a key market for RJR because improved RJR performance among younger adults could contribute more to long term profitability and positive share momentum than could be achieved from gains in other age groups.

1. Younger adults are the only source of replacement smokers.

   More than a share point of "new" 18-year-olds enter the market every year. These offer a significant growth opportunity and also shrink the share value of smokers already in the market.

2. A "first brand" strategy has significant share advantages.

   - Optimum ability to capitalize on the influx of new smokers. This gave PM a .5 point in-going advantage over RJR in 1983.
   - "First brands" compete from the high ground. They do not need switching gains to grow and can afford some switching losses. Brands which rely on older smokers must achieve net switching gains to break even on share.
   - Strength among younger adults will ultimately yield growth in older age brackets. Aging has been contributing all of Marlboro's and Newport's smoker share gains among smokers 25+.
   - Aging of loyal younger adults creates disproportionately large gains in market share, due to their increasing consumption. This does not accrue from gains among older smokers.
   - Younger adult strength, past or present, will tend to extend the lifecycle of a brand.

3. Younger adults offer the most concentrated switching opportunity.

   - Smokers 18-24 are more likely to switch.
   - Switchers aged 18-24 can provide more share advantage from aging/ increasing consumption than switchers 25+.