



EXTRA

Improved performance

Annual General Meeting Report
Gallaher Group Plc 2000



Gallaher's successful strategy delivered record results in 1999, with earnings per share up over 14%. We strengthened our position in the UK and in a number of key overseas markets, and our UK cigarette manufacturing division operated at the forefront of European production efficiency.

Since I wrote my statement in our 1999 Annual Review, the UK Government has made various announcements relating to our business. In his March Budget, the Chancellor implemented an immediate cigarette duty increase of 25p per pack. The following day, the Paymaster General provided details of the Government's anti-smuggling strategy, including confirmation of additional resources to tackle this illegal trade. I welcome the Government's commitment to clampdown on tobacco smuggling, but I have to say that I am baffled by its contradictory actions: further widening the price differentials between the UK and overseas markets will only encourage cross-border trade, both legal and illegal.

The Government has also announced its intention to introduce restrictions to prevent forestalling – the pre-payment of duty on stock ahead of a duty increase on which additional profit may be earned following the increase – from 2001. Currently, we are in discussions with H.M. Customs as to the precise details of this scheme, and I anticipate that the restrictions will be in place ahead of the next UK Budget. Looking forward, although we have earned additional operating profit in the UK from forestalling in recent years, the pre-payment of duty has incurred a related financing cost, and, as such, I believe that the implications of these restrictions will not be material to our UK pre-tax profitability.

Gallaher continues to lead the UK cigarette, cigar and pipe tobacco markets.

Reflecting increasing cross-border trade, the underlying rate of decline of the legitimate cigarette market remained close to 10% during the first three months of 2000. As a result of our successful strategy, we outperformed the market during this period, achieving a 40.2% share of consumer sales.

The premium sector's share of the market was 38.1% in the period January to March. Led by the strong resilience of *Benson and Hedges*, which broadly retained its share of the total market into this year, we maintained our commanding leadership of this high-margin sector.

The low price sector grew to 45.2% of the market in the first three months, its consumer volume sales falling by around 2%. We were the only company, however, to grow low price volume sales during the period. Our total sector volumes rose sharply, but, more significantly, on a like-for-like basis we lifted our low price consumer volume sales by nearly 9%. I am particularly pleased with *Mayfair's* continuing double-digit growth, as, since the comparable period last year, we have taken significant price increases. Our market share in this sector is now 30.1%.

Reflecting our record of creative marketing initiatives, the introduction of innovative packings for *Hamlet* has assisted our performance in the cigar market. Last month, we announced that we are launching a new cigar brand house in the UK. *Sobranie Cuban Collection*, a range of 100% Cuban leaf cigars, will be introduced to the market in June.

In the handrolling tobacco market, *Amber Leaf* keeps posting monthly share gains mainly relating to the success of the innovative piece-pack line extension.

Building on our record performance in 1999, and despite a 50p cigarette duty increase in December, Gallaher's volumes in the Republic of Ireland in the period January to April are ahead of the same period last year.

The Irish Government has signalled its intention to introduce tighter marketing restrictions during the summer. Although I do not welcome regulations that seek to impede our ability to compete with our competitors for market share, I have no doubt that the equity we have built in our strong brand portfolio, particularly in *Benson and Hedges* and *Silk Cut*, places Gallaher in a good position for the future.

In France, *Benson & Hedges Virginia* has grown volumes by more than 9% during the first four months of this year. *American Blend* is enjoying an attractive price position relative to the market, and, following its substantial profitability increase in 1999, the brand has resumed volume growth in 2000.

We continue to outperform the market in Greece: our cigarette volumes grew by 3.5% in the period January to March, versus a market growth of 0.6%. In addition, *Old Holborn's* share of the growing handrolling tobacco market has increased to 29.6%, up from 25.1% in the corresponding period of 1999.

Benson & Hedges Lights was successfully launched in Germany last year, and it continues to perform. Our distribution agreement with Reemtsma for the *Benson & Hedges* house, which commenced in January, is progressing well.

Building on the phenomenal growth of *Benson & Hedges* last year, our business in Spain is going from strength to strength: our volumes have risen 43% in the first three months of this year over the comparable period in 1999.

In Russia, importing product continues to be challenging owing to difficulties in obtaining tax stamps and to changes in Customs regulations. In-market demand for *Sovereign*, however, has remained stable. The growth of the value sector in Kazakhstan continues and currently we are examining the opportunities for enhancing our brand portfolio in this market so as to complement *Sovereign's* existing strong position.

During the period January to March, invoiced sales to the Asia Pacific region, including the successful introduction of the one milligram *Sobranie Pinks* and *Mints* offering in Japan, rose 43%. In-market volume growth was recorded in each of the key country markets (Japan, Taiwan and China) and in the region's duty free division.

Having achieved significant productivity improvements and manufacturing cost reductions in 1999, we continue to identify and plan the implementation of further initiatives. In Lisnafillan, new high-speed outering and case-erection equipment has been installed, and trials of new high/mid-speed cigarette machinery will take place later this year. Plans are in place to adjust UK stock levels in anticipation of the restrictions to prevent forestalling from 2001.

< Improved performance
Building on 1999's record results, our successful strategy continues to perform well. In the UK, we were the only company to grow low price consumer volume sales in the first three months of 2000, and, internationally we have lifted volumes in a number of markets. (*Silk Cut Extra Mild*)



Peter Wilson, Chairman

Turning to regulation and litigation. At the European Court of Justice, the oral hearing regarding the validity of the European Directive to ban tobacco advertising and sponsorship was held in April, and we anticipate the Court's judgement later this year. In the UK, along with other tobacco manufacturers, we have applied to the courts to stay implementation of the Government's proposed regulations (which are founded on the Directive) until the ECJ judgement. An appeal is due to be heard in the House of Lords at the end of this month.

The Commission of the European Union has published a draft Directive on tobacco products involving: tar, nicotine and CO yields; non-tobacco ingredients; and, additional consumer information. The Commission's proposals currently are being considered by the European institutions.

Returning to the UK. The House of Commons Select Committee on Health is undertaking an inquiry into 'The Tobacco Industry and the Health Risks of Smoking'. Gallaher has provided written evidence – our submission is published on our website (gallaher-group.com) – and I appeared at oral hearings in January. The Committee's report is expected in the summer. We have volunteered to publish documents relating to smoking and health on the internet, and currently are developing the process for publication.

Gallaher is only party to smoking and health litigation in the UK and the Republic of Ireland. In the UK, there are six actions against the Company in Scotland and Northern Ireland. A statement of claim has been served in one case. In Ireland, proceedings against tobacco companies have been commenced on behalf of over 300 individual plaintiffs, of which around 120 are against Gallaher (although no statements of claim have yet been served against us).

Gallaher has always maintained confidence in its ability to defend smoking and health actions. We will continue to defend ourselves vigorously, as and when the need arises. Gallaher will not settle actions.

Your Board continuously reviews Gallaher's capital structure against the background of the high level of cash flow generated by the Group's main businesses. The Board's objective is to reduce the Group's cost of capital while preserving the flexibility to take advantage of potential investment opportunities.

In 1999, during the period from our last AGM to the end of the year, we repurchased just over five million shares in the market. When we published our final results in March, we announced that we intended to step-up our ongoing programme of share repurchases.

Since 1 March, we have repurchased some 31 million shares in the market, returning over £94 million to shareholders.

In total, therefore, we have repurchased 5.4% of our share capital since our 1999 Meeting.

I am pleased to say that current trading remains in line with management's expectations. On your behalf, I should like to pay tribute to all our employees for their commitment to Gallaher's success. I should also like to express my personal and particular appreciation for the support I have received from Philip Burchell, who will retire at the end of June. As our Finance Director, he has contributed greatly to Gallaher's achievements, and I am sure I speak for everyone in wishing him well. The Board has announced its intention to appoint Mark Rolfe as Finance Director from July.

In January, Nigel Northridge was appointed our Chief Executive, and I took great pleasure in handing over the reins of day-to-day management to him. I have every confidence in Nigel and everyone in Gallaher to continue to deliver good performance going forward.



Peter Wilson Chairman
09 May 2000

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