TABELL'S MARKET LETTER

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DIVISION OF

Janney Montgomery Scott Inc.

MEMBER NEW YORK STOCK EXCHANGE, INC.
MEMBER AMERICAN STOCK EXCHANGE

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R.J. REYNOLDS INDUSTRIES (RJR)

Price: 61 3/4
Est. Earns/Sh* 1971: $4.75
Earns/Sh* 1970: $4.10
Cash Flow 1970: $275 Million
Range 1971: 69 1/2 - 53
1970: 55 3/8 - 34 3/8
Dividend: $2.40
Yield: 3.9%
Common Shs: 40.3 Million
*Fully Diluted

R.J. Reynolds derives about three-fourths of its annual revenues, $1.8 billion, and more than 80% of its pre-tax earnings, $382 million, from tobacco sales. Despite unfavorable health publicity, adverse regulatory decisions and heavy taxation, tobacco continues to be a very profitable business. RJR is the leading domestic cigarette manufacturer. Winston and Salem are its leading brands. Cigarette earnings evidence stable, if undramatic, growth. Leverage results from a federal excise tax of $4.00 per thousand. RJR cigarette list price at manufacturers level is $10.25 to $10.75 per thousand cigarettes, $0.205 to $0.215 per package. Selling, general and administrative expenses approximate 8% of selling price, labor, 7%, tobacco leaf, 25%, and the federal excise tax, 40%. Pre-tax margins approximate 20%. Accordingly, a very minor price increase to its distributors can have a dramatic effect on RJR earnings. For example, a 3.5% increase, such as instituted in 1970, would boost the price of a cigarette package seven tenths of one cent. But, RJR tobacco earnings will increase about 18%. It is noteworthy that in 1970, aided by the 3.5% price increase and 2.4% unit volume increase, cigarette pre-tax margins jumped from 18.7% to 21.1%. R.J. Reynolds historically has raised cigarette prices only to maintain its operating margins. Last year's increase was not needed for this purpose. However, three major cigarette manufacturers were experiencing sales declines and instituted 4.5% price increases. Common distributors promptly raised the price on all brands to conform to this increase. Thus, RJR could either join the rise or forfeit profits to the distributor. Tobacco industry unit production is obtained from the Internal Revenue figures on "removals". A removal occurs when a cigarette is moved from a bonded licensed warehouse area. This in preparation for shipping to distributors. At that point, the company becomes liable for federal cigarette excise tax. Last year, as a result of strike hedge inventory building by other manufacturers, these figures were distorted and RJR percentage of industry production fell to 31.8% from 32.4% the prior year. Without this influence and reflecting the strong marketing success of Vantage, a low tar and nicotine high flavor cigarette, RJR should regain its "normal" market share. Aiding RJR earnings in the current year are the continuing modest uptrend in unit volume, the benefit of last year's price increase for a full year, and an advertising saving that could approach $40 million.

In view of continuing negative health publicity and the recent lacklustre growth in cigarette unit sales, RJR is attempting to diversify. Containerized transportation, food products, and oil drilling are now all included in Reynold's operations. Food products include Hawaiian Punch, Chun King. McLean Industries, with its Sea Land division, is the company's most important acquisition. In 1970 McLean accounted for $374.9 revenues and a depressed $38.6 million pre-tax profits. During the past two years $317 million of equipment has been added to its fleet and an additional $500 million is scheduled by 1975. Margins were under pressure last year due to excess capacity on routes and ruinous price cutting. Price competition evolved in the North Atlantic when American Export dropped out of the rate setting conference. Subsequent prices fell so low that AEX found itself running full ships at a loss. Reinstitution of conference rates should restore stability. McLean, as the industry pioneer, is the most efficient operator. The most reliable full service and most rapid turnaround times have enabled the Company to run a fleet of 48 older converted containerships against competitions' larger, faster and more efficient vessels. New ships under construction for McLean fleet are at least twice as fast and twice as large as those it now operates. Thus, one ship will take the place of four. Present fleet on charter can be used as feeder ships or charters may be abandoned. Proposed acquisition of U.S. Lines from Kidde would give RJR 16 containerships for $65 million, considerably less than their net value. McLean ship financing is amortized from their cash flow.

R.J. Reynolds financial position is enviable. Working capital totals $570 million. Long term debt of $400 million is supported by stockholder equity of $1.2 billion. Current assets include $560 million leaf tobacco inventory at LIFO. Market value for tobacco exceeds by a considerable margin book cost. Leaf inventory accounts for approximately 24 months' sales due to lengthy curing process that is necessary. Inventory decline during the past four years is primarily the result of trimming due to sluggish unit growth. Less tobacco per cigarette is also a factor. Required Penick and Ford disposition will result in $40 million pre-tax loss that will be charged against 1969 and 1970 retained earnings. Reynolds is in an established uptrend. Support evident at 60-58 level. Point and figure intermediate objective 88.

Dow-Jones Industrial (12:00 p.m.) 892.52
S&P (12:00 p.m.) 99.55
AWT:*mn*

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