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RJR Nabisco — Investm[illegible]e Downgraded: Zero Excess Cash Flow in 1988 and a Focus on Market Share in Cigarettes Will Restrain Results

RJR Nabisco — Statistical Abstract

RJR-NYSE (250 Million Shares, $11.5-Billion Market Value)

	EPS Curr.	EPS Prev.	EPS P/E	P/E Rel. to S&P 500		Other Data	
Act 1986	$3.90		11.8			Price (12 Jan)	$46
Est 1987	4.75		9.7	1987	75%	52-Wk Range	$71-$35
Est 1988	5.75		8.0	1988	72	Dividend	$1.92
Est 1989	6.50		7.1	5 Yr Range	100%-82%	Yield	4.2%

Quarterly Earnings	1985	1986	1987E
1Q	$0.66	$0.66	$0.84
2Q	0.86	0.99	1.16
3Q	0.91	1.03	1.24
4Q	1.17	1.26	1.51E

Earnings Breakdown	1987E-88E
U.S. Tobacco	58%/58%
Int'l Tobacco	9/9
Food & Beverage	33/33

Investment Code: Current: M 46/245 Previous: M 46/243

A Actual E Estimate footnotes

We expect the shares of RJR Nabisco to match the performance of the S&P 500 over the next 6-12 months, based on the company's prospects for little excess cash flow near term and an apparent emphasis on market share, rather than profits, in its U.S. cigarette business. RJR Nabisco's earnings growth is projected at approximately 20% near term to $4.75 in 1987 and $5.75 in 1988. Longer-term earnings growth is estimated at 14%, roughly in line with operating gains of 13% annually.

There will be no excess cash flow in 1988, given higher capital outlays for the new cigarette and for Nabisco. This is a disappointment. Nabisco plans $3 billion in capital outlays over a three- to four-year period, compared with previously announced spending of $600 million annually. Nabisco will create modern "super bakeries" that are capable of handling single-serve sizes, as well as normal grocery store packs. In addition, the company's nine U.S. bakeries may be reduced to five. This move is designed to make Nabisco the low-cost producer, while capturing growth in the single-serve snacking market and the market for food away from home. The project has a five- to seven-year payback. Simply expressed, shareholders three to five years from now will realize the benefit from this program, rather than current shareholders.

RJR Nabisco appears to target market share gains, rather than maximizing profits in its U.S. cigarette business. Profit growth in U.S. cigarettes is forecast to be 10% in 1987 and 9% or less in 1988 because of a focus on lower-margin generics and heavy research and marketing expenditures for the new smokeless cigarette. Although RJR had a good unit performance in 1987, with an estimated 1% decline to 186 billion units (a near 33% share), compared with a 2% falloff for the industry, RJR management appears to be fixated on its loss of the number-one share position. We prefer companies with more commitment to profitability than to market share.

We expect RJR Nabisco's new smokeless cigarette, which is revolutionary, to have gradual consumer acceptance. Market testing may begin in mid-1988. The cost of the new product is high — $125 million pretax ($0.30 per share), plus a possible $200 million for capital additions such as equipment and bricks and mortar.

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