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Tobacco: Reshuffling the Deck

Allocable-share legislation and price promotions are driving consumers back to premium-priced cigarette brands

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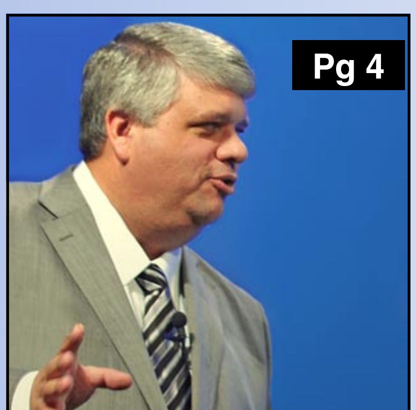

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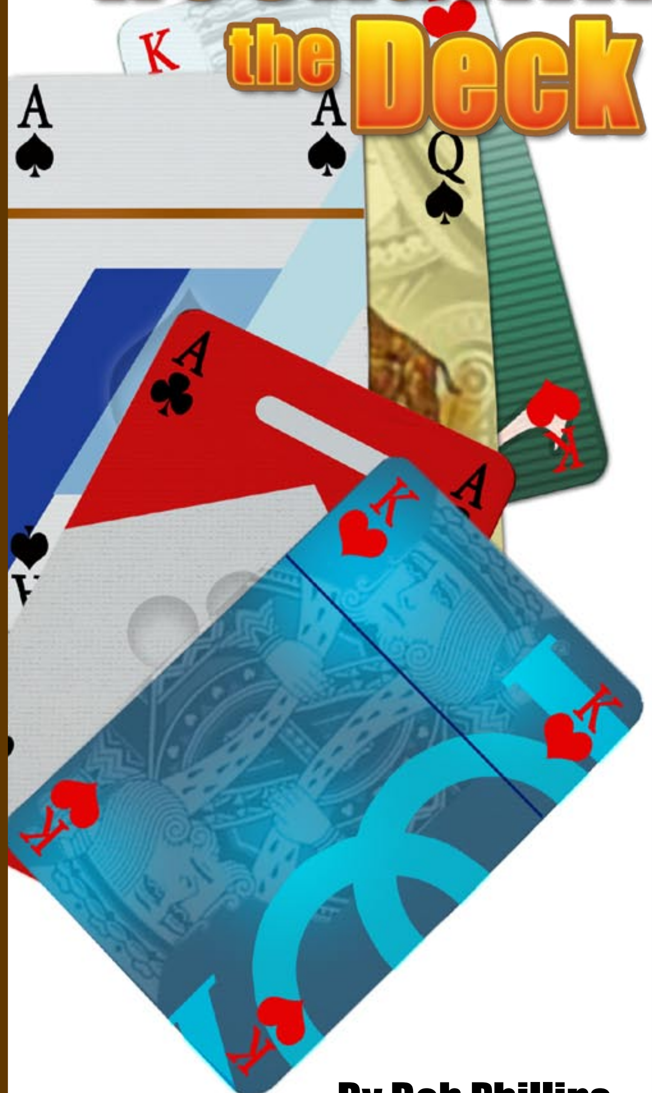
Reshuffling the Deck



A drastic reduction in the relative price gap between first and fourth tier cigarette brands has gone a long way toward creating a more level playing field.

—By Bob Phillips

After years of seeing consumers transitioning from premium-priced cigarettes to discount fourth-tier brands, a change is underway that may be halting the trend. Several factors have contributed to a shrinking of the price gap between first- and fourth-tier cigarette brands in recent months. While most obvious is voluntary compliance with the Master Settlement Agreement (MSA) by previously non-compliant manufacturers, more recently, state-level allocable-share legislation has led more fourth-tier manufacturers to incur the cost of compliance.

Because the states' MSA revenue is pegged to sales of companies compliant with the MSA, many states have initiated allocable-share legislation aimed at capturing funds from companies that heretofore had been non-compliant with the MSA.

"The larger fourth-tier manufacturers have become SPMs [Subsequently Participating Manufacturers]," explains Dan Elrod, director of sales with grocery distributor McLane Co., Inc. "The resulting exposure to payments has driven up prices for the majority of players and resulted in a shrinking absolute and relative gap."

> **"The larger fourth-tier manufacturers have become SPMs."**
>
> — Dan Elrod
> McLane Co., Inc.

According to data provided by Smith Barney, the relative gap, which stood at 73 percent in Q3 2001, has shrunk to 48 percent in Q2 2005.

Because of the narrowing of the price gap between national brands and fourth-tier brands, convenience retailers are seeing a move away from the deep discount segment and back to the majors.

"Consumers are coming back to more premium brands," says Mike Zielinksi, president and CEO of Hillsdale, Ill.-based Royal Buying Group. "I think consumers, given their choice, would rather have a branded product over a private label product."

While allocable share legislation has increased prices in the deep discount sector, simultaneously, aggressive price promotions by the major manufacturers have brought down prices among premium brands.

"The majors realized that the 96-percent share of the market they once enjoyed had shrunk to 84 percent," adds Bhavani Parameswar, vice president and CFO of Paramus, N.J.-based King Maker Marketing Inc., which voluntarily complies with the MSA. "Obviously, this is because there have been many price-value alternatives that have gained significant share, which shows consumer preference for value. So they've stepped up the promotions over the past few years to give fewer reasons for consumers to trade down, and that has lessened the gap."

According to Parameswar, at the time of the MSA, the total promotional spend by the major cigarette manufacturers in the U.S. was about $6.5 billion. Today, it's close to $11 billion. "It's not unusual to go into a store and see Marlboro marked down $6.50 or $7.00 a carton," she adds. "Because of their promotional spending, the majors have been able to keep the effective price gap in a manageable range."

Average Price per Brand in Convenience Stores

	Current Retail Price per Pack	Current Amount of Buy Down per Pack
Marlboro	$3.68	$0.67
Newport	$3.99	$0.70
Camel	$3.62	$0.76
Kool	$3.49	$0.89
Basic	$3.28	$0.89
Doral	$3.20	$0.81
USA Gold	$3.01	$0.75

Source: Smith Barney Tobacco Trade Survey

Excessive state and local taxes (i.e. "sin taxes") have also put a damper on cigarette sales. This can be particularly devastating to convenience retailers, who, according to the NACS 2005 State of the Industry report, count on

“People have not changed their consumption patterns; they have changed their buying patterns.”

— Bhavani Parameswar
King Maker Marketing

cigarettes for 34.7 percent of their total sales.

“The current weighted average state excise tax on a pack of cigarettes is about 87 cents [or $8.70 per carton],” says Bonnie Herzog, tobacco industry analyst for Smith Barney. “That’s up from 82 cents at the end of ’04 – or about a 6-percent increase. We’re still estimating a 7- to 9-percent increase by the end of the year.”

▲ *Mike Zielinski, Royal Buying Group*

According to Herzog, 17 states have excise tax legislation pending this year, while six states (Kentucky, Massachusetts, New Hampshire, Minnesota, Ohio and Washington) have already passed measures. The tax increases range from 3 cents per pack ($3.00 per carton) in Kentucky, to a proposed $2.50 per pack increase in Maryland, which would raise the tax on a carton of cigarettes by $25.00. Meanwhile, 27 states have implemented cigarette tax surcharges since 2003.

Between the health risks and increasing taxes, Herzog estimates that cigarette consumption is declining between 1 percent and 2 percent per year. But that doesn’t lessen the category’s importance.

“When you put it in terms of sales per square foot – there’s no way cigarettes take up 34 to 36 percent in square footage of the average c-store,” Zielinski says, referring to the category’s average contribution to store profits. “So it remains a pretty profitable category in those terms.”

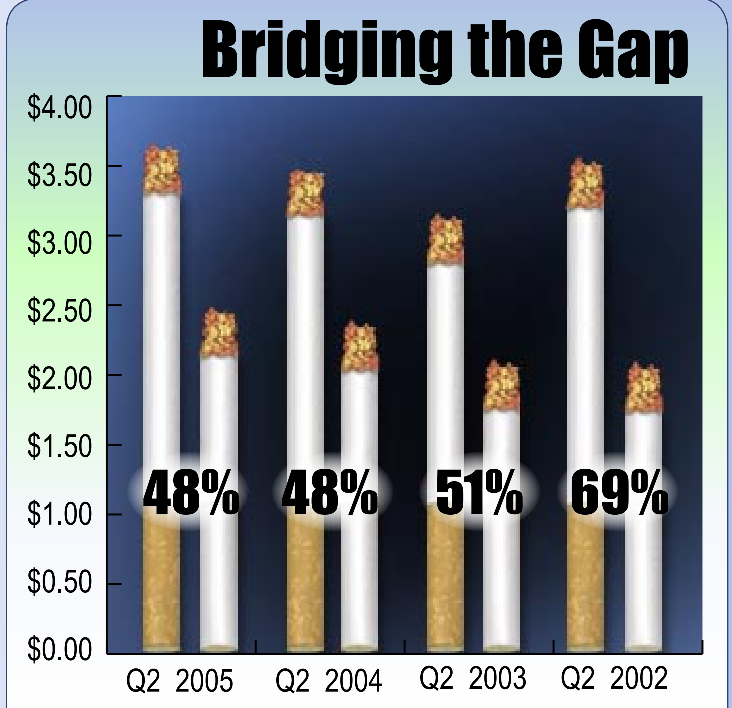
Parameswar, meanwhile, thinks that making a direct correlation between declining volume and actual consumption is naive, with smokers leaving the mainstream retail channels in droves for the Internet (until the recent credit card crackdown on Internet cigarette sales) and the growing black market.

“People have not changed their consumption patterns,” she insists. “They’ve changed their buying patterns.”

While the landscape in the volatile cigarette category is in a constant state of flux, it can still be very profitable if managed properly. Because of a franchise’s contract provisions with the c-store chains and oil companies, however, it almost seems to require the agility of a world-class juggler at times.

“It’s a category that’s become much more complex because of the contract requirements, and it takes a great deal of effort to do it right,” Zielinski says. “You obviously want to be at the highest level you can be with the cigarette companies, because that’s where you get the price breaks and can become more competitive with your pricing. But at the same time, some of those higher levels require signage or other pieces in the store that may conflict with other contracts you’ve signed as a franchise for an oil company or c-store chain. It can be difficult.”

Bridging the Gap



The relative price gap between first- and fourth-tier cigarette brands has shrunk by 21 percent between Q2 2002 and Q2 2005

Average Premium Brand

Average Deep Discount Brand (Fourth Tier)

Source: Smith Barney Tobacco Trade Survey

But be forewarned: Retailers dependent on promotional paydays from the manufacturers to turn a profit are not positioned well for future profitability. The writing is already on the wall, with Philip Morris effectively raising prices this year by reducing retail buy downs.

“Retailers have to realize that they can’t be dependent on promotional payments for profitability,” cautions Zielinski. “That means, depending on the amount of inventory they have to handle, the amount of liability associated with it, and competition, they’re going to have to adjust prices so that they can realize as much business as possible.” ■

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A Matter of Time

Philip Morris USA likely will soon be spun off from the Altria Group and become its own company. What does that bode for the tobacco industry?

In November 2004, Altria Group, Inc. CEO Louis Camilleri announced at the company's annual investors' conference that plans were ongoing to break the company up into two or three distinct businesses. When the restructuring was done, Kraft and Philip Morris USA (PM USA) would be autonomous companies unto themselves.

Before Philip Morris USA can be spun off, however, litigation pending against the company in Illinois must be resolved. In what has become known as the Price case, a $10.1 billion verdict was handed down against PM USA in March 2003. The suit alleges that Philip Morris engaged in consumer fraud by claiming its "light" products (i.e., low tar) were less dangerous, when, in fact, they may have been more dangerous.

Most industry analysts expect both a favorable verdict and Philip Morris USA to become a standalone company within a year. But what exactly will that mean for the tobacco industry and the c-store trade? Retailers are taking a "wait-and-see" approach.

"It won't have any direct, immediate effect," says Mike Zielinski, president and CEO of Royal Buying Group. "However, once they provide long-term direction from a split, I'll need to assess it."

> **"It's logical for them to look at OTP as a growth extension."**
>
> *— David Bishop, Willard Bishop Consulting*

Although the company currently owns about a 47-percent market share of the cigarette category, the U.S. market is a mature one, in early stages of permanent decline. According to Smith Barney, that leaves just two ways to grow the cigarette business:

- **Increase volume.** This, however, is difficult to achieve in an industry where volume is declining by 1 percent to 2 percent per year.
- **Expand margins.** This can be done by reducing promotion dollars and/or increasing list price.

Since both strategies are heavily reliant on factors beyond the company's direct control, many industry experts expect the company to broaden its focus beyond traditional cigarettes.

"In the U.S. market, they're continuing to test the low-risk products," explains David Bishop, director of Willard Bishop Consulting. "The benefit of that initiative will be highly dependent on FDA oversight."

Indeed, Philip Morris is supportive of all aspects of the cigarette industry coming under FDA regulation. In terms of "low-risk," the FDA would be in charge of labeling and claims, which would limit the company's future liability. In addition, in order to become FDA-compliant, cost of entry into the category by smaller manufacturers would be prohibitive.

Word on the street is that Philip Morris is happy thus far with the test of its so-called "low-risk" product (called Marlboro Ultra Smooth). Currently being tested in Atlanta, Tampa and Salt Lake City, three separate products with different taste profiles have been introduced. Smith Barney focus groups have given positive feedback on the products' taste and draw. Unlike the former "low-tar" offerings, Marlboro Ultra Smooth features a specially designed carbon chamber that is said to filter out most of the carcinogens associated with smoking.

"If there is a product on the market that is truly safer – or reduced risk – that could be a huge opportunity for everyone, quite frankly," Herzog says.

Expect the "new" Philip Morris to look at other areas within the overall tobacco category to grow business.

"From a growth perspective in the U.S. market, it's logical for them to look at OTP as an extension in the tobacco category," Bishop says.

And OTP is the most logical place to grow business. But will they acquire an existing company to enter the market – or create a product on their own? "I think they will enter on their own," predicts Herzog. "They've been working on it. Think Marlboro in a can." ■

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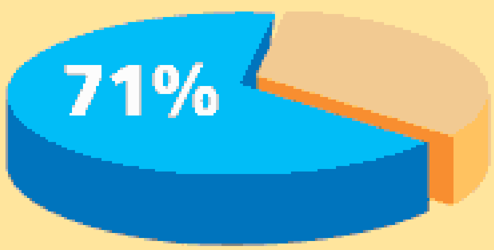

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Playing the OTP Game

MST continues to grow as a source of tobacco revenue for convenience retailers

Even though cigarette volume continues to decline in the United States at a rate of 1 percent to 2 percent per year, the importance of the tobacco category to the c-store retailer's bottom line remains clear and constant.

"Because tobacco continues to be the largest dollar volume sales category other than motor fuel, it continues to be the biggest driver of convenience store sales and profits," says Mike Zielinski, president and CEO of Hillsdale, Ill.-based Royal Buying Group, a national organization that selects, negotiates, implements, and tracks vendor programs on behalf of its members, representing over 3,700 convenience store locations.

"We keep growing our share [vis-à-vis smoke shops]. We are a destination stop for tobacco."

One logical strategy for retailers to employ: Increase overall tobacco sales by promoting the "other tobacco products" (OTP) segment – cigars, roll-your-own tobacco and accessories, and, particularly, moist smokeless tobacco (MST).

"Bottom line… OTP represents an attractive opportunity for retailers to make money," said Bonnie Herzog, tobacco industry analyst for Smith Barney, at a recent CSPNetwork CyberConference entitled Tobacco 2005: From Evaluation to Opportunity. "This could be a way to diversify your tobacco business. Do you allocate a little more shelf-space to smokeless? Roll your own? Cigars are also growing. Together, they may be a way to increase your margin."

Which Way Is Up?

Smith Barney reports that the MST segment has enjoyed healthy growth over the past four or five quarters – ranging between 5 percent and 7 percent. However, the investment firm is not sure that rate of growth is sustainable.

"I think it will continue to grow, but it will return to the historical levels of about 2 percent growth," said Herzog.

Others disagree.

"The OTP category is growing," counters Nik Modi, tobacco analyst for UBS. "This is being supported primarily by flavor innovation in cigars, and ongoing growth in the MST segment. I expect the MST segment to continue its growth at an estimated rate of 4 percent to 5 percent over the next three years."

David Bishop, director of Barrington, Ill.-based Willard Bishop Consulting, agrees with UBS' short-term assessment.

"We're seeing retailers budgeting for between 5-percent and 12-percent growth in the OTP category," he notes.

Retail Price Gap Trend (Premium vs. Deep Discount)

Source: Smith Barney Tobacco Trade Survey

Period	Average Premium Brand[1]	Deep Discount (4th Tier)[2]	Absolute Gap	Relative Gap
Q2 '05	$4.88	$1.73	$3.15	181.7%
Q1 '05	$4.46	$1.72	$2.74	159.7%
Q4 '04	$4.44	$1.68	$2.76	164.4%
Q3 '04	$4.37	$1.85	$2.51	135.7%
Q2 '04	$4.52	$1.94	$2.58	133.2%

1 Copenhagen
Skoal
Kodiak
2 Grizzly
Husky

"In particular, MST doesn't show any immediate signs of slowing down. Contrary to Smith Barney's assessment, I think it is quite sustainable for the next few years.

"It's interesting that OTP – and moist smokeless in particular – has a perceived 'health benefit' over smoking. Consumers perceive that it's 'better for you' than cigarettes. And in some cases, state attorneys general have agreed and actually have taxed moist smokeless products more favorably as a result."

Low-End Drives Growth

Of course, growth is a relative term. One factor cannot be argued: It's the low-end of the MST market that's driving all of today's growth.

United States Smokeless Tobacco Company (USST) remains the category leader with over 70 percent of the MST market, including the No. 1 and 2 premium brands, Copenhagen and Skoal. When rivals Conwood and Swedish Match entered the market with several discount brands designed to challenge USST's position, USST introduced its own value brand, Husky, and threw a great deal of its marketing muscle behind the low-end brand. As a result, most new MST consumers are entering the category via the discount doorway.

According to Smith Barney's most recent quarterly tobacco survey, which

Crystal Ball Gazing

While overall cigarette consumption is expected to decline in the U.S. through 2009, look for cigar consumption to rebound, and other tobacco products, such as roll-your-own tobacco, to enjoy solid growth.

OTP Consumption

Source: Euromonitor International 2005

Segment	2004	2009	2004-2009 CAGR	% Change
Cigars (million units)	6,262.8	6,944.2	+2.1%	+10.9%
Smoking/Rolling Tobacco (tons)	7,259.1	7,553.6	+0.8%	+4.1%
Cigarettes (million sticks)	360,400.0	298,781.9	-3.7%	-17.1%

Cigarette dollars are projected to grow in the single digits in the U.S. marketplace through 2009, while cigars and RYO tobacco are expected to enjoy double-digit growth.

OTP Sales (Millions)

Source: Euromonitor International 2005

Segment	2004	2009	2004-2009 CAGR	% Change
Cigarettes	$72,146.9	$78,552.2	+1.7%	+8.9%
Cigars	$2,287.5	$2,644.6	+2.9%	+15.6%
Smoking/Rolling Tobacco	$406.2	$550.0	+6.2%	+35.4%
Total Tobacco Category	**$74,840.6**	**$81,746.8**	**+1.8%**	**+9.2%**

polls tobacco retailers and wholesalers, more smokers are entering the MST category, but are doing so in the low-price segment. Ninety-four percent of retailers have seen more smokers enter the category compared to last year, but the majority believe this growth is being driven by lower-priced MST brands. Sixty-seven percent of retailers have seen the low-end brands (Grizzly, Longhorn and Husky) encroach on share from Copenhagen and Skoal.

USST research, meanwhile, indicates that most new MST consumers are entering the category at the high end, which would indicate they quickly change gears and switch to low-price brands.

"Clearly, there are a number of fundamental changes occurring in moist smokeless today, similar to cigarettes, with the deep-discount value items coming in and affecting the premium business very much like fourth tier has done with premium cigarettes," explains Bishop. "USST is definitely the market leader with three-quarters of the business. They introduced their own deep-discount product [Husky] in response to Swedish Match, which had previously reduced the price of its brands."

The biggest difference between the cigarette market and MST markets would be that the major companies play in all four price segments – giving them more control over the relative and absolute price gaps. According to Smith Barney research, the relative and absolute gaps between premium and fourth-tier brands were 181.7 percent and $3.15 for Q2 '05. That statistic goes a long way toward explaining the dramatic, explosive growth on the low end of the category.

Indeed, USST offers a twofold approach to the MST category: promote the profitability of the premium segment via retailer buy downs (averaging 80 cents per unit, according to Smith Barney), all the while growing the overall category by driving the fourth tier.

"USST has tactically reduced prices in low-income areas, where the discount competition is gaining most traction," says UBS' Modi. "However, my sources suggest discount brands are starting to gain more traction in higher-income areas as well."

Many in the industry think that USST's strategy to dominate the top and bottom tiers is an effort to discourage new companies and brands from entering the MST marketplace.

"I don't think that USST is going for share or trying to block new entrants, because they have already been hit with antitrust litigation," continues Modi. "They focus on category growth, which is the responsibility of the category leader." ■

[Click Here to download an audio-visual recording of the recent CSPNetwork CyberConference, "Tobacco 2005: From Evaluation to Opportunity."]

"[OTP] will continue to grow, but it will return to historic levels of about 2 percent per year"

▲ *Bonnie Herzog, Smith Barney*

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