No More Big Four?

Small cigarette manufacturers grab market share

BY ROBERT W. KIDD

Philip Morris USA Inc., R.J. Reynolds Tobacco Co., Brown & Williamson Tobacco Corp., and Lorillard Tobacco Co., popularly called "The Big Four," have held a commanding position among domestic cigarette manufacturers throughout the United States for the last 40 years. By 1997, the Big Four's combined market share hit a historical peak of 97.7 percent, according to industry analyst John C. Maxwell, Jr. in his quarterly publication *The Maxwell Report*. The United States Department of Agriculture (USDA) described the industry then as "hourglass shaped." Thousands of tobacco farmers supplied only 13 cigarette manufacturing establishments, which then shipped the manufactured product to hundreds of thousands of wholesale and retail establishments.

In the last five years, however, the tobacco industry has lost its hourglass figure as start-up competitors — including a few in the Fifth District — have entered the cigarette manufacturing market. And as the Big Four lose market share, state budgets aren't getting as much money as was originally estimated through tobacco settlements.

Susan Craven, president of the Council of Independent Tobacco Manufacturers of America (CITMA), observes that "there is a flurry of start-up activity" in the cigarette manufacturing industry. Some reports, for instance, estimate that there might currently be more than 100 startups, including those in the Fifth District such as Poison Inc. in Castle Hayne, N.C.; S&M Brands in Keysville, Va.; and Star Scientific in Chester, Va. Small manufacturers, which were relegated to only 2.3 percent of the domestic market in 1997, now account for more than 15 percent, according to *The Maxwell Report*.

Why the sudden emergence of these small manufacturers? The Big Four all point to the Master Settlement Agreement (MSA) to help explain their accelerating loss of market share. The MSA was a record-setting settlement between nearly all the states and the Big Four in November 1998. The agreement "absolutely and unconditionally" releases the participating companies from all current and future suits by participating jurisdictions in tobacco-related health-care claims. In return, the Big Four agreed to make payments to the participating states, projected at the time of settlement to be worth about $204.5 billion through year 2025.

Although the Big Four freely bargained for the terms of the MSA, they blame the payment obligations for higher prices. The major cigarette companies have increased their prices more than $1.10 per pack since 1998, effectively doubling the average price of cigarettes in five years, according to a 2001 Presidential Commission Report, *Tobacco at a Crossroad: A Call for Action.*

The steep increase in cigarette prices opened the door for smaller manufacturers with lower cost structures to grab market share. In 2001, Maxwell observed that "with ease of entry into the market being very reasonable many new companies are being formed. For only a few hundred thousand dollars, a secondhand maker can be purchased" and quickly become profitable. In an effort to explain their sharp drop in market share to stockholders, Lorillard estimated in its 2002 annual report that smaller competitors were pricing their brands as much as 60 percent below the major cigarette manufacturers

However, skeptical industry observers believe the Big Four's price hikes were much greater than required to meet their payment obligations under the MSA. For instance, the Presidential Commission Report states that only "roughly half" of the increase is to cover the costs associated with the MSA.

A Shrinking Market

According to *The Maxwell Report*, domestic cigarette shipments totaled about 403 billion in 2003, down 35 percent from 1981, when domestic shipments reached a historic high of 636.5 billion.

In the past year, the Big Four took significant steps to regain U.S. market share. On October 27, 2003, R.J. Reynolds announced its agreement to acquire Brown & Williamson (the U.S. cigarette and tobacco operations of British American Tobacco Company) and create a new holding company, Reynolds American Inc. The two companies have a combined 32 percent of the domestic market share. If U.S. and European regulators approve the acquisition, the new Reynolds American would become the second largest manufacturer behind Philip Morris, which has about 50 percent market. (Lorillard has about 10 percent of market share.) According to R.J. Reynolds, the deal is expected to improve efficiency and generate more than $500 million in annualized savings.

Rather than actively pursuing a business merger, Lorillard attempted to strengthen demand through promotional initiatives and by altering its pricing schemes. The company halted its wholesale price increases in March 2002, and in May 2003, lowered the list price of its discount brand, Maverick, by $1.10 per pack of 20 cigarettes. However, because of higher promotional expenses and lower sales volume, Lorillard's revenues and net income decreased in 2003.

Tough Times for Local Farmers, State Governments

Since MSA payments to states can be adjusted for changes in the Big Four's domestic sales and market share, state governments aren't receiving the money they had anticipated. For example, RJR's payments went from $2.5 billion in 2002 to $1.8 billion, a drop of 28 percent. (Each state's allocation of the MSA was initially based on its smoking-related health-care costs. About 9 percent of total disbursements are allocated for Fifth District states, while populous states like New York and California each receive more than 10 percent of disbursements.)

With smaller MSA payments, states are being forced to revise their budgets. For instance, Virginia's Department of Planning and Budget recommended lowering the appropriation for the Tobacco Indemnification and Community Revitalization Fund and the Virginia Tobacco Settlement Fund. Recommendations included reductions of $3.8 million and $2.9 million for 2005 and 2006 respectively.

Not only will state governments be affected, so will local economies throughout the Fifth District. Philip Morris and Lorillard both have their headquarters, manufacturing, and storage facilities in North Carolina and Virginia. Although Brown & Williamson is currently headquartered in Kentucky, the facility will close and the new company will be in Winston-Salem, N.C., home of R.J. Reynolds. The proposed acquisition will result in tobacco processing and cigarette manufacturing redundancies that will be eliminated to achieve the expected cost synergies. For instance, a tobacco-processing plant in Chester, Va., which employs 132 people, is expected to be closed.

Because demand for cigarettes is dropping, so is U.S. tobacco production. According to the USDA, total U.S. tobacco production fell from 1.1 billion pounds in 2000 to 890 million pounds in 2002. During this same time, production in the Fifth District fell from 554 million pounds to 487 million pounds. However, the Fifth District's share of U.S. production slightly increased from 52 percent to 55 percent, indicating that production is decreasing at a slower rate in the Fifth District than in other regions.

According to a 2000 USDA report, the "loss of tobacco-related income and jobs will have little noticeable long-term effect on the U.S. economy as a whole, but there will be difficult transitions for many farmers, workers, businesses, and communities." Since tobacco farming and manufacturing is concentrated in the Fifth District, and the Big Four seems likely to become the Big Three, the region is particularly vulnerable to competitive dynamics and will continue to face challenges resulting from these anticipated transitions. **RF**

Less Demand Means Less Production

Fifth District State	2000 Tobacco Production (1,000 POUNDS)	2002 Tobacco Production (1,000 POUNDS)
MD	8,265	2,380
NC	406,500	357,350
SC	81,260	59,475
VA	56,613	66,180
WV	1,560	1,950
Fifth District Total	554,198	487,335
U.S. Total	1,052,999	889,632

READINGS

"Frequently Asked Questions about the Tobacco Settlement." Washington, D.C.: National Conference of State Legislatures, March 1999.

"Tobacco at a Crossroad: A Call for Action." Washington, D.C.: United States Department of Agriculture, May 14, 2001.

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