Four Biggest Cigarette Makers Can’t Raise Prices as They Did

Frugal Smokers Are Jumping To Bargain Brands; Profits Fall at Larger Companies

Buying Marlboro? ‘Forget It’

BY GORDON FAIRCLOW

Enfield, Conn.—John Fitzgerald, 75, smoked Marlboro for nearly two decades. But last year, when the price of a pack here topped $4, the 75-year-old computer administrator decided to switch to USA Gold.

Made by a small Kentucky company, the discount brand comes in a red, white and blue pack that costs only $2.78. ‘‘That’s not too expensive, if you think about it,’’ Mr. Fitzgerald says.

At Carlow Tobacco Emporium, the store where Mr. Fitzgerald buys his cigarettes, USA Gold and other bargain brands now account for 30% of sales, up sharply from just a year ago. ‘‘It looks like the big companies are in for a rude awakening,’’ says owner Michael Walsh.

For years, the tobacco giants—Philip Morris Cos., R.J. Reynolds Tobacco Holdings Inc., Brown & Williamson and Liggett Tobacco—could raise prices with little danger of losing loyal customers. Now that has changed.

Smokers such as Mr. Fitzgerald are responding to sky-high prices by quitting entirely or switching to super-cheap cigarettes made by a galaxy of small manufacturers, few of which even existed 10 years ago. Cut-rate cigarettes with names such as Rave and Hi-Val command nearly 30% of the market, compared with 2% just four years ago.

In response to this threat, the big tobacco makers have new stepped-up 2-for-1 deals and other short-term incentives of their own. But these are expected to eat up hundreds of millions of dollars of manufacturer profits in the second half of the year, Philip Morris and Reynolds, respectively No. 1 and 2 in the industry, have already slashed their 2002 profit forecasts.

Profit Margins Drop

As a result of its current discounting, the domestic tobacco unit of Philip Morris will see its profit per thousand cigarettes fall more than 50% in the fourth quarter, to about $30.5, compared with the year-earlier period. Martin Palestina, an analyst with Merrill Lynch & Co. estimates. At R.J. Reynolds, the comparable figure will fall 70%, Mr. Palestina projects.

Shares of Philip Morris and Reynolds hit 52-week lows after the companies issued their profit warnings last month. Philip Morris has bounced back, while Reynolds is still off by about 25%.

The rise of the low-end manufacturers has raised a 50-year consolidation threat in the tobacco industry, threatening its core business and creating a robust alternative to established brands. The big tobacco companies have lost a measure of control over a market they once dominated completely. The development raises questions about the viability of their basic strategy: relying on regular, hefty price increases to fuel profit growth and, in some cases, to fund a lavish corporate lifestyle.

Now it seems the top four companies raised prices too high and too quickly.

‘‘The price gap that exists between the full price and the low end is 7 to 1 in the past,’’ Andrew J. Schindler, chairman of Reynolds, told analysts earlier this week. Philip Morris executives say that in part through their discounting, they will shrink the gap, which currently is more than 90% in some instances. At R.J. Reynolds, ‘‘we see some systemic change here,’’ says Michael E. Szymanski, chairman and CEO of the company’s domestic tobacco operations.

More broadly, improvement should come as soon as next year for several reasons, Philip Morris predicts. An expected strengthening of the overall U.S. economy would encourage consumers to return to more-expensive brands, the company says. The major manufacturers also can count on a substantial financial relief when certain of their obligations under multibillion-dollar legal settlements with state attorneys general expire next year.

Merrill Lynch’s Mr. Palestina estimates that the big companies could end up paying a total of $1.4 billion less next year than they did that year under settlements reached in 1997 and 1998. That would allow them to do more discounting without hurting the bottom line. Smaller companies, which weren’t obliged to make certain payments, won’t enjoy the relative savings next year.

Separately, Philip Morris is pushing a proposal to let the Food and Drug Administration make rules on combustible tobacco products.
Big Cigarette Makers Can’t Hike Prices

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Consumers

ist ratecigarettes. If that hap-

happened, it could hurt upstarts that lack the

resources to meet potential new safety

standards.

Before the major tobacco companies’

curb of sales of temporary discount

packages, from Procter & Gamble Co. to

dates or about 95%, since 1997. The rise

was driven by the companies’ hunger for

growing their broader markets, which have

market share in 2001, before the cur-

rent strong of Big-company discounting.

Rising prices increased the cost of smok-

ing. The number of cigarettes smoked in

the U.S. has been declining by 3% to 4% a

year for decades. The sharp rise in price

cut immediately after the state settle-

ments caused consumers to fall by about

80% in 1999.

The price increases also encouraged

more-frequent smokers to switch brands.

Some began moving from Basic and

other discount cigarettes made by the

big companies to even less expensive

varieties made by a new group of upstarts.

Philip Morris didn’t feel the sting as much

as some of its rivals, because Basic

densation is already a relatively small por-

tion of the company’s sales. But Reynolds

and Brown & Williamson, a unit of British

American Tobacco PLC, which has become

more dependent on sales of discount cigarettes,
suffered. B&W saw the number of its low-

end GMC-brand cigarettes fall more than

50% from 1997 through 2001.

In March of this year, Philip Morris

raised wholesale list prices of its pre-

mium cigarettes by 12 cents a pack, with-

out increasing the amount of coupons

and other temporary come-ons it was of-

fering. Philip Morris now says it went too

far. “We did not strike the optimum bal-

ance between volume [and market] share

growth,” says Louis C. Camilleri, who

took over as chairman and CEO in April.

State, excise-tax increases exacer-

bated the situation. Struggling with bud-

get shortfalls, 20 states have moved to

raise cigarette taxes in the past year.

The market-weighted average state cig-

arette tax climbed 46%, to 62 cents a pack

in October, up from an average of 42

By late spring, the most profitable

premium-brand lines, which for the most

part had held steady since the state

settlements, began to stumble. In last

year’s third quarter, about 75% of cig-

arettes sold in the U.S. were from Big-

brand and discount cigarettes sold in

convenience stores ranged between 50% and

65%, according to Philip Morris. The

company says its goal is to get the spread

down to the mid-40s, at which point it

expects even frugal smokers to begin to

switch back.

Forget It

Consumers have noticed the growing

price difference. Virginia Reiter, 52, who

started smoking when she was 16, says she

switched to USA Gold a couple of years

ago. “I looked at the price of Marlbo-

oro and Winston and said, ‘Forget it.’”

Ms. Reiter, who works at a Sears store

in Virginia, says she earns less than

$30,000 a year, and she is never

about a carton a week, so the price differ-

ence between USA Gold and Basic is a

“Why pay the extra price if they taste the same?” she asks. “I’d like the

USA Gold. They don’t burn my throat like Basics do. And they satisfy the urge.”

The temporary. One percent of the

U.S. cigarette market is equivalent to

about 200 million packs a year.

In the first nine months of this year,

the difference in price between Marlboro

and deep-discount cigarettes sold in

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as They Did

with the same period in 2001, Mr. Redmond says.

Beyond the current round of temporary
discount offers, the major manufacturers
are counting on a variety of tactics to re-
duce the price gap with the deep discount-
ers. Reynolds is giving retailers higher
promotional payments if they agree not to
sell any cigarettes at a price lower than
what the store owners charge for Rey-
olds's own discount Monarch brand.

Philip Morris hopes that it will gain
market share with what it calls a poten-
tially less harmful cigarette. The com-
pany's scientists have been working on a
new product they say has lower levels of
harmful chemicals than regular smokes.
Dinyar Devitre, the company's chief finan-
cial officer, says the new product could hit
the market by mid-2003. The potential for
such cigarettes is unclear, however. A pur-
portedly less dangerous cigarette offered
last year by Vector Group Ltd. has fared
poorly.