How does Big Tobacco see its future? Guest blog by Jonathan Fell

written by Clive Bates | 23 November 2016



What is the tobacco industry up to? Let's ask someone from the City who knows about it…

Note from Counterfactual. There's much speculation and theorising from public health academics about what the tobacco industry is doing and what motivates it. But this often based on a simplistic understanding of business, markets and how the industry (indeed *any* industry) works, and seasoned with selective reading of now-dated industry documents. I thought we might gain more by asking an analyst and investor for his views. So here is a guest post from Jonathan Fell, a former City of London investment bank equity analyst with over 20 years' experience following the tobacco industry and other consumer packaged good companies. He now manages a fund, in which he himself invests, that owns shares in a number of consumer companies, including tobacco stocks.

These are Jonathan's own views. This piece is not intended as investment advice, nor should it be taken as such.

_____ Jonathan Fell's guest blog starts here _____

Simon Chapman, Emeritus Professor in Public Health at the University of Sydney, is a regular contributor to, and Friend of, *The Conversation*, and on 20 October published a piece called Big Tobacco sees its future in cigarettes, not vaping. This is not the first time he's expressed these sort of views; he wrote something very similar in a BMJ blog in March 2014, Why is big tobacco investing in e-cigarettes?, which I responded to at the time via the BMJ's comment section (here and here).

Professor Chapman may well be overstating the extent to which growth in the global market for next-generation nicotine products is slowing, particularly if the success of Philip Morris International's 'heat-not-burn' product in Japan is taken into account. He is almost certainly significantly over-simplifying the debate over why kids start smoking or vaping when he writes that the…

> *…business model is . . . intriguing young people who have never used any nicotine product and who are increasingly never likely to.*

I would like to address Professor Chapman's views on the behaviours of the tobacco industry; he makes many of the classic errors of those commentating from a public health perspective.

Abuse of history and contemporary sources

There is a particular strand of research in the public health sphere that focuses on digging through tobacco industry documents, usually to make the case that the industry's behaviour is cynical and deliberately and permanently calculated to frustrate legitimate health goals. This work gets published in medical journals but it is really a version of history – except the most unhistorical history imaginable, where the conclusion often appears pre-determined and voices opposing that conclusion are excluded on the grounds they must be biased ('vested interests') and it's already been determined that they can't be trusted.

Imagine, for example, writing an account of the tobacco industry's involvement in the snus category concluding that tobacco companies *"have eliminated competition between cigarettes and lower-risk products"* without talking to any of the people actually involved in those initiatives, and ignoring many of the contemporary financial materials which would quickly show that much of the factual basis of the account was simply wrong (not least because cigarette

volumes in Sweden and Norway are still shrinking while snus is still growing, and the former monopoly snus provider Swedish Match has been losing share year after year).

Professor Chapman shows a similar affection for dredging up old documents, produced when many current senior tobacco executives were barely out of nappies, let alone employed in the tobacco business. But on this occasion it's his somewhat casual approach to more contemporary sources which has to bear the weight of his central contention: that the tobacco industry's involvement in new products such as e-cigarettes is a cynical ploy designed to prolong the profits of the conventional cigarette business.

Professor Chapman starts with a 2012 quote from Kingsley Wheaton, then BAT's Director of Corporate and Regulatory Affairs and now Managing Director, Next Generation Products:

> *Our core business is, and will remain in, tobacco.*

But Professor Chapman has omitted a rather important qualifier from Mr Wheaton's remarks; what Mr Wheaton actually said was

> *Our core business is, and will remain in, tobacco but we've always made it clear that our goal is to provide those adult smokers who are seeking safer alternatives to cigarettes with a range of reduced-risk products that will meet their varying needs.*

Had he actually talked to anyone at BAT (or any of the financial analysts following them) about the company's views on next-generation products, Professor Chapman would also have realised that Mr Wheaton's remarks were grounded in the mathematically obvious, given the relative sizes of the combustible tobacco and e-cigarette markets at the time. Professor Chapman has visited BAT's website for his figures on the sizes of the combustible and e-cigarette markets, but appears to have overlooked the Next Generation Products section that states BAT's contemporary views:

> *Traditional tobacco has been the mainstay of our business for more than 100 years – and will continue to be so for a long time to come. However, we also see huge potential in Next Generation Products, which include Vapour Products like*

> *e-cigarettes.*

At least BAT's website got a visit; Professor Chapman's take on PMI's recent investor day seems to come entirely second-hand, via an article on the website of the Motley Fool investment firm, from which he draws the conclusion that:

> *Philip Morris planned to have cigarettes 'keep bringing in the bulk of its revenue for years to come.'*

That piece, titled PMI's future in the cigarette market, was written by Dan Caplinger, a contract writer for Motley Fool and the firm's Director of Investment Planning, with a background as an estate-planning attorney and independent financial consultant. I don't doubt Mr Caplinger's experience in financial planning, but it's not clear that he's the most expert commentator when it comes to the tobacco industry.

The Motley Fool article focuses on one aspect of PMI's investor day, all the slides and prepared remarks for which are available on the company's website here.



Slide 2 of PMI's CEO presentation, September 2016

Essentially the first thing that André Calantzopoulos, PMI's CEO, said in his presentation (the first of the day) was this:

> *. . . we will continue to lead the combustible product category, leveraging the great strengths of our existing business to deliver against our current growth algorithm. We also aim to become the undisputed leader of the Reduced-Risk Product category with the highly ambitious objective of having RRPs ultimately replace combustible products to the benefit of adult smokers, society and our company.*

That's a much fairer reflection of the content of PMI's investor presentations: the company of course remains focused on its traditional business, but is also investing very heavily in next-generation products.

Is 'dual use' the real goal?

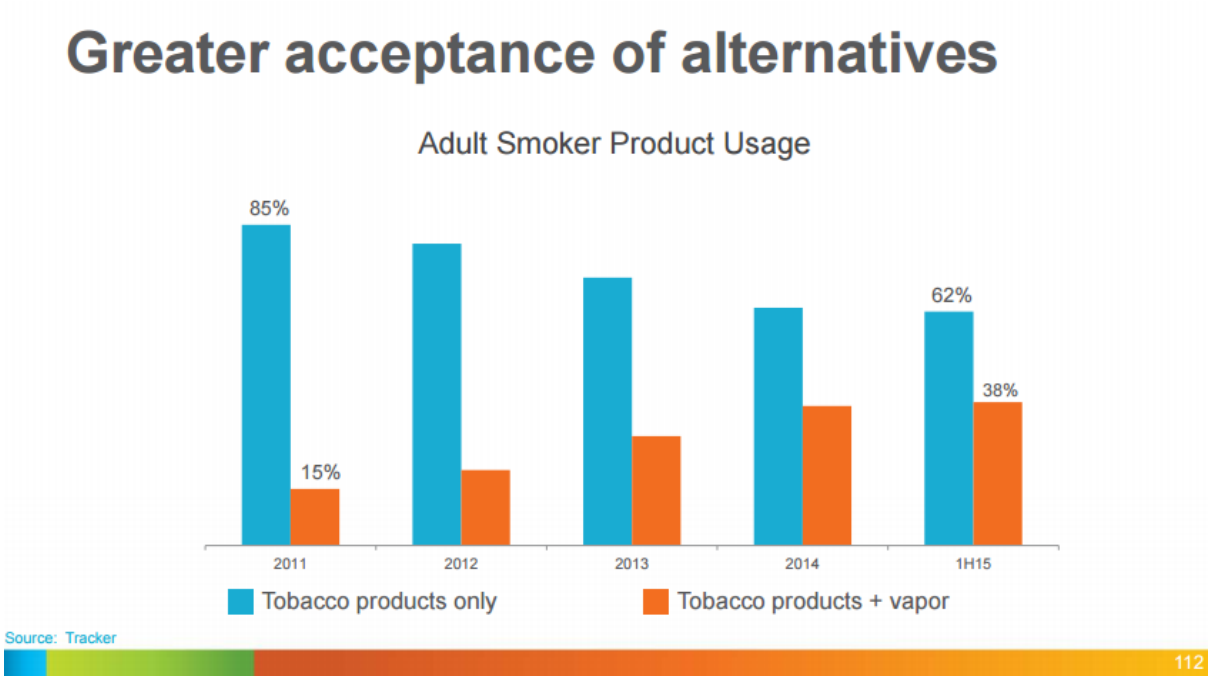
Professor Chapman has long been insistent that:

> *The very last thing that Big Tobacco hopes for harm-reduced nicotine products is that they will cannibalise their mainstay cigarette markets. Instead, the business model is dual use (people smoking where and when they can't smoke, and vaping when they can't).*

I have challenged him previously on this and the evidence he produced was rather old and very flimsy; in this latest article he doesn't produce anything other than bald assertion.

Dual use of cigarettes and e-cigarettes is common in both the US and other large vaping markets, as the following couple of charts show:

Dual use has been growing in the US



Source: Reynolds American investor presentation, November 2015

Dual use is also common in international markets

Figure 4: E-cigarette users by tobacco smoking characteristics (percentage of users), 2015[9]

	Dual user			Ex-smoker			Never smoked		
Country	2013	2014	2015	2013	2014	2015	2013	2014	2015
All	**64%**	**59%**	**54%**	**31%**	**37%**	**37%**	**5%**	**4%**	**9%**
France	51%	44%	50%	41%	50%	38%	9%	6%	11%
Germany	70%	57%	58%	25%	37%	35%	5%	5%	7%
Poland	59%	58%	56%	37%	39%	37%	4%	2%	7%
Italy	65%	60%	60%	26%	34%	34%	9%	6%	7%
UK	62%	61%	44%	35%	33%	35%	3%	6%	20%
Russia	71%	74%	70%	28%	25%	22%	1%	1%	7%
South Korea	#N/A	79%	34%	#N/A	20%	60%	#N/A	1%	6%

Source: Kantar, EY analysis

** All refers to the seven countries surveyed*

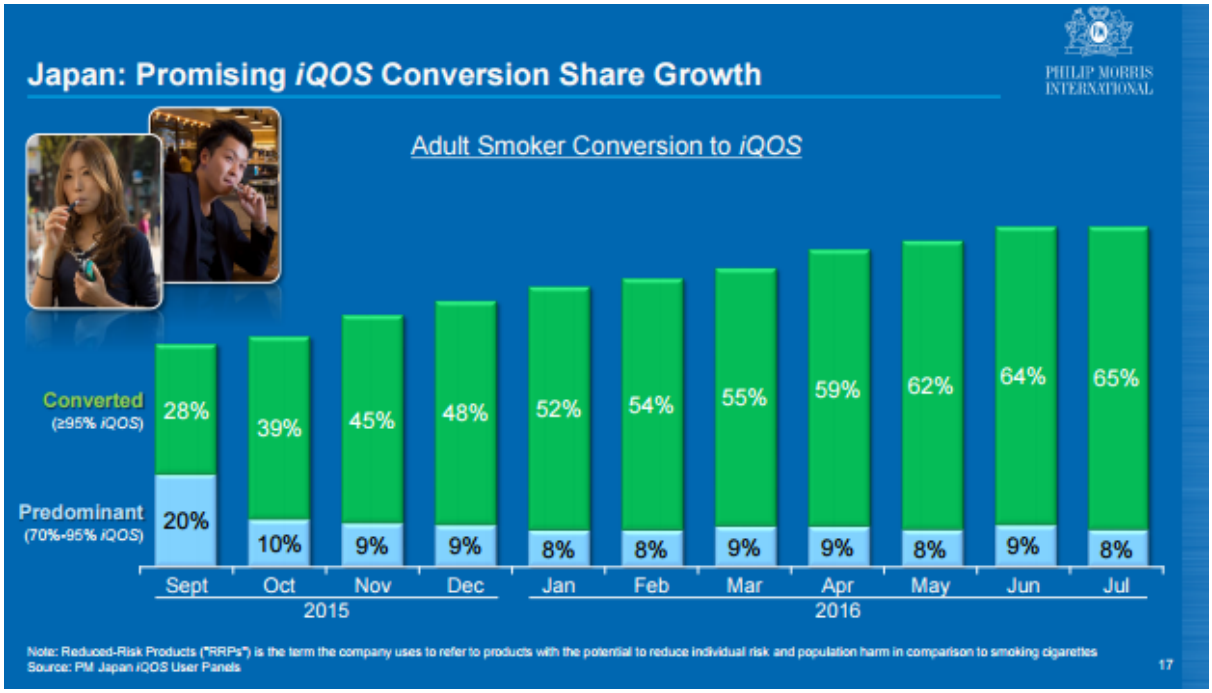
Source: E-cigarettes – an emerging category. Ernst & Young, May 2016

But just because dual use is happening doesn't mean that this is something that has been engineered by the tobacco industry. Much more likely is that the e-vapour products which are currently available to consumers are not yet good enough to encourage most smokers to quit smoking entirely and use only vaping devices. That is something that I think all of the tobacco companies currently involved in the e-vapour category admit; the better e-vapour (or 'heat-not-burn') products get, the fewer consumers will feel the need to continue using

combustible products.

PMI produced data showing that in Japan the proportion of users of its iQOS 'heat-not-burn' product who have converted either fully or predominantly has increased over time due to increasing awareness levels among smokers as well as PMI's own communication efforts becoming more effective as it has learned from experience.

Slide 17 of PMI's 2016 investor day presentation on the Asia Pacific region



Source: Philip Morris International

It appears we are at a relatively early stage in the innovation cycle, and there is a lot of room for products to improve and deliver a better experience for smokers. For instance, PMI revealed in its September investor presentations that it is about to start marketing its new *MESH* technology in the UK:

> *The MESH heating technology is a completely new approach to e-vapor generation and will be the core engine in our next generation e-vapor platform. E-liquid is precisely heated on a metal alloy mesh imbedded in a cartridge . . . this novel technology ensures the consistency and quality of the aerosol generated.*

And at the recent GTNF event in Brussels, Dr David O'Reilly, Group Scientific and R&D Director at BAT, predicted that the coil and wick system currently used in virtually all e-vapour products will go in the next two years.

E-vapour products still need to improve; 'ultimately the consumer will decide'



Source: BAT investor presentation, Leading in Next Generation Products*, September 2015*

The tobacco / nicotine industry is currently subject to technological change in a way that it probably hasn't been since the invention of the Bonsack cigarette-making machine in 1880, which started the very long decline of the chewing tobacco market. Current industry protagonists have no choice but to get heavily involved in these new products; as the rise of the e-vapour market has already shown, if they don't then smaller companies will come in and take the market from them instead. The key point here is that, as BAT put it last year,

> *ultimately the consumer will decide what they want*

There is nothing that the tobacco industry will be able to do to convince people to continue using combustible products if there is an attractive alternative product that offers consumers most of the sensory benefits of cigarette use with a small fraction of the risk.

Why do tobacco companies seek to protect their combustible cigarette business?

Professor Chapman sees further evidence of cynicism when it comes to tobacco industry involvement in next-generation products because those same companies continue to compete in the combustible cigarette market and lobby against certain regulatory initiatives. So,

> *if the industry really cares deeply about the deaths of its customers, this care is not enough to do anything to stop it selling the deadliest forms of nicotine delivery, nor to desist from its major attacks on tobacco-control policies it knows are the most effective in reducing smoking.*

But this kind of argument implies an unwillingness to consider the world as it actually is. It's not surprising that PMI, BAT and others remain committed to their conventional cigarette businesses: they are producing a product that consumers want to smoke, helping to generate tax income for governments that need revenue, and producing cash flows for shareholders that want dividends. Would demand for cigarettes disappear if major tobacco companies stopped manufacturing them tomorrow? Highly unlikely, as pretty much every other experience of attempted prohibitions of alcohol and other drugs has shown. Nor would shareholders allow managements to cease selling combustible cigarettes in the absence of realistic alternatives for consumers.

Moreover, very substantial sums of money need to be invested in R&D, innovation and marketing in order to commercialise next-generation products successfully, and manufacturers need to find a way to get these products in the hands of consumers. The combustible cigarette business is important in providing the necessary cash flows, expertise and access to distribution.

It's likely that tobacco companies will also continue to resist certain regulatory initiatives – not because the companies are immoral, but because those initiatives are stupid, ineffectual or disproportionate. Even Professor Chapman disagrees with some of the tobacco control measures which are advanced by campaigners.

The evidence of plain packaging having any impact on smoking rates is extremely thin, but it certainly takes away intellectual property from tobacco companies and

removes a means of their competing effectively against each other. So I would expect the industry to go on challenging the introduction of plain packaging, not least because even if they're unsuccessful the cases can help to clarify the basis for future legitimate competition in the inevitable event that some tobacco control campaigners decide that further restrictions are required (see How the tobacco industry is gaming Australian health regulations). And it also slows down the introduction of still more problematic – and perhaps just as ineffectual – endgame measures.

The same goes for tax increases: I don't know any major tobacco company that *"demonise(s) tobacco tax rises",* and the position of virtually all of them is that they oppose sudden and steep increases, or increases from an already very high base, because they penalise consumers and also because of the obvious risk that they exacerbate black market problems. Bizarrely, in Missouri earlier this month Public health organisations opposed Tobacco tax increase ballot measures, in part *because of the fact that they were supported by the tobacco industry.*

Why are tobacco companies investing in next-generation products?

This article (and Professor Chapman's column) has focused on PMI and BAT, but the other two major international tobacco companies are also heavily committed to investing in next-generation products, albeit with different nuances (see the recent investor day presentation for Japan Tobacco, or Imperial Brands' investor day presentation on *New Consumer Experiences*).

I think the large tobacco companies are investing in new products because:

- Like other consumer companies, they are in the business of responding to (and anticipating) what consumers want. The development of the e-vapour category has shown that there is significant consumer interest and demand for these products already, with potentially much greater demand as the products improve and regulators get clearer messages across to consumers regarding their risk relative to combustible cigarettes;
- Companies that stand still and refuse to innovate eventually go out of business. The tobacco industry has been remarkably immune from competitive pressures and disruption for the last 50+ years, but is now facing many of the same dynamics faced by other consumer companies.

Any tobacco company that doesn't invest in next-generation products is jeopardising its future;

- There is a significant profit opportunity. PMI is predicting that it will approach breakeven on its next-generation products in 2017, and that there is the potential for $700-$1,200m of profit by 2020 (for context PMI produced $11bn of operating profit in 2015, so that would represent a material contribution for a segment which would still really be in its infancy). In a recent presentation to analysts, BAT also reiterated that there is as much profit potential per normal user for novel products as there is for cigarettes.
- Finally, it's the right thing to do. Tobacco companies have been demonised for decades now, and having the chance to sell and develop products that can make a big contribution to public health goals is a major motivational factor for them and their employees.