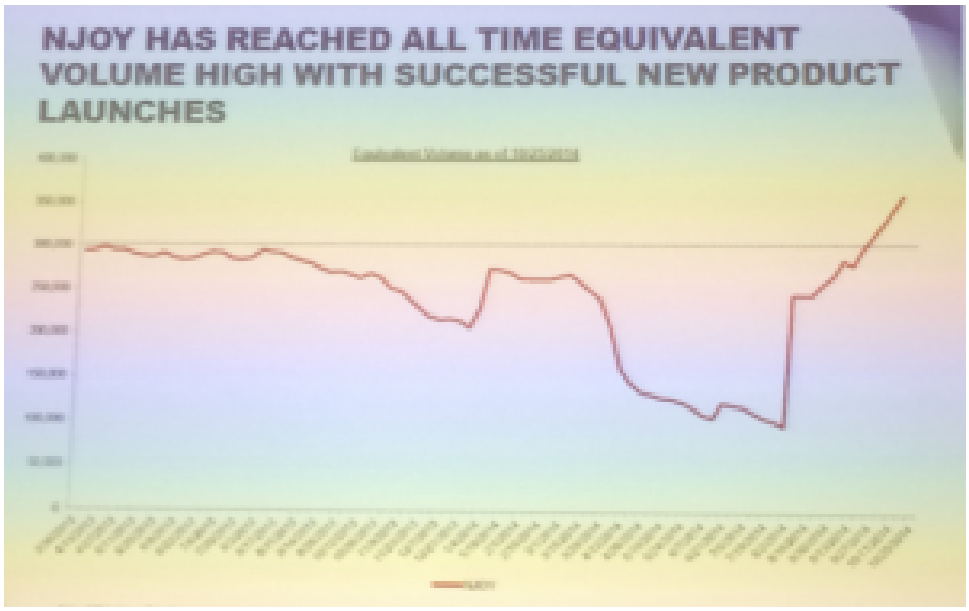
Wells Fargo second annual e-cig conference – some reflections

written by Clive Bates | 22 November 2014



The switch to 2nd generation products arrested the decline of NJOY

I participated as a panel member in the Wells Fargo Securities Second Annual E-cig Conference, chaired by Bonnie Herzog, the lead beverage and tobacco sector analyst at Wells Fargo. It was a fascinating occasion and good moment to take the temperature of the vapour market – at least as seen through the eyes of the main American players (agenda). I'm not going to write the whole thing up, but just give some overall impressions and my reflections on and after the day.

The bigger companies are beginning to understand 'vapour'. The industry is beginning to understand the vapour category (or VTM – *Vapor, Tanks and Mods* as the 2nd and 3rd generation products are referred in this forum). Also, I think the bigger players (well, some) are grasping that it is *not the same as cigarettes, and the customers think differently*. Choice, diversity, personalisation, convenience and user experience were the watchwords. I chose the striking chart from NJOY above because it illustrates how the market is looking for 2nd generation products and ready to reward those companies that provide them in accessible form.

The pace of innovation is rapid. The companies were show-casing new products and beefed up technology, and it felt to me like very significant progress had been made in a year. The cig-a-like is increasingly regarded more as a starter product than a destination. The barriers to having products that look very different to cigarettes are coming down as vaping becomes more common. I think anyone forecasting the future of this market needs to internalise the pace of change and try to recognise that the products will be completely different after 10 years of further innovation. For that reason I think Bonnie Herzog's forecast that the vapour category will surpass cigarettes within a decade is far more realistic than some suggest – by 2023 we will have *very* different products in play.

But the all-conquering products are not there yet. There is broad consensus that the products that will ultimately win over a majority of mainstream smokers are not yet on the market. But there was a palpable sense that this goal is reachable given the frenetic pace of innovation and rising customer insight in the sector. As David Sweanor put it: "*someone in this audience, maybe several of you, will become billionaires. We just don't who it will be yet*".

Convenience and ease of use is a rising focus… Companies showed modular 'plug and play' drip-free devices (the cartridge pen compared to the fountain pen), and there was a stress on ease of use and lack of spillage – sometimes combined with attacks on open systems. I think it is valuable to have easy-to-use systems to help new users into the category going straight to the 2nd generation products that are more likely to work for them. But there is no reason to have this at the expense of more versatile open systems.

…and a 'razor blade model' is emerging. This refers to the commercial model of companies like Gillette, in which they sell devices relatively cheaply and proprietary refill units with a high margin. Some companies were pursuing this, others using a 'plug compatible' model in which their refill could fit a range of products. The customer tends to benefit from interchangeability as this reduces lock in to one producer, allowing the customers to benefit from a wider range of innovation.

Flavours remain controversial, but understanding is growing. The role of flavours in the e-cigarette value proposition and migration away from smoking was well articulated and the rise in the importance of non-tobacco flavours recognised. An e-liquid company was asked if it should just rename some of the

more provocative flavour names that sound like they are targeted at youth – his assertive reply was that adults like chocolate too and if he did that they'd just find new flavours to complain about – *where do you draw the line*? A good, if inconclusive, answer to a good question.

...though flavour bans are still supported by some public health advocates. I was disappointed to discover that the American Legacy Foundation ("Legacy"), which has often taken thoughtful positions on harm reduction, supports a ban on flavours. I decided to put a challenge question on this. I don't think they have thought through the perverse unintended consequences of a ban: it would tend to diminish the vaping value proposition; close off the long term migration away from tobacco altogether for many users; stimulate a black market and DIY; harm the smaller and highly diverse non-tobacco vapour business; protect the cigarette-based business model of the tobacco industry; and probably cause more smoking, disease and death. Legacy's view is that the companies have a duty to show these products are not attracting children. Maybe… but I think Legacy has a duty not to recommend policies without taking account of unintended consequences. The rise in vaping in American youth has coincided with a sharp fall in smoking, so I doubt that Legacy has even set the right objective for their policy. It is perfectly possible that youth use of e-cigarettes is displacing smoking and benefiting health. Current figures for high school users show a very encouraging trend, even if CDC tries to spin to the contrary:

	Used in last 30 days by high school students	
Per cent	**Cigarettes**	**E-cigarettes**
2011	15.8	1.2
2012	14.0	2.8
2013	12.7	4.5

Source: CDC MMWR Tobacco use among middle and high school students, 2013 (November 2014). Note most e-cig use is by tobacco users – only 0.6% was exclusive current e-cig use in high school student.

Tobacco industry thinking (1) – competing in the marketplace. The two tobacco majors who spoke articulated their rationale for being in the market.

Brice O'Brien of RAI was good on this (I paraphrase): *we have 25% of the US cigarette market, with Vuse we go after the other 75%*. Joe Murillo of Altria/NuMark made the same case based on competition: *when customers switch we want to be there*. These comments reveal the essential truth not yet grasped in public health… competition leaves the tobacco companies with no choice but to be in this market either defensively or on the offensive …*and this is a good thing*. To the extent they produce second-rate products or fail to innovate they will lose out (or fail to gain) relative to other tobacco companies or non-tobacco vapour companies – competition will drive them to innovate and improve the products or become losers. Disruption arises when existing market shares realign dramatically, as a companies take bets on technologies that they hope will win or defend market share We are about to see a big bet on 'heat not burn', but will it work? The customers will decide that. However, there is another way…

Tobacco industry thinking (2) – competing through regulation. There are two ways of competing: one is in the market place and works by appealing to consumers; the other is in Washington DC and works by appealing to regulators. The danger is that tobacco companies know they are slow off the mark and not especially innovative, and so choose to tackle competitors through regulating them off the market or by erecting barriers to entry so high that only a few large corporations are viable. Altria and Reynolds have been criticised for extensive warnings (far beyond what they place on cigarettes – see New York Times), but this trait is most apparent with Reynolds call for a ban on open systems, in the name of health, safety and category reputation. I put it to them that this a predatory and anti-competitive bid to raise regulatory barriers to entry. Evasive answer.

Is vapour cannibalising tobacco industry margins…? Companies are primarily interested in maximising medium term profitability (or more formally, the discounted value of the future profit stream). The more they make, the faster and more sustainable the transition from smoking to vaping is likely to be. The tobacco companies are interested in the combined profit pool of their tobacco products and vapour products, not in keeping people smoking as some naive public health commentators believe. So all other things being equal, the best outcome is that they replace profits from combustible cigarettes with more profitable vapour products as that will expedite transition. The question is: does the migration from one to the other degrade or enhance profitability? Bonnie

Herzog's view is that a shift into vapour products from their core business would be margin-enhancing overall. Many assumptions have to go into that view, of course, and it matters primarily to those trying to estimate the value of firms. However, even if margins are actually squeezed, it's not as if the tobacco companies have a choice if the customer is drawn to a different product: they make no profit from customers who defect to other manufacturers' vapour products.

Vapour industry immaturity on display: the big prize is the tobacco market, not market share in the vapour market. There were signs that several of the non-tobacco companies would be quite happy to have the FDA damage or kill their competitors. For example, those relying most on 'bricks and mortar' retailing might favour bans on internet sales, those with few flavours are quite happy to see most flavours banned. I think this is a sign of immaturity and a narrow view of their market place. All the sales/volumes figures presented at the conference included only firms and products *in the vapour category*. While understandable, this creates an illusion about the real competition, which is actually with the dominance of cigarettes/tobacco – bearing in mind the US tobacco market is about $85 billion and worldwide about $800 billion. If the vapour companies took a '*bigger pie*' approach to the vapour market, rather than a '*bigger slice*' approach, they would tend to hang together more. They would focus on reducing regulatory burdens and increasing commercial freedoms more generally, rather than trying to use regulatory tactics to stifle competition and shaft competitors *within* the vapour sector.

FDA's regulatory sledgehammer is nuts. The FDA's Pre Market Tobacco Application process is likely to be the route most products go through for approval, and this imposes massive burdens. According to one experienced regulatory affairs specialist, each application would mean: "*seven or possibly eight figure costs depending what they insist on*". Such an expensive and time-consuming process will kill the vast majority of the products and firms in the market, and destroy the rapid pace of innovation we see today. Many take comfort that companies with PMTA applications in place within two years of the rule being made can keep their products on the market. But this is very short-sighted: the category needs clarity that there will be a working regulatory model, not merely a work-around for an unworkable regulatory model. The key question is can the PMTA process be adjusted to be proportionate to the very low level of

risk posed by vapour products? An abbreviated or 'light-touch' system is essential. If they don't do that, they'll end up with something as botched and dysfunctional as they have in Canada. There are faint signs of FDA recognition of this issue and openness to a more proportional (i.e, realistic) approach coded into questions FDA posed in the proposed deeming rule consultation and in recent remarks from the FDA's Center for Tobacco Products Director, Mitch Zeller. Let's hope so: this remains *the critical business risk* facing this category in the United States, and could have very negative health consequences.

Unintended consequences. My own presentation (slideshare – below) focussed on my current favourite themes: that regulation comes with unintended and harmful consequences; that regulators and the public health community are not rigorous about evaluating or even acknowledging these; and that there is a 'sweet spot' of regulatory intervention that builds confidence without damaging the value proposition or forcing a destructive retrenchment onto the industry. The second part is that an unholy trinity of (1) bureaucratic, loss averse regulators; (2) predatory businesses; (3) public health's "useful idiots"; is in operation. This forms a system which fails to recognise benefits, exaggerates risks and ignores unintended consequences, allowing the system to be 'played' for commercial advantage in a way ultimately runs counter to public health and provides the cigarette-based business model of the tobacco industry with shelter from competition.

What would a rational regulator do? The moderator of the regulatory panel asked the panellists what a rational regulator, he presumed arriving from another planet, should do. Good question: I suggested four things:

1. *Be far more rigorous about unintended consequences* – these dominate the impacts you will have, given nothing too much is wrong at present
2. *Take a few sensible regulatory initiatives* – quality standards for liquids, electrical safety, child-resistant containers etc – that do not force traumatic restructuring on the industry, but clean out cowboys and rogue products, and raise confidence of consumers.
3. *Ensure the regulatory framework promotes rather that obstructs innovation*, as this will be key to the advance of the vapour category into a large share of the tobacco market

4. *Take responsibility for candid communication of risk* in a way the consumer can understand the dramatic difference between combustible and non-combustible or vapour… and please resist any urge to exaggerate or invent risks in the name to manipulate behaviour.