

Blake Brown, Professor and Extension Economist, NCSU
Will Snell, Professor and Extension Economist, UK

October 15, 2015

Cigarette Market

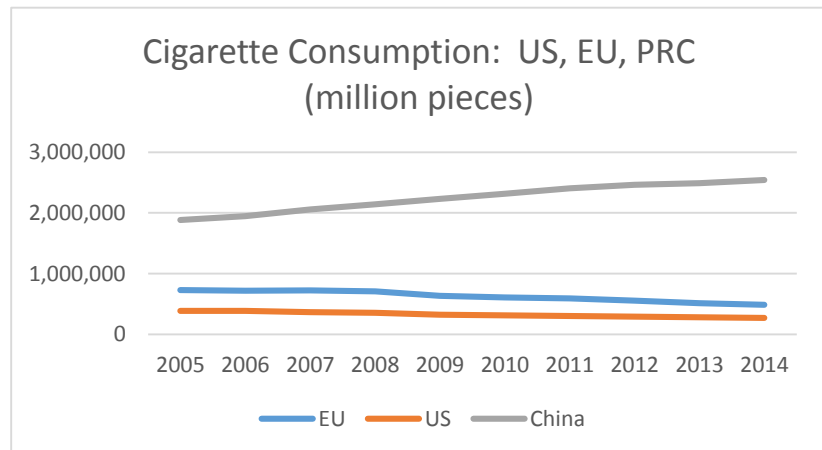
US cigarette production for the first half of 2015 reversed trends from recent years with output up 2.2 percent. Domestic consumption for the January – July 2015 period was virtually flat. US cigarette consumption totaled 270.2 billion sticks in 2014, down 3 percent from 279.5 billion in 2013. Similarly cigarette consumption in the European Union declined from 513.4 billion sticks in 2013 to 486.4 billion sticks in 2014. With continued implementation of regulations by FDA and under the EU Tobacco Products Directive, health concerns, and heavy taxation, cigarette consumption in developed countries like the EU and US is expected to continue its decline.

Despite the decline in sales quantity US cigarette manufacturers have successfully increased product prices so that before tax revenue has been maintained. Before tax revenue of US cigarette manufacturers is estimated at \$43.5 billion in 2015 with profit of \$11.9 billion. After tax revenues from tobacco products have shown continued strength with federal, state and municipal governments being the beneficiaries. According to the Tobacco Merchants Association (TMA), federal, state, and local excise and sales tax revenues, totaled \$37.9 billion in 2014 or approximately 39% of the \$96.4 billion US consumers spent on tobacco products last year. U.S. consumer expenditures on tobacco products peaked at \$100 billion in 2010, with US tobacco tax revenues also now retreating from 2011 record highs of \$40.2 billion.

In China, now the largest customer for US flue-cured tobacco, cigarette consumption continued increasing. Cigarette consumption in China was estimated at 2.543 trillion pieces for 2014. While cigarette consumption is still on an upward trend, the pace of growth is slowing and is expected to slow further. Significantly for US tobacco producers, a growing share of Chinese can now afford

to upgrade to higher quality cigarettes. Consequently sales in China of premium brand cigarettes are growing faster than overall consumption. This increases the demand for US tobacco since Chinese cigarette manufacturers use more flavor style tobacco in premium brands.

Sales of E-cigarettes and other tobacco vapor products again grew rapidly in 2015 although their share of the total tobacco products market is still small. The US E-cig/vapor market is estimated to be around \$3.5 billion in 2015, compared to more than \$95 billion in consumer expenditures of traditional tobacco products. What sort of nicotine delivery devices will emerge as winners in this race to develop reduced risk products is impossible to say. Rechargeable e-cigs/vapor devices have surpassed disposable e-cigs in sales. Traditional cigarette manufacturers have invested in both e-cig/vapor devices and heat-not-burn technologies through development and acquisitions. None of these new technologies will require as much tobacco as traditional combustible cigarettes. But heat-not-burn technologies likely will require



high quality flavor style tobacco, while production of nicotine solution for e-cigarette/vapor products require little or no traditional tobacco.

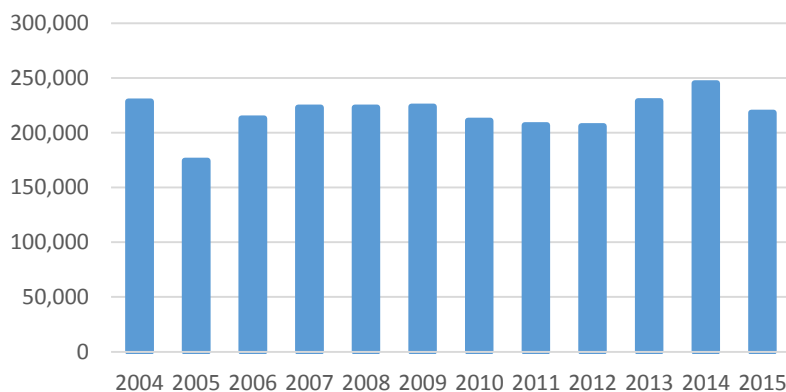
Flue-Cured Production and Market

After a large increase in US flue-cured acres in 2014 to 245,300 acres, contracts for the 2015 season were cut severely with acreage shrinking to an estimated 218,300 acres. USDA's October crop estimate for 2015 is 468.3 million pounds down from 572.9 million in 2014. While the exact total quantity of pounds contracted is unknown, production is reported to be at least 20 percent above contracted pounds. Price is down substantially from a season average of \$2.03 in 2014 and \$2.11 in 2013. Yield for 2015 was estimated at 2,145 pounds per acre, down from 2,335 in 2014.

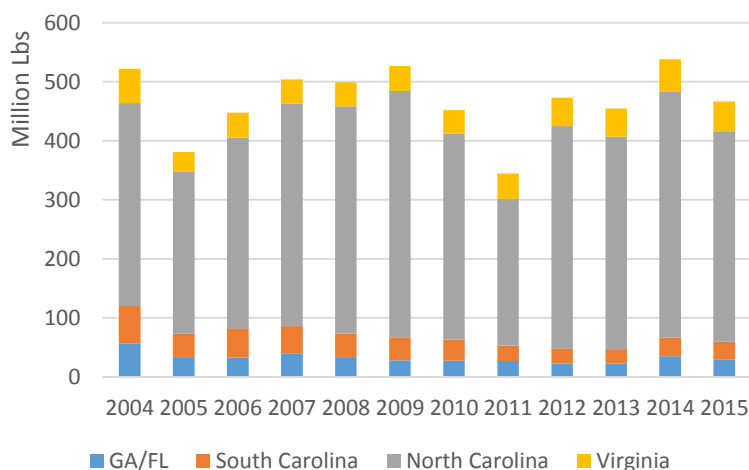
Large inventories and large changes in exchange rates seem to be the prime factors in the market downturn for US flue-cured. First, large inventories accumulated in 2014 after larger production and unexpected lower demand in a number of markets. Second, the US dollar strengthened against currencies like the euro. Simultaneously, the value of the currency of Brazil, the biggest competitor to US flue-cured, fell. The rising dollar and falling Brazilian Real mean that Brazilian products are much cheaper in the world market than US products.

Flue-cured production in Brazil declined from 1.34 billion pounds in 2014 to 1.26 billion pounds for the 2015 marketing season. In Zimbabwe, another major US competitor, production declined from 477 million pounds in 2014 to 438 million pounds in 2015. Zimbabwean flue-cured prices, which are published by the Zimbabwe Tobacco Association, declined from an average of \$1.44 per pound to \$1.34 per pound for the 2015 crop. Prices are not available for Brazilian tobacco. Smaller 2015 crops will help reduce large inventories. However any recovery in production in 2016 likely will occur in other countries, like Brazil, mainly due to the strong dollar and devalued Brazilian Real.

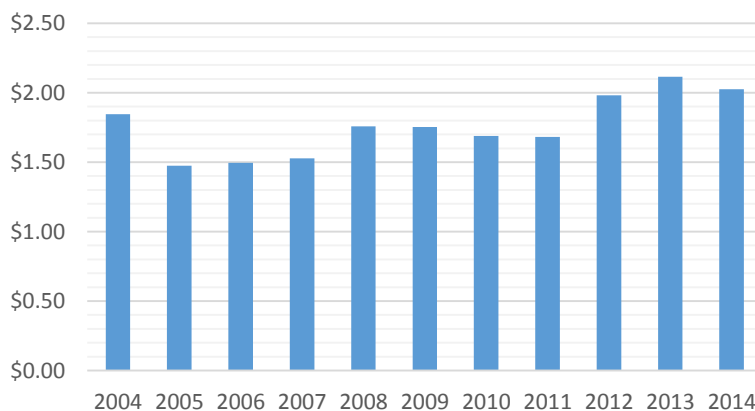
US Flue-Cured Tobacco: Harvested Acres



US Flue-Cured Tobacco Production

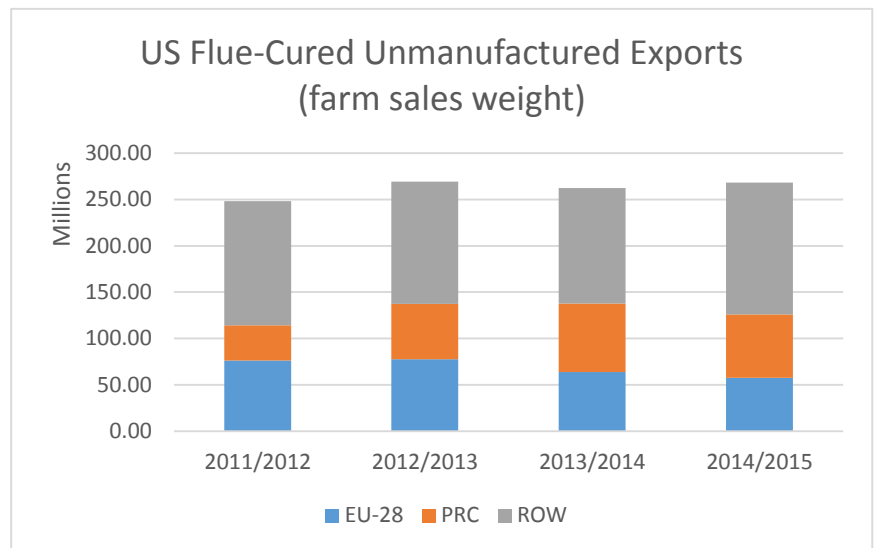


US Flue-Cured Tobacco Average Prices

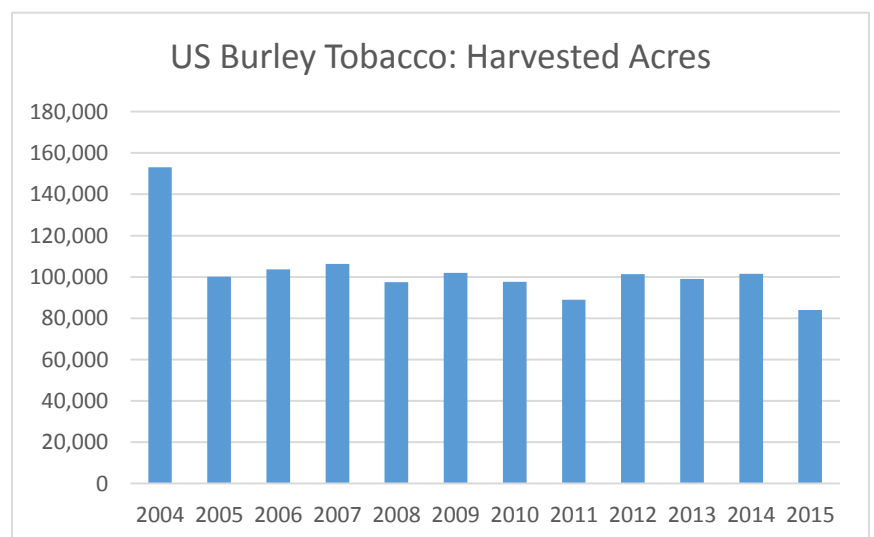


The 2016 Brazil and Zimbabwean crops have been planted. More will be known about the area planted toward the end of 2015.

Unmanufactured exports of US flue-cured tobacco rose from 262 million pounds for the 2013 crop to 268 million pounds for the 2014 crop. Exports have been on an upward trend since the end of the tobacco program. Export destinations have changed over this time. Exports to the European Union are in decline, but this decline has been offset by increasing exports to China and other Asian customers. China imported almost no US flue-cured at the end of the US tobacco program in 2004. For the 2013 marketing year, exports to China exceeded exports to the EU-28.

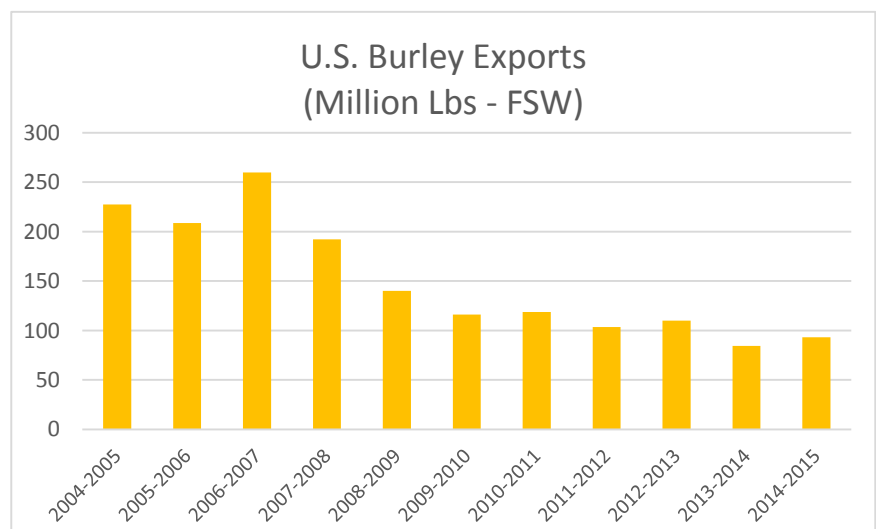


Ending stocks of US flue-cured for the 2014 crop year climbed to 530 million pounds up from 334 million pounds for the previous year. With US exports of unmanufactured flue-cured at 268 million pounds for the 2014 crop, domestic use declined from 117 million pounds for the 2013 crop to 75 million pounds for the 2014 crop. While domestic use of US flue-cured is clearly in decline, domestic use has experienced large swings in recent years. Whether the fluctuations are some artifact of the data or adjustment in stocks is not clear.



Burley Production and Market

Like flue-cured, US burley production is expected to be down considerably in 2015, following a remarkably stable pattern during the first ten years of the post-buyout era. Contract volume changes ranged from small increases for a few growers, to 100% reduction for other growers. Some companies extended contracts almost exclusively to their multi-year contract growers, resulting in the elimination or sharp



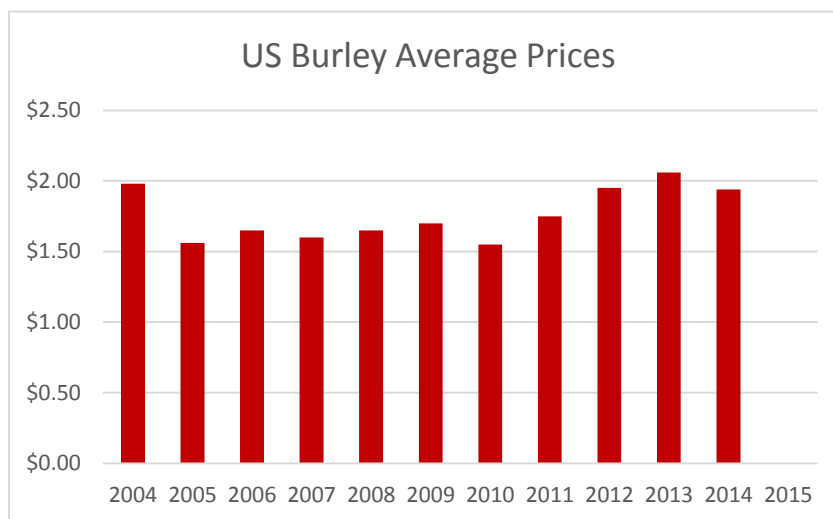
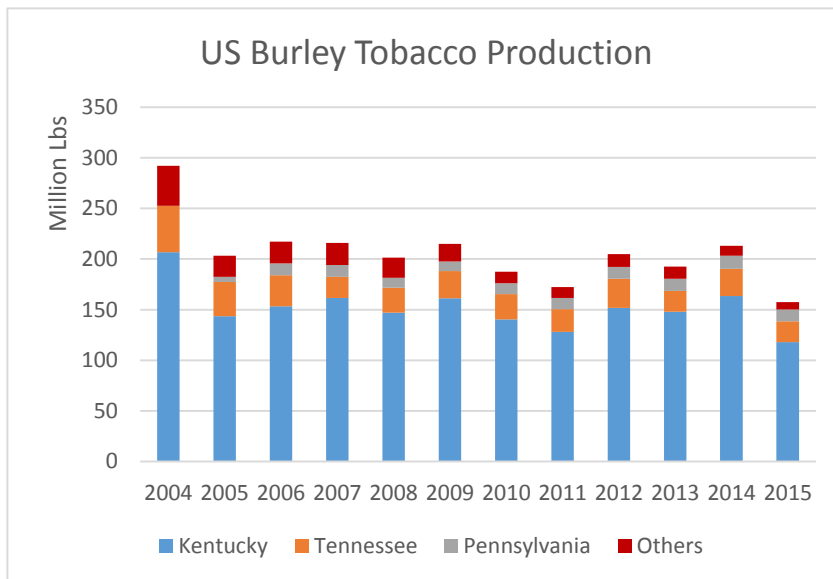
reduction in contract volume for single year contract growers while others did offer “across the board” cuts to all contract growers.

Contracts for the 2015 US burley growing season were reduced for a variety of reasons. Following an extended period of relatively tight supplies of flavor burley in the international market, a global surplus of burley rapidly materialized over the past two years, with world burley production increasing by more than 30 percent from 2012-2014. Ample supplies, combined with a strengthening dollar, and declining volume of American-blended cigarette output in many traditional markets caused US burley exports to decline by more than 20 percent during the 2013-2014 marketing year. However, US burley exports have actually stabilized in recent months indicating an improved supply/demand balance amidst a strengthening US dollar.

According to the October USDA crop report, US burley production is expected to total 152 million pounds (-29%) in 2015, compared to crops totaling in the neighborhood of 200 million pounds since 2004. Beltwide acres are down 20 percent, according to the USDA survey, while the average US burley yield is off 11 percent. A much smaller crop may be more in line with anticipated US burley needs in the current demand environment where total disappearance (exports plus domestic use) fell to 160 million pounds during the 2013-2014 marketing year.

US burley prices averaged \$1.94/lb in 2014, following a post-buyout record high price of \$2.06 in 2013. Prices for the 2015 burley crop will hinge critically on the eventual size and quality of the 2015 crop. Relatively small downward contract price adjustments for a few grades suggest that 2015 burley prices could average in the low to mid 190s for the 2015 marketing season. An anticipated lower crop size relative to current USDA estimates could maintain prices similar to 2014, but a crop in the 150-160 million pound range coupled with some quality concerns could lead to lower grower prices for the upcoming marketing season.

Looking forward to 2016, it appears burley is in a much better global supply/demand balance compared to last year. Following a 17 percent drop in world burley production in 2015, Universal Leaf is currently projecting stable global burley leaf output for 2016.



Trade and Labor Issues Complicating the Tobacco Outlook

In addition to changes in product demand and changes in exchange rate, US tobacco growers are closely monitoring trade and labor policy developments. The US just finished negotiations with eleven other countries (Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam) on the Trans Pacific Partnership (TPP) trade agreement which could have implications for future US tobacco trade. Tariffs on unmanufactured exports of tobacco from the US to some nations will be lowered as will tariffs on many agricultural exports from the US to the TPP nations. Lower tariffs will potentially increase unmanufactured exports of US tobacco. Under the agreement corporations may sue countries who do not follow the agreement. Notably the agreement denies tobacco manufacturers this ability to sue nations in the agreement that the tobacco industry deems to have violated terms of the agreement with regard to policy on manufactured tobacco products. This “carve out” only applies to tobacco product manufacturers, not unmanufactured exports of tobacco. The TPP is set for fast track approval by Congress, but still will not be considered until 2016 or later. Currently around 8 to 10 percent of US burley and flue production combined enters into TPP markets in either direct US leaf exports or in US cigarette exports which doesn’t account the amount of US leaf that is shipped into TPP markets in product form from other countries. While the net impact to the US grower of manufactured tobacco products being carved out of the TPP is uncertain, other concerns arise such as how tobacco will be treated in future trade policy negotiations as well as setting a precedent for carving out other US products in future trade agreements.

The other major concern facing tobacco producers is immigration reform. While there has been a lot of political debate on this controversial issue over the past several years, the US Congress has not moved forward legislation to address producer concerns over the availability, cost, and administrative requirements associated with an immigrant labor force that is critical to the future of US tobacco production. Even so, this issue will likely continue to receive much attention by all three branches of government in the coming year.