

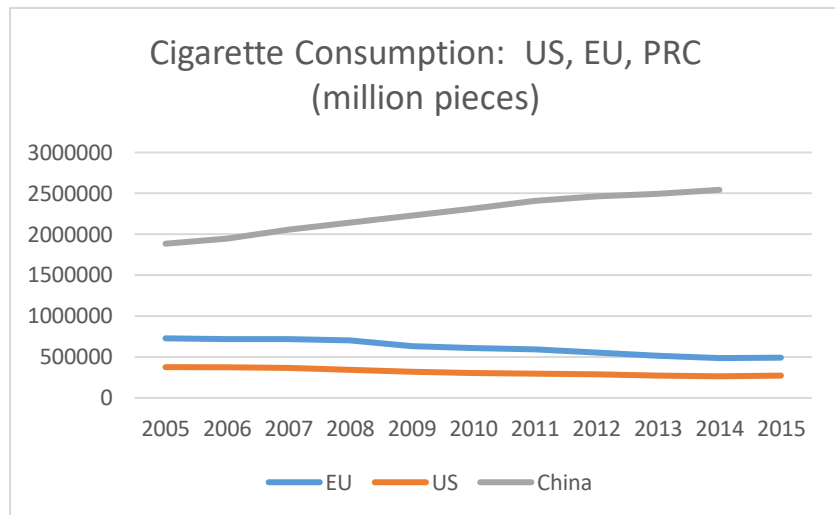
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### Cigarette Market

After increases in US and EU cigarette consumption in 2015, consumption in the US and the EU is expected to return to the same pattern of decline experienced over the last 3 decades. Most analysts attributed the uptick in 2015 consumption to higher income of smokers due to lower gas prices.

Despite the uptick in 2015 sales, before tax revenues from cigarette sales in the US have declined on average 2.3% per year from 2011 to 2016. Before tax revenue is projected to be \$37.6 billion in 2016. However profits have grown over this same period. Profit for US cigarette manufacturers in 2016 is projected to be \$12.1 billion up from \$11.9 billion in 2015. In FY 2014 federal, state, and municipal excise taxes on cigarettes amounted to about \$30.4 billion.



The trend of increasing consumption in China seems to be ending with consumption leveling out and possibly beginning to decline in the future. 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 still growing. This increases the demand for US tobacco since Chinese cigarette manufacturers use more flavor style tobacco in premium brands. As incomes increase in many developing countries, this pattern of smokers shifting to more consumption of premium brand cigarettes is likely to spread increasing the demand for flavor style flue-cured.

Globally, revenues from tobacco product sales are projected to grow over the next five years despite an expected downturn in smoking. *IBISWorld* estimates revenue in 2015 at \$643.8 billion and projects revenues will grow to \$703.8 billion over the next five years. Increasing revenues despite a slowing in consumption is resulting in strong profit growth globally.

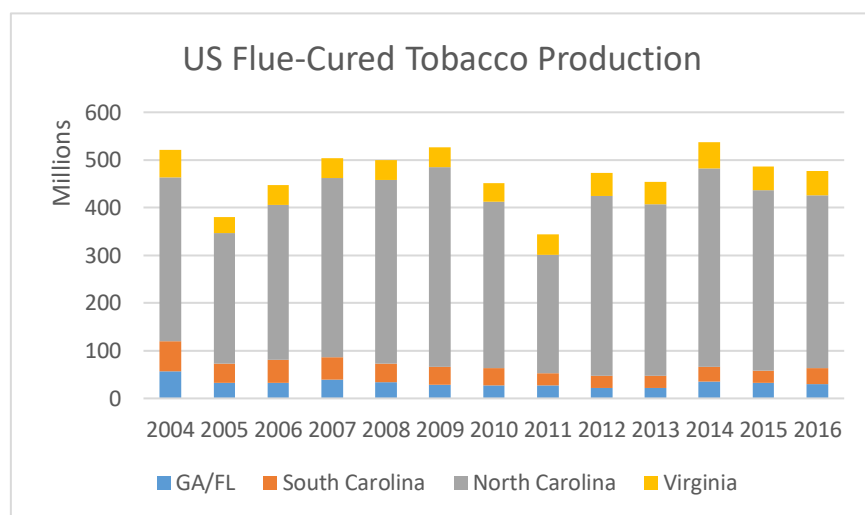
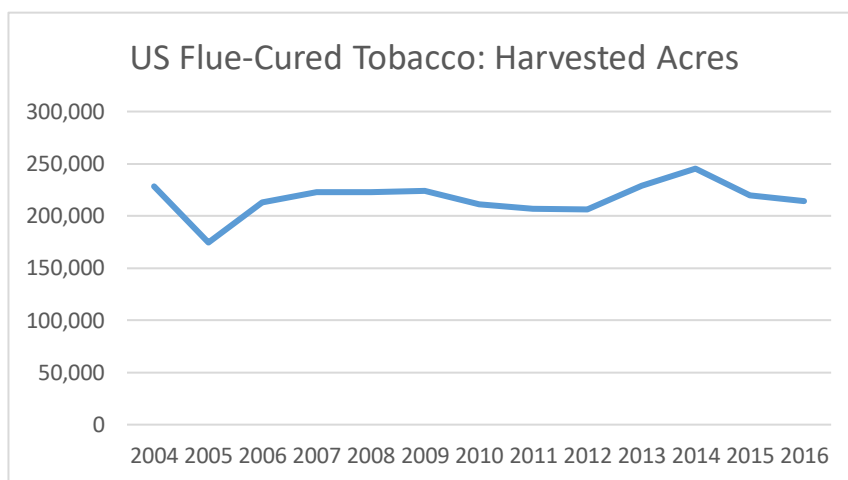
Sales of E-cigarettes and other tobacco vapor products continued to grow globally with sales of e-cigarettes and e-vapor products estimated to be \$8 billion in 2015 according to *Euromonitor International*. In developed countries the regulation and taxation of e-tobacco products continues to be controversial with some health advocates lobbying for strict regulation and taxation while others see vapor products as less harmful alternatives to combustible products. In the US, FDA continued with implementation of regulations on e-tobacco products. Many analysts feel that the most likely scenario for vapor tobacco products is that regulation in developed countries will significantly stifle growth and in particular disadvantage smaller manufacturers causing many to exit. Ironically this will likely slow declines in the combustibles market since fewer smokers will switch to vapor products.

## Flue-Cured Production and Market

After severe cuts in contracts for the 2015 season acreage fell to 220,000 acres with production at 486 million pounds down from 573 million pounds in 2014.

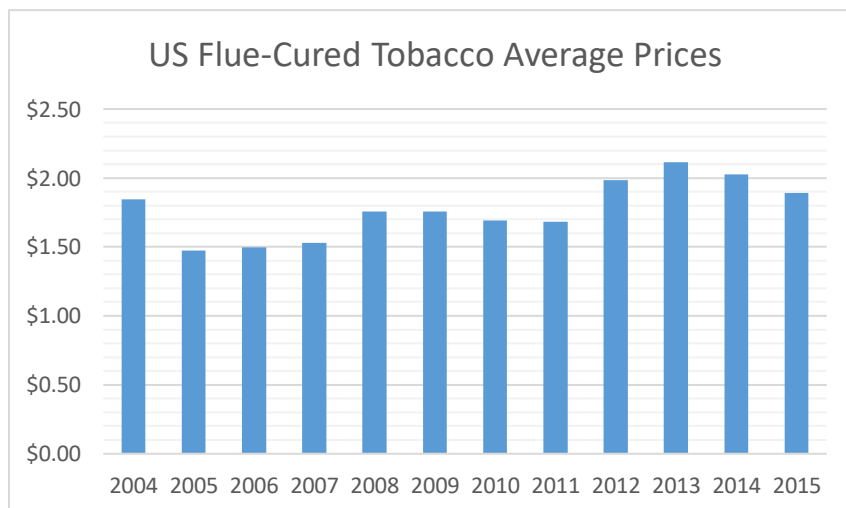
USDA's October crop estimate for 2016 is 213,000 acres with production of 474 million pounds. Yield for 2016 was estimated at 2,226 pounds per acre about the same as the 2,210 pound per acre yield of 2015. Average price received in 2015 was \$1.875 per

pound according to USDA, down from \$2.03 per pound for the 2014 crop. North Carolina had the highest average price in 2015 at \$1.89 per pound.

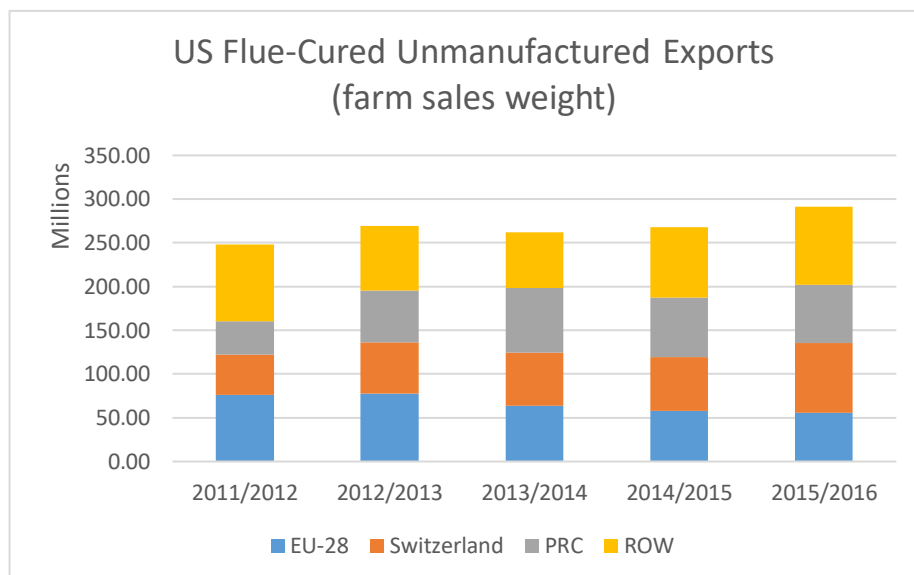


Large inventories that were problematic going into the 2015 crop had largely disappeared by 2016. The quick reduction in inventories is mostly due to excessive rain in Brazil that led to the smallest flue-cured crop in 2016 in over a decade. The 2016 Brazil crop was reported to be just over 1 billion pounds, according to Universal Leaf, down from 1.26 billion pounds in 2015.

Zimbabwe experienced severe drought during autumn 2015 leading to a smaller 2016 flue-cured crop. Zimbabwe production for 2016 was estimated at 438 million pounds, down from 477 million pounds in 2015 according to the Zimbabwe Tobacco Association. A strong US dollar and weak Brazilian Real still allowed Brazilian leaf to be priced substantially cheaper than US leaf despite the reduction in supply. The difference in exchange rates for US and Brazilian currency were primary factors that resulted in no increases in most 2016 US grower contracts. Industry forecasts indicate increases in Brazil flue-cured plantings that with decent weather could lead to a 2017 Brazilian flue-cured crop of over 1.3 billion pounds.



Unmanufactured exports of US flue-cured tobacco rose from 268 million pounds for the 2014 crop to 291 million pounds for the 2015 crop. Exports rose despite the strong US dollar because of the weather induced small supply of Brazilian and Zimbabwean flue-cured. Exports to the European Union (EU-28) declined to 55.7 million pounds down from 57.7 million for the 2014 crop. However exports to Switzerland increased from 61.4 million for the 2014 crop to 79.7 million for the 2015 crop. The exports to Switzerland represent not only US tobacco bound for other European countries, but also tobacco bound for Asia. After US exports to China rose to 73.9 million pounds for the 2013 crop, they decreased to 66.7 million pounds for 2015. The decrease in exports to China was reportedly due, at least in part, to the accumulation of significant inventories of flue-cured tobacco by Chinese manufacturers.



Exports to the rest of the world increased for the 2015 crop to 88.9 million pounds, up from 80.6 million pounds for the 2014 crop. An important, if not the most important, driver for increased US flue-cured exports is rising income of smokers in China and other Asian countries. As smokers in developing countries have greater disposable income, they tend to upgrade the brand of cigarettes they smoke. This increase in premium brands leads manufacturers to increase the share of flavor style flue-cured in their purchases.

Use of US flue-cured by US cigarette manufacturers rebounded from 74.6 million pounds for the 2014 crop to 159.2 million pounds for the 2016 crop. Domestic use dipped dramatically to 118 million pounds for the 2013 crop then again to 74.6 million pounds for the 2014 crop. Despite the wild swings, domestic use appears to be declining significantly, probably faster than the decline in US cigarette consumption. This precipitous decline may be, in part, due to less tobacco being used per cigarette due to new manufacturing technologies and perhaps even due to smaller cigarettes.

## Burley Production and Market

The global burley supply/demand balance has improved greatly over the past year which resulted in modest changes in U.S. burley contract volume for 2016, following significant reductions in 2015. Smaller crops in South America, Africa and the United States, coupled with a surprising modest increase in U.S. cigarette production in 2015 helped offset the adverse impacts of a strengthening U.S. dollar on U.S. burley international competitiveness. Globally, world burley production for 2016 is forecast to be down around 5% from last year, but close to 20% off the most recent peak in 2014.

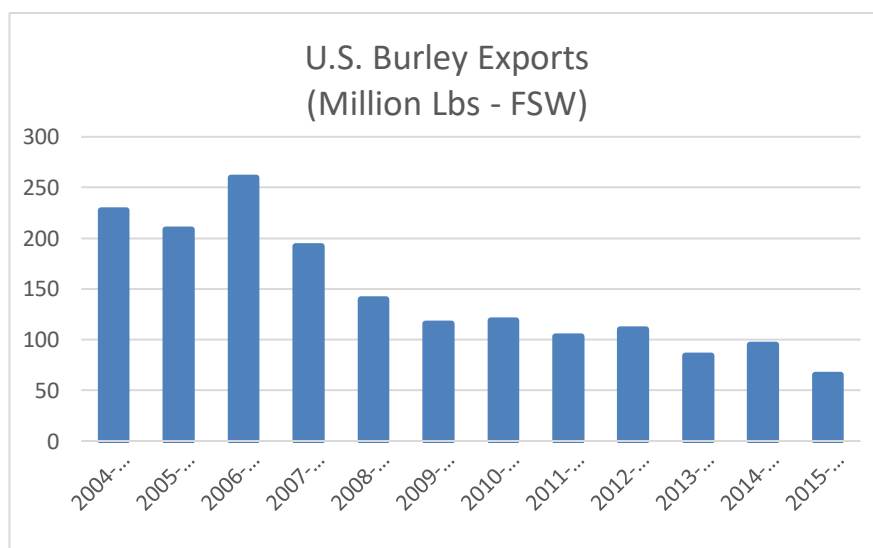
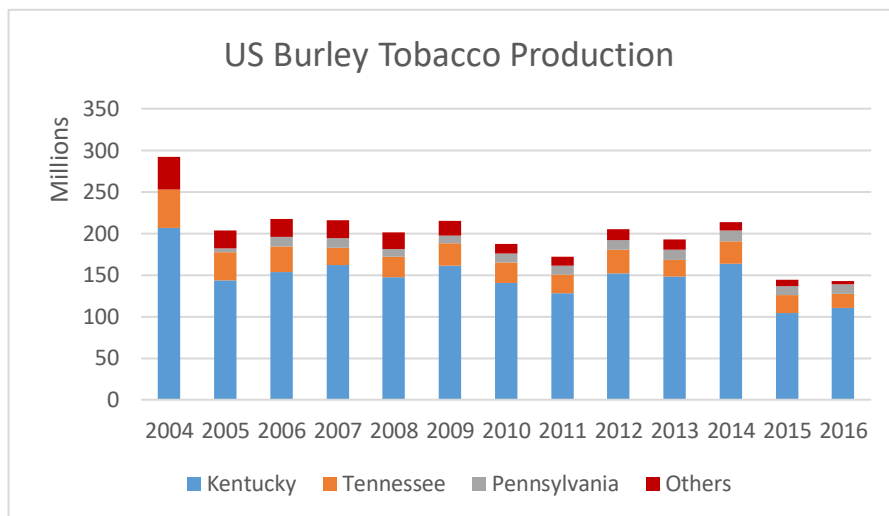
U.S. burley production is projected by USDA to total 143 million pounds for 2016, roughly the same size of the 2015 crop, but well below crops totaling around 200 million pounds during most of the post-buyout period. Due to adverse weather conditions, U.S. burley yields will likely be well below average for the 2016 crop, but USDA predicts 3,000 additional burley acres will be harvested this year. While USDA adjusted the size of the U.S.

burley crop down from earlier estimates, most analysts within the trade believe the 2016 crop will be noticeably smaller than the 143 million pound estimate from the October USDA crop report.

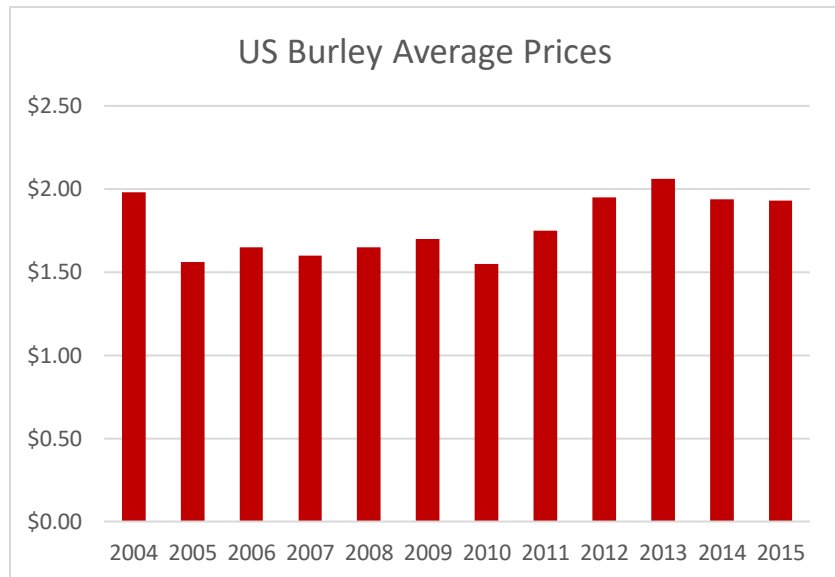
On the demand side, U.S. burley exports have dropped by more than 30% during the past marketing year as the market adjusted to excessive global supplies of lower priced leaf (aided by a stronger U.S. dollar) and slumping product sales in some blended cigarette markets. Unlike U.S. flue-cured tobacco, the U.S. burley sector has not benefitted much from expanded sales of leaf to China since the Chinese cigarette is predominately a flue-cured product.

Domestically, demand for U.S. burley remains relatively weak as the market reverts back to more traditional annual declines in U.S. cigarette sales and the

continued use of a relatively high volume of imported burley. Collectively, the current export and domestic market for U.S. burley calls for smaller burley crops of approximately 135 to 145 million pounds compared to the fairly consistent 200 million pound disappearance levels maintained during the first ten years of the post buyout era (2015-2014).



Prices for the 2016 U.S. burley crop will weigh upon a likely smaller production level than desired, but one that may have some quality concerns as well giving late curing conditions. U.S. burley contract price schedules were lowered for some grades, which, along with quality concerns could put some downward pressure on prices for some growers. However, the quality of some of the earlier harvested burley appears favorable. U.S. burley prices have averaged around \$1.95 for



the past two growing seasons, compared to \$2.06 in 2013. Accounting for inflation, U.S. burley grower prices have declined by more than 20% relative to the pre-buyout era, while production costs (especially labor costs) have increased and yields have not improved as anticipated following the exit of many lower yielding producers. Consequently, margins for remaining growers are tightening, with many contemplating future investments in a crop with a very uncertain future. Besides future product demand, labor challenges, crop insurance availability and cost, and regulatory/trade policy issues are on-going concerns. Even in the midst of a stronger U.S. dollar/slumping exports coupled with declining domestic and international sales of American-blended cigarettes, U.S. burley needs for 2017 could stabilize or increase modestly, depending on the eventual size of the 2016 burley crop.

### **Dark Tobacco Market**

Given the decline in the U.S. burley economy, along with other slumping ag enterprises, dark tobacco has become a more important crop in Kentucky and Tennessee in recent years. The dark tobacco regions have benefitted from expanding smokeless tobacco sales and limited competition worldwide due to superior producer management skills and overall leaf quality. Consequently, profit margins for dark tobacco consistently exceed flue and burley profit margins, although increasing labor costs have narrowed net returns in recent years. The near 30-year growth in U.S. snuff production continues, but the growth rate has slowed in recent years which has constrained the recent expansion in U.S. dark tobacco production. Following a sustained period of 4 to 6% annual growth, U.S. snuff production increased 2.5% in 2015 and appears to be following a similar pattern in 2016. U.S. dark tobacco exceeded 24,000 acres in 2014 and 2015, but fell to less than 23,000 acres in 2016. In response to a very poor growing season, U.S. dark fire cured production is expected to total 53.3 million pounds in 2016, down approximately 20 million pounds from 2015 levels. Prices for dark tobaccos hit record average levels (nearly \$2.70/lb for dark fire-cured and \$2.37/lb for dark air-cured) in 2015. Prices are expected to remain relatively strong for the 2016 crop with the potential of expanded contract volume in 2017 to account for the significantly smaller crop this past year.