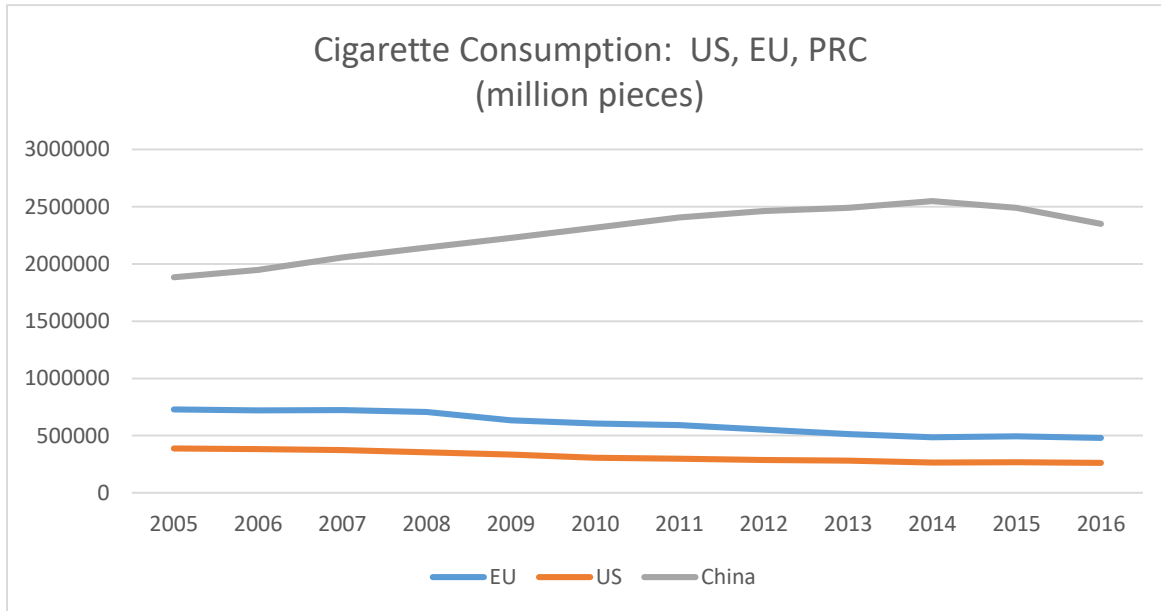


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Cigarette Market

Global cigarette consumption continued to decline due to lower smoking rates, not only in the EU and US, but also in China. However this trend will be partially or fully offset in some developing countries because of the growth in population of smoking age adults.



According to an IBISWorld Industry Report global revenue from tobacco products, including tax revenues, will continue to grow despite lower cigarette consumption. This is due to increased cigarette prices both in terms of before tax prices from cigarette manufacturers and increased cigarette taxes. Consequently, both tax revenues and industry profits are expected to continue to grow. IBISWorld expects global revenues from tobacco products to be \$662.9 billion in 2017.

Global per capita income, particularly in developing countries with higher smoking rates, is expected to continue growth. Significantly for US tobacco producers, growing incomes means that more smokers will upgrade to premium brand cigarettes that contain more flavor style tobacco. This trend will partially offset declining demand for flavor style tobaccos in developed countries where smoking rates continue the long term trend of significant decline.

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 over \$12 billion in 2016 according to Euromonitor International. While sales of e-cigarettes seems to be slowing with many analysts predicting limited growth, a new vapor product has emerged. Philip Morris International (PM) had introduced iQOS, a heat-not-burn (HNB) product, in test markets in Japan and Italy in 2014. The product has done very well growing to over 12% market share in the Japanese cigarette market in just two years. PM has indicated a major commitment and shift away from traditional combustible cigarettes to iQOS. British American Tobacco and Japan Tobacco have also introduced HNB products. PM hopes to have manufacturing capacity in place in Europe to produce 100 million Heets, the tobacco product used in the iQOS device, by the end of 2018. PM has submitted an application to FDA for approval of iQOS as a modified risk tobacco

product in the US. HNB products could bring about the transformational change in the tobacco products market that has eluded e-cigarettes.

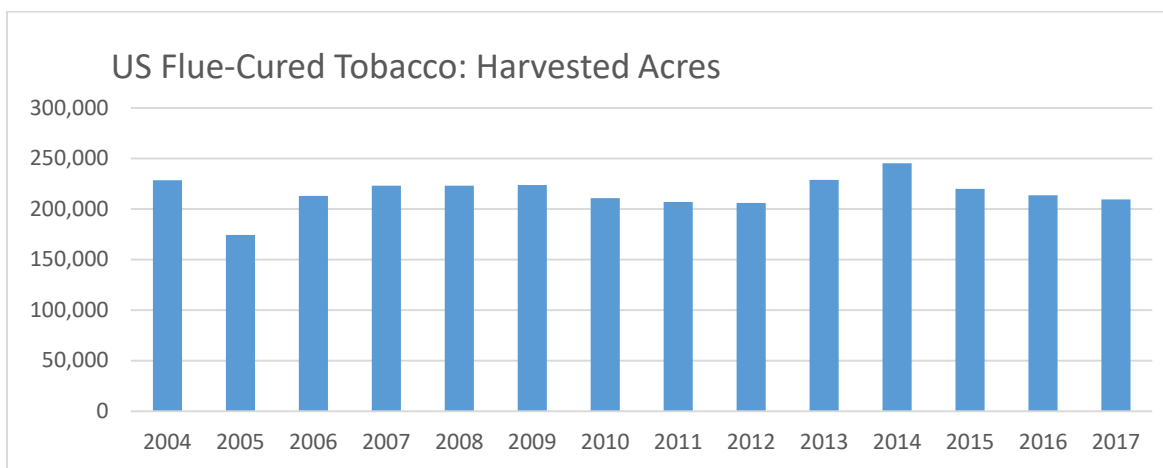
HNB products contain 30-50% of the quantity, by weight, of tobacco of the quantity contained in combustible cigarettes. The tobacco in the HNB products is highly processed but, according to manufacturers of HNB products, must be high quality tobacco. In addition, manufacturers say that consistency of quality is very important. Not surprisingly, strict adherence to GAP by growers is very important. Based on these characteristics of HNB products, U.S. flue-cured growers should be well positioned to supply this emerging market.

Flue-Cured Production and Market

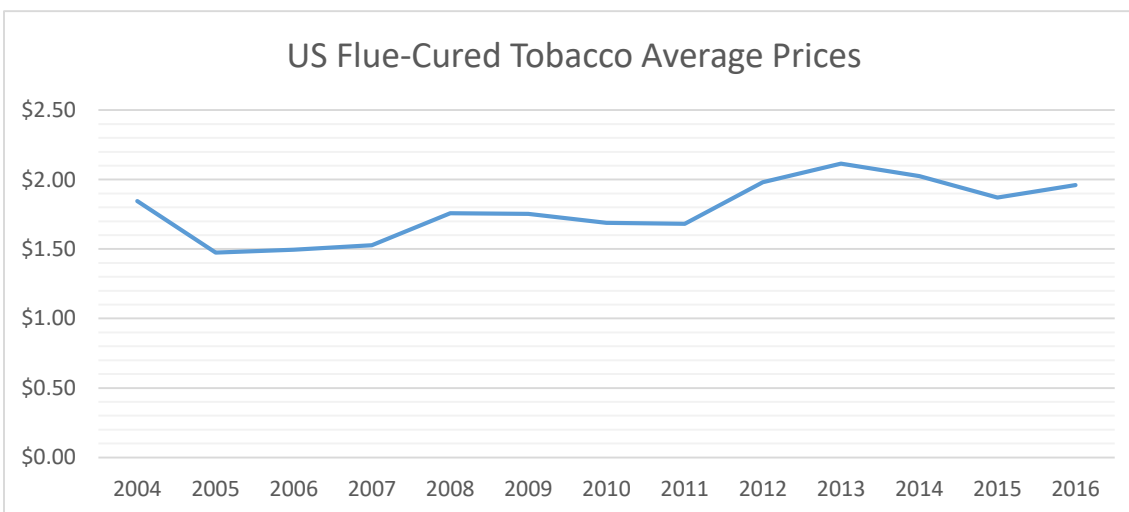
At 209,500 acres harvested acreage of U.S. flue-cured tobacco is forecast to be down slightly from 213,500 acres in 2016. Yield for 2017 was estimated at 2,254 pounds per acre over 200 pounds greater than the 2016 yield of 2,021. Consequently production for 2017 is forecast at 472,200 pounds up from 431,450 pounds in in 2016. Average price received in 2016 was \$1.96 per pound according to USDA, up from \$1.873 per pound for the 2015 crop.

Table 1. U.S. Flue-Cured Tobacco Production, Stocks and Use. (Farm Sales Weight, 1000 pounds)

Marketing Year	Beginning Stocks	Production	Total Supply	Ending Stocks	Total Disappearance	Exports	Domestic Use
2004-05	822,848	499,330	1,322,178	795,968	526,210	188,627	337,583
2005-06	795,968	380,900	1,176,868	604,018	572,850	258,425	314,425
2006-07	604,018	446,510	1,050,528	493,248	557,280	247,017	310,263
2007-08	493,248	503,760	997,008	396,757	600,251	304,996	295,255
2008-09	396,757	499,220	895,977	360,324	535,653	304,166	231,487
2009-10	360,324	525,400	885,724	398,853	486,871	303,798	183,073
2010-11	398,853	451,860	850,713	381,925	468,788	258,937	209,851
2011-12	381,925	344,610	726,535	319,179	407,356	248,181	159,175
2012-13	319,179	472,900	792,079	260,393	531,686	269,158	262,528
2013-14	260,393	454,350	714,743	334,500	380,243	262,277	117,966
2014-15	334,500	537,800	872,300	529,637	342,663	268,087	74,576
2015-16	529,637	486,250	1,015,887	565,719	450,168	289,692	160,476
2016-17	565,719	431,450	997,169	500,189	496,980	234,563	262,417
2017-18	500,189	472,200	972,389				

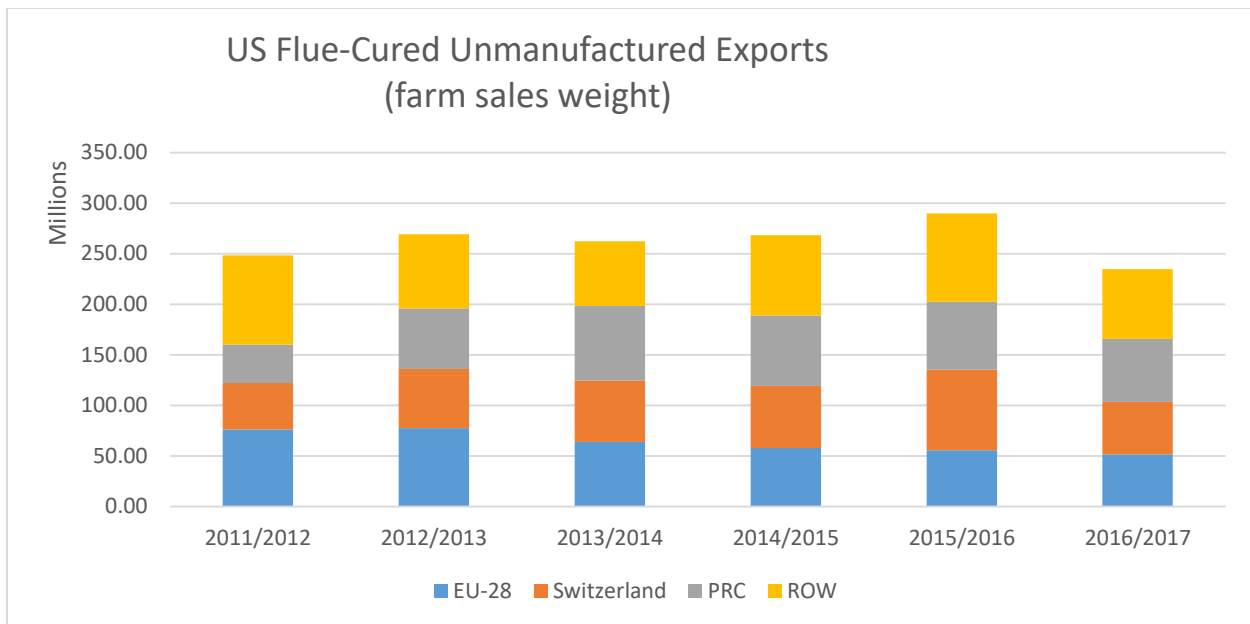


Higher quality with a reasonable supply/demand balance led to higher prices in 2016 than in 2015. The 2017 Brazil crop was reported to be 1.37 billion pounds, according to Universal Leaf, up from a recent low of 1.01 billion pounds in 2016. Universal forecasts the 2018 Brazil crop slightly lower at 1.32 billion pounds. The 2017 Zimbabwe crop was estimated to be 403 million pounds down from 442 million pounds in 2016. The 2017 average price per pound in Zimbabwe was expected to be about \$1.34 per pound; about the same as in 2016.



Unmanufactured exports of US flue-cured tobacco fell from 290 million pounds for the 2015 crop to 235 million pounds for the 2016 crop. Exports declined despite strengthening of the Brazilian Real against the US dollar. This was likely due to lower U.S. production in 2016. A stronger Brazilian Real and a larger 2017 U.S. crop should lead to higher exports for the 2017 crop.

Exports to the European Union (EU-28) declined for a second year from 55.7 million pounds to 51 million for the 2016 crop. Exports to Switzerland fell from 79 million pounds for the 2015 crop to 52 million pounds for 2016. Exports to Switzerland represent not only US tobacco bound for other European countries, but also tobacco bound for Asia. US exports to China continued to decline from 67 million pounds for the 2015 crop to 62 million for the 2016 crop. Use of US flue-cured by US cigarette manufacturers increased again from 160 million pounds for the 2015 crop to 262 million pounds for the 2016 crop.



Summary

- The global cigarette industry continues to earn robust profits despite declines in cigarette consumption in most markets.
- Rising incomes of smokers in developing country markets are increasing consumption of premium brands even when overall cigarette consumption is declining. Growth of premium brands generally implies greater demand for flavor style tobaccos.
- Heat-not-burn products are potentially game changers for the tobacco industry. HNB products contain much less tobacco than combustible cigarettes, but require higher quality tobacco.
- Brazil's 2017 and 2018 crops are each over 1.3 billion pounds, but global stocks of flue-cured are reportedly not excessive.
- Exchange rates are slightly more favorable for U.S. flue-cured exports with the Brazilian Real strengthening some against the dollar.
- Given current market conditions there is not a compelling case for substantial increases or decreases in 2018 contracted pounds in the U.S.
- Intermediate to long-term market factors point to continued exit of flue-cured growers and consolidation of remaining growers.