Reynolds American/Lorillard: A Closer Look at Reynolds’ Arguments on Unilateral Effects, Head to Head Competition

Conclusion

According to a source close to the matter, Reynolds’ primary argument for FTC clearance of its Lorillard acquisition will focus on the ostensibly limited head-to-head competition between the two firms’ brands. Specifically, Reynolds will argue that the firms’ Newport and Camel premium equity brands are not close substitutes, and that as a result, a post-merger unilateral price increase for either brand would prove unprofitable, as consumers would simply switch to Altria or Imperial products.

This argument is Reynolds’ strongest—if the FTC does clear Reynolds/Lorillard, stakeholders should expect the ostensibly limited competitive interaction between the two firms’ premium equity brands to feature prominently in the FTC’s closing statement. The argument, however, has certain weaknesses, as Newport’s market leadership in menthol—coupled with Camel’s growing competitive significance in the segment—could point to the potential for unilateral effects, and reduced promotional competition in particular. Additionally, Camel and Newport heavily overindex among younger smokers, and the FTC may conclude that the two brands compete closely head to head for the adult smokers under 30 who drive competition industrywide.

In this article, we examine Reynolds’ unilateral effects arguments more closely, including takeaways from a discussion with Luke Froeb, Director of the FTC’s Bureau of Economics from 2003 to 2005. Key points for stakeholders to consider include:

- **Highly differentiated products; limited substitution key to Reynolds’ argument.** Although the FTC views the relevant product market as all cigarettes, cigarette brands are highly differentiated. Reynolds argues that Camel and Newport are not close substitutes, as both brands compete much more closely with Marlboro than with one another. As such, the Lorillard acquisition would give Reynolds neither the incentive nor the ability to unilaterally increase the price of either brand, as smokers would switch to Altria or Imperial brands, thereby rendering a unilateral price increase unprofitable.

- **Newport’s menthol leadership; Camel’s increasing push into the segment point to potential for unilateral effects.** However, when one firm has a market-leading share in a particular segment, as Newport does in menthol, it may be uniquely well-positioned to capture consumers switching in response to a post-merger price increase. Additionally, Camel Menthol is the #1 or #2 menthol brand in 15 states, which points to significant competitive interaction with Newport in at least some areas of the country.

- **The brands’ strengths in adult smokers under 30 likewise point to significant competitive interaction.** Camel and Newport enjoy very favorable demographics, and heavily overindex among adult smokers under 30 (ASU30). Because older smokers demonstrate very high levels of brand loyalty, competition for contestable ASU30 drives competition industrywide. As a result, the FTC is highly likely to view the brands’ competitive interaction for ASU30 as the appropriate metric through which to measure potential competitive effects.
• **Unilateral effects—promotional competition could be key.** In addition to potential unilateral list price increases, the FTC’s investigation will focus on the likelihood that the Lorillard acquisition would provide Reynolds the incentive and ability to scale back promotional and discounting activity, especially for its growing Camel Menthol styles.

**Key Points**

**Differentiated products and substitution.** The Reynolds/Lorillard merger would increase concentration significantly in the already highly concentrated US market for cigarettes. Cigarettes, however, are highly differentiated products. The importance of market structure, and market concentration metrics such as HHI, is significantly less probative of competitive effects in mergers involving differentiated products than in deals involving homogenous products. As a result, the extent of Reynolds’ and Lorillard’s brands’ competitive interaction, rather than overall market concentration figures, are likely to drive the FTC’s competitive effects analysis.

Post-merger unilateral price increases or other competitive effects are most likely if merging parties’ differentiated products are close substitutes, in the sense that smokers who consider a Reynolds brand, such as Camel, their first choice would switch to a Lorillard brand, such as Newport, (or vice versa) in response to an increase in Camel’s price. “The standard models of price competition say that substitution matters, and if they’re not substitutes for each other then there’s very little competition lost by this merger—that would be the logic behind their argument,” explains Luke Froeb, who served as Director of the FTC’s Bureau of Economics from 2003 to 2005, and is now an Associate Professor of Management at Vanderbilt University.

**Using overall market shares as a proxy, Camel and Newport demonstrate very limited competitive interaction.** An increase in Camel’s price post-merger would prove profitable if a significant percentage of consumers who switched in response would choose to substitute to Newport or another Lorillard (or Reynolds) brand. If a significant enough percentage of switchers would substitute to a non-Reynolds brand, however, such a price increase would prove unprofitable. Antitrust economists refer to the fraction of customers switching from one product to another in response to a price increase as the products’ “diversion ratio.” By multiplying the diversion ratio by the switched-to products’ gross margin (the percentage gap between price and incremental cost), economists can develop predictions regarding a merger’s likely unilateral effects.

Although consumer surveys are often the most compelling evidence of likely diversion ratios, pre-merger market shares can also serve as a rough measure of how consumers will respond to post-merger unilateral price increases. Using overall retail market shares as a proxy, Reynolds will argue that its Camel brand would be unlikely to capture a significant percentage of switchers responding to a unilateral price increase for Lorillard’s Newport brand, while Newport would likewise capture very few switchers responding to a unilateral increase in Camel’s price. Newport brand has a market-leading 37.1% share of the menthol segment.

Using menthol market shares as a proxy, Newport’s closest substitute is Marlboro Menthol, with a roughly 20% share of the segment. Kool, which Reynolds has agreed to divest to Imperial, has a roughly 5.7% share, while Camel’s share of the menthol segment is just 4.3%. And although Reynolds’ Pall Mall has grown its menthol share in recent years, Pall Mall competes in the discount segment, and may not significantly interact with the premium Newport. Using these numbers as a proxy for diversion ratio, Marlboro Menthol would be expected to
capture the highest percentage of switchers responding to a unilateral post-merger increase in Newport’s price. Kool would likely capture the next highest percentage of switchers, with Camel a distant third. As a result, Reynolds will argue that it would not have the ability to profitably increase Newport’s price post-merger, as a very significant percentage of consumers lost in response to a price increase would switch to a non-Reynolds brand.

A similar scenario would likely play out in non-menthol. Marlboro is the dominant brand in non-menthol, while Newport’s recently-introduced non-menthol styles account for a mere 1% share of the overall retail market. If Reynolds were to unilaterally increase the price of its non-menthol Camel brands, then switchers would presumably substitute primarily to Altria’s Marlboro, with substitution to Newport non-menthol extremely limited. A unilateral price increase would, once again, prove unprofitable. In short, Reynolds will argue that, at least using overall market share as a proxy for likely diversion ratios, Camel and Newport are not close substitutes. And given the brands’ very limited head to head competition, a post-merger unilateral price increase would merely divert market share to Altria or Imperial. If the FTC clears Reynolds/Lorillard, it will be primarily due to the strength of this substitution argument, in spite of the fact that the deal would significantly increase concentration in an already highly concentrated market.

Newport’s menthol leadership and Camel’s menthol push complicate the argument. Given Camel’s relatively limited share in menthol, Reynolds will argue that a unilateral increase in Newport’s price would simply divert switchers to Marlboro Menthol or Kool. However, the FTC will also explore the converse question—how would consumers react to a unilateral increase in Camel menthol’s price? If a brand is the market leader in a particular segment, as Newport is in menthol, it is very likely to capture a disproportionate share of customers switching from a smaller brand. So, although Camel is a relatively small player in menthol, given Newport’s market leadership, Newport would appear well-positioned to capture a significant percentage of switchers responding to a unilateral increase in price for Camel’s menthol brands.

A second fact pointing to potential unilateral effects is Camel’s growing competitive position in menthol. In Q1 2011, Camel’s menthol brands had just over a 2% share of the menthol segment. However, Reynolds has aggressively promoted its Camel menthol styles since 2011, and in just three and a half years, the brand has more than doubled its overall share of the menthol segment, to 4.3% at the end of Q2 2014. As Reynolds president Andrew Gilchrist explained in a November 2012 presentation: “The primary driver of Camel's overall share growth continues to be the brand's menthol styles...[a]s a matter of fact, Camel is now the #1 or the #2 menthol brand in 15 states.” These states are likely in the Western US, outside of Lorillard’s core geographies in the Northeast, Midwest and Southeast. That said, this statistic points to outsize, and growing, competitive interaction between Camel and Newport in some areas. This interaction would appear poised to grow absent the merger—Lorillard’s 2013 Investor Day presentation refers to Newport’s expansion in non-core geographies as one of the firm’s key strategic priorities.

Furthermore, Reynolds executives’ past statements point to important competitive interaction between Reynolds and Lorillard in menthol. During Reynolds’ 2011 Investor Day, Reynolds Executive Vice President John Brice O’Brien noted that for Reynolds’ full-flavor menthol brand Camel Crush Bold: “we're also seeing high competitive interaction with both Newport, as well as Marlboro Menthol smokers, and we expect to see Bold broaden Camel's consumer appeal, its geographic appeal, as well as driving additional growth.” And although Reynolds’ discount Pall Mall brand may demonstrate more limited competitive interaction with Newport, Brice explained during Reynolds’ 2012 Investor Day that Reynolds had “expanded 4 new styles into the Pall Mall
menthol family,” and specifically “2 full-flavor style[s] in king-size and 100s to compete more effectively for [the] competitive Newport smoker.”

**The brands’ strengths in adult smokers under 30 likewise point to competitive interaction.** Because of the tobacco industry’s unique competitive dynamics, overall market shares are less indicative of brands’ competitive interaction than is typical of other markets. Older cigarette smokers exhibit high rates of brand loyalty and low rates of switching. Adult smokers under 30 (ASU30), however, are much less likely to have settled on a usual brand, and are much more likely to switch in response to pricing and promotions. Given that ASU30 are contestable, cigarette producers price and promote primarily to win this demographic—and this competition drives pricing and promotions industrywide. “If it is the case that older people don’t switch, they’re locked into a brand, but young people when they’re initially choosing they’re very sensitive to price, that means these things are really good substitutes for young people and that’s the critical competition that you’d want to preserve,” Froeb explains.

Given this competitive environment, the FTC is highly likely to view competitive interaction for ASU30s as the relevant metric through which to view brands’ competitive positioning. And viewed by this metric, the Reynolds/Lorillard combination, and the Newport/Camel combination in particular, is significantly more problematic. Both Lorillard and Reynolds overindex among ASU30s—in fact, the combined firm would have market-leading share in the demographic—about 47.1% pre-divestitures (Reynolds 27.6%, Lorillard 19.5%), with Altria at 42.9%. And because the Imperial divestiture brands (Kool, Salem, Maverick and Winston) heavily underindex in ASU30, excluding these brands would reduce Reynolds’ share in the demographic only slightly.

Reynolds and Lorillard’s overperformance among ASU30 is primarily a function of the Newport and Camel brands’ popularity with younger smokers. A 2012 Surgeon General’s report reveals that Newport (21.8% share) and Camel (12.4% share) heavily overindex among adolescents (12-17) and young adults (18-25). And this trend appears poised to accelerate. According to Citi Investment Research and Analysis, Camel grew its market share among 12-17 year old smokers 21.4%, and among smokers age 18-25 65.2%, from 1999 to 2010. Newport’s share growth in the same demographics over the same time period was 10.7% and 29.9%, respectively, while Marlboro lost 11.4% among 12-17s, and 20.4% among 18-25s during that same time period. These trends point to continued ASU30 growth for the two brands, and Camel in particular, as these adolescents and young adults age. In addition, these trends point to increased competitive significance of Camel’s menthol styles as well, which already heavily overindex among ASU30.

**Unilateral effects—promotional activity.** In evaluating the likelihood of post-merger unilateral effects, the 2010 Horizontal Merger Guidelines focus primarily on the likely effects of a unilateral post-merger 5-10% price increase, and whether such a price increase would prove profitable, or instead divert significant sales to competitors.

However, price increases and lessened competition can take a number of different forms—in the cigarette industry, given the heavy emphasis on promotion at the point of sale, reduction in promotional spending could lessen competition and lead to a loss of consumer welfare as well. As Luke Froeb explains: “In cigarettes, for example, the promotion and advertising and brand-building are very important to competition. So when you look at just price competition you’re putting this very complex world into this very simple box. You’re saying the only dimension of competition is price, and we’re only going to block mergers that raise price. And that’s just not how the agencies look at things, it’s a very simplistic way of looking at things and the agencies will ask the
question how these guys compete and how this merger changes that competition. And if they don’t compete on price they can look at other dimensions and they can say look are consumers going to be harmed if we lose the promotional competition, the placement competition so the other dimensions of competition on which firms compete?”

In 2004, the Commission explained that the cigarette industry’s primary competitive dynamic, aside from the now lessened competitive threat from “deep discount” manufacturers, was “competition among premium brands in the form of brand equity investments, including various types of price discounts and promotions” which manufacturers make “principally to attract smokers under 30 to adopt [their] brand.” In addition to potential unilateral list price increases, the FTC’s investigation will focus on these price discounts and promotions, and specifically the likelihood that the Lorillard acquisition would provide Reynolds the incentive and ability to scale back promotional and discounting activity, especially for its growing Camel Menthol styles. According to a 2013 Lorillard presentation, in 2012, Camel promoted 36% of its menthol sales with factory packed discounts, significantly higher than Marlboro Menthol’s 26% and Newport’s 1%. Given these numbers, Reynolds’ incentives to discontinue its aggressive promotions for Camel Menthol, after acquiring the market leading menthol brand, will likewise be a key area of FTC inquiry.