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Philip Morris International/Altria: Merger Would Increase Buyer Power, Drive Tobacco Prices Lower, American Tobacco Farmers Say

A merger between Altria (MO) and Philip Morris International (PM, PMI) would increase the combined firm's buying power, push tobacco prices lower and ultimately drive some growers to exit the market, five U.S. tobacco farmers told *The Capitol Forum.*

The deal would "make a bad situation worse for farmers," said Hampton "Hoppy" Henton, a Kentucky grower and treasurer of the Council for Burley Tobacco, an organization representing farmers of the crop.

The tobacco growers expressed their concerns as the companies, previously a single firm, on August 27 disclosed talks to re-combine, in a deal that would create a tobacco giant with a market capitalization approaching $200 billion.

At first glance, the merger wouldn't face obvious U.S. antitrust challenges. Altria, which dominates the U.S. cigarette market through its Marlboro brand, operates in the U.S. only. PMI, by contrast, sells only outside of the U.S., meaning that the deal wouldn't reduce American consumers' competitive options.

But the companies do compete head-to-head to purchase tobacco—in fact, farmers identified the firms as two of the four key buyers of U.S. tobacco. Given declining demand and Chinese tariffs, farmers said that foreign or smaller domestic buyers were unlikely to significantly increase their U.S. tobacco purchases in response to post-merger price reductions. Not only that, but PMI, unlike Altria, eschews direct contracts with U.S. tobacco farmers—a model that if extended to the post-merger company would further drive down prices, farmers said.

Given these dynamics, a deal could draw FTC scrutiny over buyer power effects. Although the U.S. agencies rarely enforce on such monopsony theories of antitrust harm, agriculture markets are oftentimes an exception to this rule. And the question could prove especially relevant today, as monopsony questions attract increasing academic and agency attention, and farmers, a key component of President Donald Trump's base, face ongoing economic challenges in the run-up to the 2020 election.

A PMI spokesperson declined to comment on the farmers' concerns, instead providing a 2014 press release describing the company's U.S. tobacco purchasing model. An FTC spokesperson declined to comment. Altria didn't respond to a request for comment.

Declining demand. The PMI/Altria merger talks occur against a backdrop of a long-term decline in demand for combustible cigarettes in most markets—a dynamic tied at least in part to a recent, dramatic rise in e-cigarette consumption.

The latter trend spurred Altria's December 2018 move to acquire a 35 percent stake in Juul Labs—a deal that continues to face an in-depth FTC antitrust review. Juul, which dominates the U.S. e-cigarette market, is also facing an FTC investigation into its marketing practices, the *Wall Street Journal* reported on August 29.

U.S. tobacco farmers have also felt the impact of declining smoking rates, which have served to dramatically weaken their pricing leverage with major purchasers.

"We don't have the option of switching from company A to B," said Henton. "Farmers could switch, but nobody else is taking growers."

"Most companies are closed as far as taking new customers—they all have all the pounds they need," added Donald Mitchell, a Kentucky burley tobacco grower, and board member of the Burley Tobacco Growers Cooperative Association. "We are all on the edge of the cliff as it is. Even if prices do not change from what they are now, I may be exiting the industry."

Purchasing options. Altria, PMI, R.J. Reynolds—acquired by British American Tobacco (BTI, BAT) in 2017—and Japan Tobacco International (TYO: 2914, JTI) are the dominant buyers of U.S. tobacco, farmers said.

Altria, JTI and Reynolds contract directly with U.S. growers. PMI, however, discontinued direct contracts with U.S. farmers in 2015 and now purchases through two leaf dealers—Alliance One and Universal Leaf—that effectively act as middlemen between the farmers and PMI.

Altria, which commanded a 55.1 percent share last year, per Wells Fargo data, and Reynolds (34 percent) dominate the U.S. cigarette market. Although neither PMI nor JTI sell meaningful volume into the U.S., both companies market American-style blend cigarettes outside of the U.S., with PMI holding the international rights to Marlboro, and JTI the rights to the Camel and Winston brands in more than 100 countries.

Local companies active in the world's top three cigarette markets—China, Indonesia, and Russia—aren't significant purchasers of U.S. tobacco, growers said. This includes China National Tobacco Corporation (CNTC), which, by virtue of its near-monopoly in the world's largest tobacco market, accounts for roughly 43 percent of global cigarette sales, per Euromonitor data.

CNTC had in recent years purchased significant volumes of U.S. flue-cured tobacco through direct contracts and leaf dealers such as Universal Leaf and Alliance One, said Norman Harrell, director of the North Carolina Cooperative Extension office in Wilson County. But the Chinese government's April 2018 move to increase tariffs on U.S. tobacco from 10 percent to 35 percent has decimated U.S. exports to the country; in response, CNTC discontinued purchases directly from U.S. farmers and now buys little, if any, U.S. tobacco from leaf dealers, Harrell said.

Imperial, the world's fifth-largest cigarette firm (4 percent global share), controls about 7.3 percent of the U.S. market, but also buys little or no U.S. tobacco, farmers said. An Imperial spokesperson, however, disputed that characterization, telling *The Capitol Forum* that the company buys U.S. tobacco through both direct contracts and leaf dealers, and had increased its purchases of U.S. tobacco over the past three years.

Monopsony questions. Nonetheless, while PMI (14 percent global share), BAT (12 percent global, 34 percent U.S.), and JTI (8 percent global) account for just 34 percent of the world market for the sale of cigarettes, the companies, along with Altria, account for the vast majority of U.S. tobacco purchases, said William Snell, a tobacco industry expert and extension professor at the University of Kentucky.

By way of example, Henton estimated that of the 80 million pounds of burley tobacco sold in Kentucky through contracts in 2018, Altria purchased 25 million; Universal Leaf, 22 million; JTI, 16 million; and Reynolds, 10 million. Universal Leaf's purchases were primarily, if not almost exclusively, earmarked for PMI, Henton said.

Burley, known for its strong, cigar-like taste, is one of three primary types of tobacco used in cigarettes, and is often blended with Virginia (flue-cured) and oriental tobacco varieties in American-style cigarettes.

In fact, attributing Universal Leaf's Kentucky contract purchases solely to PMI, Altria and PMI purchased about 58.8 percent of Kentucky's contract burley tobacco production in 2018—a market share typically indicating that a firm holds monopsony power, or the ability to purchase goods at prices below competitive levels.

To be sure, other buyers do compete to purchase U.S. tobacco, including small leaf dealers, manufacturers and tobacco cooperatives. These purchasers, however, are small and offer few contracts. "Right now, with a surplus market, many of these smaller buyers do not need much, if any, U.S. tobacco given low-price options overseas," Snell said.

"Just because there is a buyer out there does not mean they are going to buy tobacco, or buy it at a decent price," added Blake Brown, a North Carolina State University professor who focuses on agricultural and resource economics. This dynamic also means that smaller domestic contract or auction buyers are unlikely to serve as viable purchasing options for U.S. tobacco growers who balk at lower post-merger prices, farmers said.

Tariffs have effectively excluded Chinese purchasers from the U.S. market. And non-Chinese foreign buyers may also be unlikely to significantly increase their purchases post merger, as a strong dollar and high costs have rendered U.S. production significantly more expensive than tobacco produced in nations such as Brazil, Zimbabwe or Malawi, the farmers said.

"Labor is the biggest single input in the cost of production of tobacco. Wages in North Carolina are $12.25 per hour whereas overseas in some tobacco-growing regions, tobacco growers are making less than a dollar every day," said Lee Wicker, the deputy director of the North Carolina Growers Association.

Local markets? Although the merger would reduce the number of firms active on the U.S. purchasing market, the combination could have unique effects on smaller growers, who may have even more limited options for the sale of their crops.

In fact, geography and transport costs play a key role in farmers' buyer pools. That means that although leaf dealers like Alliance One and Universal Leaf buy internationally, U.S. tobacco farmers—the vast majority of whom operate in Kentucky, North Carolina and Virginia—oftentimes can only sell to buyers near their farms.

Like many Kentucky farmers, Darryl Varner delivers his tobacco by truck to receiving stations of the three companies he sells to: Altria, Universal Leaf and Reynolds. For Varner, distance is a key factor determining who can buy his tobacco.

"The other companies are too far away. The logistics of hauling tobacco make it too difficult to go to another buyer," he said, adding that companies like PMI, JTI and Alliance One have either closed down or moved some buying stations out of Kentucky, further limiting farmers' options.

Especially in a declining demand environment, growers fear that a PMI/Altria tie-up would reduce their options and position the remaining buyers to impose even lower rates, which could push farmers—many of whom are already struggling—to the edge.

"Growers cannot afford to take a price reduction in the sale of their tobacco," said Harrell.

Contract models. Further exacerbating farmers' concerns is that PMI and Altria operate two different purchasing models in the U.S.

Although both firms historically contracted directly with U.S. farmers, PMI in 2015 discontinued direct contracts in favor of purchasing through leaf dealers, in a move a company executive said would help it "achieve important supply chain efficiencies while remaining a major purchaser of U.S.-grown tobacco."

Altria, by contrast, buys directly from U.S. farmers. Direct contracts provide the company more control over tobacco production, as Altria sends its grower representatives to farms to work with contracted growers and enforce its production specifications, industry experts said.

Altria's direct contracts tend to be higher-priced and more consistent than PMI's prices through Alliance One and Universal Leaf, farmers and industry experts said.

"If I took a grade of burley tobacco and sold it to Universal, it would average $1.85-$1.90. If I took the same grade of tobacco to Altria, it would average to $2.05-$2.06," said Varner.

Although PMI doesn't buy directly from U.S. growers, the fact that PMI is the key customer for the two leaf dealers, who in turn compete with Altria to purchase U.S. tobacco, means that the merger could nonetheless increase the combined firm's buyer power and push tobacco prices lower, growers said.

Farmers also fear that a merger could lead to Altria adopting PMI's model of buying through leaf dealers rather than through direct contracts, which could lead to lower prices.

For example, one North Carolina tobacco grower who requested anonymity said he splits his production evenly between Altria, Universal and Reynolds.

The difference between selling his tobacco directly to Reynolds and Altria, and the leaf dealer is that Universal not only pays lower prices but also doesn't notify him of the price until 45 days into the season, the farmer said.

"If we have to sell the tobacco we currently sell to Altria to a leaf dealer, we would not remain a viable business," he said.