

U.S. Tobacco Situation and Outlook

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Tobacco Products

United States

With large increases in both federal and state excise taxes late last decade, U.S. cigarette consumption had declined from 4 to 8 percent per year from 2007 to 2010. With few further increases in excise taxes, the decline in cigarette consumption slowed to 2.6 percent in 2011. According to the Centers for Disease Control cigarette consumption in 2011 was 292.7 billion cigarettes, down from 435.6 billion in 2000. With increased excise taxes both state and federal revenues from cigarette taxes have risen. With the federal cigarette excise tax rate at \$1.01 per pack federal cigarette tax revenues in FY 2011 were \$15.1 billion. The median state cigarette excise tax was \$1.25 at the end of 2011. In FY 2011 states collected \$17.3 billion in revenues from state cigarette taxes.

Bans on smoking in public places have increased significantly over the last decade. As of July, 2012 only 10 states had not enacted any general statewide bans on smoking. Over 80 percent of the U.S. population lives under a ban on smoking in workplaces, and/or bars, and/or restaurants according to the American Nonsmoker's Rights Foundation.

FDA continued with its progress in implementing the 2009 Family Smoking Prevention and Tobacco Control Act. Some of the significant provisions under enforcement are the ban on use of any flavorings in cigarettes except menthol and the requirement for cigarette manufactures to report to FDA an established list of harmful and potentially harmful constituents in cigarettes. A ban on menthol as a flavoring is under consideration. Requirements for graphic warning labels on cigarettes were to have gone into effect in September, 2012, but a U.S. Court of Appeals upheld an earlier court decision in a suit of the federal government by U.S. cigarette manufacturers that strikes down the requirement for graphic warning labels on the grounds that they violate the First Amendment.

International

Cigarette production continues to increase in the Peoples' Republic of China. According to a May, 2012 market research report by Frost and Sullivan the PRC accounted for 39 percent of global tobacco consumption in 2011. From 2004-2011 PRC cigarette production grew at a compound annual growth rate of 3.9 percent. Frost and Sullivan project that this growth will continue at an annual growth rate of 2.9% to 2016. The *2012 Supply and Demand* report by Universal Leaf Tobacco Company, Inc. reports a compound annual growth rate of PRC cigarette production from 2006 to 2011 of 3.7 percent with PRC cigarette production in 2011 of 2,427 billion cigarettes. With income growth in the PRC the demand for premium style cigarettes is also reportedly growing. Similarly, cigarette production and consumption continues to grow in other parts of southeast Asia.

In the European Union, as in the U.S. and other developed countries, cigarette consumption continues to decline. According to industry reports and a September, 2012 press release (*European Union Poised to Ban E-Cigarettes and Smokeless Tobacco*) the EU is ready to ban all flavorings in tobacco products. This precedes the 2012 Conference of the Parties on the

World Health Organization's Framework Convention on Tobacco Control (FCTC) set for October, 2012. Over 170 countries have signed a tobacco control treaty under the FCTC. At the last conference in 2010 the organization recommended that all member countries implement regulations for flavorings used in tobacco products. Speculation is that the 2012 conference will provide stricter guidance furthering the trend of banning flavorings in cigarettes. According to Universal Leaf Tobacco Company's *2012 Supply and Demand* report global cigarette production outside the PRC has declined at a compound annual rate of 0.6 percent since 2006.

U.S. Flue-Cured Situation and Outlook

U.S. flue-cured growers experienced the best weather and the best crop since the 2009 crop. Both quality and quantity improved over the weather stressed crops of 2010 and 2011. The October 1 USDA crop report estimates 2012 U.S. flue-cured production to be 494.6 million pounds with yield at 2,376 pounds per acre and harvested acreage at 208 thousand. This is up from 344.6 million pounds in 2011. Reports from extension and industry contacts place the 2012 crop at considerably smaller levels. For example, the September 2012 *Crop and Market Report* from Universal Leaf Tobacco Company reports an estimate of 450 million pounds for the 2012 U.S. flue-cured crop.

With very good quality in the U.S. and strong demand for flavor style flue-cured, 2012 prices may have been at record highs. USDA reported an average price per pound for flue-cured in 2011 of \$1.68. Average price for 2012 could be close to \$2.00 per pound. During the season some companies increased the prices offered across all grades of flue-cured. Farmers reported very good grades for their 2012 crop.

Good quality is one of several reasons for higher prices for the 2012 crop. Flavor style flue-cured tobacco is grown mainly in the U.S. and Brazil with Zimbabwe re-emerging with a good flavor style crop in 2012. Due to poor weather, Brazil and the U.S. had poor to mediocre quality crops in 2010 and 2011. Consequently global supplies of premium style flue-cured tobacco are low even though overall supplies of flue-cured are up. If this is the only factor in higher prices, then if the 2013 Brazilian crop is of good quality and sufficient quantity U.S. prices could return to lower levels in 2013. However tobacco buyers are indicating optimism for the flue-cured market beyond the 2012 crop. More than a few buying interests are actively seeking ways to both retain current growers and increase production.

There are two other plausible reasons for increased demand for U.S. tobacco. First increased cigarette production in China, particularly of higher end cigarettes, may be increasing the amount of flavor style flue-cured needed in Chinese cigarettes. Second, the global trend toward banning flavorings in cigarettes may increase the amount of flavor style flue-cured needed in blends to compensate for no flavorings. Brazil seems to have hit a ceiling on the amount of flavor style flue-cured they can produce. If so, then increased demand for flavor style flue-cured must be met with increased production in the U.S. and Zimbabwe.

How real is this perceived increase in demand for U.S. flue-cured? The answer is not easy. Global cigarette production outside of China continues to decline with tightening smoking restrictions, higher taxes and health concerns. The coming year will tell much about how serious buyers are about increasing or retaining U.S. flue-cured production. Curing infrastructure is aging and with much uncertainty in the tobacco outlook and strong prices for competing crops, growers have little or no incentive to re-invest in curing capacity. Re-investment in curing infrastructure likely will require industry involvement in lowering per unit curing costs and evidence of long term commitments.

Exports of U.S. flue-cured declined for the 2011 marketing year. This decline was not due to a decline in demand but reflected the reduced supply of U.S. flue-cured available in 2011 due to adverse weather. Statistics on July 1, 2011 stocks are not yet available, but ending stocks are expected to be down given the very tight supplies in 2011. Exports should rebound toward the 300 million pound level in the 2012 marketing year.

Table 1: U.S. Flue-Cured Tobacco Production, 2004 to 2011, in million pounds.

	Florida	Georgia	North Carolina	South Carolina	Virginia	U.S. Total
2004	9.8	46.7	344	63.4	57.6	521.5
2005	5.5	27.8	273.9	39.9	33.7	380.8
2006	2.9	30.1	324.0	48.3	42.0	447.2
2007	n/a	39.8	376.8	46.1	41.0	503.8
2008	n/a	33.6	384.7	39.9	41.0	499.2
2009	n/a	28.0	417.6	38.8	42.0	526.4
2010	n/a	27.4	348.6	36.0	39.9	451.9
2011	n/a	26.8	248.0	26.3	43.5	344.6
2012	n/a	24.1	394.1	28.4	48.0	494.6

(Source: USDA, NASS, *Crop Production Report*, October 2012)

Table 2: Flue-Cured Tobacco Production , Stocks, Supply and Disappearance (farm sales weight million lb)

Marketing Year	Beginning Stocks	Production	Total Supply	Ending Stocks	Total Use	Exports	Domestic Use
2004-2005	822.8	499.3	1,322.2	796.0	526.2	188.6	337.6
2005-2006	796.0	380.9	1,176.9	604.0	572.8	258.4	314.4
2006-2007	604.0	446.5	1,050.5	493.2	557.3	247.0	310.3
2007-2008	493.2	503.8	997.0	396.8	600.2	305.0	295.3
2008-2009	396.8	499.2	896.0	360.3	535.6	304.2	231.5
2009-2010	360.3	525.4	885.7	398.8	486.9	303.1	183.8
2010-2011	398.8	451.9	850.7	381.9	468.8	258.9	209.9
2011-2012	381.9	344.6	726.5			248.4	

(Sources: USDA-AMS Tobacco Stocks as of April 1, 2012. USDA-NASS. USDA-FAS GATS)

U.S. Burley Situation and Outlook

The outlook for the U.S. burley has, at least in the very near term, improved considerably with a significant tightening of the world supply/demand balance. This is primarily in response to a large decline in African burley production along with smaller, full flavor Brazilian and Argentine crops. U.S. burley growers are expected to produce and market a larger crop in 2012, with improved prices, and the potential for expanded acreages in 2013.

According to the latest USDA crop report (October 2012), U.S. burley acreage is up 14 percent from 2011 levels. While the drought certainly impacted the 2012 crop, tobacco, being a dry weather crop, fared fairly well given the extreme weather conditions. Currently, USDA has the 2012 U.S. burley crop pegged at 202 million pounds, which is 17 percent above the 2011 crop, and the third largest since the 2004 tobacco buyout. However, housing labor challenges, along

with late crops being susceptible to frost, may constrain some growers from harvesting all available acres.

Worldwide, Universal Leaf Tobacco Company estimates that global burley production fell 25 percent in 2012, despite gains in U.S. production. In response to very depressed prices for the 2011 crop, Malawi burley production plummeted nearly 70 percent in 2012, down to around 140 million pounds versus a crop exceeding 450 million pounds in 2011. Poor weather conditions led to Brazil's burley production falling from 245 million pounds to 187 million pounds – its lowest level since 1998. Argentine burley production for this previous crop year was also down 16 percent.

Given the tight world supply/demand balance, the U.S. market can certainly absorb an expected larger 2012 crop. Assuming a decent fall curing season, look for U.S. burley prices to increase from last year's \$1.75 per pound average on the heels of the current demand conditions coupled with slightly higher contract prices. The top quality burley contract grades for the 2012 crop are around \$1.90 per pound with #2 quality generally in the low \$1.80s. However, contact and auction prices could conceivably be larger given current market conditions and the expectation of a very good quality crop.

U.S. burley disappearance in recent years has stabilized to around 210 to 220 million as both exports and domestic use have been fairly flat. Tight U.S. burley supplies have limited export opportunities for this past year, despite favorable exchange rates. Domestic use continues to be hindered by declining domestic consumption, but the rate of decline in U.S. cigarette consumption has fallen over the past couple of years, which has supported domestic burley demand amidst tight world burley supplies.

In response to higher global prices and the depleted level of non-committed stocks, world burley production is forecast to increase by more than 20 percent in 2013 as Africa, and to a lesser extent South America rebounds. This is expected to put global burley supplies more in line with anticipated burley needs.

Based on the anticipated supply/demand balance, look for U.S. burley contract volume requests to stabilize or perhaps even increase if the eventual size of anticipated 2012 U.S. burley marketings do not materialize. Similar to 2012, the question becomes given other profitable options, concerns over labor and other regulations, dilapidating infrastructure, and increasing contract demands of the companies (i.e., GAP requirements) how will U.S. burley growers respond to these opportunities in the coming year. Long-term, the outlook for burley hinges critically on the global regulations on flavorings which are currently a critical ingredient in cigarette blends containing burley tobacco.

Dark Tobacco Situation and Outlook

U.S. dark tobacco growers continue to benefit from growing domestic snuff sales and limited foreign competition. U.S. snuff consumption has been increasing annually since the mid 1980s. Sales were up around 4% in 2011 – similar to the gains during the early part of 2012 and the annual growth patterns experienced over the past decade. On the supply side, dark tobacco acres have been adjusting the past few years in response to an excessive crop produced in 2008. According to USDA's October crop report, U.S. dark fire-cured production is three percent higher than last year's crop, while dark air-cured production is down seven percent. The anticipated crop sizes are getting close to recent useage levels, indicating that the industry is moving toward ideal supply/demand balances. Look for dark fire-cured prices to be slightly

higher than last year's average of \$2.56 per pound for dark fire-cured and \$2.28 for dark air-cured.

Table 3: U.S. Burley Tobacco Production, 2004 to 2012, in million pounds.

	Kentucky	Tennessee	Pennsylvania	North Carolina	Others	U.S. Total
2004	206.7	46.1	n/a	6.6	32.8	292.2
2005	143.5	34.0	4.8	5.0	16.1	203.4
2006	153.3	30.8	11.6	6.6	15.0	217.1
2007	154.0	20.8	10.8	6.6	15.2	207.4
2008	147.0	24.7	9.9	5.6	14.3	201.5
2009	161.3	26.9	9.4	6.3	11.0	214.9
2010	140.4	24.9	10.1	4.0	8.2	187.6
2011	128.0	22.5	11.0	3.4	7.4	172.3
2012	148.0	30.4	11.5	3.6	8.7	202.2

(Source: USDA, NASS, Crop Production Report, October 2012)

Table 4: Burley Tobacco Production, Stocks, Supply and Disappearance (farm sales weight million lb)

Marketing Year	Beginning Stocks	Production	Total Supply	Ending Stocks	Total Use	Exports	Domestic Use
2004-2005	540.0	280.1	820.1	492.6	327.5	227.6	99.9
2005-2006	492.6	203.4	696.0	403.4	292.6	200.4	92.3
2006-2007	403.4	217.1	620.5	296.2	324.4	259.8	64.6
2007-2008	296.2	207.4	503.6	256.2	247.4	192.1	55.3
2008-2009	256.2	201.5	457.7	239.2	218.5	140.0	78.5
2009-2010	239.2	214.9	454.0	237.7	216.4	116.0	100.4
2010-2011	237.7	187.6	425.3	208.2	217.1	118.8	98.3

(Source USDA-AMS Tobacco Stocks as of April 1, 2012. TOB-218. June, 2012.)