

# Lehman Brothers Kuhn Loeb Research

INDUSTRY COMMENT

## THE NEW CENTURY: NEW PACKAGING, NEW PRICING MAY HELP CIGARETTE INDUSTRY CONSUMPTION

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John C. Maxwell, Jr.

On May 24, R.J. Reynolds announced a new cigarette product called Century. It will be marketed in two types -- one with 16 milligrams of tar, the other with 10 milligrams. Century cigarettes will come 25 to the pack and nine packs to the carton, rather than the customary 20 and 10 respectively. The product should be in 65% of the U.S. market in a couple of weeks, but will be excluded at first from some major markets because of state tax procedures that are based on 10 cigarettes and multiples thereof. We expect this situation to change.

The wholesale price of Century will be \$22.76 per 1,000 rather than the normal \$26.90, which would indicate a savings of more than a dollar per carton at the grocer. Reynolds indicates that it will concentrate on carton sales. It believes it will not be necessary to have as much sustained advertising or marketing money behind Century as it would behind a regular product, and it also expects to save some money on packaging with only nine packs per carton. Thus RJR expects to maintain margins on this product.

We had anticipated this move. As we pointed out in our first quarter cigarette report (April 21), "It is entirely possible that we are moving toward price bracketing as is the case in the rest of the world, with diverse pack sizes, pricing and cigarette sizes the rule rather than the exception. We would not be surprised to see one of the majors come out with an economy brand priced somewhere between generics and regulars."

We therefore look upon the Reynolds move as a positive for the cigarette industry rather than a prelude to a price war. A price war means cutting prices on old products, as it happening now with Coke and Pepsi. The Century cigarette is a new product representing a new pricing and packaging area, and it obviously fills a consumer need. As we have pointed out, generics now have 2.5%-3% of the domestic market, indicating consumer demand for a less costly cigarette. Century appears to meet that demand, and will likely take a meaningful share of its growth from the generics. It should be noted that until now, the cigarette industry has been one of the few consumer areas with a single pricing/packaging level. In the case of wine, autos, etc., the buyer has a wide range of choices.

With a great deal of assurance, we look for Philip Morris and Brown & Williamson to come out with similar new cigarette entries. Whether these will turn out to be 25 to-the-pack types or fall into other packaging and pricing areas, we

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obviously do not know at this time. However, we believe that we are getting into a kind of price/packaging market that is common around the world, and that this has come about because the retail price of a pack of cigarettes is approaching \$1.00. Most countries have at least four or five price/packaging categories. This pricing/packaging mode obviously is not feasible when the price per pack is \$0.30-\$0.40.

Our basic outlook for the cigarette industry is bullish. This new trend in packaging and pricing may impact margins slightly over time, but this could be offset by better unit gains. We believe that the ultimate impact will be to (a) retain consumers who might otherwise have left the market; (b) attract new customers; and (c) lend excitement to this rather prosaic market, which in itself should engender new users because of new marketing and pricing techniques. Thus we see no reason to change our earnings estimates for the various cigarette companies.

We also look for an industry price increase on the order of 4%-5% in the next few months. Although the group may remain under pressure for the near future, we continue to recommend purchase of R. J. Reynolds Industries (RJR - 50) and Philip Morris (MO - 57 7/8), as the only companies that we see gaining market share over time.

Lehman Brothers Kuhn Loeb Incorporated managed or co-managed a public offering of securities within the last three years of Philip Morris Inc.