

SMOKING ROOM

U.S. tobacco sees China as salvation

By HILARY KRAMER

The Marlboro Man, symbol of the Wild West, needs to ride into the Far East to survive.

Here in the U.S., Philip Morris International and the rest of the tobacco industry faces enormous pressure with tax increases, litigation risks, rampant counterfeiting and bans in places like New York bars.

As quickly as the number of smokers decline in the U.S., though, they are increasing in developing countries — especially in China, the biggest tobacco consumer in the world, with 25 percent of the world's smokers.

But to reach those consumers, Philip Morris, a division of Altria, must navigate delicate negotiations with the Chinese government, which is eager to hold on to its \$90 billion cigarette monopoly. So far, no foreign tobacco company has gotten permission to enter China.

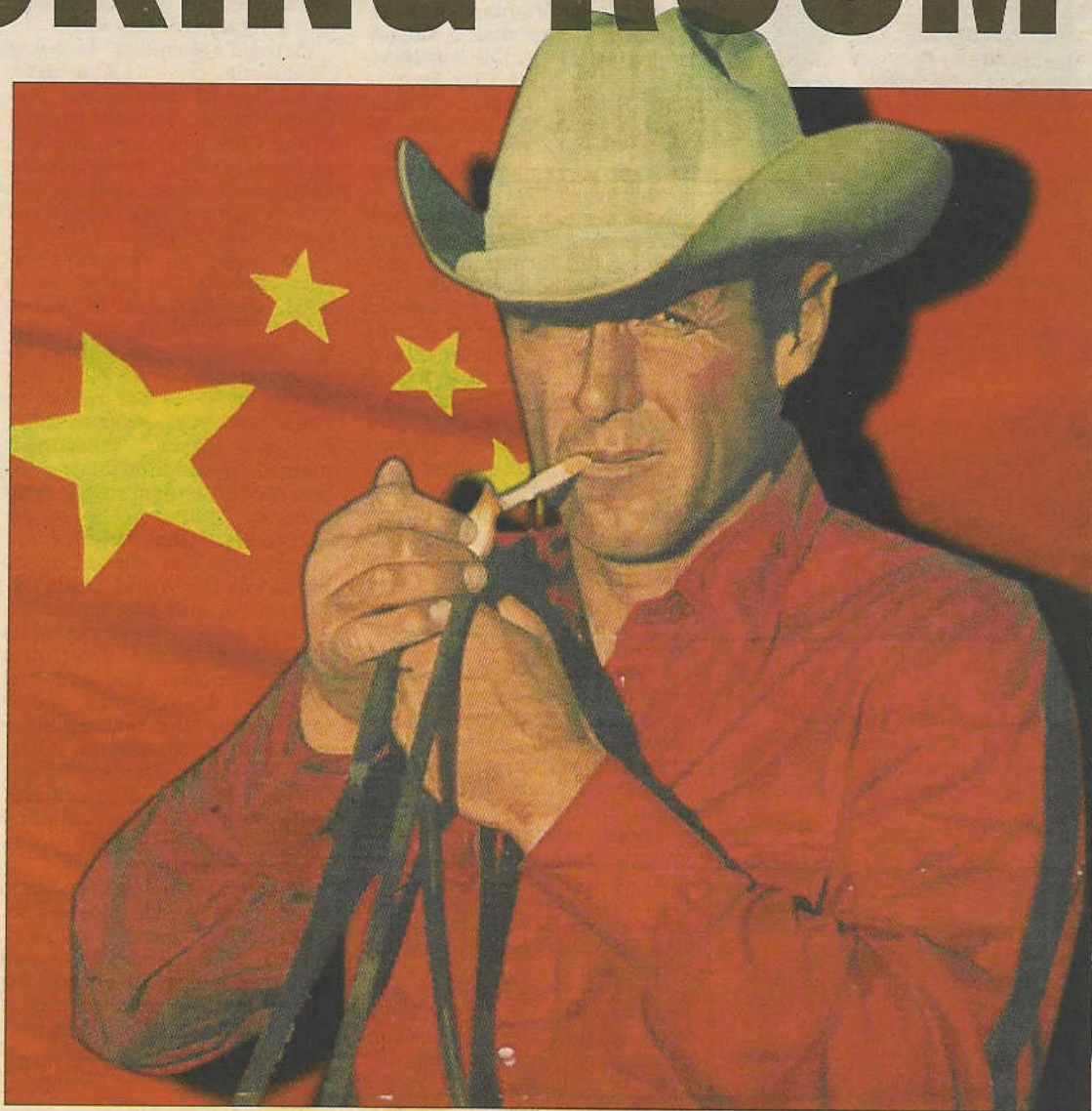
"China is one of our greatest long-term opportunities," said David Sylvia, an Altria spokesman. "Our hope is that the Chinese market will be liberalized to allow the sale of Marlboro, but we expect that the distribution will be handled by the Chinese state monopoly."

Even with that limitation, the potential is tremendous. Just 10 percent of China's market share would equal \$17 billion in revenue — more than all of Philip Morris' U.S. sales in 2003.

The sales also could offset the enormous legal judgments that have been levied against Altria and others in the U.S. and Europe. The companies face yet another court case on Sept. 21 — a \$280 billion federal health suit.

In all, 350 million Chinese smoke — 50 million of which are teenagers. Sixty-two percent of Chinese men smoke, but fewer than 7 percent of Chinese women do, which could change as social pressures ease.

This translates into huge money for the Chinese government. The tobacco business, operated through the State To-



bacco Monopoly Administration (STMA), recently announced that the Chinese tobacco industry's total profit was more than \$12 billion — along with additional tax receipts of more than \$8 billion.

"There's resistance by the Chinese government to allow in foreign competition," said David Adelman, a food and tobacco analyst for Morgan Stanley. "The Chinese enjoy the \$80 to \$90 billion in sales as well as tax income. This is a profitable business and they're naturally hesitant to jeopardize its future."

The Chinese also are touchy about negotiations. Last month, British American Tobacco announced that it would be the first foreign company to manufacture cigarettes in China. BAT publicly stated that China Eastern Investments was its local partner in the

building of \$1.5 billion factory capable of producing 100 billion cigarettes annually.

But the Chinese government, annoyed by the announcement, denounced the agreement as false and, according to industry insiders, BAT's punishment "for jumping the gun will be a decade or two of waiting outside the gates."

But there's hope for the tobacco companies, Adelman said.

"Ultimately, China will allow foreign companies to come in and compete on what will eventually be a level playing field. There have been many prior monopolies privatized in the world and the consistent sight is a foreign manufacturer gaining market share," he said.

As for the Marlboro man, he could ultimately be a dominant player in China. Today, no Chinese brand has more than a 2 percent share, with

no main brand. Analysts are bullish on Philip Morris's prospects for dominance.

Global prospects have U.S. analysts changing their minds about once-stagnant tobacco stocks. Merrill Lynch analysts project Altria will pop from \$49 to \$63 a share in the next year — a potential return of 38 percent. Smith Barney Citigroup recommends Altria with a \$65 stock target.

As for the lawsuits, Adelman said Altria has managed its cases well, and doubts that the company is heading for future trouble with foreign governments.

"Internationally, there are no opportunistic plaintiff attorneys and no class action capacity," he said. "The Chinese government is also in the cigarette business and won't sue itself... and many countries won't want to give up the tax revenue."