

U.S. Tobacco Situation and Outlook

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Tobacco Products

The U.S. Food and Drug Administration (FDA) continues to work on implementation of the Family Smoking Prevention and Tobacco Control Act. FDA published the final regulation requiring color graphics depicting the negative health consequences of smoking appear on cigarette packages. The Tobacco Products Scientific Advisory Committee (TPSAC) of FDA published recommendations that cigarettes not contain menthol flavorings. Other flavorings had already been banned under the new legislation. What sort of restrictions FDA will actually implement on menthol cigarettes and its impact on tobacco is still uncertain. TPSAC is ready to begin examining the health consequences of dissolvable tobacco products and how they should be regulated. Mixed with the issue of dissolvable tobacco products is how to regulate harm reduced tobacco products. Recommendations on the use and marketing of harm reduced products will potentially have a substantial impact on the demand for tobacco since harm reduced products likely will contain less tobacco per unit.

Cigarette excise taxes continue to climb. The average state excise tax per pack was \$1.45 at the end of 2010, up from an average of \$1.32 at the end of 2009. The federal excise per pack was raised from \$0.39 to \$1.01 in 2009. The average price per pack of cigarettes in the U.S. was \$5.55 at the end of 2010 with \$2.46 of the price per pack being state and federal excise taxes.

As of July 1, 2011 22 states had laws in place that completely banned smoking in non-hospitality workplaces, restaurants and bars. Another 12 states ban smoking in either restaurants and bars or the workplace. U.S. cigarette consumption decreased 5 percent per year in each year 2008 and 2009. From 2009 to 2010 cigarette consumption fell over 8 percent to 307 billion pieces. However, data through the first seven months of 2011 reveal that U.S. cigarette consumers may have adjusted to the relatively large price hikes in recent years as U.S. consumption (as well as U.S. cigarette production) is only down around 2 percent so far this year.

Alternatively, U.S. smokeless consumption continues to increase, following trends established over the past two decades. Last year, snuff production was up 6.5 percent and increased another 4.4% during the first seven months of 2011. Smoking restrictions, successful marketing of traditional as well as the introduction of new products, along with perceived lower health risks have collectively benefitted the smokeless sector in recent years.

Flue-Cured Situation and Market Outlook

The 2011 U.S. flue-cured tobacco crop was characterized by extreme weather conditions reducing both yields and quality. Much of eastern North Carolina east of Interstate 95 was under extreme drought conditions during much of the growing season. Then early in the harvest season hurricane Irene passed over eastern North Carolina dumping much needed rain but also causing severe wind damage; especially east of Interstate 95. Much of the crop in eastern NC had significant wind damage. As of October 1 USDA-NASS estimated NC flue-cured yields at 1,700 pounds on 168 thousand harvested acres down from an August 1 estimate of 2150 pounds per acre for forecast North Carolina flue-cured production of 285.6 million pounds.

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	27.0	285.6	23.2	46.8	382.6

(Source: USDA, NASS, Crop Production Report, October 2011)

The rains from hurricane Irene helped some of the NC piedmont flue-cured tobacco crop. The biggest concern for tobacco in piedmont NC and south side Virginia was a late harvest and danger of frost. Virginia's flue-cured crop for 2011 was estimated at 46.8 million pounds. The crop in Georgia and South Carolina was estimated at 27.0 million and 23.2 million pounds, respectively. The USDA-NASS October 1 crop estimate places 2011 U.S. flue-cured tobacco

production at 382.6 million pounds. U.S. flue-cured production in 2010 was 452 million pounds.

The 2011 Brazilian crop of flue-cured tobacco was reported to be over 1.5 billion pounds (Universal Corporation "World Leaf Production," August 4, 2011). This is the largest Brazilian crop since 2005 and 200 million pounds more than initial forecasts for the 2011 crop. With the U.S. crop initially expected to be 475-500 million pounds, excess supply of flue-cured tobacco was a concern. However the reduction in the 2011 U.S. crop due to extreme weather has removed much excess supply from the global market.

Prices offered in contracts signed in spring 2011 were mostly flat to slightly higher than 2010 contract prices. A new potential buyer emerged in spring 2011 and signed contracts with numerous growers for reportedly over 100 million pounds. For most growers the amount signed with this buyer was a small portion of their total production. Unfortunately, this new buyer was not able to purchase the tobacco for which it had signed contracts. Since hurricane Irene had destroyed a large portion of the 2011 crop, demand was sufficient from other buyers to take any pounds growers had produced for the new buyer. In addition another leaf dealer offered to honor the contracts with the new buyer.

Prices received at harvest are quite variable depending on quality, in particular the extent of storm damage. The reduction in supply due to hurricane Irene prompted at least one buyer to increase prices paid by \$0.05 per pound. Farmers fortunate enough to have good quality tobacco received premium prices.

Total use of U.S. flue-cured tobacco was down for the 2010 marketing year. Domestic use was up from the 2009 marketing year, but exports were down over 40 million pounds. The drop in exports for the 2010 marketing year is not surprising given that production for 2010 was down from 2009. However the main factors driving exports lower may have been the poor quality of much of the 2010 crop and the large supply of Brazilian tobacco that became available in early 2011 (the second half of the 2010 marketing year for U.S. flue-cured tobacco). Exports for the 2011 marketing year would have likely recovered had so much of the 2011 crop not been lost to drought and hurricane Irene. Domestic use and exports will likely decrease again for the 2011 marketing year but not as much as the decline in production since manufacturers will probably draw down stocks to partially offset low 2011 production.

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

(Source USDA-AMS Tobacco Stocks as of July 1, 2011. TOB-215. September, 2011. USDA-FAS.GATS)

Burley Situation and Market Outlook

U.S. burley farmers were facing many of the same adverse demand conditions entering the 2011 growing season as they experienced in 2010 – declining domestic demand, excess world burley supplies leading to slumping exports, and regulatory uncertainty on both the domestic and international front. Aggregate burley contract volume was likely reduced again in 2011, but some buyers actually did boost contract volume for some growers. Despite excess world burley supplies, high quality stocks entering 2011 were fairly tight following the disastrous 2010 U.S. burley crop, along with subpar quality crops in 2007 and 2008. Thus some companies may have boosted contracts of their “better” quality growers to replenish depleted inventories. Another potential reason could be a rebounding in the share of U.S. burley in domestic blends. Imports have plagued the U.S. burley industry for decades and continue to make up a large percentage of domestic blends. But disappearance data (see table below) indicate that U.S. burley use has actually increased in recent years even with declining domestic cigarette consumption.

While there has been apparent renewed interest (at least in the short-term) for U.S. burley by domestic buyers, the largest portion of the crop is purchased by the international market. Similar to U.S. flue-cured, the value of the dollar has kept U.S. burley price-competitive in the world market in recent years. But a doubling of burley production in the African market from

2007 to 2009 flooded the international tobacco market, displacing U.S. burley around the globe the past couple of years. Plus, it appears that manufacturers and dealers worldwide are lowering their ideal desired inventory levels in response to uncertainty over potential flavoring bans and due to technological advances in cigarette manufacturing as they attempt to minimize storage costs and speculative risks. Consequently, U.S. burley exports have slumped by more than 50 percent since 2007 which has had devastating impacts on a crop that had previously sold nearly 75 percent of its production to international customers.

As a result of these and other adverse factors, U.S. burley acreage is forecast to be down 8 percent in 2011, with 9,000 less acres in Kentucky, but 1,000 more acres in Tennessee and 400 more acres in Virginia relative to last year. Burley acreage is also up in Pennsylvania, which has emerged as an important source of U.S. burley in the post-buyout era. Speculation that North Carolina would expand burley acreage after quota restrictions were lifted has not materialized due to relatively low yields and high production costs. Belt-wide yields for the 2011 burley crop are forecast to be below average in response to excessive heat and dry conditions in parts of the burley belt. According to the October USDA crop report, the U.S. burley crop is expected to total 173 million pounds in 2011, 9 percent lower than last year's 188 million pound crop.

Table 3: U.S. Burley Tobacco Production, 2004 to 2011, 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	23.8	10.7	3.4	7.5	173.4

(Source: USDA, NASS, Crop Production Report, September 2011)

Relying on the August 2011 Universal Leaf Tobacco Company Production Report, world burley production is estimated to be 2 percent higher in 2011, following a 9 percent reduction in 2010.

According to the report, 2011 burley production in Brazil is up 30 percent while African production is virtually flat from 2010, but 7 percent off its record crop in 2009. Despite the boost in Brazilian burley, high quality burley stocks remain relatively flat in the world market – especially given that some industry representatives claim the September 2011 USDA estimate for U.S. burley may be too high.

On the demand side, domestic use of U.S. burley surprisingly has rebounded some of late, despite declining U.S. cigarette consumption. Technological changes in cigarette manufacturing and introduction of new tobacco products has likely reduced overall domestic use per cigarette, so evidently U.S. burley use has been gaining relative to imported burley in the U.S. market in recent years. But the extremely poor quality 2010 crop likely limited additional market share gains for U.S. burley in manufacturing U.S. cigarettes in 2011 and into 2012. On the international front, U.S. burley leaf exports continue to slump. Following its record high of nearly 260 million pounds in the 2006-2007 marketing year, U.S. burley exports fell to 116 million pounds in the 2009-2010 marketing year and will likely come near that level when the 2010-2011 data are finalized. Combining projections for domestic use and exports, U.S. burley disappearance likely fell below 200 million pounds for the 2010-2011 marketing year.

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				

(Source USDA-AMS Tobacco Stocks as of July 1, 2011. TOB-215. September, 2011. USDA-FAS.GATS)

Assuming a decent curing season evolves, the structure of contract prices coupled with the stocks situation indicates that U.S. burley prices should rebound back to into the \$1.70s and

1.80s per pound for the upcoming marketing season after the extremely poor quality 2010 crop averaged \$1.50 per pound, with many growers receiving less than \$1.00 per pound for inferior leaf.

Burley's outlook beyond 2011 hinges critically on a multitude of uncertainties including the following:

- Will the U.S. burley export market rebound? This will be very dependent on what evolves with respect to international flavoring/additive regulations, foreign burley production, exchange rates, and potential sales in the all important Chinese market.
- What impact will future FDA policies have on domestic burley demand and required production practices?
- What about consumer acceptance/make-up of new tobacco products in midst of expanding regulations and public smoking restrictions?
- What about labor cost and availability versus adoption of "affordable" mechanization?
- How will profitable alternative ag enterprises impact future U.S. burley production and the number of farmers growing the crop?

Dark Tobacco Situation and Market Outlook

The situation for U.S. dark tobacco growers is much different from what most other tobacco growers are experiencing. Dark continues to benefit from growing domestic snuff sales and limited foreign competition, which has resulted in profitable prices and an optimistic outlook for most U.S. dark tobacco growers in the post-buyout era. Following two straight years of supply adjustment, it appears that the industry once again is close to an acceptable supply/demand balance.

According to the USDA's October crop report, U.S. dark fire-cured acres are up nearly 7% in 2011, while dark air-cured acres are relatively flat from 2010. Total U.S. dark fired production is pegged by USDA at 52.4 million pounds, compared to 48.4 million pounds in 2010. For dark air-cured, USDA is projecting a 2011 crop of 15.6 million pounds up slightly from last year. Look for dark tobacco prices to remain near recent levels (\$2.25 per pound for dark air-cured and \$2.50 per pound for dark fire-cured) for the 2011-2012 marketing year.