AHEAD OF THE CURVE

Even as cigarette volumes decline, independent leaf merchants are doing good business supplying new and existing niche markets.

By George Gay

"We decline new sales regularly due to short supply." Now there's a statement designed to make the average businessperson wince. And it is one that you are unlikely to have heard much in relation to the wider tobacco industry. But it was one made by John Wallace of Leaf Only as part of an email exchange that *Tobacco Reporter* had with four independent leaf dealers in January.

The issues of leaf volumes and in-demand types and qualities were being discussed when Wallace said it was difficult to figure out if the overall demand for tobacco leaf was increasing or decreasing, but that demand for certain varieties and types of tobacco had increased during the past couple of years. Specifically, broadleaf wrappers such as Connecticut and Pennsylvania were increasingly in demand, as were dark air-cured wrappers.

"As far as I can tell, it's a classic case of supply and demand," said Wallace. "Cultural changes in the USA as well as abroad are big contributors to this. Manufacturers need wrapper leaves to create innovative tobacco products, and it seems like we just can't buy enough wrappers. We decline new sales regularly due to short supply."

Although Kohltrade's Hardy Kohl Jr. did not mention supply-side shortages, he had a similar take on the demand situation, saying it was perhaps the case that demand was decreasing in respect of some types and varieties but increasing for others, such as niche products. "Our main focus is still on Virginia and burley from Brazil, Africa and India, but we see an increasing request and sales for shisha tobacco and some other specific grades like Kentucky fire-cured, fermented and dark-fired for specific solutions," he said.

Efe Abdullahoglu, manager of business development and strategic planning at Star Agritech International (SAI), was broadly in agreement with both Wallace and Kohl. He put some numbers on the fall that had occurred in leaf tobacco usage by saying that, from 2016 to 2017, global cigarette consumption had fallen by about 5 percent from 5.7 trillion sticks to 5.4 trillion sticks, a fall that, in 2017, had embraced even China, which hitherto had recorded increasing consumption. He attributed the decline, which had continued last year, partly to a shift in consumers' preferences to innovative products such as e-cigarettes and an increased awareness of the health risks associated with smoking.

But while the overall demand for leaf tobacco had been falling, he added, demand for derivatives had been increasing as a quest by manufacturers for lower blend prices had come to dominate the market. This quest had seen reconstituted tobacco, cut rolled expanded stems (CRES) and dry ice expanded tobacco take up to 40 percent of cigarette blends—and, at the same time, decrease nicotine contents.

Rainer Busch of NewCo looked at volumes from a slightly different angle. Whereas, he said, industry intelligence

Photo courtesy of NewCo

Rainer Busch


Photo courtesy of Leaf Only

John Wallace, third from the right in the front, with the Leaf Only team.

indicated that volumes were down, looking at current stocks, the demand/supply situation seemed "pretty balanced." However, while expressing hope that the farmers and industry in Zimbabwe would be able to grow, buy, process and export the coming crop, he added a warning that the current political situation in Zimbabwe might put pressure on other flavor markets, especially Brazil.

Although Busch did not mention lower blend prices directly, he linked demand to the quest for better yields. Demand, as always, was to be seen in respect of competitively priced, medium-quality, good cutting leaf, whether it was filler or aromatic tobacco. Demand was also high for brighter, cleaner scrap tobaccos. But there was less demand for high-quality, expensive tobaccos and for cheap tobaccos with off-taste, bad degradation and poor cutting quality.

Niches

All the above comments seem in line with what you might expect, coming as they do from four independent leaf dealers that, to a certain extent, have their own customers or that supply the different needs of the same customers. Overall, demand is falling, but when you delve down into the details, the niches that the independents have made their own are stronger.

And in the same way, there need be no surprise that not everybody agreed on the demand for quality leaf. Kohl said that Kohltrade, in its 11th crop year, was seeing demand focus on good-quality tobacco. Consumers were becoming more demanding, so the manufacturers that were buying higher-grade tobaccos were doing better in the market. But there's a catch. Better quality tobacco didn't necessarily translate into better prices and margins. The name of the game was balancing quality with price, Kohl added.

For Abdullahoglu, it is filler grades that are most in demand in respect of cigarette tobaccos. There were two main reasons for this. Firstly, while some consumers were shifting to innovative products, others were moving to traditional cigarettes with lower nicotine levels, which implied that the percentage of filler grades in cigarette blends was increasing. Secondly, increasing prices were pushing people to change from premium cigarettes to lower- and medium-segment products. Given that smokers were demanding—unwittingly, of course—more cigarettes with filler grades and given that filler grades were cheaper than flavor grades, manufacturers were in a win-win situation. Even multinationals were shifting some of their production to low-nicotine cigarettes.

Having a good demand for your leaf products is great for business—though, as Wallace mentioned at the start of this piece, this applies only if you can obtain the supplies to meet that demand. And he took this idea a little further when asked specifically about leaf supply. Demand for wrapper leaf was outstripping supply, he said, because not only was it difficult to get new farmers to grow these types of tobaccos, but because even existing farmers faced a conundrum. "While the demand for wrapper leaves is high, the demands for lower grades and filler leaves hasn't changed much—at least in our case," said Wallace. "So if a farmer grows 30 percent wrapper leaf, what is he to do with the other 70 percent? What if a farmer has a bad year and can only make 5 percent wrapper?"

During the past two years, Kohltrade has been going down the route of verticalization to help ensure that it obtains the supplies it requires. Currently, it buys 20 percent of its needs directly from farmers and has it processed on third-party threshing lines, but it hopes to grow this proportion to 50 percent during the next two years.

SAI, meanwhile, believes that it is important to be fleet-of-foot when it comes to geographies. The company was able to obtain the tobacco it needed for its customers only from the regions where it was strong, so the trick was to foresee the shifting demand trends—something that SAI had done when it moved its major leaf-sourcing capabilities from Africa to South America. It was important to grasp what people were going to need on a global scale and act before that trend changed.

Advance notice

Also on the question of supply, Busch brought up an issue that has been around ever since leaf dealers first supplied tobacco to manufacturers. While NewCo could obtain pretty much whatever its clients required, it could be of even better service if they provided more advanced notice about their volume requirements and, especially, price targets, he said.

But on the question of prices, Busch seemed relaxed when asked if, along with the other independents, he was able to obtain good prices for the tobaccos he supplied or if he felt that he was being squeezed. "Of course," he said, "offers are submitted with a kind of wish price but are always negotiable. Once a client has approved the quality and shows serious purchase interest, we usually are able to close a deal that's good for all the parties involved."

Abdullahoglu, too, was confident about negotiating prices that worked for all parties, partly because SAI is good at predicting trends. "We know and understand tobacco; we like to get our hands dirty in the field," he said. "The mobility of our young and ambitious team makes us capable of finding the right product for the right market with the right price."

Kohl, however, felt that margins were sometimes squeezed by customers who sought better quality tobacco at the same price. This meant that dealers needed to be more efficient and work with bigger volumes.

For Wallace, the question of price again went back to demand and supply. "For some varieties, we are able to maintain good pricing," he said. "If competitors undercut us, we can usually just wait for them to run out. When the global supply for particular leaves is short, it doesn't make much sense to sell at reduced margins. For other varieties where supply isn't an issue, we have to make sure our prices are very competitive."

Very satisfactory

Of course, the proof of the price pudding is there to see at the end of the year. So how did these companies fare last year and are they confident about this year? Kohl said he couldn't complain about 2018 because the company had met its goals, but he was more upbeat about this year. He said he was very optimistic about 2019 because of the quality and volume of the crop in Brazil, because the new government there seemed supportive of business and because a more stable political situation would mean fewer currency fluctuations. This all added up to the prospect of a sales increase this year despite the increased competition in the market.

Abdullahoglu was in no doubt about 2018 because SAI had increased its revenues by 200 percent, or about 2019, when it plans to increase its revenues again by 200 percent. The company, which last year was rebranded from Star Tobacco to SAI, is now engaged in its latest initiative: New World Luxury Brands, which is going to compete in the cigar and pipe markets.

NewCo is said to have had a "very satisfactory" year in 2018 and is expecting the same in the future. Indeed, as this report was being prepared, the company was enlarging its service team and moving into bigger offices in the same town in Friedberg, Bavaria, Germany. The newly renovated offices that occupy four floors and that were originally built in 1547 are in the heart of the old city next to the town hall. "Our business is not driven by growth but by sustainability and the satisfaction of all trade participants," said Busch. "We are very

Photo courtesy of Leaf Only

Dark air-cured wrappers have been in high demand.

Photo courtesy of Star Agritech International

Star Agritech International's headquarters in Istanbul

happy with our clientele and have built up a mutually beneficial cooperation with most of our suppliers."

Wallace also hinted at a very practical sustainability in saying that 2018 had been another record year for Leaf Only, and it was the company's hope that it could continue its growth in helping farmers sell their crops for many years to come.

Investments

So if independents are obtaining reasonable prices on at least some of the tobacco they are selling, the question arises as to whether they should be investing, and if so, in what? And here, as if to underline their independence, each of the companies had a different take on investments. In line with the increase in demand for derivatives, Abdullahoglu said, SAI had invested in two reconstituted tobacco factories in 2018, one of which had opened in December and the other of which is scheduled to open in April. In addition, SAI had made an initial investment in a greenfield CRES plant in Malta and was evaluating another opportunity in Indonesia. At the same time, heat-not-burn products and electronic cigarettes comprised another area that offered huge opportunities, he said, opportunities that SAI had already started looking into.

Kohl, who pointed out that investment could sometimes amount to a question of survival, said that Kohltrade was currently investing in technology, marketing and verticalization.

Busch made the point that there was a time and place for investments. For instance, NewCo had made an investment in a new DIET line that was built at a Continental Tobacco site in Hungary in 2013, he said. But he was not convinced that this was the time to be making investments, and, for sure, he added, this was not the moment to be investing in further threshing capacities. He did, however, concede that if a company had surplus cash, it could consider investing in crop financing in countries with high interest rates.

Finally, staying true to the name of his company, Wallace said that stocking up on tobacco leaves that were in short supply and high demand was a good idea. "Whatever it takes to get them," he said. "Just pay careful attention to quality because if the quality isn't there, customers won't buy them. It's not difficult to lose 50 percent of your investment on subpar tobacco."

Although focused investments were seen to offer some opportunities, none of the companies that took part in the interview saw much, if any, opportunity arising if or when merchants took their eyes off the tobacco ball as they sought to score from ventures into other industries. Indeed, there was some concern that independents were being squeezed out of the marketplace, in some cases because they had simply bet on the wrong horses. Busch suggested, for instance, that there had been some attrition among independents who had committed to farmer crops and invested in factories. But, by contrast, individual traders had increased in numbers, he said. A lot of leaf experts who were reaching retirement age were enjoying prolonging their connection to the trade by maintaining their contacts and relationships. At the same time, others who were losing their jobs before retirement were realizing that they could maintain their incomes by trading small volumes.

Finally, *Tobacco Reporter* asked about sustainability. Was the current system of leaf production, purchase and trade sustainable from the point of view of independents? At this point, Kohl, Wallace and Busch seem fairly relaxed, but Abdullahoglu was clearly concerned about the situation in Africa. Tobacco growers in Africa always struggled with their leaf tobacco production and trade because there were a handful of buyers in the market that dictated purchase prices through their hired intermediaries, he said. African contractual farmers were supported, at the start of the season, with the purchase of tools, equipment, seed, etc. But these items were sometimes provided at inflated prices that were deducted from their selling price.

Additionally, he said, these contracts were generally for a single year, which failed to provide long-term financial security. And the other important aspect was the unpaid family labor (poverty limits farmers' ability to employ paid labor), whose costs were not reflected in the final purchase price.

Such issues seem bad enough in isolation, but Abdullahoglu said that these problems were unknown in the U.S. or South America, where growers had the protection of farmer unions and associations, which seems to raise some uncomfortable questions about just why the situation is as it is in Africa. TR