

Philip Morris—Puffing Away In Japan

By Jack Burton

Philip Morris K.K. is a big fish in a small pond. The Japanese subsidiary of the American tobacco giant has a 75 percent share of the imported cigarette market, although foreign brands account for only 2% of all cigarettes sold in Japan. Dealing in Japan since 1952, Philip Morris has achieved success in Japan with two charcoal filter cigarettes, Lark and Parliament. Recent moves by the Japanese government to liberalize the tobacco market have raised expectations that Philip Morris and other foreign cigarette makers can boost their sales in Japan. Philip Morris K.K. was established April 1 this year to take full advantage of the liberalization. But Philip Morris K.K. President Guy R. Aelvoet remains critical about obstacles facing his company and others in the competitive Japanese cigarette market, which is dominated by Japan Tobacco Inc., the recently denationalized successor to the Japan Tobacco and Salt Public Corporation. Aelvoet, former vice president-marketing for Philip Morris, Asia, first came to Japan in 1975 for two years and then returned in 1982 to assume his present position.

Q: On April 1, the Japanese government liberalized the market for tobacco products in Japan. What were some of the liberalization steps that made it easier for foreign tobacco companies here?

A: First of all, I think we have to clarify the word "liberalization." The market is liberalized in as much as the government has liberalized the importation and distribution of tobacco products in Japan. It has not liberalized the manufacturing monopoly and it still keeps the market very well protected by the imposition of an import duty. However, I believe that the Japanese government has taken very positive steps in starting to open the market for foreign-manufactured cigarettes. We have much more flexibility than we had ten years ago. The liberalization process started in October 1980 with MAD (marketing, advertising and distribution) negotiations. And April 1 is really the consequence of trade negotiations between the governments of the U.S. and Japan on the question of to-



Philip Morris K.K. President Guy R. Aelvoet
photo: Caroline Parsons

bacco. We feel that the actions the Japanese government has taken on the tobacco industry are a far cry from what was recommended by the Doko committee and there is still a lot of ground to be covered before this market can be called open.

Q: What obstacles remain?

A: The major obstacle we face is really the pricing of our products. The price differential between our products and the major domestic brands is caused by the imposition of an import duty, which is multiplied by the excise system—the national consumption tax and the national tobacco tax. For us, that tax is 85 percent *ad valorem* and 15 percent specific. The *ad valorem* portion of the excise tax multiplies the 20 percent import duty to approximately 40%, so we are faced with a price differential that certainly limits the growth of our products in this market for at least the near future. We have repeatedly asked the government to consider revising the taxation system so that if there is going to be an import duty, then that import duty will be the only penalty we will have to face in entering this market.

Q: But the Japanese government says that the import duty in America, for example, on foreign cigarettes is the same as it is here.

A: That is correct. But the difference is that the federal excise tax system in the U.S. is 100 percent specific and thus the

only differential that a foreign product pays to enter the U.S. is the import duty, whereas here, the import duty is multiplied by the excise tax, what we call the tax-on-tax system, which doubles the import duty.

Q: Do you see any progress being made on lowering the import duty?

A: The way we see it, either the government reduces the import duty or opens its market to manufacturers or acts to maintain the import duty at its true level. We don't want to dictate to the government of Japan how it should solve the tobacco issue. However, it is truly unfair to talk about liberalization when you are forcing an equivalent competitive product to pay a 40 percent price differential. American cigarettes are competitive everywhere else in the world. There is absolutely no reason why they can't be competitive in Japan. Research shows that of all smokers in Japan interviewed, at least 60% have bought or smoked our product in the last six months, but can't afford to buy it on a regular basis because it is too expensive. So we are not talking here about "your product can't sell in Japan because it's not suited to the Japanese consumer." In fact, two of the major monopoly products are direct copies of our own brands that have found very good acceptance with Japanese consumers. Cabin is a direct copy of Lark and the recently-introduced Cosmos is a fairly blatant copy of our own Parliament. It's really a matter of the government protecting its industry. They have good reasons for doing so, but if you want to protect an industry don't talk about a liberalized market.

Q: If Japan Tobacco Inc. (JTI) gave up its manufacturing monopoly, that would mean you could manufacture cigarettes in Japan, which in turn would bring down the price of your cigarettes.

A: Or if the Japanese government wants to maintain its manufacturing monopoly, it should abolish the import duty because there is no reason to have an import duty when you don't allow other people to manufacture here. In

the U.S., there is an import duty because anyone can go into the U.S. and invest in the tobacco business and make cigarettes there. In fact, two out of the six tobacco manufacturers in the U.S. are foreign-owned.

Learn to be competitive overseas

Q: *Why do you think there has been so much trouble in opening up the market? Is it because the Japanese government has owned the tobacco monopoly?*

A: Japan is not unique in this sense. There are still many government monopolies around the world, including ones in France, Italy and Austria, and in Asia, those in Korea, Taiwan and Thailand. It's a very easy way to collect money; it's an easy way of indirect taxation. The Japanese monopoly was created in 1904 during the Russo-Japanese war and has been used as an indirect tax collector ever since. Until March 31, it was just that. It didn't make any profits, it just collected taxes and remitted them to the government and in return it got a budget on which it operated. It served as a very good political protector for the tobacco farmers. Here is the real reason why the government is in a difficult political position, because of its historical protection of the Japanese farmer. The government has, by the nature of its political system, protected the farmers. We have no qualms about that. What we have problems with is that there has never been a dialogue between foreign manufacturers and Japanese tobacco leaf growers. Nobody is saying that we wouldn't use Japanese leaf if we were able to manufacture in Japan. What we are saying is that if you want to protect your industry and continue to protect your farmers, why don't you join us in international competition. And to learn to be competitive overseas, let us come here and be competitive. I think that message has never got across to the farmers or to the JTI labor force. Everybody is focusing on us as the villains coming here to break rice bowls, to take jobs away from Japanese. That is absolutely untrue.

Q: *You mentioned before that France and Italy have tobacco monopolies. But American tobacco manufacturers, I believe, have still been able to capture about a quarter of the market in those two countries. Why have American tobacco companies been successful there, but not here? What are the obstacles you face in Japan that you don't face in France and Italy?*

A: The French and Italian monopolies became unglued because of the Treaty



Philip Morris K.K. holds 75% of Japan's imported cigarette market.

of Rome and the formation of the EEC. We don't mind having monopolies in Europe because we can manufacture in a non-monopoly country, such as West Germany or Belgium or Holland, and ship freely to Paris or Rome. That is the major difference.

Q: *If the market was completely liberalized, what would be the foreign market share?*

A: That is very difficult to predict. We cannot predict whether our market share will be 3 or 5 or 10%. But if we were able to sell our products to the Japanese consumers at a price they are willing to pay, I think the picture would change in Japan. Not in the next year, but in the normal Japanese time frame, which is 10 to 15 years down the road. I think the tobacco industry, as opposed to many other industries, is a patient one. Market penetration has been gradual in most of the markets around the world, so we are not looking for results in Japan tomorrow. Nobody is claiming that liberalization is not working or that the government is not making the right decisions on liberalization. But don't say your market is open when it is not. Be clear about it. Say "Look, we have an import duty because we want to protect our farmers." Americans are a very simple people. If you tell them that "This is the problem and this is what I am doing about it," they are much more capable of accepting that as a burden than hearing "Well, the market is open and it's you guys who can't do it." That irks.

Q: *When you say that the Japanese aren't forthcoming, would you include as one example the fact that Japan Tobacco Inc. is supposed to be a private company, although all its shares are still held by the government?*

A: The answer is contained in the question. If the government owns 100% of the company and has a 98 percent market share, isn't that a monopoly by definition in anybody's language?

Cigarette advertising

Q: *Until recently, foreign tobacco*

companies were severely limited in the amount of advertising they could do on television due to an ad spending formula that was based on sales volume. However, this restriction has been abolished. What happened?

A: The industry, as in other countries, has a rule of self-regulation concerning advertising. Since 1981, we have lived with an advertising code that was imposed by the monopoly. We had agreed in conversations prior to March 31 to continue it, but that agreement was questioned by the Japanese Fair Trade Commission. We had to abolish the allocation system, so advertising is liberalized with the same set limit for everyone. Ad spending is not based on annual sales volume anymore. Whether you have a one percent share or a 60 percent share, the allocation base is the same.

Q: *Now that Japan has partially deregulated cigarette advertising on television, which goes against the trend in most other countries to clamp down on such advertising, how long do you think this situation will last?*

A: Not long. There's going to be a rush of advertising from everybody. Some of the industry members are more responsible than others. I believe the government will take steps when and if cigarette advertising becomes excessive. The basic law that regulates cigarette advertising in Japan, article 40 of the tobacco law, specifically says that cigarette advertising should not become excessive. I believe that with the recent deregulation, cigarette advertising could become excessive and the government will have no choice but to take steps to limit advertising. I think that within the next 2-3 years we will be faced with a ban on TV advertising.

Q: *Have you noticed any improvements in the sales of your product since April 1?*

A: Not really, but we didn't expect any. As long as that price differential remains, it will be a long time before we can speak about improvements. Of course, the Japanese government and JTI are quick to point out that imports are growing at a "fantastic" rate of 15% per annum,

while Japanese brands are decreasing by 0.4%. Well, I would rather have a decrease of 0.4% on sales of 300 billion cigarettes than a 15 percent increase on sales of 6 billion cigarettes anytime. We are growing and continuing to grow at the same rate as last year, which is a fairly reasonable rate. But at this rate, it will take us between five and seven years to achieve a 5 percent market share and that is unacceptable.

Distribution system works

Q: *Are you still using the JTI to help distribute your products in Japan?*

A: Everybody uses the Tobacco Haiso, which is a distribution company majority-owned by the JTI. It's the only game in town. It is the simplest distribution system you can think of. It goes directly from the manufacturer to the retailer, with no wholesaler. It's simple, so why should we want to break it up? Everybody is claiming that the Japanese distribution system is the most complicated in the world, but here we have a very simple system, so let's keep it.

Q: *But one of the complaints about the pre-April 1 market was that foreign companies were forced to rely on the tobacco monopoly for distribution and there was some suspicion that they were not treating you on an equal par with their own brands.*

A: For the moment they are playing fair. From October 1, we will be on the same delivery frequency as domestic brands. As far as we are concerned, we have no complaints now. Our volume is not big enough now to afford our own distribution system. Another major drawback is the payment of municipal taxes. There are 3,470 municipalities in Japan. Each of them has to be paid on a weekly basis by brand, which we would have to do ourselves if we set up a separate distribution system. If the Haiso performs fairly, if it doesn't charge exorbitant prices, I don't believe it is in our interest to change. If worse comes to worse, we will do our own distribution. It's their choice and they make good money from us.

Q: *You are also cooperating with Mitsui and Nissho Iwai. What exactly is their role?*

A: We import cigarettes into Japan through a 100 percent owned Philip Morris subsidiary and sell them to Nissho Iwai for the western part of Japan and Mitsui for the eastern part. In turn, the two trading houses sell the cigarettes to the Tobacco Haiso in their respective areas. But the primary role of Nissho Iwai and Mitsui is merchandising. If you want

to put up point of sale material or install posters, that is the role of Mitsui and Nissho Iwai. This is a role that our sales force in the U.S. does by itself.

Q: *Philip Morris is the most successful foreign tobacco company in Japan with about 75% of the import market. Why are you doing better than other foreign competitors, such as R.J. Reynolds and Brown & Williamson?*

A: Basically because the company has products in Japan that have found favor with the Japanese consumer. We have been in Japan since 1952. We were at one time on the same level as everybody else until we introduced Lark and Parliament, two charcoal filter brands. Because of that, volume sales took off suddenly and we were capable of investing more in R&D than our foreign competitors. It's basically the old story that you hear. If you want to be successful in Japan, you have to pay the price in terms of R&D, product research, people and time.

Q: *Why is Lark, which isn't that successful in the U.S., doing so well in Japan?*

A: It's a question we have asked ourselves many, many times. Why do the Japanese people like charcoal? Charcoal has been used as a purifier in Japan for many centuries. I think the Japanese, with their obsession for cleanliness, associate charcoal with a purifying substance. I don't think Lark was created with that purpose in mind. It just happened to suit the Japanese consumer and it helped popularize charcoal filters to the extent that charcoal filter cigarettes now constitute 72% of the market.

Image but also product quality

Q: *There's a story that Lark got its start in Japan by being distributed widely throughout nightclubs in the Ginza. Is that true?*

A: Sure. So was Parliament, although we don't do it anymore. Foreign brands were always overpriced in Japan so you had to find people with fairly high disposable incomes to buy your product. Going into the *mizushobai* night life area had several advantages. First of all, the customers were on expense accounts so they could charge anything, including expensive foreign cigarettes. The hostesses in the nightclubs wanted to be seen doing the "right" thing and cigarettes were part of that. At the same time, they accustomed customers to that brand. That is really how Lark got started. It used to be smoked by hostesses and then patrons and then it went out from there and became an acceptable brand. Some

people still consider Lark a *mizushobai* brand, although that image is fading. Most of our customers are now in the 24-32 age bracket.

Q: *Do you think that people buy foreign cigarettes because they have a certain cachet?*

A: I think foreign brands are recognized for what they are. We use better tobacco, we use better package design and we make better cigarettes. I think if you ask the average Japanese smoker, he understands that American tobacco is good tobacco. So on top of the cachet of paying 40% more, people recognize that they might get a better product taste-wise. Image has a lot to do with it, but also product quality.

Q: *One of the interesting things about Philip Morris in Japan concerns Marlboro, which is your largest selling brand around the world except in Japan. Philip Morris licensed the Japan Tobacco and Salt Public Corporation to manufacture Marlboro, but it is not a big seller here. Why?*

A: At the time the agreement was signed in 1972, Hi-lite was the best selling cigarette in Japan and Marlboro was tailored to the Hi-lite taste. But Marlboro was too little, too late. The full flavor market was replaced by mild cigarettes and Marlboro was a full flavor brand, so it was against the trend. Also people didn't know where Marlboro fit in. It was neither fish nor fowl. It wasn't a domestic product but it wasn't an imported product either and the price was somewhere in between in the ¥260 category. It's been a sore point on both sides, but I believe that it still has a good chance in Japan. Marlboro hasn't emptied its six shooter yet. We are currently renegotiating re-agreement with JTI.

Q: *Why did Philip Morris sign the licensing agreement with the Japan Tobacco and Salt Public Corporation for Marlboro, which is really your ace in the hole since it is probably the most well-known cigarette brand in the world?*

A: The man who signed the licensing agreement is now the chairman of our company, Hamish Maxwell, and he had excellent foresight about Japan. He felt that licensing Marlboro with the JTS insured that Philip Morris would be the closest foreign manufacturer to the largest cigarette company in the free world outside America. If nothing else, I think that Philip Morris is closer in spirit to the Japanese monopoly than any other foreign manufacturer. It has created exchange and communication at all levels of the monopoly. From the president on down to the salesmen, they know us and I think that has been a very positive move. ●