

Strategy Paper
Is Phillip Morris a good fit for Mary Jane?



Team:
Jason McLaurin
O.B. Osifekun

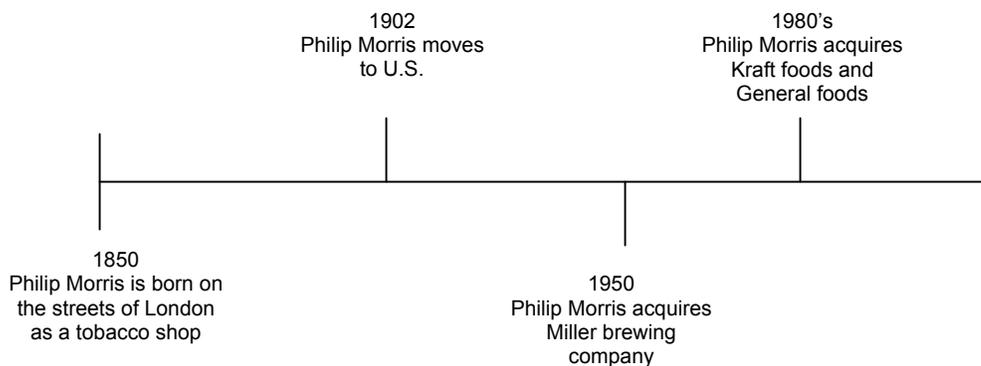
Professor McAfee
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Introduction

Currently there is much debate taking place in Nevada over an issue that appeared on the statewide ballot. If Question 9, had been voted for in the affirmative marijuana in the entire state of Nevada would have been legalized for up to 3 oz (approximately four packs of cigarettes). Although the initial attempt to legalize marijuana was defeated, Robert Kampia, director of the Washington, D.C.-based Marijuana Policy Project, pledged that further legislative attempts in other western states would be made over the next two to four years. Now that changes are coming to play that could legalize marijuana in the near future, a company will have to be prepared in order to capture this emerging market. There is no better company to fill this role then Philip Morris Inc.

Philip Morris found its origin's in London during the mid-nineteenth century as a retail tobacco shop. As time went on Philip Morris grew and was eventually incorporated into the United States in 1902. By the 1950s Philip Morris was making its first attempts at diversification outside of the tobacco industry. In 1969 Miller brewing company was acquired and during the 1980s Philip Morris continued to diversify even further by purchasing Kraft Foods and General Foods. Philip Morris has continued to grow and succeed, on average, in every one of these arenas.¹

Exhibit 1: Timeline of Philip Morris Inc.



History of Marijuana in the U.S.

Marijuana was first brought to the New World by the Spanish by 1545. Hemp was one of the major cash crops in the southern states until 1890, when it was replaced by cotton. During this era some patent medicines contained marijuana for its use in reducing labor pains, nausea, and rheumatism. Its use as an intoxicant was commonplace from the

¹ http://www.philipmorris.com/about_pm/history/pm_history.asp

1850s to the 1930s. In the 1920s marijuana enjoyed extreme popularity in music and show business circles, due to the lack of availability of alcohol during prohibition. In the 1950s it was an accessory of the beat generation; in the 1960s it was used by college students and “hippies” and became a symbol of rebellion against authority. The Controlled Substitution Act of 1970 classified marijuana as having high abuse potential and no accepted medical use. The “zero tolerance” environment of Bush and Reagan led to strict laws relating to the possession of marijuana and increased vigilance against smuggling at the borders. As of now, marijuana is still illegal. Current statistics, however, show increasing use during the 1990s.²

**Percentage of 12th-Graders Who Have Used Marijuana
Monitoring the Future Study**

| | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|-------------------------|-------|-------|-------|-------|-------|-------|-------|
| Ever Used | 36.7% | 32.6% | 35.3% | 38.2% | 41.7% | 44.9% | 49.6% |
| Used in Past Year | 23.9 | 21.9 | 26.0 | 30.7 | 34.7 | 35.8 | 38.5 |
| Used in Past Month | 13.8 | 11.9 | 15.5 | 19.0 | 21.2 | 21.9 | 23.7 |
| Daily Use in Past Month | 2.0 | 1.9 | 2.4 | 3.6 | 4.6 | 4.9 | 5.8 |

3

Philip Morris - Business Analysis

Philip Morris Companies Inc. The Company manufactures and sells cigarettes in the United States. The subsidiaries and affiliates of the Company manufacture market and sell tobacco products and food products worldwide. The product segment of the Company is classified into tobacco, food, beer and financial services. The Company's major premium brands include Marlboro, Benson and Hedges, Merit, Virginia Slims and Parliament. The food segment retails packaged food which includes cheese & cheese products, processed meat and poultry products, coffee, ready to eat cereals, salads, desserts and snacks. The beer segment includes Red Dog and Icehouse. During the year, the Company acquired Nabisco Holdings Corp, Balance Bar Co., and Boca Burger, Inc. Tobacco accounted for 61% of 2000 revenues; food, 33%; beer, 5% and financial services, 1%.⁴ Philip Morris is the biggest distributor of consumer goods in the world.

Competitive Analysis

When analyzed within the Porter framework, the distribution of marijuana could be extremely profitable. Much of this profitability rests upon the role of the government. Regardless of the level governments regulation however, Philip Morris is best positioned to achieve profitability in this industry.

² source: “An unbiased history of marijuana” www.marijuana.com/knowledge/history/Default.htm

³ source: <http://www.druglibrary.org/schaffer/history/history.htm>

⁴ Philip Morris 2001 Annual Report

Threat of new Entrants - Low

The legalization of marijuana in the US must be met with some form of regulation or quality control due to strong political and cultural sensitivity to the issue. Most likely, regulation of the industry would be in the form of licensing to different firms for the production and distribution of the product. Expensive licenses would be granted to the firms that have prior experience in similar industries, like tobacco or alcohol, and prior responsibility in educating the public on the potential dangers of their products. Only a few firms could handle this responsibility. Also, a small amount of firms in the industry will probably be mandatory because the higher number of firms involved, the higher the difficulty of government supervision. Therefore, the threat of new entrants will be low due to strict regulation and the high need for consumer-safety conscious firms.

Rivalry - Low

Due to the environment of heavy regulation and government intervention rivalry in the Marijuana industry will be low. One of the main factors that promote rivalry is the number of firms in the industry. Since a relatively small numbers of firms are suited to enter into this industry, more flexibility in pricing and, therefore, the possibility of profits will exist. Competition would most likely be quality based, with an emphasis on such factors as flavor, smoothness, and mind-altering effects, as is demonstrated by the tobacco industry. In the past, heavy government regulations in other industries (airlines) have often resulted in quality-based competition.

Supplier power – Moderate

The existence of supplier power will also have to do with regulation. If only a few areas are licensed to grow marijuana a small supply will be created, resulting in strong supplier power. High supplier power would allow for growers of marijuana to take a piece of, or even eliminate profits from Philip Morris's standpoint. If, however, the government allows for domestic production to be more flexible, since marijuana is easy to grow, supplier power will be lower. The focus of this analysis is to realize that there could be problems caused by strong supplier power. A company that already does a lot of business with agriculturally based products would have a lot of bargaining power with the same producers. An example of a company with this bargaining power would be one that specializes in, for example, food and tobacco distribution. Getting a large market share early on in the marijuana industry will be imperative for Philip Morris to attain this bargaining power.

Buyer Power – Low

Buyer power, at first, will be extremely low due to the small group of distributors that will be created by regulation. To the initial entrant buyer power will be practically non-existent, since the quantity of marijuana cigarettes that any one entity will buy is unlikely to be a large portion of the whole. Buyer power could also be high. If the government were to allow only one distributor of marijuana based products, there would be extremely high buyer power.

Substitutes

The substitutes of this product will have to fall into two broad categories: legal and illegal substitutes.

Legal Substitutes: The main legal substitutes to marijuana are alcohol and tobacco. Some individuals who prefer to have one or the other of tobacco, alcohol and marijuana will see these three as substitutes. Their substitutability can be seen by the large increase in marijuana use during prohibition. Without competition from alcohol, the popularity of marijuana increased tremendously. However, most individuals consume at least one of the above mentioned products in addition to marijuana. As such, these products could be potential substitutes, but if marketed correctly they could be seen as potential compliments to marijuana

Illegal Substitutes: These products include cocaine, heroine and illegally produced marijuana. The marijuana industry's success is related to how well the Federal Government can control the penetration of illegal drugs into the nation. A strategy that the firm can employ to battle these substitutes is to initiate "educational" programs differentiating marijuana from these illegal drugs. That would allow for old associations of marijuana being in the same classes of these more potent and dangerous drugs to be changed. Another strategy would be to claim marijuana as the only legal--illegal drug. This would create strong incentives to take the cheaper choice with no possibility of incarceration.

Complements

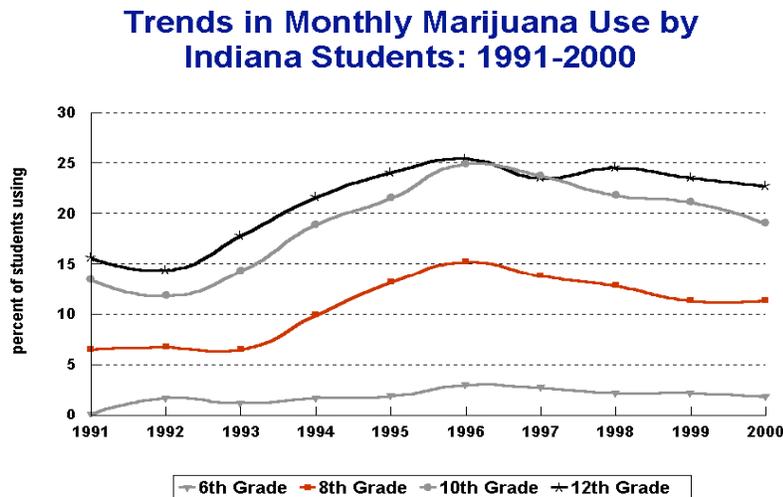
Something that is interesting about the marijuana industry is that substitutes can also be potential complements. A large proportion of marijuana users combine use with other substances such as alcohol and tobacco. A large hurdle for a firm in the marijuana industry is to maximize the advantages of tobacco and alcohol through their uses as complements while minimizing their negative substitutable attributes. Assuming high government regulation, synergies created by complements could be the key to dominance in the industry. Complements could range from free snack foods with the purchase of marijuana to "buy a 12-pack of Icehouse get one pack of Marlboro Greens free." By creating synergies for the buyers more value will be given, and higher profits will be achieved.

Product Life Cycle

The product life cycle of marijuana is another tool to test the viability of this industry. An analysis of the product life cycle of marijuana could give some insight to trends that we may expect in this industry, how long these trends could last and how we should react to these trends. The four phases of each product life cycle are introduction, growth, maturity and decline.⁵ The following is an analysis of these phases as they pertain to marijuana:

Introduction

The introduction phase of legal marijuana in the market will be significantly different from the introduction phase of many other products. McAfee cites the introduction phase as one where consumers are educated about the new product and are induced to try the product. Marijuana needs this to much less of an extent. A 1969 survey (Gallup 1969) showed that 12 persons in every 100 young adults in the U.S had ever tried marijuana. The poll also reveals that an additional five million adults would try marijuana if offered.



Source: Indiana Prevention Resource Center at Indiana University, 2000

The trend in the 90s for students in Indiana can be seen from this graph:

Familiarity with marijuana can be seen from this graph despite its current illegality. In *Marijuana and Social Evolution* by Hochman, he states, "...marijuana smoking has become an increasingly common phenomenon among many groups in the US and can no longer be seen as strictly subcultural or deviant." Thus, the numbers and the statement above show that very little, if any at all, consumer education will be needed for our

⁵ "Competitive Solutions" McAfee

product. Little introduction is necessary for marijuana, consumers are already aware of it and the demand for the product is growing.⁶

Growth and Differentiation

McAfee states that this is the stage where most profits are made, sales grow rapidly, costs fall due to economies of scale, demand increases and costs incurred in the introduction stage due to research and development are recouped. This is entirely true for our product, except that the growth will occur almost simultaneously with the introduction of the product. This occurs for the same reason that the introduction phase is almost non-existent – the product already exists in the black market and is flourishing. McAfee also states that the growth stage is when firms build their brands and differentiate to different varieties of their products. This would be an excellent strategy for Philip Morris to undertake as soon as the product is introduced. The advantage of being recognized as an established brand already exists for the company. Thus, most of the focus of this stage would be not to strengthen the brand name, but more so to introduce variety to the product. This has already been done in the tobacco industry with lights, menthols and slims. At this stage the market settles on a number of preferred designs, therefore production can be focused on them to enable more growth. The length of this phase is open to debate. In the black market the product is still growing and has not slowed down according to the poll results in 1971. This phase is ongoing right now. Additionally, any substance that is more potent would be illegal leaving many who do not wish to take the risk of criminal charges to obtain such products. These facts make the next two phases of the product life cycle highly speculative and open to interpretation simply for the fact that the two have not occurred for the product in the black market. Our analysis of the next two phases will be based on a negative shock to the demand that could be caused by the growth of another closely related industry even though Philip Morris is a major player the only other related industry that is legal.⁷

Maturity

At this point of the product life cycle the demand of the product has peaked and reached a stable level. McAfee states that for a non-durable product such as ours, this demand should be at a relatively high level. He also states that the focus of the firm at this stage must be two fold – minimize costs and stop margins from deteriorating by segmenting the market. Based on the economies of scale that Philip Morris would be enjoying at this point, costs should already be low and our focus would be better aimed at market segmentation. The development of our varieties should be channeled and aimed at different groups of consumers in our markets and the most made out of these market segments. The identification of these segments should be simple enough, starting with

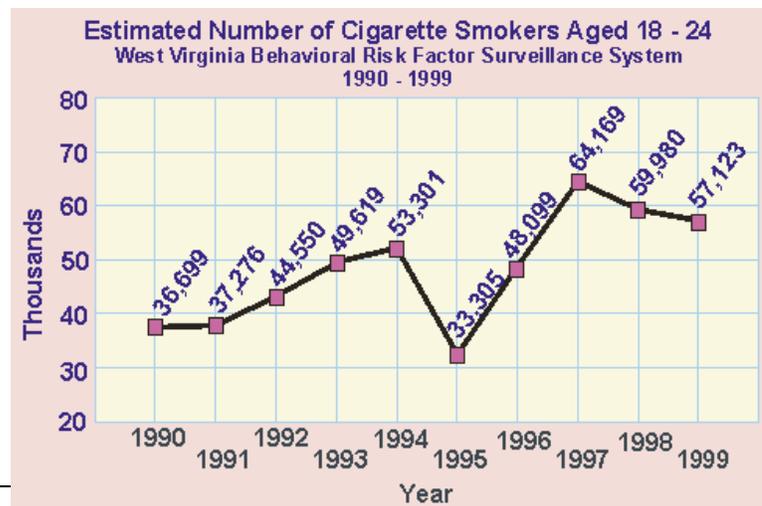
⁶ “Marijuana and Social Evolution” JS Hochman

⁷ “competitive solutions” McAfee

the college freshman to the aging hippy from the fifties and sixties. We should be able to identify a number of segments in this market and develop the best variety of our product to satisfy these different groups of consumers. Once these segments and their corresponding varieties have been identified, our products can then be marketed with the corresponding complements for the different market segments.

Decline

The decline of our product, though hard to imagine, would have to come with the discovery of some new substance. This substance would have to have similar or better effects, have safe side effects and be legal. The process just described, if the substance were discovered today, would take at least some time before the substance would pose such a threat that its introduction to the market would cause a decline on our product. The tobacco parallel that we have drawn on with this product, however tells a different tale. In his book McAfee gives tobacco as an example of a product that is abandoned by many customers. This evidently seems to be true with net revenues in domestic tobacco during the second quarter for Philip Morris is down by 4.4%, a striking difference from being up by 7.8% during the same quarter just a year ago.⁸ So does Philip Morris just harvest and exit industry at this point? A further look at the financial statements shows that net revenues in international tobacco for the same quarter are up by 5.8%. This could give us a clue into the strategy of marketing our product abroad in countries that have not banned the product e.g. The Netherlands. As with tobacco this avenue could prove to be an important one for revenue with a declining market for our product. Looking at how long it took for cigarettes to decline however, it could be safe to say that decline due to abandonment by consumers would not be in the near future for our product. Looking at the decline in cigarette smoking, it would be useful to point out that the demand fluctuates. Looking at the graph below that shows the number of smokers aged eighteen to twenty-four in West Virginia. We see that the graph does not increase or decrease at a steady rate (www.wvdhhr.org):



⁸ www.Philipmorris.com

This might be an indication that the current decline in cigarette smoking is not long term. The current decline might be due to the number of these eighteen to twenty-four year olds who just picked up smoking as a phase. The decline caused by such consumers could be misleading because there is still a relatively moderate level of demand as shown on this graph except for the year 1995. A parallel to this could also be used for the marijuana industry. Any decline in demand might be due to people who abandon it but it could easily rise due to another generation that picks it up. Our products demand is very dependent on social trends so they will see different fluctuations in demand, but none of these fluctuations is a cause to exit from the industry.

Philip Morris – Fit into Marijuana Industry

Experience with consumer goods

Since Philip Morris's conception it has specialized in consumer goods. Two of the major areas that Philip Morris is most experienced with are agricultural and "sin goods."

Philip Morris has over a century and a half's worth of experience in agricultural goods. In fact, all of the goods that they produce are agriculturally based. Philip Morris's experience in this market would give them a huge advantage were they to enter into the marijuana cigarette market. In addition they could cross fertilize their marijuana industry with the several other agricultural products they sell. This would greatly reduce the risk of high supplier power.

Philip Morris has also been extremely involved in the distribution of "sin goods." These goods for the most part include tobacco and beer. Philip Morris has succeeded in alleviating many of the problems that arise from selling these products. Some of these problems include heavy litigation and the lobbying of government officials in order to minimize financial penalties often referred to as "sin taxes."

Marketing Machine

The Philip Morris marketing machine is enormous. Just in 2001 alone they spent close to 33 billion dollars on marketing, administration and research costs with about 1/3 of that going to marketing alone. They also have extensive experience in marketing to different cultures around the world as well as developed regional guidelines for marketing within the United States. Philip Morris easily has the resources to complete the delicate task of marketing and researching the distribution and growth of marijuana.⁹

⁹ http://www.philipmorris.com/docs/investor_rel/2002_FactBook.pdf

Consumer Education

Philip Morris is heavily involved in what they like to call responsible marketing. Responsible marketing is following guidelines and restrictions set by the government for marketing their cigarette segment. Some of these restrictions include:

- forbids participating cigarette manufacturers from directly or indirectly targeting youth;
- imposes significant restrictions on advertising, marketing and promotional programs or activities, including cartoons, outdoor and transit advertising, product placement in media, branded merchandise, free product samples and sponsorships.
- prohibits cigarette manufacturers from engaging in brand-name sponsorships of concerts, events in which minors are a significant percentage of the intended audience and events in which any paid participants or contestants are minors.¹⁰

Philip Morris is no stranger to government intervention. Policies that are already in place for tobacco can easily be modified to encompass laws relating to marijuana distribution as well.

Economies of Scale

Due to the massive size of Philip Morris it can take advantage of many economies of scale that other potential competitors would not be able to. One, as described earlier, is their marketing machine. By shifting a portion of their billions already invested in marketing Philip Morris could easily get the word out about the legalization and the availability of marijuana. Another large economy of scale can be obtained by either using or adapting current tobacco technology to make marijuana cigarettes. Heavy cross-fertilization between their already dominant tobacco industry and their new marijuana industry would be extremely beneficial. Commercial and financial economies of scale will also be enjoyed because of the large size of Philip Morris.

Litigation Experience

Philip Morris is no stranger to litigation. Every year Philip Morris spends 100 million dollars just to fund its legal department.¹¹ Philip Morris's experience with litigation in the area of "sin goods" will provide an advantage as well. Even now Philip Morris is involved in a tobacco lawsuit against the department of justice. Litigation experience will be extremely important in the marketing and selling of marijuana due to the large political and social conflicts over the use of marijuana. It should also be noted that despite the losses that Philip Morris incurs in litigation, the sale of tobacco is still profitable to this company.¹²

¹⁰ <http://www.philipmorrisusa.com/DisplayPageWithTopic917.asp#2>

¹¹ Philip Morris 2001 Annual Report

¹² <http://www.usdoj.gov/civil/cases/tobacco2/complain.pdf>

Philip Morris – Strategies for Success

Lobbying to be the Government Guinea Pig

It is logical to assume that any initial legalization attempts will require heavy regulation by the government. With question 9 in Nevada it required the state government to implement a system whereby adults could obtain marijuana through a legally regulated market, rather than from the criminal market.¹³ Philip Morris could step in and lobby to be the guinea pig in the infant market. Preferably the Federal Government would deal with Philip Morris exclusively in this new industry and treat it as an experiment as the two parties learn as they go before any licenses are issued to other manufacturers. Although at first heavy regulation would include high taxes and most likely small profits the advantages in traveling down the learning curve would be extremely valuable. Philip Morris has extensive lobbying resources that, if turned toward the marijuana issue, would allow for a high probability of success in getting access to commercial marijuana distribution.

First Mover

If Philip Morris Succeeds in lobbying the government to be the guinea pig it will give them a first mover advantage protected by strong regulation. By being the first mover Philip Morris will gain brand name recognition for the future. To the buyers Philip Morris could easily portray itself as the company that battled to ensure the rights of people to smoke marijuana. Whether or not this statement is true, only the first mover will have this advantage. A government protected monopoly will also allow Philip Morris a lot of freedom to make mistakes and experiment to find the best way to succeed in this industry.¹⁴

Integration into the Tobacco subsidiary

As mentioned earlier, Philip Morris has extensive experience with “sin goods.” The most prominent of these “sin goods” is tobacco. Capacity could easily be obtained from Philip Morris’s capital in the tobacco industry. Even if methods of packaging and the filtering of smoke were altered for marijuana, Philip Morris could reduce costs by creating a pilot program for marijuana within its tobacco infrastructure. The distribution and packaging, if not the growth and filtering, would be very similar. The advantage of integration is to reduce liability. What if government regulation is too strict or the sale of marijuana isn’t profitable? Integration would allow for easy exit, if the marijuana industry turns out to be bad for Philip Morris, due to the lower level of investment required. It should also be

¹³ “Question 9” Nevadans for responsible law enforcement
<http://www.nrle.org/>

¹⁴ McAfee “Competitive Solutions”

made clear that marijuana does not have to be integrated into the tobacco infrastructure permanently.

Pricing Strategy

The objective of a price discrimination strategy is to obtain the highest amount of profit from the different market segments for a product. As we identify the different market segments based on tastes and habits that could correspond to the age, income or gender of consumers, our pricing strategy would be to charge different prices for the slightly differentiated forms of our product that could appeal to these segments. The high-end variation of our product would be modeled for high income consumer preferences and would therefore be priced higher than the rest of the products since this segment of the market is the least price sensitive. On the other hand, the most price sensitive segment of the market would be charged a low price for our low end variation. The adoption of this pricing strategy is similar to what is already in place for tobacco cigarettes with the differentiation based on the taste, feel and potency of the product. Philip Morris could also study information gained about smoker preferences from their tobacco industry segments and cross-apply it to the marijuana industry.

Conclusion

Phillip Morris has several attributes that will allow it to gain an advantage over competitors in the marijuana industry. The company's extensive experience with "sin goods" and strong position in the consumer goods market make Phillip Morris a perfect candidate for entry.

Phillip Morris has proven that it can handle the pressures necessary in dealing with goods that are extremely culturally and politically sensitive. Their position in the tobacco market not only allows them experience with litigation, but also experience with smokers and safety regulations. Assuming that government regulation is not so extreme that it destroys profitability in the industry, we believe that Phillip Morris could be very successful at making marijuana profitable.