Tobacco Firms Rush to Diversify

by Rudolph A. Pyatt, Jr. and Sari Horwitz

U.S. tobacco companies, awash in cash from cigarette production and sales, will become even more aggressive in the mergers and acquisitions that already have made them competitors in several major businesses besides tobacco, industry analysts preidct.

Billions of dollars from cash-rich tobacco companies have filtered into significantly large segments of the national economy—from the manufacture of consumer products to delivery of health-care services to the operation of major department stores.

The blockbuster acquisition of General Foods Corp. [October 1985] by Philip Morris Inc. and the purchase of Nabisco Brands Inc. by R.J. Reynolds Industries Inc. earlier [in 1985] are among the most notable of the industry's diversification moves to date. But they represent a well-established trend that began in the tobacco industry more than 20 years ago, analysts point out. Long before the merger binges of the 1970s and 1980s, the tobacco industry began snapping up companies such as Pacific Hawaiian Products Co. (Hawaiian Punch) and Allen Products Co., makers of Alpo dog food.

Still, Philip Morris' $5.6 billion acquisition of General Foods—the biggest merger outside the oil industry—coming so soon after RJR's takeover of Nabisco, has fueled speculation that tobacco companies may be positioning safety nets for a big fall by their basic business. More specifically, some observers suggest, an acceleration in diversification may have been prompted by the industry's concern over a welter of pending product-liability suits.

Industry officials emphatically deny any such motivation, pointing to a long skein of acquisitions that were undertaken as hedges against possible slumps in the industry growth. But while they deny that they are diversifying because they think the cigarette industry is endangered, they are also quick to say that they want to change the image of their firms from cigarette companies to diversified consumer products corporations.

The tobacco industry could suffer serious damage from product liability suits. By diversifying, a company might declare bankruptcy of its cigarette business and still operate its other subsidiaries.

Asked if the acquisition of Nabisco was a direct response to potential product-liability suits, J. Tylee Wilson, Reynolds' chairman and chief executive officer, said the two are not related.

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"We believe that offering a broad range of consumer products is in the best interest of RJR shareholders," he continued.

The threat of product-liability suits "played no specific role" in Philip Morris' decision to acquire General Foods, according to Hamish Maxwell, Philip Morris' chairman and chief executive officer.

"We're obviously concerned about [product-liability], but we're not worried about it," Maxwell continued.

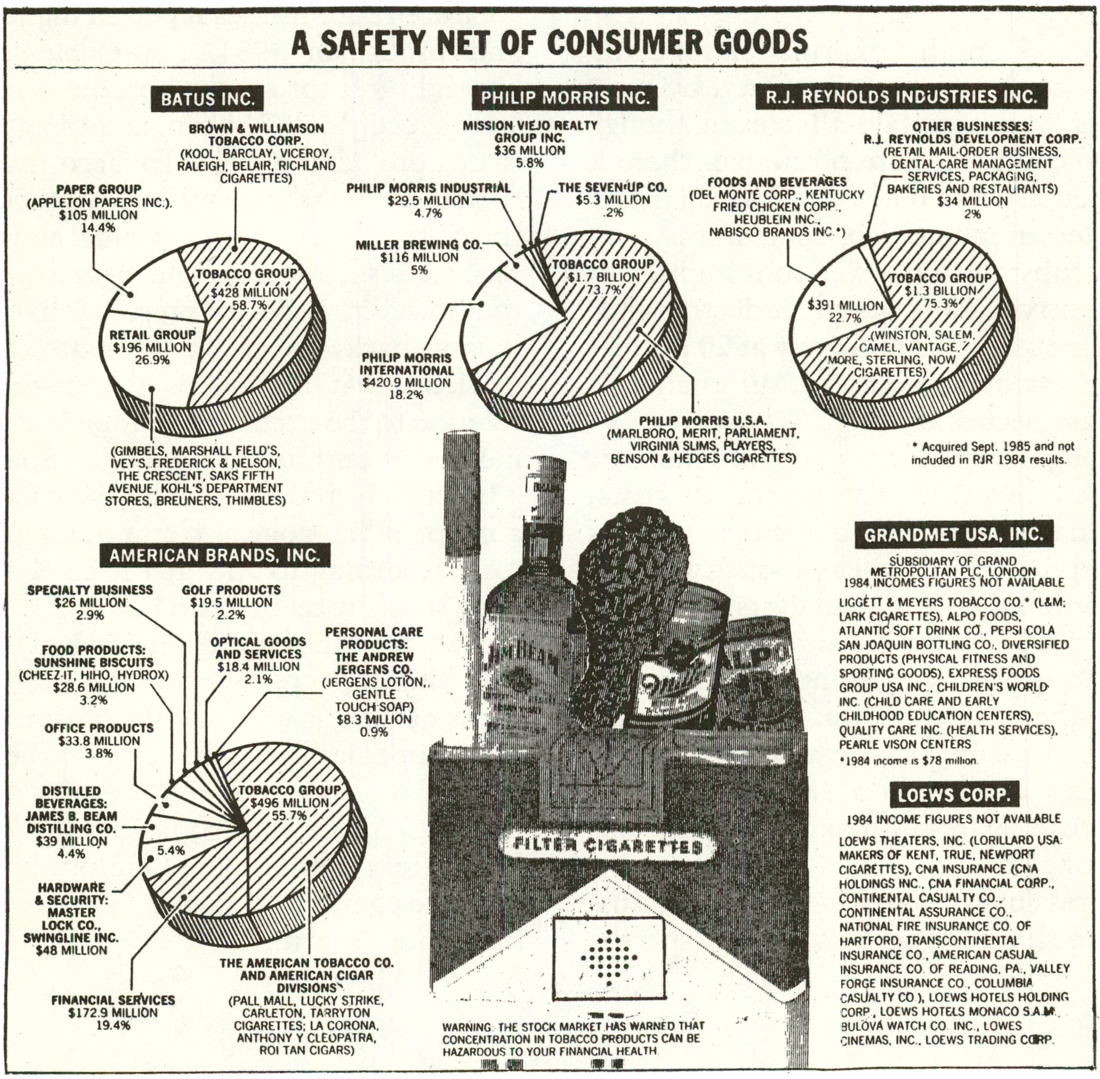
Many analysts agree with tobacco company officials that an apparent acceleration in diversification has little to do with the specter of product-liability suits against the industry. But some say litigation is a major concern among tobacco companies.

"The companies won't admit it, but I think it would be naive to believe that diversification is not related to product-liability," said David A. Goldman, tobacco industry analyst at Dean Witter Reynolds.

Goldman said that the tobacco industry could suffer serious damage if any of several product-liability suits are successful. By diversifying, he suggested, a company might declare bankruptcy of its cigarette business under Chapter 11 and still operate its other subsidiaries. "Let's assume a suit is successful. Clearly, if you diversify, you have one more safety net before you go belly-up," Goldman said.

Saul Steinberg, chairman of Reliance Insurance Co., a major property and casualty insurance underwriter, expressed his concern about the pending lawsuits.

"There has not yet been a single case that has linked the product [cigarettes] to cancer," Steinberg said. "Such a case will be decided, and that will have unbelievable ramifications. Once the first case is lost, and I'm told it will be lost, thousands of cases will be brought. It is a problem of incalculable cost. If it gets to be something like



asbestos, the winners will be the lawyers and the losers will be industry and the public. If the case goes this way with tobacco, you're going to see a bloodbath.''

The tobacco industry managed to snuff out a series of lawsuits that were brought between 1950 and 1970 by smokers who blamed cigarettes for lung cancer. But a new brace of lawsuits—at least 30, according to recent estimates—have been filed against the industry, which has failed thus far to block their litigation.

''I think there is no correlation'' between diversification and the threat of product-liability suits, said John C. Maxwell, tobacco analyst at Furman Selz. Tobacco companies find themselves in a position where it's necessary to ''throw off excess cash'' and it is ''just a good policy to use that cash for the good of your stockholders rather than put it in CDs [certificates of deposit],'' analyst Maxwell said.

Another explanation for diversification is offered by most analysts who maintain that even though tobacco companies are profitable, there is little growth left in the market, which is controlled essentially by six companies.

With substantially lower consumption in this country, ''The cigarette industry is just not an industry that will grow at 20 percent a year,'' said Neal Kaplan, an analyst at Interstate Securities.

Although growth in the tobacco industry has been relatively flat in recent years, profits have continued to climb because of pricing programs, higher productivity and lower production costs, analysts point out.

Ironically, the death claims attributed to cigarette smoking continue to increase despite the mandatory warning that is carried on the labels of cigarette packages: ''Warning: The Surgeon General has determined that cigarette smoking is dangerous to your health.''

Congress has ordered the tobacco industry to begin placing new, more specific health safety warnings on packages of cigarettes and in cigarette advertisements and to change the messages every three months.

The presence of those warnings, both on cigarette packages and in print advertising, render product-liability suits virtually moot, according to the industry as well as some analysts. ''When you've got on the label for 20 years that [cigarettes] can kill you, how can you sue?'' asked Maxwell of Furman Selz.

Anne Browder, the assistant to the president of The Tobacco Institute, said the industry is genuinely concerned about the health of consumers. She added, however, that smokers are ''intelligent enough to make their own decisions.''

Browder noted that anti-smoking campaigns and statements associating cigarettes with health hazards have had a negative impact on sales.

Cigarette companies reported higher sales and profits in 1984, nevertheless. U.S. expenditures for tobacco products in 1984 were a record $28.7 billion, according to estimates provided by The Tobacco Institute.

The stock market continues to react negatively to the pending lawsuits and other problems surrounding the cigarette industry, however. Tobacco companies have been buying back significant amounts of their stock but that hasn't proved to be the right solution to the excess cash problem or to the industry's performance on Wall Street.

Indeed, the product-liability issue has been a major psychological factor among investors, according to Arthur Kirsch, financial analyst at Drexel Burnam Lambert. ''Investors are unwilling to take the risk of staying with the [tobacco] stocks with the uncertainty of the litigation and the prospects that the companies may lose some of the cases and have to pay money.''

Diversification into other areas ''makes Wall Street a little more comfortable with [tobacco companies] stocks,'' said Kaplan of Interstate Securities.