

A Sweet Deal for a Tobacco Executive

Wall Street Journal; New York; May 13, 1998; By Jeremy Bulow;

Abstract:

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But this time Mr. LeBow has come up with a new way to get money: have Congress give it to him. Under the Commerce Committee's bill, tobacco companies are to pay higher taxes on the sale of cigarettes, increasing to 65 cents a pack in 1999 and \$1.10 a pack beginning in 2003. But Liggett has been made exempt from this tax, so long as it keeps its market share below 3%. Liggett argues that it deserves the break for turning over secret industry documents to the state attorneys general whose lawsuits against tobacco companies spurred the current legislation.

Full Text:

Which single person stands to benefit the most from passage of the Senate Commerce Committee's recently approved tobacco legislation? Surprisingly, the answer is not a trial lawyer, though it is a man who's spent plenty of time in court -- bankruptcy court, to be exact. Bennett LeBow, controlling shareholder of the Brooke Group Ltd., personally stands to "earn" hundreds of millions of dollars a year if the bill becomes law.

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How much is this exemption worth? Even with the tax increase, the Treasury predicts cigarette sales of slightly over 20 billion packs a year. So if Liggett

kept production down to 600 million packs (it sold 322 million last year), it would enjoy a \$1.10 per pack, or \$660 million, cost advantage over its competitors. To keep this in perspective, note that cigarette manufacturing costs are about 20 cents per pack.

If Liggett only adds a dollar to its price when all other manufacturers will be forced to raise prices by \$1.10, Liggett should easily be able to get its 3% share. And the dollar a pack would fall directly to the bottom line, increasing Liggett's pretax profits by \$600 million per year. Liggett has agreed to pay 27% of its future profits in settlement of its health care litigation with the states, and Mr. LeBow owns 51.5% of Brooke, so his share of the bounty will come to \$225 million per year. The state attorneys general, who must not have understood the implications of this provision, agreed to lobby for the Liggett exemption as part of their latest deal with the company, announced March 12. Perhaps because of the possibility of such a bonanza, Brooke's stock-market value has risen from a low of \$37 million (\$2 a share) a year ago to roughly \$200 million today, despite the company's precipitous operating decline. If Congress comes to its senses, the deeply indebted company will be worth nothing. But if the bill passes as is, Brooke would be worth at least five times its current price.

Side by side with the Liggett provision is another, potentially more destructive proposal, encouraging the 100 or so small cigarette manufacturers and importers in the country to increase production. While they are not given as juicy a deal as Liggett, they only have to pay 25% of the \$1.10 on the first 150 million packs they sell and 50% on the next 150 million. So a small manufacturer, currently selling just a few million packs, will be able to crank up production and sell up to 150 million packs for 80 cents a pack less than any of the majors can charge for generic cigarettes.

These firms currently sell only one out of every 1,000 cigarettes in the U.S., but I predict they (and some new entrants) will soon be selling billions of packs per year if the new law is passed, flooding the market with cheaper cigarettes while destroying the businesses of the major companies. As a business school professor, my advice for aspiring young entrepreneurs will be: Start a small cigarette company.
