OVERVIEW

RESEARCH REPORT, FINDINGS AND DATA

Analysis and Key Findings

1. **Point-of-purchase displays are advertising and should be recognized as advertising. Moreover, point-of-purchase tobacco displays, or tobacco "power walls," arguably are and may have been for many years the most important advertising medium available to the tobacco industry.** Given that Canadian governments have expressed a commitment to stop tobacco advertising directed at children, the failure until recently of governments to prevent tobacco point-of-purchase advertising has left children vulnerable to this powerful marketing medium.

   Given the restrictions on tobacco advertising and distribution, and the elimination of sponsorship, the resources previously invested in other forms of tobacco advertising and promotion have been refocused on point-of-purchase. In the process, the convenience store remains the main distribution and marketing communications channel for tobacco manufacturers. This has created a mutual dependency between manufacturers and convenience stores.

   The concentration of marketing dollars at point-of-purchase is not just because of the limited options open to tobacco companies. We stress that point-of-purchase advertising has always been important to tobacco companies. A market study by Brown & Williamson, a sister corporation to Imperial Tobacco Canada Limited, Canada's largest tobacco company, shows "the store environment, especially displays inside stores, is the biggest source of advertising awareness for all cigarette trademarks."

2. **"Power walls" of tobacco product displays are very effective at reaching and influencing children and teens. Tobacco companies spend large sums of money on point-of-purchase advertising in convenience stores, especially near schools and malls where young people congregate**. Point-of-purchase is an effective communications channel because of its capacity to reach youth and its ability to generate tobacco brand awareness and image.

   Survey research commissioned for this report as well as research from existing sources, including tobacco industry documents, combine to expose the influence of power walls on children and teens. Our research found:

   - Over 60% of youth from non-smoking households believe that power walls might influence kids to try smoking;

- 85% of kids from non-smoking households spontaneously name convenience stores as a place that sells cigarettes;
- Over 40% of kids from non-smoking households can spontaneously name brands of cigarettes.

We surveyed youth from non-smoking households in order to minimize the influence that factors other than retail displays (e.g. parental or sibling smoking) might have on their answers. Because youth from non-smoking households are less likely to become smokers than youth with parents who smoke, and because the youth interviewed may have been (or thought they were) overheard or monitored by a parent, the impact of tobacco power wall advertising on youth may be understated by our survey.

In addition, tobacco power wall displays apparently influence kids more strongly than they influence adult smokers:

- Teens are more likely than adults to say they are influenced by promotional pieces in convenience stores (73% of teens vs. 47% of adults);
- While 62% of kids from non-smoking homes believe that power walls influence youth to try smoking, and 39% of all Ontario adults believe that power walls influence cigarette purchases, only 19% of Current smokers believe that power walls are a factor in continued smoking.

Power walls are also influencing some Former smokers and Current smokers who have quit or have tried to quit:

- 24% of Former smokers believe that power walls are a factor in continued smoking;
- 14% of Current smokers who have tried quitting believe that power walls are a factor in continued smoking.

At first blush, these numbers may seem low. However, given the millions of smokers in the Ontario market, even if power walls influenced a small percentage of the market, the morbidity and mortality impact related to such influence would be substantial.

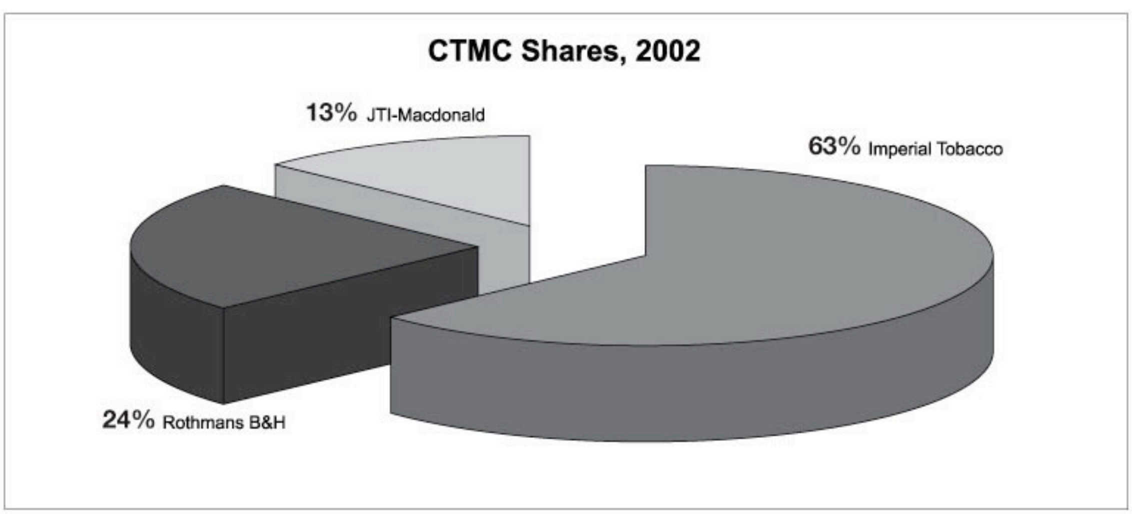
3. **Tobacco companies maintain that their point-of-purchase advertising has no impact on non-smokers and, in particular, that it has no impact on youth**

smoking. The manufacturers claim that power walls only target smokers, particularly those who might switch brands. Our surveys combined with existing research show that these claims do not make economic sense.

By claiming to target only brand switchers, tobacco companies imply that they are not aiming to increase the size of their market, or to combat their market's decline. In fact, tobacco companies need new customers to survive. Children and teens, relapsed quitters and immigrants are virtually the industry's only source of replacements.

Tobacco companies are estimated to spend over $300 million annually in Canada on point-of-purchase advertising, displays and listing allowances ostensibly to influence only brand switchers. We are being asked to believe that they are spending close to $9,000 per convenience store to reach as few as 8 smokers per store who are brand switchers. That's over $1,000 per switcher, whose total value to the tobacco companies and convenience stores averages $600 a year (excluding the approximately 70% of price in taxes paid for cigarettes at retail). Even if there are close to 30 switchers per store (using a very high estimate of 14% of smokers being brand switchers), the average cost to the manufacturers is $300 per brand switcher.

In a concentrated market like cigarettes, where three companies dominate, the potential for brand cannibalization is high. "Cannibalization" is the term used to describe switching between two brands produced by the same manufacturer: the company does not gain from the brand switch. Imperial Tobacco, for example, with a market share of over 60%, is likeliest to have customers switch from one Imperial brand to another: a zero-sum game. And in the current climate of switching mainly to lower-priced brands, cannibalization costs money. People switch from a premium brand to a cheaper brand.



Even if tobacco manufacturers were targeting adults, in any product category, marketing communications directed to young adults will reach and influence teens. “Target” and “Direct” marketing are not exact sciences, and there is “spill” into adjacent groups in any such marketing campaign. In addition, the social and aspiration elements of teens include looking to their immediate elders (who are allowed to smoke) for brand cues. Smoking rates are highest among young adults, and teen smoking rates are not abating. Socially and logically, there is a connection.

Many convenience stores are more actively involved in tobacco marketing than merely benefiting from point-of-purchase contracts. Half of teen smokers illegally obtain their cigarettes in stores, not from friends or family. One-third of convenience stores illegally sell cigarettes to minors. This figure has grown since 1999.

4. **The retail losses predicted by the tobacco industry, and especially by convenience store operators, are unlikely to materialize. A ban on tobacco point-of-purchase advertising is not a prohibition on the sale of tobacco products. Tobacco is addictive. There will still be addicted smokers wanting to buy the product, with or without power walls and other tobacco displays.** While retailers may lose tobacco listing allowances in the short term, other companies and products will compete for the prime real estate behind the cash register. The back wall has been called the “center stage” of convenience stores. A medium so effective for tobacco companies can be expected to be effective for other manufacturers – and valuable.

Approach

Making at least 4 tobacco-purchasing trips per week, smokers are key convenience store ("c-store") customers. Smokers are very loyal to the c-stores they choose to frequent. 83% of Canadian smokers visit c-stores every month.

Making several trips per week, kids are key c-store customers, too. (Many kids visit c-stores more often than their parents think they do.) Kids are very loyal to the c-stores they frequent. 76% of Canadian kids aged 12 to 18 visit c-stores every month.

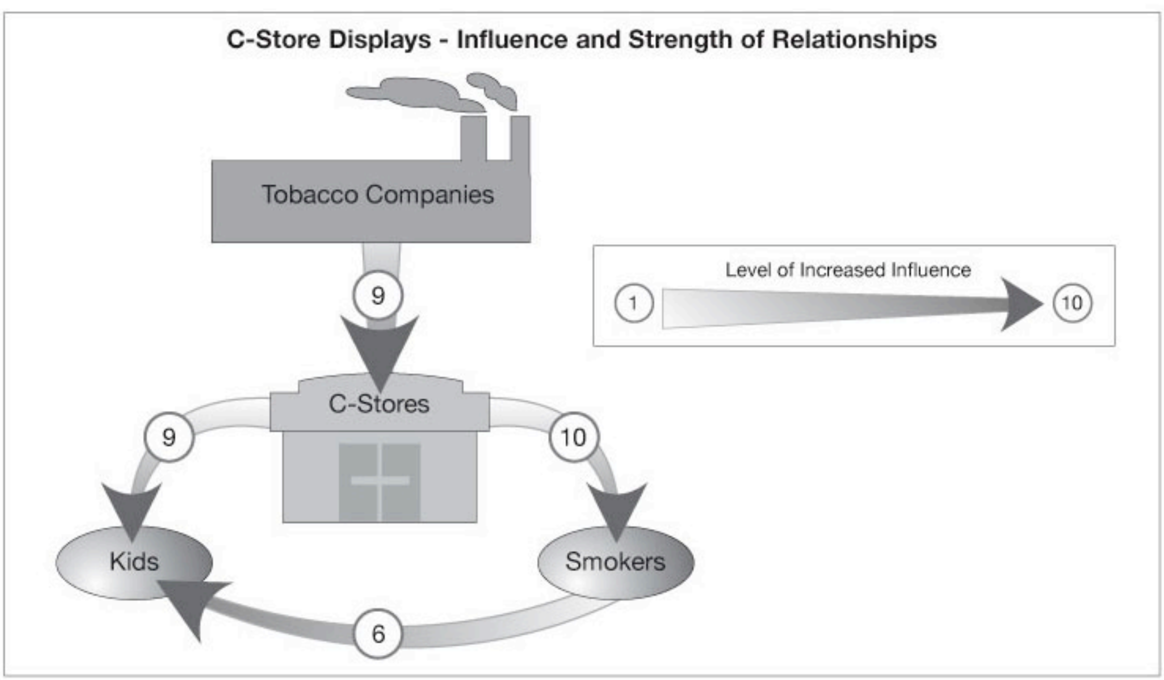
In assessing the effects of tobacco point-of-purchase ("POP") displays in c-stores, we need to consider several points of view:

- Tobacco companies as marketers
- POP advertising effectiveness, generally and for tobacco, on adults and teens
- Convenience stores (including those in gas stations), as both distributors and social agents, vis-à-vis smokers and teens
- Smokers, as both c-store customers and as social agents who influence kids
- Former smokers, as c-store customers and potential future smokers
- Current smokers who have attempted to quit
- Kids, as both c-store customers and potential smokers

This review of North American industry, government and academic research since 1999 concentrates on Canadian sources. Ontario data is shown where available.

We also incorporate data from two Ontario surveys commissioned in March 2005. These surveys gauge the effects of tobacco POP in c-stores:

- A major survey of Kids and parents from non-smoking households
- A short survey among Current and Former smokers, included Attempted quitters



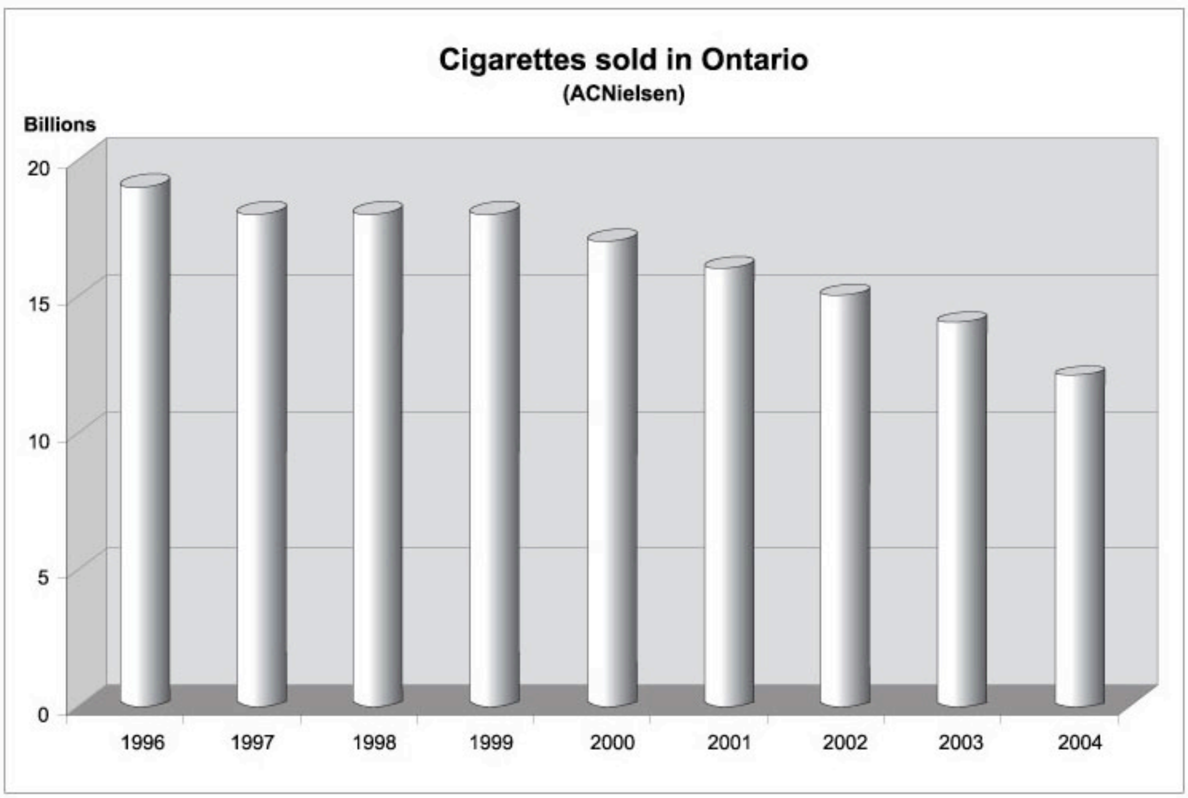
Tobacco companies

Warren Buffet has been called "the greatest investor in the world". He was a director of RJ Reynolds when he was famously quoted: "Tell you what I like about the cigarette business. Costs a penny to make, sell it for a dollar. It's addictive. And there is a fantastic brand loyalty."

NOTE: Market measurements for the Canadian industry are inconsistent. The Canadian Tobacco Manufacturers' Council (CTMC) consists of only the three largest companies, so smaller companies' data is not included in CTMC reports. Some smaller companies produce store brands for specific retailers, or distribute only regionally, so their sales don't appear in all retail reports.

Tobacco companies sold 12 billion cigarettes in Ontario in 2004, worth at least $4.2 billion at retail.

In Canada, tobacco is an industry in decline. Since 2000, the number of smokers in Canada has fallen by almost a million. According to ACNielsen, unit sales in Ontario were essentially flat until 1998, but have been declining at an increasing rate every year since. In 2004, unit sales declined by about 14% vs. 2003.



Total domestic tobacco sales by CTMC companies dropped between September 2002 and September 2003, with the biggest drop in tailor-made cigarette sales, which dropped 14% nationally. Sales of fine cut tobacco products were down 4% nationally.

2002-03	Tailor-made	Fine cut
Atlantic	-19%	-3%
Quebec	-17%	-11%
Ontario	**-14%**	**+3%**
West	-11%	+1%
National	-14%	-4%

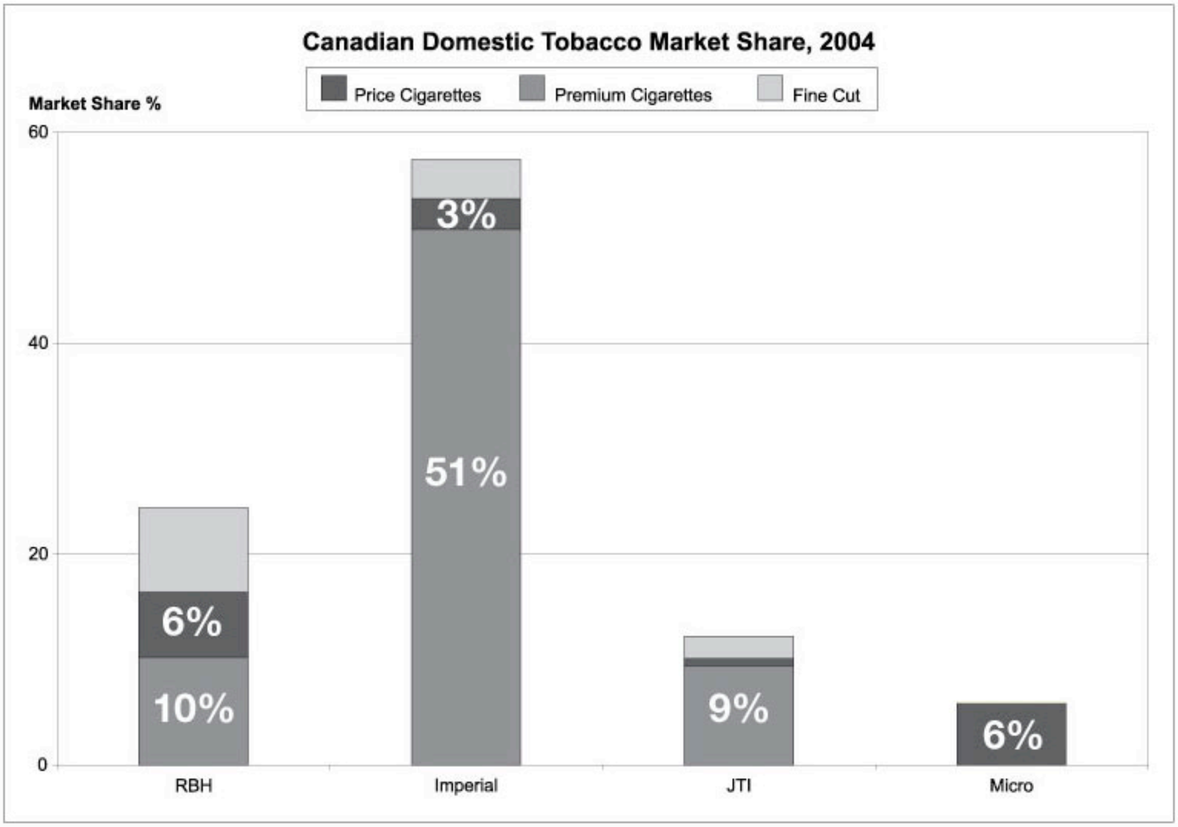
However, tobacco is an extremely profitable business. Despite the pressures the industry is under, *Canadian Business* magazine recently recommended Rothmans, Benson & Hedges (RBH) as a defensive investment, because it has stable and predictable profits, plus increasing dividends. RBH has seen increasing sales and cash flows in the past few years, and earnings at 24% of sales. (The average Canadian corporation has earnings at 7% to 8% of sales.) Sales increases in a declining market are due to RBH's quick move into lower-priced brands.

Year ended March 31 ($M)	**2004**	**2003**	**2002**
Sales, net of excise duty and taxes	$ 620.1	$ 575.5	$ 562.5
Cash flows from operations	225.6	137.3	183.9
Earnings before minority interest	151.1	144.9	144.5
Earnings for the year	90.3	86.7	91.5
Dividends paid	54.6	217.9	42.2

Tobacco competitors

Three large tobacco companies dominate the cigarette market in Canada: Imperial Tobacco Canada Limited; Rothmans, Benson & Hedges Incorporated; and JTI-Macdonald Corporation. In 1999-2000, their combined net sales were approximately $3 billion. For the year ending December 2002, combined sales for the "big three" were $3.2 billion. By March 2004, combined sales of the "big three" receded to $3 billion, eroded by new "micro" manufacturers.

With 57% of the total tracked domestic market in March 2004, Imperial Tobacco (ITL) sells more tobacco in Canada than any other manufacturer. ITL manufactures the two leading premium cigarette brands: du Maurier (35% market share) and Players (28% share). RBH has the second-largest portion of the domestic market (including roll-your-own) at 24%, while JTI-Macdonald is #3 in Canada with a 12% share.



ITL's head office is located in Montreal. Imperial operates cigarette manufacturing plants in Montreal and Guelph, Ontario, as well as four tobacco processing plants in Aylmer, Ontario. Imperial employs approximately 2,000 people across Canada. In 1999, net revenues totaled $1.7 billion. Brands in Canada:

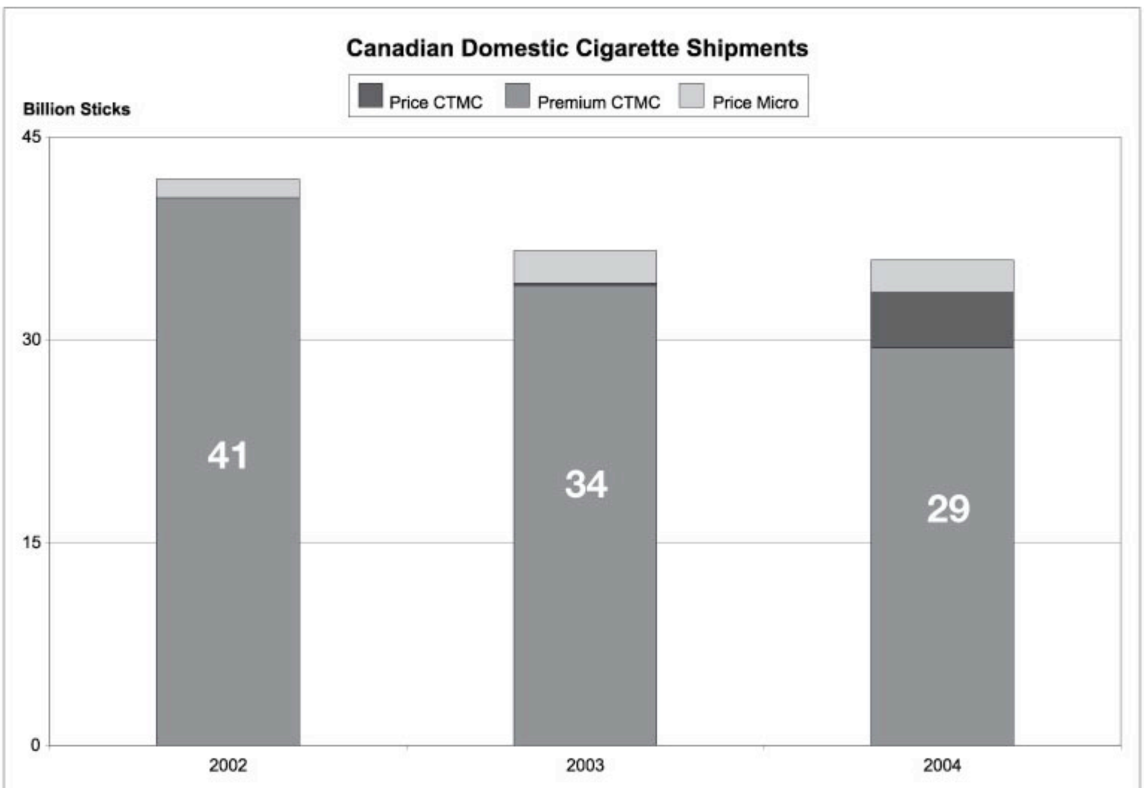
Avanti	du Maurier	Vogue
Medallion	Player's	Matinée
Cameo	John Player	
Peter Jackson	Sweet Caporal	

Rothmans, Benson & Hedges (RBH) is Canada's second largest tobacco company, with 16% of the Canadian cigarette market in 2001. Owned 60% by Toronto-based Rothmans Inc., it is the only publicly traded tobacco company in Canada. RBH has offices all over Canada, with approximately 780 employees. In 1999-2000, net sales of RBH totaled $533 million; by 2004 sales rose to $620 million. RBH has been gaining market share with its lower-priced brands. Cigarettes comprise 67% of sales; fine cut comprises 32%, and other tobacco products 1%. Brands in Canada:

Number 7	(24% of sales)	Accord
Benson & Hedges	(11% of sales)	Dunhill
Craven	(10% of sales)	Mark Ten
Rothmans	(9% of sales)	Oxford
Belvedere	(3% of sales)	Black Cat
Viscount	(3% of sales)	Peter Stuyvesant
Belmont Milds	(2% of sales)	Sportsman
Canadian Classics	(1% of sales)	Craven "A"
		Captain Black

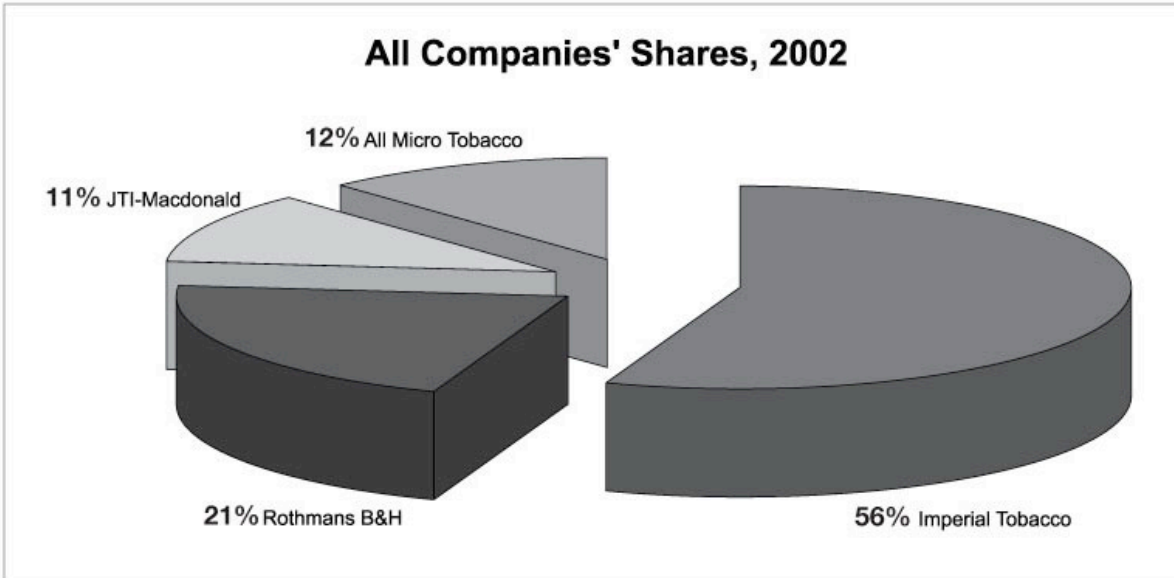
The #3 tobacco company in Canada is JTI-Macdonald Corporation, with a declining domestic market share of 12% in 2004. In 1999, JTI-Macdonald controlled 13% of the market in Canada. The company's market share is due mainly to one major cigarette brand, Export "A", the third largest selling brand in Canada (12% market share). The head office in Toronto employs 570 people.

After years of domination, Canada's main tobacco manufacturers are being challenged for market share for the first time in decades. The same has happened in the United States, where the discount brands have forced the major makers to introduce their own lower priced brands.



Discount products appear to have stabilized declining volume in Canada. Within the "big 3", discount brands are a key factor. RBH in particular has gained market share by moving into discount brands.

There are two dozen newer companies ("micro tobacco") processing cheaper imported tobacco. They captured up to 12% of the national cigarette market by 2002, up from just 2% in 2001. The new companies shared more than 18% of the Quebec market, and about 5% of Ontario's, by 2003. Typically these companies specialize in some way, either by regional distribution or by producing store brands.



The three largest micro competitors sell their generic offerings for $1 to $1.25 less a pack than leading brands.

Grand River Enterprises (GRE) exports 80% of its brands (such as Seneca) to USA. In Canada, GRE sells its cigarettes to non-natives through c-stores in every province east of Ontario. GRE brands for Canada include Sago, DK, and Putter's Light. Production has increased significantly:

- January 2001 4,500 cases of cigarettes
- January 2002 10,200 cases
- January 2003 25,600 cases (250 million cigarettes).

Tabac ADL sells its cigarettes almost exclusively off native reserves. ADL began manufacturing cigarettes in 1998. Brands include Virginia Select and Bailey's. According to a company partner, ADL is the fourth largest tobacco company in Canada, employing 175 people. In 2002, the Federal Business Development Bank (an arm of the federal government) declared ADL "Company of the Year" in the St-Jean region of Quebec.

Bastos du Canada produces its own brand, Smoking, as well as generic brands such as Gipsy (for Loblaws), Celesta (produced for Sobeys) and Dakar (for the Metro grocery chain in Quebec). The company employs 50 people.

Although competing with each other on a brand basis, tobacco companies consider government, with the "anti's" (their nick-name for the anti-smoking or tobacco control lobby), to be their biggest competitor. The antipathy between tobacco companies and legislators goes back several decades. The industry is required to submit detailed operations data, increasingly so in recent years. The industry has come to operate in a "siege mentality".

While the industry is subject to close government scrutiny, the government does not share the information with third parties. Access to Information requests are almost always met with opposition by tobacco companies' lawyers. The tobacco companies often act in concert, from court cases to retailer education.

Tobacco companies appear to demand secrecy of their suppliers. We have found only one packaging designer (Thomas Pigeon) and one POP supplier (Admark) who list Canadian tobacco companies as clients.

JTI no longer has a Canadian website. Imperial Tobacco has hired Meyers Research Center, a US company, to conduct market research in Canada. "Off-shoring" may be a way of avoiding Canadian legislative scrutiny.

Tobacco products & prices

Cigarettes are the #1 product form sold. Cheaper make-your-own (MYO) or roll-your-own (RYO) products, cigars (a premium product) and smokeless tobacco are increasingly popular. (The terms “tobacco” and “cigarette” are virtually identical in this analysis: cigarettes account for 96% of all tobacco products sold in Ontario.)

As tobacco taxes have increased, tobacco companies have offered lower-priced brands to compensate. Discount price cigarettes manufactured by CTMC companies are called either “value for money” (or “VFM”), “price category” or “discount brands”. In Ontario, these VFM brands grew from 6% in 2003 to 21% share of market volume by 2004; growth has been higher in other regions of Canada. One tobacco company estimates these price brands could reach 40% share.

In Canada, RBH has positioned Number 7 as its VFM brand and positioned Canadian Classics in the same price tier, while Imperial reduced the price of Peter Jackson and Matineé. JTI-Macdonald created two new value brands, Legend and Studio, and began selling them through an exclusive marketing agreement with Couche-Tard and Mac’s stores.

As retail prices have climbed, a consumer switch to more affordable alternatives has accelerated. Sales figures from Imperial Tobacco Company Ltd./CTMC for 12 months ending September 2003 show that price brands posted the largest gains in the Canadian marketplace and comprised 13 of the top 20 tailor-made gainers.

All varieties of Number 7 held a 3.8% market share in 2003, a huge increase of almost 3 percentage points. Peter Jackson reached a 1.4% market share in 2003, up 1.2%. Studio captured 0.1% share, and Legend also reached 0.1% market share. These brands all gained share again in 2004, at the expense of established leading brands.

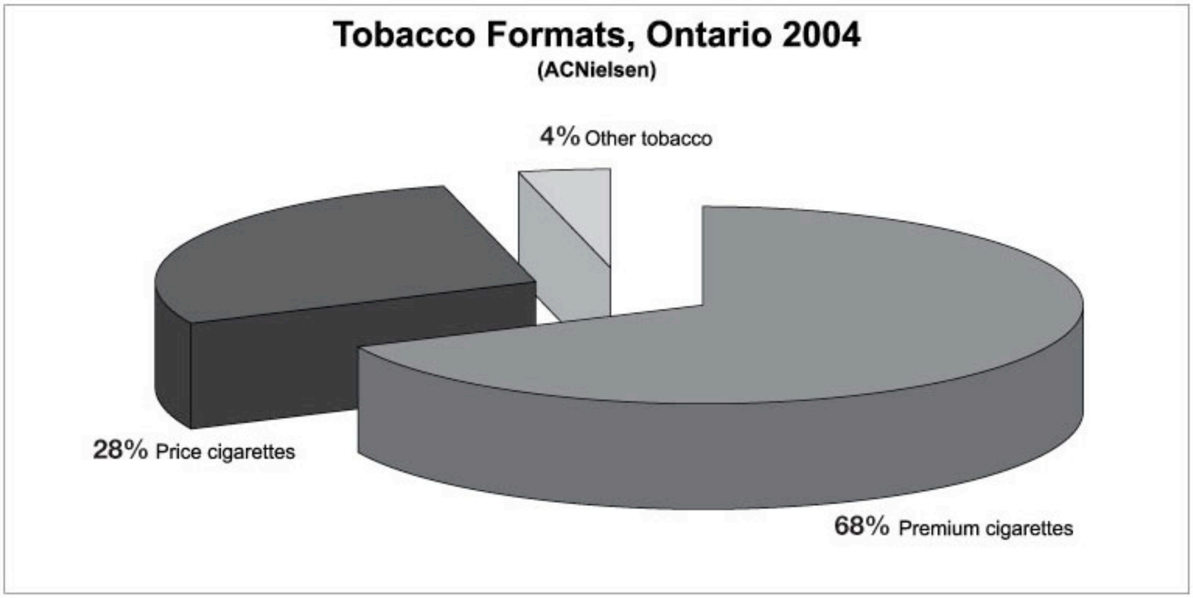
Top 20 SKU Gainers	**Sep ’03-’04 Share**	**Top 20 SKU Losers**	**Sep ’03-’04 Share**
Number 7	+6.9%	du Maurier	-5.6%
Peter Jackson	+4.7%	Players	-4.5%
Canadian Classics	+1.4%	Rothmans	-0.6%
Studio	+0.5%	Export “A”	-0.6%
Legend	+0.3%	Craven “A”	-0.2%

Over the past few years, as taxes on tobacco have increased, retail prices for product from the big three manufacturers have gone up accordingly, contributing to an erosion of sales volumes. The price increases (+14% in 2001, +15% in 2002, and +10% in mid-2003) prepared the Canadian market for discount alternatives. The sale of price brands has quickly grown to a significant market force, as consumers switch from tailor-made brands to lower priced brands, and escalating multi-level pricing in the market.

Average pack prices, Ontario	**May ‘01**	**Nov ‘04**
Total brands	$4.56	$8.06
Tier 1 price brands (original discount level)	$3.67	$6.85
Tier 2 price brands (recent deeper discount level)	NA	$6.55

The new tobacco companies are built largely on low-priced products. The share of discount cigarettes produced by micro manufactures (who are not part of CTMC) increased by an estimated 57% from mid-2002 to mid-2003.

The industry price category, including price cigarettes and fine cut tobacco, contributed 44% of total sales in the Atlantic region, 39% in Quebec, 25% of the West but only 11% of Ontario during the August-September 2003 reporting period. By 2004, price brands rose to 28% of the Ontario market.



Tobacco marketing

Global ownership allows the major tobacco companies to share marketing "best practices" around the world.

- Imperial Tobacco is a wholly-owned subsidiary of British American Tobacco (BAT), a UK-based tobacco company that also owns Brown & Williamson in the United States and has holdings on every continent. Brown & Williamson had a U.S. market share of 11% in 2000. In 2003, BAT produced 792 billion cigarettes worldwide, with a global market share of almost 15%.
- RBH is owned 40% by an affiliate of Altria (parent of Philip Morris). Altria is the biggest tobacco company in the United States, with a 48% market share in the first quarter of 2003. In 2003, Philip Morris accounted for about 15% of the global cigarette market.
- JTI-Macdonald is a wholly owned subsidiary of Japan Tobacco International, whose major shareholder is the Japanese government. JTI-Macdonald was formerly RJR-Macdonald, a wholly owned subsidiary of American tobacco company, RJ Reynolds International. In 1999, Japan Tobacco Incorporated bought RJR-Macdonald (and the rights to its Camel brand), and its named changed to JTI-Macdonald Corporation.

Tobacco companies state that their marketing communications are intended to influence only smokers who might switch brands.

Brand switchers are estimated to be anywhere from 4% or 5% (based on recent Canadian industry data) to 14% (from a recent US trade publication) of all smokers. The 4% figure is calculated from a Meyers Research Center survey cited by Imperial Tobacco; 5% comes from RBH's annual report. The figure has been rising recently as price brands become more popular.

"Brand" has a different meaning to tobacco companies than it has to most consumer packaged goods ("CPG") marketers. Most CPG marketers consider the name to be the brand: e.g., Blue, Tide, Listerine, Rice Krispies. Tobacco companies, however, consider the individual Stock-Keeping Unit ("SKU", a level of detail found on the UPC bar code) to be a "brand": e.g., Players Extra Light Regular is considered a different brand than Players Extra Light King Size. "Variety" or "family" are the terms tobacco companies use to describe what others might call a "brand", e.g., "all Players varieties" means combined Players SKU's.

Smokers are known to be loyal to both brand and SKU. We have observed a smoker leave a c-store empty-handed because his particular SKU was not available at that store: the same brand name, strength and pack size were available, but in a different length.

"Switching" may also have a different connotation to tobacco marketers than it has to most CPG marketers. Some researchers believe that new smokers (including kids and immigrants) and returning smokers (who had quit but have "relapsed") are included in the term "switchers" (i.e., from no brand to any brand).

Tobacco marketing communications

In each of 2001 and 2002, Canadian tobacco companies spent over $300 million on marketing communications ("marcom"), in addition to the money paid to retailers in listing allowances.

Reporting Period	Total spend ($M)
January – June, 2001	$140.2
July – December, 2001	$164.4
January – June, 2002	$171.7
July – December, 2002	$128.9

The vast majority of these funds are believed to be POP displays, signage, etc. In addition to POP, Canadian tobacco companies spend marketing dollars on:

- Controlled circulation magazines – Since October 2003, Imperial Tobacco has published *Rev*, with a circulation of 120,000 (also available online) to highlight Players.
- Imperial also has a program for du Maurier called *definiti*, which includes a publication, website with radio, celebrity endorsements, and bar promotions.
- Websites – including $2.5 million for mychoice.ca
- Other direct marketing
- Non-tobacco promotional products that display a tobacco brand element: golf balls, pocket knife, pen, blanket, banner, display booth, bag, ballot box, clock, port glass, pipe, and filter tip tubes.
- Events – Cigarette companies have hired models to promote products in bars and at outdoor events. RBH has a proprietary National Bar Program. Imperial has a separate subsidiary, Rumbling Wall Events.
- Sponsoring c-store and other retail industry associations – Imperial Tobacco, RBH, JTI and National Smokeless Tobacco Company all sponsored the recent Convenience U conference in Toronto. Imperial is a sponsor of the Canadian Federation of Independent Grocers' annual POP awards.

Tobacco companies often refer to their marketing communications as "consumer education", and attempts to limit tobacco marcom have been decried by the industry as contributing to consumer ignorance (as well as an assault on the constitutional right to free speech).

The economics of tobacco companies' marketing communications and sponsorships have been dissonant, when we compare the stated aims vs. the actual spending patterns or standard marketing practice.

- Typically, declining industries spend very little on marketing communications; the "Ad: Sales" ratio is typically at its lowest level for declining industries (vs. growth or mature industries). But in the tobacco industry, marcom spending by the major Canadian companies is increasing, while their market continues to shrink.
- Recently, du Maurier had a Product Knowledge contest among c-store operators. Cash prizes totaled $50,000. This program is being repeated in the near future. We have never seen a retailer Product Knowledge program with such high rewards.
- The du Maurier Arts Council was established to sponsor the arts in Canada. In 2000 – 2001, the program was extended to award bursaries to photographers. Five photographers shared under $40,000, or less than $8,000 each. The cost of the marketing communications announcing this initiative was $1.1 million.

Combining the funding for marcom and listing allowances, we get a national figure of $377 million in 2002. Assuming that about 80% of this is POP (displays, in-store advertising and listing fees) as per USA figures:

Canada	$377 million
80% on POP	$300 million
Ontario @33% of market	$100 million
C-stores @75% of sales	$75 million
8,400 c-stores in Ontario	$8,900/store
Listing allowances per c-store	$1,500/store
Displays, ads etc. per c-store	$7,400/store

If tobacco companies are spending about $300 million annually in Canada on POP marketing communications, displays and listing allowances to persuade only brand switchers, they are spending close to $9,000 per c-store to reach as few as 8 smokers per store who are brand switchers. That's over $1,000 per switcher, whose total value to the tobacco companies and c-stores averages $600 a year (excluding the approximately 70% in taxes paid for cigarettes at retail). Even if there are closer to 30 switchers per store (using a very high estimate of 14% of smokers being brand switchers), that average is $300 per brand switcher.

In a concentrated market like cigarettes, where a few companies dominate, the potential for brand cannibalization is high. "Cannibalization" is the term used to describe switching between two brands produced by the same manufacturer: the company does not gain from the brand switch. Imperial Tobacco, for example, with a share of 60% of the tailor-made market (excluding RYO), is likeliest to have customers switch from one Imperial brand to another: a zero-sum game. And in the current climate of switching mainly to lower-priced brands, cannibalization costs money: people switch from a premium brand to a cheaper brand.

Tobacco retailers

In addition to the $300 million for marcom, tobacco companies paid retailers listing fees of over $77 million in 2002. (This figure rose to $88 million in 2003.) Many such programs depend on the volumes of company product sold, rewarding retailers for selling more product.

Reporting Period	Total spend ($M)
January – June, 2001	$34.1
July – December, 2001	$40.4
January – June, 2002	$32.7
July – December, 2002	$44.5

Tobacco customer base

In the long term, the tobacco industry needs new smokers to survive.

- The national mortality rate from tobacco causes is at least 47,000 annually; this steadily reduces the customer base by almost 1% a year. Smokers have shorter life spans than non-smokers (8 years shorter, on average).
- Half of smokers eventually quit. Typically, smokers start before they're 19 years old and smoke for 34 years. (One-quarter of Ontario's adult population is former smokers who've quit.)
- Three-quarters of current smokers have tried to quit. Quitting usually takes several attempts.

Only one-tenth of people who have ever smoked regularly are dedicated smokers; most want to quit. The net effect in Ontario is an annual loss of up to 8% from the current customer base, approaching 40% over 5 years. Relapsed quitters, immigrants and kids currently aged 10 to 19 are the only replacements.

One scenario for Ontario in 2005:

Current adult smokers	2 million
16,000 tobacco deaths/year	- 16,000
75% attempt to quit; less than half succeed	- 425,000
Without replacement	1.5+ million
Half of 2004 quitters relapse	137,000
5% of kids currently 15-19 start smoking	20,000
4% of kids currently 10-14 start smoking	16,000
125,000 immigrants/year; 25% smoke	31,250
End of year	1.7+ million

POP advertising effectiveness

Manufacturers' displays and signage in stores are known as POP (for "point of purchase") or POS (for "point of sale"). In addition, manufacturers pay retailers for shelf space, conduct product knowledge programs with retail staff, and can pay retail staff extra commissions for promoting a product.

Promotional allowances paid to retailers are also known as slotting, display, or placement fees. These payments take several forms: cash, invoice and payables reductions, free equipment, prizes, etc. In return, retailers agree to stock and promote products per contract specifications. These requirements include keeping the product stocked on the shelf, and guarantee display placement (minimum "facings", height, location, etc.) The agreements can also specify price discounting, advertising placement locations and occasions, etc.

POP has been called "the last 3 feet of the marketing plan". Typically, two-thirds of shoppers do not make their final brand purchase decision until they're in the store. Few people use a written shopping list, particularly in c-stores. Although the category to be purchased is often decided in advance, POP can be a strong influence in final brand choice. Additionally, POP can drive impulse purchase at the category level, which is particularly prevalent in c-stores.

Point Of Purchase Advertising International ("POPAI") is the world's largest trade organization devoted to POP. POPAI claims that stores are an advertising medium, comparable to print and broadcast media.

According to a POPAI survey, in-store ads are highly effective:

- 40% of consumers recall the presence of in-store advertising.
- Consumers recalled in-store advertising for an average of 29% of all products purchased, with carbonated beverages, cigarettes and coffee enjoying the highest rates.
- 79% of respondents said that in-store ads provide "helpful" information; 59% indicated that they appreciate the degree to which in-store ads educate them about product benefits.
- 79% believe their store has the right amount of in-store advertising; an additional 10% say they want more in-store advertising.
- 69% indicated that window ads caught their attention and 43% of ads were found either at the aisle or cooler; 38% were seen outside.

More than half of all teenagers say they are influenced by in-store displays: banner/window signs influence 47%, and 44% are influenced by in-store promotional signage.

Tobacco POP advertising

Tobacco companies spend an estimated $300 million annually in Canada on POP presence, including listing fees of nearly $80 million. These figure has increased over time: in 1996, tobacco companies spent $60 million on in-store signage and retailer payments, and another $60 million on sponsorships and sponsorship communications. Now that sponsorships are banned, retail promotional allowances have increased.

US studies have found that retail displays increase average tobacco sales by 12% to 28%. Conversely, 4% to 6% of cigarette volume is lost when the counter doesn't communicate price or special products to smokers.

ACNielsen determined that 42% of retail outlets in Canada carried some form of tobacco POP advertising in 2003, up from 33% in 2002. In some cities, tobacco POP ad presence doubled in one year. 64% of chain c-stores, and 42% of independent c-stores, carried tobacco ads.

- Counter-top displays accounted for 68% of all tobacco brand ads in-store; one-third of all stores had these displays. These accounted for 79% of all ads in chain c-stores, 69% in gas stores, and less than 2/3 in independent c-stores.
- No one brand had ads in over one-third of stores visited. Players was the predominant brand advertised, in 28% of conventional chains, 16% of gas stores and 14% of independent c-stores.
- Danglers, shelf-talkers and other ad types were more widely available than in 2002 and captured a larger share of tobacco ads in the marketplace.
- Stores near schools or malls were slightly more likely to have tobacco POP advertising.
- Stores with tobacco POP ads carried an average of 2.4 pieces, up from 1.7 in 2003. Chain c-stores carried more such ads (3.3 pieces, on average) than gas and independents.

Following the ban on tobacco sponsorship, tobacco companies realigned their in-store merchandising. Traditionally predominant posters were replaced by counter-top displays. Danglers were more widely used in 2004 than ever before. Other "traditional" vehicles (like calendars and clocks) are making a comeback.

One industry publication advises: "As with any other aspect of tobacco sales, partnership with a distributor is crucial to gaining sales. Even if revenues are being shaved, having the best-advertised and priced tobacco products will ultimately result in more customer traffic and potential for unrelated purchases. This has made it vital for manufacturers to partner with retailers to optimize space and visibility for the category. Merchandising and marketing message space are at a premium and require strategic placement."

The US Department of Justice maintains that POP marketing helps tobacco companies create brand awareness and associated image. A market study by Brown & Williamson showed "the store environment, especially displays inside stores, is the biggest source of advertising awareness for all cigarette trademarks".

According to Philip Morris: “Retailers should focus on competitive pricing and value, responsibly merchandise the category in a well-organized and attractive presentation, ensure youths don't have access to cigarettes, focus on the profitability of premium brands, provide fast and friendly service, clearly communicate promotional value to consumers and efficiently manage inventory.”

According to tobacco companies, in-store signage for tobacco products has no impact on non-smokers. Imperial Tobacco cites a Meyers Research Center survey of Canadian adults that found 99% had made their tobacco purchase decision before entering the store. (This figure may include non-smokers whose decision is to *not* purchase tobacco products.) As another proof, a spokesman for RBH recently stated that marijuana use is higher than cigarette smoking among youth, despite the lack of signage for marijuana.

Despite the addictive nature of tobacco and strong cigarette brand loyalty, there is an impulse aspect to cigarette purchase, which can be segmented by key target groups:

- Smokers could try a new brand (particularly lower-priced)
- Young Adult and Occasional smokers are less likely to have firm brand preferences
- Smokers who are trying to quit might be tempted back to the category (relapse)
- Former smokers who have quit might be tempted back to the category (relapse)
- Teens are tempted by POP to try smoking (new to category)

In one study comparing photographs of stores with no tobacco advertising vs. stores with advertising, students perceived easier access to tobacco products at the stores with tobacco advertising.

Retail Services Institute

RBH runs this program to manage relationships with retailers and bars. It includes:

- Printed materials, namely newsletters, pamphlets, brochures, instruction sheets, booklets and binders of loose sheets, all of an informative nature in relation to consulting and management services; educational services and insurance services for store operators; teaching materials, namely, newsletters, pamphlets, brochures, instruction sheets, booklets and binders of loose sheets, all of an informative nature in relation to consulting and management services, educational services and insurance services for store operators; calculators, layout IT for store layout.
- Audio tapes, namely pre-recorded audio tapes, video tapes, namely pre-recorded video tapes, bulletins, all of an informative nature in relation to consulting and management services, educational services and insurance services for store operators.
- Consulting and management services relating to the operation of stores, educational services, namely the provision to retailers of teaching materials namely newsletters, pamphlets, brochures, instruction sheets, booklets and binders of loose sheets, all of an informative nature; disseminating information relating to the operation of stores, namely the distribution of printed materials and teaching materials to retailers, namely newsletters, pamphlets, brochures, instruction sheets, booklets and binders of loose sheets, all of an informative nature.
- Insurance services, namely the recruitment of strategic partners and allies in the insurance field for direct provision of retail insurance services by such partners and allies to the retail trade, financial services, namely the recruitment of strategic partners and allies in the financial services field for direct provision of retail financial services by such partners and allies to the retail trade, promotional services, namely the recruitment of strategic partners and allies in the field of advertising and marketing for direct provision of retail advertising and marketing services by such partners and allies to the retail trade.

C-stores

Every day, 1.2 million Ontarians visit convenience stores.

In Canada, 40,000 stores sell cigarettes; 25,000 of these are c-stores. There are over 8,400 c-stores in Ontario. Most Ontario c-stores are independents; almost 3,000 outlets belong to chains.

Combining gas pumps with a c-store ensures c-store traffic; c-stores are being encouraged to gas and car wash facilities, and the major oil companies seldom open a new outlet without a c-store in it.

In addition, other retailers are developing new c-store concepts. Shoppers Drug Mart and The Bay are opening mini-c-stores in selected locations. Canadian Tire is opening "Q" stores, consisting of gas pumps in front of a 10,000 square foot "ultimate convenience centre". Pricing is at grocery store levels, rather than the higher "convenience" price level. Fresh food will be a primary difference vs. traditional c-stores; CTC has arrangements with Sobeys, Starbucks and Richtree/Movenpick.

Canada is "over-retailed", meaning there are more stores than the population requires, and the rate of store openings outstrips population growth.

Drug stores are considered the main retail category competitors to c-stores. Drug stores have been leveraging the packaged beverage categories to attract customers who would otherwise go to c-stores.

In Ontario, drug stores cannot sell tobacco products. Department stores are a key competitor to c-stores in the tobacco category, particularly on cartons of low-priced brands. The trend is toward single-pack sales, however (possibly driven by tax increases driving up the total price of a carton), ensuring tobacco sales for c-stores.

Nationally, nearly 20 million Canadians aged 12+ shop at c-stores every month. On average, these customers make at least 8 trips a month (2 trips weekly). Almost half of c-store customers are Heavy visitors, making 11 or more trips monthly (about 3 trips weekly), and accounting for over two-thirds of total monthly traffic in c-stores nationally.

'000's	All 12+	12-18	Smokers
Visit c-store in past month	19,795	2,322	5,203
Light (1-5 trips/month)	6,047	801	2,254
Medium (6-10/month)	4,425	571	1,290
Heavy (11+/month)	9,323	950	1,659

C-store sales & profitability

NOTE: Financial metrics for the Canadian industry are inconsistent. Some measurement systems and some stores do not include lotteries in their reports. Also, other sources of revenue – phone cards, ATM fees, gasoline, car wash – are often not included. ACNielsen data does not include these items, concentrating on scanned consumer packaged goods ("CPG's"). Also, retail association memberships are skewed toward chains, franchises and larger stores, which tend to have wider category selection and/or larger store area, which in turn have proportionally lower cigarette sales.

Total weekly c-store sales in Canada average $12,000 to $14,000. (This includes lottery revenues, phone cards and other categories, but not other sources of revenue such as gasoline or income from cash machines.) A few very large c-stores drive the higher figure; 14% of stores have sales higher than $25,000 per week. The range is very broad: over one-third of stores fall below $10,000 weekly.

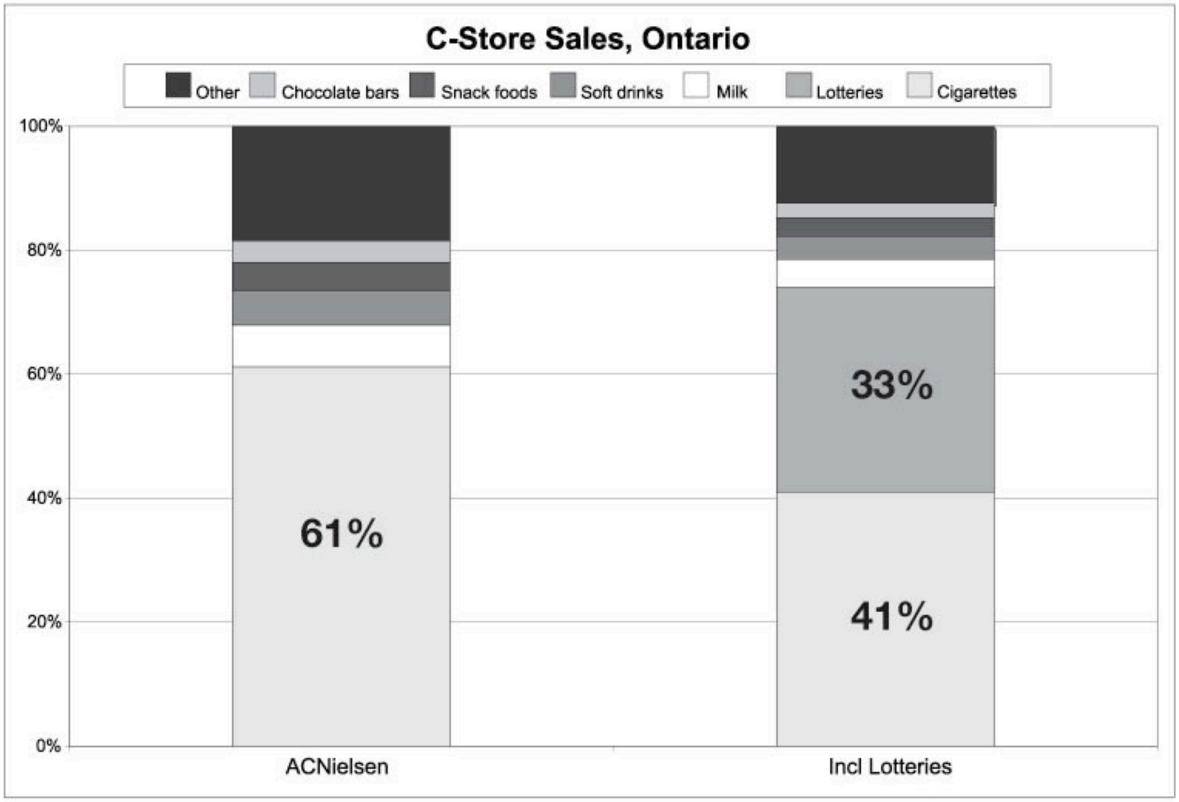
Total sales/week	% of stores
$25,000+	14%
$15 - $25,000	21%
$10 - $15,000	25%
$5 – $10,000	21%
Under $5,000	19%

Typically, most convenience stores process about 150,000 transactions a year, or 12,500 per month, and a great many of those customers are loyal visitors who shop more than once a week. The average transaction is $16.

- The average c-store size is 1,700 square feet.
- Cigarettes account for over 60% of sales (excluding lotteries). They make up the largest portion of total inventory value (30%+) and account for 26%+ of total gross margins. However, cigarettes require only about 2% of a c-store's area. (Note that over two-thirds of tobacco sales at the till are taxes.)
- We estimate Lotteries average 33% of total weekly sales; margins are typically 7%. (Including lotteries in c-store sales, cigarettes would be over 35% of sales – still the #1 category.)
- The major non-lottery categories – cigarettes, beverages, grocery and confectionery – account for 58% of total gross margin dollars.

As the range of merchandise available in c-stores expands, the percent of sales from key categories is diluted. Larger stores are less reliant on cigarettes. But tobacco is always the #1 category.

Interestingly, c-stores get most of their sales from two "adults-only" categories that kids can see but can't legally buy: tobacco and lotteries.



Small "mom & pop" c-stores are not highly profitable; margins 2% or lower are cited by the industry. Cigarettes, being the largest sales category and having high margins, are therefore crucial to small operators. In addition, listing allowances paid by tobacco companies are crucially important to these families.

Tobacco in C-stores

Now that drug stores in Ontario can no longer sell tobacco, c-stores and tobacco companies have become mutually dependent. C-stores have been described as being "the future" for the tobacco industry. Tobacco companies are visible supporters and vocal advisors of the c-store industry.

Tobacco companies are concentrating their marketing dollars at the point-of-sale to the extent that the store is their primary communication channel with customers.

According to NFO CF Group data for Imperial Tobacco, most cigarette smokers purchase tobacco at convenience, gas and smoke stores. Nationally, figures from July 2003 showed convenience retailers held 71% of the market, with Central Canada outlets commanding a 79% share.

In 2004, c-stores accounted for 73% of Ontario tobacco sales, and 65% of National volume.

C-retail shares	2003	2002
Canada	71%	70%
East	74%	71%
Central	79%	81%
West	56%	51%

In Ontario, c-stores are the primary distribution channel for tobacco products.

- Over 70% of all tobacco products are sold via c-stores
- Cigarettes account for over 60% of c-store's total sales (excluding lotteries, etc.)

The smaller the c-store, the more dependent it is on tobacco sales. Larger c-stores, which approach small grocery stores in size, offer more product mix, so their sales from other categories are relatively higher (although tobacco is still a leading category).

Total weekly sales of cigarettes in Canadian c-stores average between $3,200 and $4,900. 23% of convenience retailer operators report weekly cigarette sales of $1,000 or less; 36% report sales of more than $5,000.

Cigarette sales/week	% of stores
$7,000+	22%
$3 - $7,000	30%
$1 – $3,000	25%
Under $1,000	23%

Tobacco POP advertising in C-stores

ACNielsen estimates the average c-store receives $1,500 a year in listing allowances for stocking tobacco products. Anecdotal evidence suggests figures from $1,000 to as high as $10,000, with a figure of $4,000 to $5,000 cited by the Quebec c-store association. (Bear in mind that the chains, franchises and larger independents tend to be members of these trade associations, and that surveys of their members will be on the high side, since they sell higher volumes of tobacco and have more bargaining power.)

C-stores are unique among Ontario tobacco retailers in that the back wall, situated near the main entrance/exit, at the cash register, is virtually unavoidable by shoppers. Department and grocery stores do not have a consistently visible equivalent; cigarettes in these stores tend to be sold at a separate counter that is not necessarily seen by all shoppers.

Tobacco companies say that store displays are an important means for tobacco companies to capture (or retain) customers who switch brands. Switch-over sales occur due in large part to the ads and product displays on the back bar shelf behind the counter. Tobacco companies that do not have such space cannot adequately compete.

To quote one USA expert: “In order for c-stores to retain tobacco customers, the back bar should be set up as close to space-to-share as possible. Pricing must be in line with the competition and signage needs to be uncluttered and focused on top-selling brands.” One retail consultant has called the back-bar “center stage”.

Teens are more likely than adults to be influenced by tobacco promotional pieces in convenience stores (73% of teens vs. 47% of adults). Comparing our surveys of kids and adults, the impact of tobacco displays is at least twice as strong on kids:

- 35% of kids aged 11 to 18 think that c-store tobacco displays make kids try smoking; another 27% think it might
- 19% of adult smokers agree that c-store tobacco displays encourage people to continue smoking

Brands advertised most in c-stores:

2003	Chain c-stores	Independent c-stores	Gas c-stores
Players	28%	14%	16%
du Maurier	26%	12%	13%
Export “A”	18%	9%	10%
Benson & Hedges	13%	7%	7%
Others	38%	20%	19%

Tobacco ads in c-stores:

2003	**Chain c-stores**	**Independent c-stores**	**Gas c-stores**
% Stores Carrying Any Ad	63.6%	42.3%	44.3%
Average # All Ads In Store	*3.1*	*2.3*	*2.2*
% Stores With Counter-Top	53.4%	32.7%	36.4%
Ave. # Counter-Top Displays	*2.8*	*1.9*	*1.8*
% Stores With Danglers	8.9%	6.3%	4.9%
Average # Danglers In Store	*2.1*	*1.6*	*1.9*
% Stores With Shelf Talkers	6.9%	4.1%	4.1%
Ave. # Shelf Talkers In Store	*1.6*	*1.7*	*1.7*
% Stores With Posters	4.2%	2.7%	1.5%
Average # Posters In Store	*1.6*	*1.8*	*1.8*
% Stores With "Other" Ads	10.4%	7.6%	7.5%
Ave. # "Other" Ads In Store	*1.4*	*1.4*	*1.4*

C-stores, Tobacco & Crime

C-stores are using crime statistics related to cigarettes as part of their argument to keep power walls uncovered. Tobacco companies, and increasingly oil companies, support this.

The November 2004 *Tobacco Related Crime Study*, prepared by the Inkster Group for the OCSA, indicates that c-stores have experienced a 127% increase in break and enter incidents since 2001-02, while convenience gas bars have seen an increase of 29%. About 53% of reported crime events at c-stores involved cigarettes. The report also finds a very strong correlation between cigarette prices (driven largely by taxes) and c-store crimes: “The increase in tobacco-related crime appears to correspond with the increase in tobacco taxation.” However, there are flaws in this study:

- Statistics are not compatible or directly comparable across jurisdictions; as the report states, “Unfortunately, there is a minimal consistency in the collection of crime statistics between the various police services.”   Some regions include residential break-ins with their retail crime statistics, for example.
- The c-store industry is publicizing the apparently very high correlation (0.97) between cigarette prices and the incidence of B&E and robberies. But as the report states, “However, more than three years of data, and data during years of no price increases, would be required to prove this statement.”

Comparing USA vs. Canadian store layouts, we see that centralizing tobacco products near the cashier yields less crime. US stores often relegate the new discount brands to self-serve areas away from the cashier; the financial strength of the established tobacco companies allows them to keep the back-bar to themselves. One chain moved all cigarettes behind the counter; this reduced “grab-and-run” thefts and lowered shrinkage by US$200,000 in 2003.

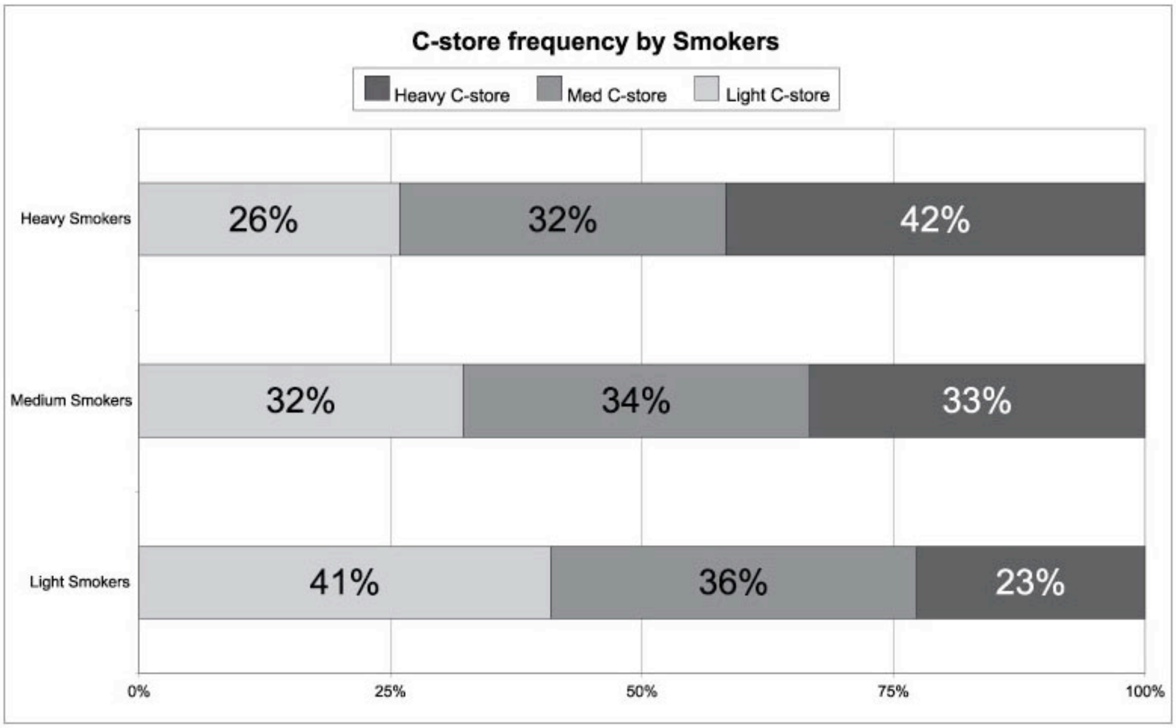
Smokers in C-stores

There are over 2 million smokers in Ontario, about one-quarter of the adult population.

With 4 to 6 tobacco-purchasing trips per week, the smoker is a key c-store customer. The customer base is strong and smokers are very loyal to the c-stores they choose to frequent. In addition, cigarette smokers purchase more soft drinks, coffee and snacks. (Adult non-smokers do not go to c-stores as often as smokers do.)

C-stores have become heavily dependent upon smokers. In planning a c-store, retailers are advised to plan 50% of their sales from the 2% of store area devoted to tobacco products, with a gross margin of 10% to 15%.

The more you smoke, the more often you go to c-stores. Also, smokers are more likely than other people to do most of their regular grocery shopping at c-stores.



Heavy smokers are also heavier consumers of many other products that c-stores rely on. PMB data indicates that heavier smokers are:

- Heaviest pop drinkers
- Heavier gum chewers
- Heavier chocolate candy consumers
- Heavier corn/tortilla chip consumers
- Heavier potato chip consumers
- Heavier candy/mint consumers
- Heavier "party mix" snack consumers
- Heaviest frozen snack & dessert consumers

Heavy smokers are only one-third of all smokers, but purchase two-thirds of all tobacco products. They smoke at least 10 packs a week, twice the average.

The average smoker spends at least $45 weekly on cigarettes alone, plus other products. Heavy smokers spend at least $70 weekly on cigarettes alone. **Each** smoker therefore represents annual cigarette sales of over $2,300, or a potential gross annual profit of at least $230 to the c-store owner.

We conducted a survey of over 330 Ontario adults who currently smoke or have quit smoking. Three-quarters of current smokers have tried to quit in the past. Nearly one-fifth of these smokers who have tried to quit believe that power walls in c-stores encourage them to continue smoking.

Former smokers

There are more former smokers than current smokers in Ontario. Half the adult population of the province has been regular smokers at some time.

One-quarter of former smokers believe that power walls in c-stores encourage them to continue smoking.

Kids

There are 5.4 million Canadian young people whose weekly incomes range from $66 for 12- and 13-year-olds to $374 for those 22 to 24 years of age.

In one survey, we focused on nearly 200 Ontario kids aged 11 to 18 who live in households where nobody uses tobacco products. (This removes smoking parents or siblings as a possible influence on the kids' knowledge of tobacco products.) Among these kids:

- 85% spontaneously name c-stores as a place that sells cigarettes. In addition, 16% know that gas stations sell cigarettes, and 30% name food stores.
- 77% go to c-stores at least once a week
- 41% can spontaneously name cigarette brands; half of these kids can name more than one brand (up to 7).
- 63% believe that cigarette displays in c-stores might influence kids to smoke

A study of 7th graders found that virtually all reported seeing tobacco advertising and promotions, and that 70% indicated receptivity to tobacco marketing materials beyond simple awareness (e.g., collecting, displaying, wearing or using tobacco promotional items).

44% of teen smokers buy cigarettes from a store; 56% rely on friends or family.

In 2003, one-third of c-stores sold cigarettes to minors. The rate of compliance with the law has deteriorated since 1999.

Normalization in C-stores

"Normalization" is a term used to describe the place of cigarettes in everyday life. Tobacco companies resist the "denormalization" of their products (via bans on advertising, sponsorship and displays) and their industry (via demands from "ethical" investors on pension and mutual funds to divest tobacco holdings).

The placement of tobacco products in proximity with other categories plays a role in tobacco consumption. Tobacco could be perceived as being as harmless as any other CPG; and the impact of the health warning messages on the packages might be blunted by this "halo effect".

Research shows that the more strongly a young person overestimates smoking rates, the more likely they are to start smoking: if they are influenced by smokers, advertising or other everyday observations to believe that smoking is common or popular, they are more likely to become smokers themselves. "Normalization" is believed to be a factor in youth perceptions that smoking is more common than it actually is.

Counter-top displays, being at the eye-level of young children, are particularly contentious. The tobacco industry and c-stores in Ontario have ceded that space, but believe they will retain the back wall.

Adult smokers outnumber kids by a ratio of 2:1 in Canada. Young adults aged 19 to 24, particularly young women, are the heaviest smokers in Canada, on a per capita basis. Kids don't have to look far to see a smoker, probably one they know, and likely one they admire.

Young smokers are well known to their peers. Although 16% of kids aged 15 to 19 are smokers, nearly 90% of all the kids in this age group know someone their age who smokes. Although younger kids are less likely to smoke, we still find one-quarter of those aged 12 to 14 knowing someone their age who smokes.

Many c-store operators know customers by name; many customers visit the same c-store every week for years. C-store owners are encouraged by the tobacco industry to leverage their personal relationships with customers to build loyalty and sales. In the words of one retail consultant, "… there is an opportunity to develop an oasis, where your customers will feel genuinely welcomed and valued."

Many c-stores use the word "smoke" in their names. Many c-stores still have old tobacco-sponsored signage associated with their names.

Looking at the dynamics of c-store traffic demographics, kids are in regular contact with smokers, particularly heavy smokers. Many people smoke just outside c-stores. Smokers are also heavy consumers of many of the products that kids buy most … plus cigarettes.

Compared to the total population aged 12+:

- Kids and smokers are convenience stores' frequent customers
- Kids and heavier smokers are heaviest pop drinkers
- Kids and heavy smokers are heavier gum chewers
- Kids and heavy smokers are heavier chocolate candy consumers
- Kids and heavy smokers are heavier corn/tortilla chip consumers

- Kids and heavier smokers are heavier potato chip consumers
- Kids and heavy smokers are heavier candy/mint consumers
- Kids and heavy smokers are heavier “party mix” snack consumers
- Kids and smokers are heavier cough drop consumers
- Kids & heavy smokers are heaviest frozen snack & dessert consumers

Sources

This report is based on facts from a wide array of media: print, online, academic papers, legislative and legal proceedings, trade events, and databases. We also conducted two telephone surveys, and have accessed recent market surveys conducted by others.

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