

The Sleeping Dragon

BY STEVE HONG

The world's largest tobacco consumer, and a dominant supplier of e-cigarette hardware, China has yet to live up to its staggering potential as a vapor market.

The Chinese vapor market is still in its infancy compared to many Western markets, a surprise considering the importance of China to the nascent global industry. China is the birthplace of the e-cigarette, which was invented by pharmacist Hon Lik in 2003. Most of the e-cigarettes sold around the world are manufactured in China, where hundreds of factories produce hundreds of millions of units per year. In addition, there are more than 300 million smokers in that country, so there is a large addressable market for vapor products. Vapor market growth might be impeded by the fact that China is much more tobacco-friendly from a legal and social perspective. Smoking cessation is not a widely-accepted idea, and tobacco regulation is far more lax compared to that of Western markets.

Jackie Zhuang is the deputy general manager of Huabao International, a tobacco flavorings company in China that also produces e-liquid. He is also a doctoral candidate at the Maastricht School of Management, in the Netherlands, where his research includes an assessment of the Chinese market for e-cigarettes. Through his academic work he provides some insight into why the vapor market in China is not more developed.

To understand e-cigarette use in China, one has to look first at the state of tobacco use in that country. With

more than 300 million smokers, the potential market for e-cigarettes is staggering, but Zhuang points out that there are significant obstacles to its viability. First, tobacco plays a significant role in modern Chinese life. For instance, business meetings commonly start with the mutual lighting of cigarettes by business associates. Also, cigarettes are typically given out as party favors to guests at weddings—smoking them is thought to be the harbinger of a good marriage. These are just two examples of how tobacco cigarettes are embedded into Chinese culture. Replacing traditional cigarettes would also mean changing social norms.

Another obstacle to the adoption of e-cigarettes is the state of smoking cessation in China. Anti-smoking messages have been a part of the American public health consciousness for decades, but in China, smoking cessation is relatively novel. Even so, the government must contend with the increasing cost of tobacco-related death and disease. An estimated 1 million Chinese people died in 2014 from tobacco-related diseases. The government has run campaigns urging people to stop smoking, featuring celebrities such as Bill Gates; former NBA star Yao Ming; and Peng Liyuan, the wife of Chinese President Xi Jinping. But thus far, evidence suggests that they have not had great impact. According to a 2010 study, 76 percent of Chinese smokers had no intention to quit—a stark contrast to the 69 percent of American smokers who report wanting to quit smoking, as reported by the Centers for Disease Control and Prevention. In 2007, according to Zhuang, there were 100 smoking-cessation treatment centers in China to help smokers break their habits. However, most are now closed or closing.

According to Jiyong Jin, research fellow at the Oxford-Princeton Global Leaders Fellowship Program, there is a lack of political will to put tobacco-control policy in place because of the importance of the industry to the Chinese economy. Zhuang further points out in his research that while the cigarette market in the U.S. shrinks year after year, the market in China continues to match GDP growth (at 7.5 percent in 2014). The tobacco industry is vitally important to the Chinese economy, and its growth is in part due to the effective management of the China National Tobacco Company (CNTC), a government-run monopoly that controls the industry.



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Tobacco continues to play a significant role in modern Chinese life.

The CNTC was formed by the Chinese government in 1982 to counteract black market tobacco manufacturing and rationalize the highly segmented tobacco industry. It has been successful in doing so by several measures. In an effort to streamline manufacturing, the CNTC has consolidated manufacturing to 94 factories today from an estimated 400 factories in 1982. Additionally, the CNTC operates an estimated 160 brands and continues to innovate in marketing, following a strategy of creating higher value, high-priced brands to appeal to the increasing number of higher income Chinese. However, despite this success, Zhuang points out that the public has questioned “low efficiency and uneven resource [distribution].”

Today the CNTC enjoys a virtual monopoly in the largest market for cigarettes in the world with a 98 percent market share. By unit volume, the Chinese market is more than eight times the size of the U.S. market. An industry that large is important to the 500,000 workers employed directly by the industry and the 20 million workers whose income is at least in part derived from the tobacco industry. The industry is important to the Chinese government as well; it derives 7 percent of its revenue each year from tobacco.

Zhuang’s research also assesses the current state of

the e-cigarette market in China. In many ways, the Chinese market mirrors the state of the U.S. market in its infancy. He estimates that the market value is currently \$40 million to \$50 million, only a fraction of more mature Western markets. Also, he estimates that more than 90 percent of sales are online. Although there are a few dedicated vape shops, they are rare. Manufacturers’ commercial practices are not those of an established industry. Ads include falsified celebrity endorsements, and counterfeit units of more reputable brands are also common.

THE CHINESE MARKET MIRRORS THE STATE OF THE U.S. MARKET IN ITS INFANCY.

In recent months, Zhuang says that e-cigarette sales in China have increased. He reports that search activity for e-cigarettes in November of last year was 1,132 percent higher than activity from November 2013. Domestic sales, Zhuang asserts, may have picked up because international sales have cooled and manufacturers are looking for new markets—in this case, their domestic market. Another motivation for increased e-cigarette purchases was gift-giving. According to Zhuang’s research, only 33 percent of those who purchased e-cigarettes did so for self-use. One demographic that has responded particularly well to e-cigarettes is female smokers. According to Zhuang’s research, 45 percent of e-cigarette users are female,



Photo: Taco Tuinstra

According to some estimates, Chinese e-cigarette manufacturers employ 170,000 people.

despite the fact that the vast majority of smokers in China are male.

Though conditions for growth of the vapor industry are less than ideal and the market is still in its very early stages, Zhuang still sees an opportunity for e-cigarettes in China, in part because it may be a chance to reinvent the Chinese tobacco industry and resolve many of its inefficiencies.

One of these inefficiencies lies with some low-priced cigarettes. According to Zhuang, some low-priced cigarettes are a tax burden because production occasionally requires subsidies from the government. The purpose of the subsidy is to keep prices down for low-income consumers. Retailers tend not to like these brands because they are low-margin. Replacement of these products with e-juice, which is potentially cheaper by the unit, could eliminate the need for government subsidies and actually create the opportunity for positive tax revenue. E-juice could provide a better margin for retailers, as well.

Zhuang also feels that another reason for e-cigarettes to supplant tobacco in China is because of its growing economic importance. He claims that 170,000 people in China are employed by e-cigarette manufacturers.

Changes in the global cigarette market have not been lost on the CNTC. Zhuang anticipates that as tobacco control increases in China, smoking cessation will enter the public consciousness and alternatives to smoking will gain a foothold in the Chinese market. This is not lost on the state-run tobacco company. Much like other big tobacco conglomerates, the CNTC has expressed

interest in developing new products, including heat-not-burn products and e-cigarettes. Zhuang says that this is an opportunity to reform the tobacco industry according to a more market-driven model.

Moreover, Zhuang points to a few other expected events as indicators of growth in the Chinese domestic e-cigarette market. Namely, he expects three major vapor trade shows

in China this year as well as two or three initial public stock offerings from Chinese e-cigarette manufacturers.

CNTC HAS EXPRESSED INTEREST IN DEVELOPING NEW PRODUCTS, INCLUDING E-CIGARETTES.

Steve Hong is the principal of Roebing Research, a boutique market-research firm dedicated to the vapor industry, and the author of "Next Wave of Open-system Device Consumers," a consumer insights report. For details, visit <http://roebingresearch.com/reports>. **V**