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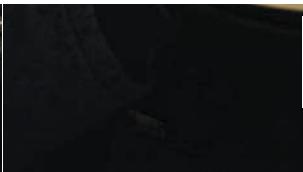
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Getting Rich



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By Andrew Martin

Photographs by Gilles Sabrie

The China National Tobacco Corp., which serves China's 300 million smokers, is by far the largest cigarette maker in the world. In 2013 it manufactured about 2.5 trillion cigarettes. Its next largest competitor, Philip Morris International, produced 880 billion.

In terms of market share, China National is bigger than its next five competitors combined; its growing sales have accounted for a net increase in global production, even as volume at its competitors has fallen. While Marlboro remains the most popular cigarette in the world, China National boasts 7 of the top 10 brands, including Red Pagoda Mountain and Double Happiness. In all, the company made 43 out of every 100 cigarettes in the world last year, according to Euromonitor International. Despite its size, China National is little known outside of China: Almost all its cigarettes are sold in the country, where it has no real competition.

A conglomerate on the order of the old Gulf + Western, China National runs more than 160 cigarette brands, manufactured in about 100 factories across the country, and uses its earnings to invest in banks, luxury hotels, a hydroelectric plant, a golf course, and even drugmakers. Most of its money goes to its owner, the Chinese government; the tobacco industry accounts for about 7 percent of the state's revenue each year, and China National controls as much as 98 percent of the market. All told, the industry in China employs more than 500,000 Chinese. They are among roughly 20 million people who get some income from tobacco, including members of 1.3 million farming households and workers at 5 million retailers, according to government figures. The extent to which the government is interlocked with the fortunes of China National might best be described by the company's presence in schools. Slogans over the entrances to sponsored elementary schools read, "Genius comes from hard work. Tobacco helps you become talented."

The government runs China National as a largely opaque monopoly. The company has successfully blocked competition from Western tobacco makers by limiting imports or domestic production by foreign companies. In the past decade, as smoking has ebbed in other parts of the world, China National has been on a remarkable tear, gobbling up market share and building blockbuster brands. It generated about \$170 billion in revenue in 2012, more than Apple.

While the growth of its cigarette production has slowed, the company is making more money than ever in the same ways its Western competitors do: by pushing premium brands. Some are low-tar, some are organic, and some feature tobacco from American farmers, whose fortunes have risen along with the demand from China. But China National is being challenged as never before. Faced with a mounting death toll from smoking-related diseases, the Chinese government in the last year has issued a flurry of anti-tobacco edicts and proposed reforms.

China National doesn't seem too concerned. The general manager of the company is Ling Chengxing, 57, the onetime mayor of Fengcheng in southeast China. He began his tobacco career in 1992, running China National's branch in Jiangxi prov-

ince. At a January meeting of cigarette brand managers and tobacco regulators, Ling announced his projections for the industry's contribution to the government: an increase of 8 percent in 2014. But, he said, "strive for 10 percent." He's a nonsmoker himself.

China National was founded in 1982 to counter a black market explosion in cigarette production; there were about 400 factories in China at the time, three times more than central planners had approved. Its first headquarters was a one-story, red-brick guest house in Beijing. The building, owned by the air force, sat next to a pile of heating coal. Its two dozen employees shared desks.

The company got crucial early help from a scientist with the U.S. Department of Agriculture, which was eager to expand scientific cooperation and trade as relations between the countries thawed. Tien-chioh Tso, a slight, bespectacled Chinese man, had immigrated to the U.S. to accept a fellowship at Pennsylvania State University, where he pursued a graduate degree in phytochemistry and agronomy. His career was devoted to tobacco research; he quit smoking in 1964. He died in 2013, at the age of 95.

In 1977, with China emerging from the Cultural Revolution and decades of isolation, Tso, then 59, was invited to deliver a series of lectures. It was his first visit to the country in 30 years. "Everything seemed gray. People with gray faces and forced gray smiles wore unisex gray uniforms," he wrote in his autobiography. "Everyone seemed to be in a gray, gray mood."

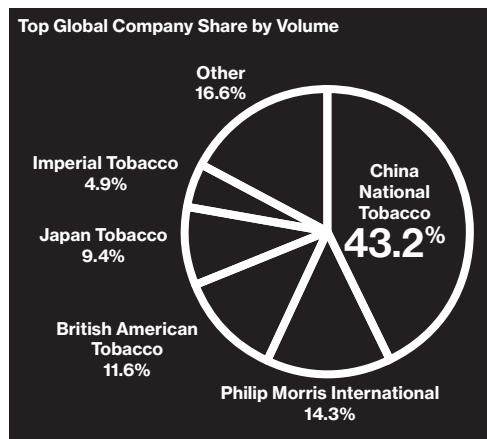
Tso found a tobacco industry that was an uncoordinated sprawl of antiquated factories and communal farms producing low-quality cigarettes. Many Chinese couldn't afford even those. Cigarettes, along with grain, sugar, and bicycles, were in such short supply that they were rationed. He lectured about trends in tobacco science, advances in cigarette manufacturing, and the development of lower-tar cigarettes.

He also toured tobacco fields and cigarette plants, including one in Wuhan, in central China. "I had not been at all impressed with what I had seen and observed, and I remarked, frankly, that I felt that there should be no more smoking permitted inside the manufacturing area,"

Tso wrote. He chastised workers for wasting raw materials. "They should also be more circumspect in their use of time by cutting down on chatting during working hours and especially between shift changes."

"These suggestions were gracefully and politely accepted," Tso wrote. In the following decades he visited China more than 100 times, first as a USDA scientist and, after retiring in 1983, as a consultant for tobacco companies including China National and Philip Morris. He helped the Chinese figure out how to fund agricultural training and warned them that their genetically modified tobacco crops would scare off Western buyers.

As China reached out to America for technical aid, Western companies sought a way in. Philip Morris subsidized two cigarette factories in 1988 and almost a decade later provided corporate jets when China's top tobacco regulator, Ni Yijin, visited the U.S., according to internal industry memos. The company's objective was to build its relationship with Ni and to impress upon him that Philip Morris was the "preferred partner" to modernize and restructure China's tobacco industry. The visit was carefully orchestrated with talking



points, seating charts, and gifts for Ni (such as a \$700 Steuben crystal eagle) determined months in advance.

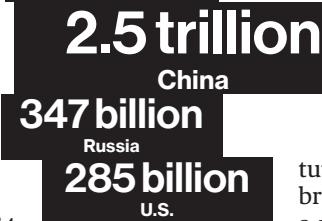
For his part, Tso couldn't understand why Western companies were so fixated on China. "It was very unlikely that the rank and file Chinese would ever be able to afford the premium prices of the U.S./U.K. cigarettes, even when manufactured locally," he told British American Tobacco executives, according to a 1984 memo. But China's tobacco business grew along with the Chinese economy, and premium cigarettes now account for more than 20 percent of the market.

Today, Tso's contributions to the industry are part of the permanent exhibit at the China Tobacco Museum in Shanghai. One photo shows him inspecting waist-high tobacco leaves, wearing a pink hat with the Chinese characters for "Beijing" on it, the kind tourists typically buy.

For all the success of Tso and other pioneers in modernizing the industry, as late as 2000 it remained inefficient and uncompetitive. Provincial governments blocked sales of cigarettes from other provinces, boosting consumption of local products and their own tax revenue at the expense of building strong national brands. "Each province put up a ring fence," says Yang Guo'an, a tobacco historian and compiler of *The Complete History of Tobacco in China*. "The monopoly was really local monopolies."

To fix the problem, the government tapped Jiang Chengkang, a onetime village official in Fujian province who had turned the local tobacco subsidiary from a money loser into a company with 20 percent growth for three consecutive years. When he took over China National in 2002, his first move was to separate

2013 retail volume
by number of cigarettes



cigarette manufacturers from their sales forces, reducing the incentive to push local brands.

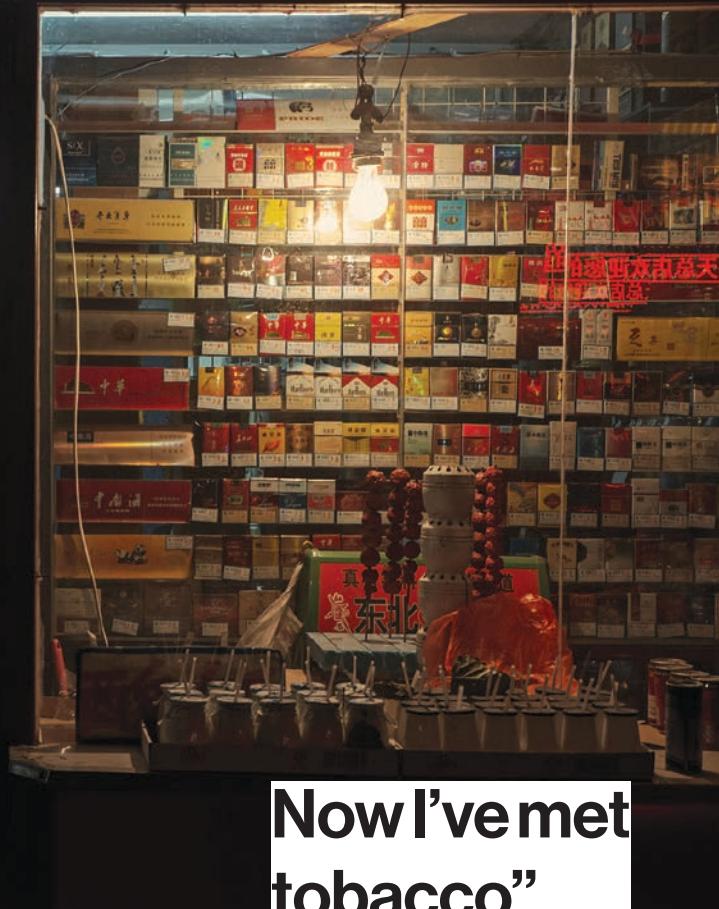
He dropped underperformers and merged subsidiaries, cutting the number from 123 in 2002 to 30 in 2009, according to a 2012 report by the Brookings Institution. "CNTC learned that if you have a thousand brands you cannot grow a brand," says Zhang Dan, a marketing employee for China National in the early 1990s who now works for a tobacco machinery company in the Netherlands.

There are many things about China National that remain unknown. It did not make Ling or other tobacco executives available after repeated requests for an interview, as is the company's custom with outside media. Unlike state-owned enterprises that have a publicly traded arm, such as China National Petroleum Corp., China National Tobacco does not report its earnings. But the tobacco industry's contribution to the state is published on a yearly basis.

China National also doesn't make public the salaries of its employees. What few records and media reports are available suggest they're paid significantly better than most Chinese. A report from Jiangsu province, for instance, showed that tobacco plant workers in 2011 made, on average, \$18,800 a year—more than in any sector besides the securities industry.

A tour of one cigarette factory owned by Jiangxi Industrial, a China National subsidiary, provides a window into the company's hugeness, as well as how it cranks out cigarettes. Near the factory in Nanchang, the smell of tobacco wafts across a jogging path that circles a nearby lake. The

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plant, which has 1,500 employees and is roughly the size of four Walmarts, receives tobacco leaf shipments from southern China, Zimbabwe, Brazil, and the U.S. Metal tanks hold Chinese herbs that will eventually be mixed with tobacco leaves to enhance the taste and distinguish Jiangxi cigarettes from other brands. “It’s like adding seasonings to a frying dish,” says Zhou Aisi, the employee who provides a tour.

The spiced tobacco is sent along conveyer belts to an adjoining hall where at least some of the 20 sets of packaging machines run 24 hours a day, seven days a week. Each machine is capable of rolling 8,000 cigarettes a minute and sealing them into 400 packs. In all, Jiangxi Industrial produces 59 billion cigarettes per year, 70 percent of them at the Nanchang plant.

Another view of China National is on display along North Sichuan Road in Shanghai. The Chunghwa Experience Store is to tobacco what Apple stores are to electronics, an emporium that displays its cigarettes as if they were museum pieces. The dominant color is stop-sign red. In the front window, a carton of Grand Chunghwa—among the most expensive brands in the country—is displayed under a spotlight, like a diamond necklace at a jeweler. Dozens of different cigarette packs sit in glass counters, and store employees, hip and fresh-faced twentysomethings, offer samples. For all the glamour, there are few customers.

“Cartier doesn’t have a lot of visitors, either,” says a young clerk, Zhou Zuyi. Wearing a T-shirt with a pack of Double Happiness on the front, she has fake black eyelashes and hair to her waist, the bottom half dyed gold. “All this is about building a brand like that.”



Not surprisingly, given the terrific success of China National Tobacco, the incidence of lung cancer in the country is soaring. Smoking-related diseases are expected to kill more than 1 million Chinese this year. Unless the prevalence of smoking is reduced, by 2050 the annual figure will increase to 3 million. According to the World Health Organization (WHO), the government hasn’t been an energetic regulator. It’s resisted higher taxes on cigarettes and imposed only tepid warning labels on packs.

Regulation is run by the State Tobacco Monopoly Administration, which imposes quotas on tobacco leaf production and cigarette manufacturing while also overseeing warning labels and advertising bans. The agency works closely with industry, to say the least. For all practical purposes, China National and its regulator are the same entity: They share headquarters in Beijing and have the same organizational structure, the same website, and even the same chief executive, Ling. (His deputy at the regulatory agency, Li Keming, happens to be the younger brother of China’s premier, Li Keqiang.)

The government’s equivocal tobacco control policies have created their share of absurd moments. In 2000 the tobacco regulator joined China’s delegation to WHO talks on a landmark antismoking treaty. Before each negotiating session, the regulatory agency hosted a dinner for China’s delegation and offered participants a parting gift—a carton or two of cigarettes.

Even before China ratified the treaty, the regulator developed strategies for skirting the more onerous restrictions. Among the ploys, it recommended that warning labels not be printed in black and white but rather in hues that better fade into the color scheme of the pack. The regulator gave the research team an award for developing the countermeasures. And in the years since China ratified the treaty in 2005, its

DATA: BLOOMBERG, EUROMONITOR, WORLD HEALTH ORGANIZATION (WHO'S TOBACCO WORK IN CHINA IS BACKED BY THE BLOOMBERG INITIATIVE TO REDUCE TOBACCO USE.)

share of the global cigarette market has increased by almost 30 percent.

Last year, China National opened an office in suburban Raleigh, N.C., to facilitate its growing purchases of American tobacco. Dried tobacco leaves decorate the front lobby. (Employees there also declined to comment.) Selling cigarettes blended with American tobacco remains a niche in China. But it's part of a broader strategy to focus less on volume and more on higher-quality, higher-profit smokes. In a few years, China has become one of the biggest export markets for North Carolina tobacco.

"At the end of the day, it's about the money," says Linwood "Sonny" Scott, one of the largest U.S. tobacco farmers, in Lucama, N.C. "They put a little American tobacco in the cigarettes; they sell more and make more money. And that's good for us."

A few years ago, a delegation from China National showed up at the farm of Thaddeus "Pender" Sharp III, whose family has grown tobacco near Sims, N.C., since the late 1800s. Wearing business attire and bearing gifts, they told Sharp they wanted to buy some of his tobacco. Sharp says China's cigarette market reminds him of the U.S. of his childhood, when "people smoked everywhere but church" and the government didn't care much about tobacco's effects. Inevitably, he says, China will strengthen its antismoking laws and persuade more smokers to stop. For now, though, China National represents a way for the Sharp family to prosper.

"It's not like we are going to quit because 50 years from now everyone might not smoke," says Sharp, who hangs his gift from China National, a hand-painted scroll, near the door of his office. "Hell, no! We are going to make a living for 50 years."

China National has learned from America.

In 1997, Philip Morris worked with China's tobacco regulator to minimize the impact of global anti-smoking efforts, and China National continues to borrow from the Big Tobacco playbook. It's addressing concerns about smoking by marketing low-tar cigarettes as less harmful. The U.S. prohibited the marketing of low-tar cigarettes in 2010, and the practice is prohibited by the WHO tobacco treaty. That's because medical experts determined that smokers of low-tar brands end up smoking more cigarettes or inhaling more deeply. In China, sales of low-tar cigarettes, which can cost as much as three times the high-tar brands, have increased by more than 3,000 percent since 2008, according to Euromonitor.

China National is looking for other new ways to make money, such as peddling cigars to upwardly mobile Chinese who consider them a status symbol. It struck deals with Philip Morris International and British American Tobacco to promote Chinese cigarettes overseas, a small but growing business. And its regulator is lobbying to assume oversight of the booming e-cigarette market, according to an Aug. 11 article in the *Hong Kong Economic Journal*.

"Tobacco control in China is a complicated game," says Dr. Yang Gonghuan, former deputy director of the China Center for Disease Control and Prevention. "It's an understatement to say [the regulator] is not excited about controlling smoking. They work very hard towards the opposite."

Some antismoking advocates are optimistic that China's leadership may finally be getting serious about curbing cigarettes. (Bloomberg Philanthropies supports antismoking efforts in China through public health authorities and nongovernmental groups.) On Nov. 24 the cabinet, known as the State Council, published a draft proposal that would ban all forms of tobacco

Smoking rates

300 million
Number of smokers
in China

1/3
of all cigarettes
are smoked in China

Fatality rate in China

1 million
Approximate number
of deaths every year caused
by tobacco

100,000
die from secondhand smoke

3,000
people die every day because
of direct or indirect exposure
to tobacco, or 1 person every
30 seconds

advertising, prohibit smoking indoors in public places, and require that warning labels cover half the cigarette pack. While not yet approved, the proposal, among a series of similar measures that have emerged from the government in the past year, would be "an unprecedented step forward," says Angela Pratt, who leads the WHO's tobacco control efforts in China. Smoking restrictions have already taken effect for government officials, who late last year were told to refrain from smoking in public. Laws prohibiting

smoking in indoor public places have passed in many cities, including, in November, Beijing. And the Central Party School, a training ground for communist leaders, released a 239-page report that recommended removing the tobacco regulator from oversight of smoking control.

"We still have a very long way to go, but I am very optimistic," Pratt wrote in a Dec. 3 e-mail. "I don't think the significance of the new draft law (coming at the same time as Beijing passed a 100 percent smoke-free law) can be overstated."

But some antismoking measures remain in draft form, and the country's leaders continue to resist higher taxes on cigarettes. Existing antismoking laws tend to be weakly enforced or left to earnest volunteers. In Shanghai the city government relies on 1,800 of them to monitor its public smoking ban. On patrol in Shanghai's Yangpu district one recent morning, one volunteer, a former shop attendant named Zhang Yuemeng, walks into a Web cafe where the smell of cigarettes still lingers. Nobody is smoking, but she eyes two young men, sitting side by side and playing cards. One has his foot on a tabletop. Zhang takes a closer look. No ashtrays, no butts, but each man has a pack of Double Happiness and a lighter in front of him. This time, she lets them off with a warning. "Would you tell them not to smoke?" Zhang asks a cafe attendant.

Zhang is on patrol three or four times a month, peering into cafes, hotels, and government offices. She wears a pink T-shirt and a laminated card around her neck that reads "Tobacco Control Supervisor." The volunteers have had some success: Last year, for the first time, eight government agencies were fined for failing to enforce the ban. "Things are improving," says Zhang Lan, another volunteer. "But relying on volunteers is not going to cut it."

In a rare court challenge last year, an activist named Li Enze filed a lawsuit attempting to take on China's tobacco powerhouse. He alleged that the marketing of one low-tar cigarette brand, Black Tiger, was fraudulent. Li, 39, had gained some renown in 2006 by standing in a busy Beijing street in his underwear to protest China Mobile's texting fees. In his latest campaign, he argues that China National's characterization of its products as "less harmful" amounts to a bogus marketing strategy to reap "massive and growing economic benefits." Black Tiger cigarettes, marketed by Jiangxi Industrial, are named after a local, sun-dried variety of tobacco that's mixed with liquefied herbs to create the strong taste favored by Chinese smokers. "It's a less harmful treat," the company claimed in an advertisement.

"The rest of the world has proved this is just a commercial gimmick, but in China it is flourishing," Li told the court earlier this year. Judges ruled against the lawsuit and rejected a subsequent appeal after tobacco regulators called it malicious and a waste of the court's time. "I thought the telecom and railway companies were rich and powerful," Li says. "Now I've met tobacco." **E** — *With Bloomberg News*