Socio-regulatory upheaval, reference points and strategic evolution of the cigarette industry

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Received 1 December 1998; accepted 1 December 1998

Abstract

During the past 3 decades, the US cigarette industry has seen increased social and political turbulence affect market growth. The six major competitors (Phillip Morris (PM), R.J. Reynolds (RJR), American Tobacco, British American Tobacco (BAT), Lorillard and Liggett & Myers) have all responded to the increasingly unattractive environment through diversification efforts. Still, facing similar, hostile environments, the various patterns of product and international diversification of the firms have been divergent in terms of both scope and depth. The integration of strategic reference points offers a preliminary explanation for these divergent strategies. Firms who were industry leaders and industry laggards regarding average industry performance indicators were observed to take greater strategic risks in each decade. Firms performing at the industry median took relatively less risk in each decade. © 2000 Elsevier Science Inc. All rights reserved.

Keywords: Socio-regulatory upheaval; Reference points; Strategic evolution; Cigarette industry

1. Introduction

One began to suspect that the attack on smoking in America . . . was escalating rather out of hand when in 1996 the Attorney General of Texas announced, apparently in all seriousness, that history will record the modern-day tobacco industry alongside the worst of civilization’s evil empires . . . (The Economist, December 20, 1997, p. 59)

Tushman and Romanelli (1985) argued that as a result of discontinuous change occurring in an industry’s environment, firms undergo strategic reorientations. More recently, Hamel and Prahalad (1996) proposed industry convergence as well as the redefinition of industry boundaries in industries undergoing extreme turbulence. Furthermore, Chakravarthy (1997) has suggested that strategy researchers have been focused on stable environments when explaining strategic behavior of firms. Subsequently, he called for more research to be completed which applies strategic frameworks to turbulent environments.

Our research studies the strategic actions of firms operating in an industry that has been undergoing a continually increasing turbulence for the past 3 decades. The above introductory quote is illustrative of the combined political and social pressures on the cigarette industry that have been continually increasing during this period of time. Hamel and Prahalad (1994) suggested that speed is of the essence in turbulent industries due to shorter product life cycles and tighter development times. For example, due to global deregulation and privatization activities as well as rapidly changing technology, firms in the telecom industry must react quickly in terms of becoming full-service firms while simultaneously penetrating overseas markets. In contrast, the turbulence associated with the cigarette industry is a longer-term socio-regulatory agitation that has caused the major competitors in the cigarette industry to strategically react at various points in time during the last 30 years. Since the landmark Surgeon General’s report during the 1960s, the cigarette industry has been an example of an extremely turbulent, even hostile, industry (Jones, 1997). The war waged against the tobacco industry by the combined forces of government, media and the legal profession culminated during 1997 with the “Tobacco Accord.” Thus, in the more than 3 decades between the Surgeon General’s report and the
on-again-off-again “Tobacco Accord,” the firms that dominated the industry instigated strategic reorientations.

In our research, we use these significant industry events as temporal boundaries to frame the examination of the strategic redirections taken by the major competitors in the cigarette industry. Our study is organized as follows. First, grounded in strategic management literature, we present a framework that combines dual product and international diversification patterns and industry turbulence. We then examine the specific diversification patterns of the major firms in the industry. Through this investigation, divergent diversification patterns emerge regarding firms experiencing similar external environmental opportunities and constraints. These results lead to the second part of our study, which uses a strategic reference point perspective to help explain the strategic divergences over time. Specifically, we study the major firms (Phillip Morris (PM), R.J. Reynolds (RJR), British American Tobacco (BAT), Liggett & Myers, Loews and American Tobacco) that have historically dominated the cigarette industry to better understand the linkages among the socio-regulatory environment, core business growth, strategic reference points and strategic diversification.

2. Core business attractiveness and diversification

Firms need to realign their strategies when their external environment changes (Russo, 1992; Smith and Grimm, 1997). The initial research focus of our paper is to investigate the environmental factors that have caused firms within the same industry to pursue different scopes and degrees of diversification. Wolf (1977) contended that both internal and external environmental changes force firms to realign their strategies. Additionally, Myers et al. (1993) suggested that organizational responses are generated at both the firm and industry level and that external factors shape actions taken by populations of firms, especially in industries undergoing extreme turbulence.

2.1. Cigarette industry attractiveness

Extending these arguments, our research initially suggests that two distinct external variables pose significant constraints to the cigarette industry and, subsequently, the competing firms have shaped their respective strategies based on these constraints. These external factors, which combined are a proxy for the overall attractiveness of the core cigarette business, include (1) the maturing and decline of US market growth, and (2) pressure from societal and political influences.

Regarding the maturity and decline of the US market, gross consumption peaked in 1981 whereas per capita consumption hit its high in 1963. The rate of decrease both in overall and per capita consumption has slowed somewhat in the 1990s. Regarding the socio-regulatory environment, the anti-smoking movement (both politically and socially instigated) has had fundamental effects on the cigarette industry. First, it caused smokers to question the healthfulness of cigarettes. Second, the campaign brought about a significant demographic shift, away from the affluent, well-educated, white, male population toward both a lower-income, blue collar constituency and women and minorities (Jones, 1997). To counter the threat of the declining US market, competitors in the cigarette industry began a pattern of product and international diversification. For instance, in 1970, US firms exported 29 billion cigarettes. By 1995, exports increased to over 230 billion cigarettes. Just as significant as this internationalization was the degree of product diversification occurring between 1970 and 1995.

2.2. An industry attractiveness — diversification framework

International strategy researchers have focused on geographic diversity rather than domestic product diversity of the firm (Stopford et al., 1980). In contrast, strategic management researchers see diversification primarily as firms adding new products and/or markets to their existing scope (Ramanujam and Varadarajan, 1989). Relative to the separate streams of literature regarding international and product diversification, respectively, little research has simultaneously studied these two levels of diversification. These research efforts have usually integrated a performance dimension into the dual diversification study. Furthermore, the results of these research efforts have not been consistent.

For example, Simharya and Hand (1990) used the two as independent variables and compared relative firm performance of each. Likewise, Tallman and Li (1996) compared international and product diversity of multinational entities (MNEs) and found a relationship between product diversity and performance. Still, unlike Kim et al. (1989), Tallman and Li (1996) did not find that international diversification moderates the relationship between product diversification and performance. Most recently, Hitt et al. (1994) found that, when performance is measured by return on assets, product diversification has a positive mediating effect on the international diversification–firm performance relationship. However, when performance is operationalized as an indicator of innovation, the mediating effect switches to a negative influence.

Our study employs both patterns of strategic diversification in the cigarette industry as dependent variables and proposes that dual diversification will be a function of core industry attractiveness. Kashlak and Joshi (1994) introduced a framework that linked international and product diversification moves of telecom firms to core business growth and regulatory environment. When the regulatory environment was favorable and core business growth high, limited diversification activities were discovered. In contrast, when
the regulatory environment was unfavorable and core business growth was low, significant dual product and geographic diversification occurred. Extending this framework, we propose that core business growth and the socio-regulatory environment will affect diversification by firms in the cigarette industry. Fig. 1 illustrates the proposed model.

Specific to the cigarette industry, Fig. 1 illustrates the environment of the 1970s as compared to that of the 1990s. Even though there was socio-regulatory pressure in the 1970s, it was much more lenient when compared to the current 1990s pressures. Thus, because of their core US business maturing/declining over time and because of increasing socio-regulatory pressures, it is expected that the major cigarette firms would have pursued high levels of both international and product diversification.

3. Actual diversification patterns in the cigarette industry

Contrary to expectations, the major competitors in the cigarette industry were pursuing very different degrees of both product and international diversification as of 1995. Furthermore, each company had a unique diversification strategy during the three separate time periods of our study (1970–1975, 1980–1985, and 1990–1995). Below we present a summary of the major diversification activities of each of the competitors during the 25-year study before offering a comparative perspective.

3.1. Phillip Morris

During the early part of our study period, PM proved to be the most cautious of the firms regarding product diversification, remaining largely dependent on cigarettes. During the mid-1980s, PM stepped up diversification activities, purchasing General Foods in 1985 and acquiring Kraft in 1988. Compared to product diversification, PM pursued a much more aggressive international diversification. In 1972, PM passed RJR as the leading US firm in terms of international sales. By 1995, it had five times as many sales as RJR. Interestingly, PM bought Liggett & Myers’ international cigarette business during this time period. As of the mid-1990s, PM held over 30% of market share in Europe and approximately 15% of the Japanese cigarette market.

3.2. R.J. Reynolds

Compared to PM, RJR was a more aggressive product diversifier during the early part of our study period. Before its major acquisition of Nabisco in 1985, RJR already had acquired Chun King, Del Monte, and Heublein. RJR pursued a broader range of industries as well including international transportation, petroleum and energy. By
1995, however, RJR had refocused on cigarettes and food (Nabisco, Planters and Lifesavers). Regarding international diversification, even though it was surpassed by PM in 1972 (in terms of international sales), RJR still has been very aggressive. For instance, in China, RJR developed a marketing agreement in 1980 and a subsequent joint venture manufacturing pact in 1988. In the Soviet Union during 1990, a 14-billion/year cigarette contract was signed. Since that time, RJR has over US$300 million in the former Soviet Republics where they continue to hold the market lead.

3.3. American Tobacco

Even though American Tobacco was the last major cigarette firm to diversify by product during the 1960s, by 1977, it has a cigarette to total business ratio of 65%. Previous to that year, American Tobacco entered (1) the office supply business with the purchases of Acme Office Records and Swingline, (2) the hardware business by acquiring Master Lock and Marvel Lighting, (3) toiletries by purchasing Jergens, and (4) sporting goods through acquiring Titleist. The company spent approximately US$1.8 billion in product diversification activities between 1970 and 1980. As of 1994, the sales ratio of cigarettes to total sales had shrunk to 59%. In terms of international diversification, American Tobacco lagged behind PM and RJR and concentrated overseas efforts in Great Britain. In fact, in terms of sales, American Tobacco was slightly more of an international cigarette company than a US one. Still, these sales were restricted to Britain and thus the scope of international diversity was small.

3.4. British American Tobacco

Brown & Williamson (B&W) is the US subsidiary of the BAT. From its inception, B&W was a geographic diversification for BAT, which has heavily internationalized into over 160 countries. It was the world leader in terms of cigarette sales until 1991, when it was surpassed by PM. Furthermore, similar to PM’s acquisition Liggett & Myers’ international cigarette business, BAT purchased the international cigarette business of Loews (Lorillard). During the 1970s, BAT initiated a major product diversification—especially in retailing—in the US, including Kohl’s Food and Department Stores and Gimbel’s/Saks Fifth Avenue, International Stores and Argos. Additional resources were directed toward the paper-making and printing industries including the acquisition of US-based Appleton Papers, the world’s leading producer of carbonless papers. During the 1980s, BAT diversified into financial services, spending over US$2.0 billion to acquire Britain’s Eagle Star Holdings and Hambro Life Assurance. Subsequently, in 1988, BAT purchased the US-based Farmers Group for US$5.2 billion. Ultimately, BAT’s strategy was to be a globally diversified company composed of four equal segments: cigarettes, retailing, paper and financial services.

3.5. Lorillard

Beginning in 1968, Lorillard was the tobacco arm of the Loews. Lorillard itself had not diversified. However, in the 1970s, Loews began larger scale diversification activities including the purchases of CAN Insurance and Bulova Watch. Additionally, Loews bought a controlling 25% interest in CBS in 1985. From a geographic diversification perspective, Loews sold Lorillard’s international cigarette business in 1977, thus eliminating its overseas cigarette future.

3.6. Liggett & Myers

During the 1970s, Liggett & Myers had effectively diversified into the liquor industry, with that line of business contributing 24% of total sales. Additionally, by 1979, pet foods were contributing 19% of total sales and cigarettes and related products were down to 33% of total sales when Grand Met completed its purchase of Liggett. In 1986, Grand Met, focusing on the food and liquor industries, divested Liggett’s cigarette business. Since that time, Liggett has focused more than any other competitor on the US cigarette business.

3.7. Comparative diversification postures

Fig. 2 illustrates the comparative diversification postures of the six firms. As a measure of the firms’ respective product orientations, we used the Herfindahl-type index that is based on the share of a firm’s sales in each four-digit SIC industry and has been employed previously in strategy research (Grant et al., 1988; Tallman and Li, 1996). Similar to Stopford and Wells’ (1972) method of counting foreign subsidiaries, we measure firm internationalization through a measure of country scope. Counting the actual number of countries where firms have subsidiaries has been determined to be a reasonable proxy for international diversity (Ramaswamy, 1993; Tallman and Li, 1996; Sherman et al., 1998).

As Fig. 2 illustrates, whereas three major players have not strategically responded as expected, PM, RJR and BAT have all proactively diversified, both from a product and geographic perspective. Still, there are significant differences among the firms who have responded as expected. Thus, to try to understand the strategic divergences of firms operating under similar external environmental constraints, we integrate the concept of strategic reference points below.

4. Strategic reference points

Our second level of analysis incorporates strategic reference points to further explain the patterns observed over
our 25-year study. In industries undergoing change, Fiegenbaum et al. (1996) argued that a firm’s reference points might be linked to strategic realignment. Decision-makers will use targets, benchmarks or reference points to evaluate risky strategic choices (Kahneman and Tversky, 1979). Researchers have found empirical support for the influence of reference points at the organizational-level of analysis (Fiegenbaum and Thomas, 1988; Chang and Thomas, 1989). Still, to date, international and product diversification patterns have not been viewed through a strategic reference point perspective.

Fiegenbaum et al. (1996) suggested that strategic benchmarks may be referenced with both internal and external dimensions. Internally, reference points may reflect a firm’s core competencies, particular function or value-added activity. Internal reference points may also use output measures (such as ROE and ROA) to compare and evaluate explicit firm performance (Rappaport, 1986). External reference points may focus on competitors, customers and social responsibility (Fiegenbaum et al., 1996). Porter (1980, 1985) suggested that the most accepted external reference point deals with competitors and the ability to sustain a competitive advantage. Historically, relative market share has been a common external reference point for firms. Thus, to further analyze the diversification patterns of the cigarette firms, we integrate the firms’ relative market share.

5. Linking strategic reference points and diversification

From a prospect theory viewpoint, Kahneman and Tversky (1979) suggested that firms will use reference points to evaluate risky strategic choices. These researchers have also found evidence suggesting that organizations are both risk-seeking (Bowman, 1980) and risk-averse (Bettis, 1981). That is, based on their relative positions in an industry, firms may either seek or deflect risk. These organizations will choose strategies, and the associated risk of the strategies, depending upon whether the respective top management teams see themselves as being above or below a reference point (Fiegenbaum, 1990; Fiegenbaum et al., 1996; Singh, 1996). Thus, a U-shaped perspective may be visualized where: (1) firms who are at the extreme high or low relative to the reference point seek a higher degree of risk, (2) firms moving closer to the reference point, take on a decreasing amount of risk, and (3) firms at the reference point are comparatively risk-averse.
Diversification strategies may be viewed in terms of risk. Literature has suggested that unrelated diversification reduces an organization’s risk from a portfolio perspective yet increases it from a shared knowledge viewpoint. Still, in a...
turbulent environment that has affected the cigarette industry, lack of diversification may be construed as taking on increased risk—that is, betting more and more on an industry with declining growth and with increasing political and social pressures (Amihud and Lev, 1981).

Therefore, in the cigarette industry, we expected that the industry leader and laggard (the firms farthest from the median market share reference point among the major players) would assume the most risk and thereby be diversifying comparatively less than the other firms. Subsequently, firms closest to the reference point would assume the least amount of risk and thereby be diversifying at a comparatively higher rate.

To test these assumptions, we compared the relative position of the major US-based competitors in terms of market share in 1970, 1980 and 1990, respectively, to the charge in each firm’s product diversification posture 5 years later. That is, based on its industry position in 1970, 1980 and 1990, respectively, would a firm be more or less likely to increase its diversification away from cigarettes by 1975, 1985 and 1995, respectively? We did not include BAT in this piece of our study because we did not have exact sales of all four-digit SIC sectors in which it was involved worldwide.

Using the Herfindahl-type index based on the share of a firm’s sales in each four-digit SIC industry to measure product diversification, we calculated the change in diversification over each of the three 5-year periods (1975/1970, 1985/1980 and 1995/1990). We then linked each of these ratios to the industry position of the major cigarette industry competitors at the beginning of each decade. Fig. 3 illustrates a graphical representation of the results for each decade.

6. Conclusion

Consistent with approaches taken in strategic management literature, our research initially examined the effects of the external environment on diversification patterns of the major competitors in the cigarette industry. However, during the 25-year study period, the various firms did not all behave as expected. There were varying degrees of both product and international diversification during the 1970s, 1980s and 1990s. Furthermore, within each decade, the individual firms changed their respective diversification postures relative to each other. Thus, to explain these variations, we employed strategic reference points as proposed by Kahneman and Tversky (1979) and more recently advanced by Fiegenbaum et al. (1996).

As depicted in Fig. 3, in all 3 decades, both the leading firm and lagging firm in the industry experienced less change in diversification than firms who were closer to the reference point of market share. In fact, between 1980 and 1985 and then again between 1990 and 1995, the industry leader and laggard seem to be refocusing on the cigarette industry and not increasing product diversification, even at a decreasing rate. Thus, our findings do not fully support traditional strategic management literature that suggests that, as an industry is maturing or stagnating due to external environmental pressures, an increase in both product and international diversification will occur.

In all 3 decades, the specific cigarette firm that correlated to the reference point (that is, the median firm representing the third out of the five competitors in terms of market share) changed its diversification posture more than any other firm did. Furthermore, in each decade, the firms who were second and fourth, respectively, in terms of market share, pursued product diversification at a rate greater than either the industry leader and laggard but less rigorously than the median firm. Thus, if diversification out of the cigarette industry is seen as a risk-averse move and lack of diversification as one of risk-seeking, the five major competitors—relative to each other—mirror prospect theory and strategic reference point predictions.

7. Research limitations and future directions

Even with the above linkage of product diversification activity to strategic reference points over 25 years, our research still represents an initial attempt to examine an industry undergoing a continuing and increasing turbulence due to social and regulatory pressures during the past 3 decades. Still, it is quite preliminary and has limitations that must be highlighted. For instance, because of the small number of competitors, a more rigorous statistical analysis was not used. As more independent variables are introduced into the second phase of this study, a cross-sectional/time-series method may be applied. Thus the total of 150 data points (six companies over 25 years) would lend itself to more statistical rigor.

The second part of the analysis excluded BAT’s product diversification patterns due to reporting limitations. To attain a truer comparative picture of the industry, the UK-based BAT data must be integrated into the analysis. Subsequently, if the reference point linkages continue to hold in the three separate decades, stronger theoretical conclusions may be advanced.

Further future research efforts may delve more deeply into the international diversification aspect and employ more rigorous measures such as foreign subsidiaries’ sales to total worldwide sales (Stopford and Dunning, 1983; Geringer et al., 1989) and foreign assets as a percentage of total assets (Daniels and Bracker, 1989). Additionally, other independent variables may be theoretically argued as antecedent conditions of product and international diversification. Consistent with the arguments and evidence that both internal and external factors will simultaneously influence strategy (Wolf, 1977; Sherman et al., 1998), a linkage between corporate governance and dual international and product diversification may be proposed. For example, the charac-
teristics of both the various boards of directors and top management teams of the respective cigarette industry firms may be studied in relationship to the strategic moves discussed in this research. Similarly, the institutional investor factor that surfaces in corporate governance literature may also be theoretically linked and tested in future research.

Additionally, an attempt may be made to operationalize the socio-regulatory environment in different countries to study the linkage between international diversification and host country environment in this specific industry. Finally, a performance variable may be applied to the current and future analyses to examine the results of the divergent strategies uncovered in this study. As suggested above, most of the research that has simultaneously studied dual product and international diversification patterns has done so with a performance variable included. Still, in the future, increased empirical research is needed to better understand the interactions among the critical environmental contingencies in industries undergoing turbulence, subsequent dual diversification patterns and resulting firm performance.

References