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With Merger, Tobacco Takes On Technology

By STEVEN DAVIDOFF SOLOMON

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Disruptive technology can spur takeovers as companies, fearing for their business, race to bulk up and acquire innovators.

But who would have imagined this phenomenon taking place in the 400-year-old American tobacco industry?

The second- and third-largest cigarette companies in the United States, Reynolds American and Lorillard, have confirmed that they are in talks to combine. The merger would result in an American cigarette industry dominated by two players — the new combined company and the Altria Group, the maker of the Marlboro brand.

The three companies now control roughly 90 percent of the $90 billion to $100 billion United States tobacco market, with Altria taking roughly half of the total market.

Because of declining sales in the still highly profitable American cigarette market, a move toward consolidation was perhaps inevitable. Reynolds has already spun off its international operations. So it is no surprise that the companies, left with few expansion opportunities, are seeking to join forces to lift profits through cost savings.

But the companies could have tried to merge years ago. Why now?

It may very well be a result of that disruptive technology known as e-cigarettes.

The e-cigarette market is growing at phenomenal rates and could surpass $2

billion in sales this year, according to some reports.

As was the case during the dot-com boom, when many made wild forecasts of potential Internet users and revenue, people are already predicting that sales of e-cigarettes will surpass those of regular cigarettes — well, by 2047, according to one analysis by Bloomberg Industries.

By 2047, many of us could also be underwater because of global warming, assuming we are alive.

In other words, e-cigarettes have momentum, but we do not know if they will succeed. They may very well be a fad.

Still, fear of this technology is rumbling through the industry. But unlike, say, the taxi industry, which is contending with the likes of Uber, Big Tobacco is well coordinated and has deep pockets.

Lorillard has already acquired Blu eCigs, the largest American seller of e-cigarettes, which has a 40 percent market share. Reynolds, under the leadership of Susan M. Cameron, has also released its own e-cigarette but is viewed by the industry as behind in this market.

An acquisition of Lorillard would thus catapult Reynolds ahead of Altria in the e-cigarette category. It would also add Lorillard's menthol cigarettes to Reynolds's offerings.

Reynolds and Lorillard would have to sell some brands to satisfy antitrust regulators. This is where the Imperial Tobacco Group comes in. Imperial Tobacco, from Britain, would take advantage of Reynolds and Lorillard's hunger to merge to gain a significant presence in the United States, most likely at a good price.

One way to view this deal is that it is all about coping with a declining industry. But this transaction is also about fear: fear that new technology will put an end to your old business.

A combined Reynolds and Lorillard would be the front-runner in e-cigarette technology. They would also benefit from an absence of advertising restrictions on e-cigarettes. That advertising might even provide a boost for traditional cigarettes.

A giant tobacco merger would not be that much different from Facebook's $16 billion acquisition of WhatsApp or Google's $3.2 billion deal for Nest Labs. Companies are paying large premiums because they fear the next big technology and the destruction it may bring. Of course, that destruction may not come to pass — but then again, it might.

The merger of Lorillard and Reynolds shows that no industry is safe from technology's transformative effects and the accompanying uncertainty.

Welcome to the 21st century, cigarettes.

http://dealbook.nytimes.com/2014/07/11/how-disruptive-technology-is-spurring-tobacco-merger-talks/?_php=true&_type=blogs&_r=0

Steven Davidoff Solomon, a professor of law at the University of California, Berkeley, is the author of "Gods at War: Shotgun Takeovers, Government by Deal and the Private Equity Implosion." E-mail: dealprof@nytimes.com | Twitter: @StevenDavidoff