

THE PROFIT MOTIVE AND GLOBAL CORPORATE CITIZENSHIP: A CASE STUDY ON THE SPIN-OFF OF PHILIP MORRIS INTERNATIONAL

James S. Welch Jr*

Abstract *This article addresses the spin-off of Philip Morris International (PMI) from Altria which took place back in 2008. Since that time, PMI has done very well in overseas markets, and most especially in developing markets. By 2010, PMI had gained an estimated 16 percent share of the total international cigarette market outside of the U.S. (excluding China) with revenue of \$27 billion and operating income of \$11.2 billion. With 2012 results, PMI reported worldwide revenues of \$31.4 billion and an operating income of \$14.2 billion, according to the company's annual report. This rapid revenue growth and income expansion has not come without ethical considerations. As the spin-off resulted in the move of the company headquarters from New York City to Lausanne, Switzerland, PMI became less restrained by the regulatory environment in their new home. PMI was able to capitalise on lower tobacco standards and limited advertising restrictions in global markets (and most especially developing markets) without the constraints of the negative regulatory environment and negative public attention back in the USA. This article weighs the ethical concerns of moving business to areas of less regulation versus the business advantages of such moves. There are many reasons why American corporations have begun to spin-off their international operations, but the question remains, whether the business is conducted domestically or internationally: Is the fiduciary duty to shareholders greater than the moral duty to prospective global consumers?*

Keywords *Fiduciary Duty, Ethics, Globalization, Ethical Decision Making, Profit Motive*

INTRODUCTION

By this point, millions of YouTube watchers have seen the video clip of the infamous “Smoking Baby from Indonesia” which was quite popular a couple of years ago and continues to attract interest. The clip features a then two year old Indonesian boy named Aldi, who, at the height of his cigarette addiction, was smoking forty cigarettes a day (ITN News, 2011). Cigarettes in Indonesia are cheap and plentiful, in large thanks to Philip Morris International, which acquired domestic manufacturer Sampoerna in 2005 and now has thirty percent of the market (PMI, 2005). While the video has caused some public relations concerns back in the United States, the move that Altria made five years ago to spin-off their international cigarette operations, provides that very little domestic regulation follows Philip Morris International into these very lucrative international markets (Hafez & Ling, 2005). It is essentially left up to governmental regulation and pressure in those local markets to address any product or marketing concerns (Hafez & Ling, 2005).

There is no doubt that legal, regulatory, and political restrictions can limit the growth potential of U. S. companies both domestically and abroad (Donohue, 2010). These restrictions can include regulations governing production

and marketing in addition to involving complicated and expensive taxing structures (Heinemann, 1992). All of these legalities can affect the corporate bottom line. This is especially true in highly regulated industries. There are few options to manage these regulatory concerns, as well as to avoid negative public sentiment of certain unpopular industries. There has, however, been a recent effort to spin-off international units, manage them from overseas headquarters, and potentially avoid some domestic pitfalls which hinder international growth (Deal Journal, 2011). This issue can be examined using a case study analysis concerning that spin-off from Altria, Philip Morris International.

NEW ALTRIA STRATEGIES FOR CHALLENGING TIMES

Perhaps the biggest consideration regarding the potential spin-off of a corporation's international operations is simply a matter of market evolution. Since products and industries have a life cycle, marketing and production efforts vary dependent upon the particular stage of market evolution. The four stages of industry evolution, introduction, growth, maturity and decline, determine the scope and effectiveness of marketing plans and can lead to drastic measures to try and

* Visiting Assistant Professor of Management, Eckerd College, St. Petersburg, Florida, USA. E-mail: welchjs@eckerd.edu

keep a company on the growth track (Pearce & Robinson, 2008). For example, the Tobacco industry can be categorised in different evolutionary stages dependent upon global location. While a company such as Altria's Phillip Morris unit, prior to spin-off, had substantial opportunity globally, the United States cigarette market was most certainly a declining market due primarily to legal/political concerns and public sentiment (Altria, 2007). However, internationally, the stage of tobacco industry evolution varies widely. The stage facing the tobacco industry in Europe and South America could be described as a mature market with some pockets of growth, while the Asia market could be described as solidly in the growth stage (Pearce & Robinson, 2008). Obviously this affects the marketing and production strategies of a company like Philip Morris. In the Growth stage, a firm wants to establish brand recognition, add product variants, improve product quality, and make most cost effective use of distribution channels (Pearce & Robinson, 2008). In the Mature stage, a firm wants to aggressively promote products in new markets, work to differentiate their product, and build customer loyalty (Pearce & Robinson, 2008). So, a global company must use appropriate strategy based on particular location and the evolutionary stage for that location. A company that seeks to be a truly global enterprise and develops its strategy based on the global marketplace widens its base for growth substantially.

However, even with an international strategy, there are still domestic legal and political parameters that can restrict the operations of the company (Cateora *et al.*, 2009). For Philip Morris and other companies with an international presence, the long arm of U. S. law reaches them wherever they conduct business around the globe. If a business practice is illegal in America, it may also be illegal in other nations (Pearce & Robinson, 2008). When a company expands its market to include foreign jurisdictions, their efforts may be limited by U. S. regulation and political sentiment. For many companies this is not a problem, but for a company like Philip Morris, which faces ever-expanding domestic regulation and tremendous public scrutiny, their global efforts could well be hindered by these domestic concerns.

As a result, Philip Morris International became a stand alone unit in early 2008 in order to take full advantage of global opportunities (Tong, 2007). As mentioned, the United States cigarette market is a mature market which is facing increased regulation and public scrutiny. This limits the ability of Philip Morris to expand into new products. By creating a stand alone Philip Morris International, they can more completely capitalize on global growth. Since the spin off they have expanded product offerings which they market to specific global markets from Europe to South America to Africa to Asia to Australia, essentially the rest of the globe. Some of these markets are not bound by restrictions such as tar and nicotine levels, while others open up possibilities for new products taking advantage of present taxing structures

of the host nation (O'Connell, 2008). These new products and marketing schemes have enabled PMI to greatly increase market share and profits outside of the U. S. (O'Connell, 2008).

In addition to the creation of a stand alone entity to enable product development and market expansion globally, they also simplified decision making as part of the restructuring by allowing local managers to have the power to make decisions regarding products and marketing in a particular region. Furthermore, they streamlined manufacturing by manufacturing the entire international supply from outside the United States. Philip Morris International established their headquarters in Lausanne, Switzerland which manages operations in over 160 countries. The U. S. operation continued to be handled by Philip Morris USA, headquartered in Richmond, Virginia (O'Connell, 2008). This restructuring of international strategy opened up a variety of new tactics and opportunities without the shackles of domestic regulation.

THE BENEFITS OF GLOBAL RESTRUCTURING FROM THE PROFIT PERSPECTIVE

As PMI restructured, they aimed to expand sales internationally without the regulatory and public policy restraints inherent in doing business in the U. S. PMI has been able to target various areas throughout the world where tobacco use is growing. The spin-off enabled new corporate strategy to be developed with related functional tactics. Corporate strategy alone is only one piece of the plan, strategy also requires specific actions in order to implement the strategy (Pearce & Robinson, 2008). Functional tactics are those specific actions that lead to implementing strategy (Pearce & Robinson, 2008). Functional tactics include production aspects such as facilities and equipment, sourcing, operations planning and control, as well as marketing concerns such as product, price, place, promotion (Pearce & Robinson, 2008). Since the new entity was now out of reach from domestic regulatory authority and legal system, PMI developed a blitz of new products. PMI developed new products based on consumer tastes and preferences, while also in consideration of regulatory and taxing schemes within the diverse foreign jurisdictions (Associated Press, 2007). PMI, in creating a standalone unit for international business, also streamlined production by using facilities outside the U. S. (Associated Press, 2007) The company has also been able to implement aggressive marketing plans without restrictions that they face in the U. S. The roll out of product and marketing, without U. S. interference, has enabled the firm to continue to grow its position as the largest non governmental tobacco company in the world. This also enabled PMI to expand through acquisition. For

example, in July 2009, PMI entered into an agreement with Swedish Match AB to purchase its South African affiliate, Swedish Match South Africa, a leading pipe tobacco and snuff manufacturer (PMI, 2009).

To capitalise on growth, a company must exercise control over the three levels of the external environment, remote, industry and operational (Pearce and Robinson, 2008). By this strategic move, PMI has exercised control over the remote environment, perhaps the one that is the most difficult to impact of the three. By making PMI a stand alone unit, they are not subjected to regulatory issues in the U. S., not to mention the growing negative sentiment regarding tobacco use in the U. S. By developing business in other parts of the world, PMI can continue to develop product, pursue aggressive marketing, without as much legal and/or public restraint as is at work in the United States. Many developing nations are a fertile ground for selling tobacco products and have far less restrictions regarding content of the product as well as marketing efforts. By creating a stand alone entity, developing new products for international markets, depending upon preferences and regulatory issues, PMI is demonstrating a level of control over the very difficult to control remote environment.

The spin-off of Philip Morris International also enables the company to develop successful generic and grand strategies. The generic strategy emphasized by Philip Morris International is differentiation. Differentiation calls for the development of a product that offers unique attributes that are valued by the consumer to be better or different than what is offered by the competition. Philip Morris uses this strategy as it addresses the personal preferences of smokers in different parts of the globe while also considering different governmental regulation and taxing schemes. In a similar way, the grand strategies used by Philip Morris are designed to capitalise on global opportunities. They especially emphasize market and product development with this new endeavour. Market development involves marketing present products, often with only minor modifications, to customers in related market areas by adding channels of distribution or changing content of advertising or promotion (Pearce and Robinson, 2008). In terms of market development, they are aggressively promoting new products in both new and established markets. Some of these efforts are successful while some are not. For example, they had an experiment in Zurich, Switzerland called "The Heatbar Tasting Room." (O'Connell, 2008). This was a bar which featured one of their new products, the Heatbar. The Heatbar was a hand held device that holds and heats the cigarette, without burning it. It represents an attempt to greatly reduce second hand smoke and eliminate ash. Developing a bar to introduce the product was certainly a novel idea but it was not a very successful one as very few patrons actually visited the establishment (O'Connell, 2008).

Notwithstanding some bumps along the road, such as the Heatbar disappointment, PMI was able to expand product development as a part of its grand strategy. Product development involves substantial modification of existing products or creation of new but related products (Pearce & Robinson, 2008). Increased market share is achieved by penetrating existing markets and incorporating product modifications into existing items or developing new products connected to existing products (O'Connell, 2008). In terms of product development, PMI continues to modify products dependant on global location (Assunta & Chapman, 2008). Increasing tar and nicotine where governmental regulations permit and using other product modifications in other locations dependent upon consumer tastes (Assunta & Chapman, 2008).

For the time being, these strategies seem to be successful and certainly the spin off of PMI allows more freedom of movement within these strategies, but the question remains, how will PMI see increased profitability from these efforts? To answer this important question, we can analyze the case from the viewpoint of Economic logic (Hambrick & Fredrickson, 2005). Economic logic is one of the five elements of strategy described by Hambrick and Fredrickson in their article, Are you sure you have a strategy? Economic logic answers the question: how will we obtain our returns? (Hambrick & Fredrickson, 2005) Specifically, how can a company obtain profits over and above the company's cost of capital? (Hambrick & Fredrickson, 2005) The most successful strategies have a central economic logic (Hambrick & Fredrickson, 2005). For Philip Morris International, the economic key is their effort to obtain premium prices for their products. They seek to achieve this globally by providing a unique and differentiated product. While there are cheaper cigarettes available around the world, including in the growing markets previously mentioned, PMI wants to provide product for those smokers that are ready to upgrade quality. PMI attempts to gain new buyers for its products by offering quality production and marketing to the world cigarette market. For example, Philip Morris has developed fancier packaging intended to get smokers to pay a premium for their brands. They also continue to develop product, within the host nation's regulatory guidelines, that offer what customers want. In some areas of the globe, this could mean higher tar and nicotine than is allowed in the U. S. In addition to dealing with economic logic on the price side, firms can also use the cost side of the equation by lowering production and addressing other overhead costs such as taxes. For example, in Germany, Philip Morris launched the "Tobacco Block System" to try and take advantage of taxing structures in Germany which tax "roll your own" tobacco products at a much lower rate (O'Connell, 2008).

Finally, a spin-off of an international unit could potentially open up opportunities for certain funds to invest in the

domestic unit. Many socially responsible investment funds cannot invest in stocks that are on the fund's "Restricted Security List." (Cortez et al., 2012) Some of these funds, for example, cannot invest in alcohol, tobacco, gambling or defense related companies (Cortez et al., 2012). If a U. S. corporation has an international unit which engages in such activity, there are a number of socially responsible funds that cannot invest in them (Cortez et al., 2012). However, if the prohibited activities are spun-off into separate legal entities, this would open up the possibility of investment. Unfortunately, this spin-off did not affect Altria, since their remaining domestic units, include tobacco and alcohol operations. However, the previous spin-off of Kraft Foods from Altria did free up such socially responsible investment funds to expand investments into the Kraft spin-off.

THE ETHICAL CONCERNS OF GLOBAL RESTRUCTURING

While there is certainly a long list of pros for this strategy, there are some concerns. If a U. S. multinational corporation moves offshore in order to avoid the domestic regulatory environment it can raise an ethical dilemma (Shirane et al., 2012). In the case of Philip Morris, activists believe there is an ethical issue regarding the products offered and marketing techniques employed in developing nations (Hafez & Ling, 2005). These are nations which can ill afford the increased cost of tobacco-induced disease. Philip Morris does have a specific history of trying to make money off of the developing worlds poor and middle class to the detriment of public health and its related costs (Myers, 2008). In 2001 Philip Morris used a cost benefit analysis to try and persuade governmental officials in the Czech Republic to limit taxation on tobacco products in that cigarettes were not a drain on the country's budget. In their cost benefit analysis they determined that the government actually saved money on health care, pensions and housing when smokers died prematurely. (New York Times, 2001) Another sad truth about this story is that there was more outrage in the United States over the analysis than there was in the Czech Republic (New York Times, 2001). More recently, the "smoking baby" clip seems to suggest that there continue to major ethical concerns regarding tobacco use in developing markets. However, since Philip Morris International is no longer a domestic corporation, it has no legal and perhaps very little moral, responsibility to address the concerns of American citizens.

However, there is always the risk that the host nation can employ its own regulatory restrictions. For example, China recently passed a ban on smoking in public places (Reuters, 2011). Even though subsequent reports have indicated this ban has little effect, it does demonstrate that other nations are not without political and legal recourse (Haas, 2011). A move offshore may free a company from too much domestic

interference, but this does not prevent regulation in the host nation. In time, Philip Morris will face increasing global restrictions as other nations realize the costs involved by relaxed tobacco standards.

Furthermore, it could also be a public relations blunder as this gets published to the domestic community. If a U. S. corporation is seen as running from U. S. regulation, the move could backfire as American consumers could react negatively to the publicity. So far there have been few public questions regarding the spin off of PMI. This could be because most U. S. citizens, including anti-tobacco organisations, are not fully aware of the tactic of moving offshore.

CONCLUSION

Anytime a corporation alters structure and strategy, there is a tradeoff. Tradeoffs are not necessarily bad according to business strategy author, Michael Porter. Porter believes that a sustainable advantage requires a tradeoff (Porter, 1996). For Porter, a tradeoff describes the fact that more of one thing will require less of another thing. (Porter, 1996) He believes that tradeoffs are vital for strategy. They require the firm to choose a certain emphasis over another one, and this limits what the firm can do. However, this limitation allows the firm to focus more directly. The goal of strategy is to choose what not to do and to focus on certain areas where the firm can find the greatest success. (Porter, 1996) Philip Morris has weighed the pros and cons regarding this recent move, and obviously determined that the tradeoffs were worth the change. PMI can now focus on providing premium tobacco products to the growing markets, without the worry of the domestic market.

Notwithstanding any personal ethical concerns about the PMI spin off, it seems that in a highly regulated industry, an international unit may do well to incorporate overseas. There are few legal prohibitions to such maneuvers, even though such moves still must be approved by the Security Exchange Commission and other regulatory agencies (PMI, 2011). Given the potential benefit, it appears that this tactic is worth pursuing for other U. S. companies with substantial domestic restriction. Obviously, if a company faces high political and legal hurdles in the U. S. they have a fiduciary responsibility to maximize shareholder value in whatever way they can, including a spin-off of international operations. In retrospect, the PMI spin-off has been extremely successful. By 2010, PMI had gained an estimated 16 percent share of the total international cigarette market outside of the U. S. (excluding China) with revenue of \$27 billion and operating income of \$11. 2 billion (ABC News, 2011). With 2012 results, Philip Morris International reported worldwide revenues of \$31. 4 billion and an operating income of \$14. 2 billion, according to the company's annual report (PMI, 2012).

So, with the potential to unlock shareholder value and expand corporate profits, American corporations are likely to continue the move separating out their international operations. To address any related ethical and moral concerns, concerned stakeholders have no choice but to rely on public relations pressure back home. In regards to the smoking baby of Indonesia, Philip Morris simply insisted that they do not market to children while maintaining the status quo of advertising and sales operations in the country (The Smoking Gun, 2006). In fact, PMI spends more than \$200 million marketing in Indonesia, and overall sales have increased by 25 percent in the last decade (ABC News, 2011). However, when a toy manufacturer began making a smoking baby toy, complete with little toy cigarettes, the company had to get involved and threaten legal action. According to Philip Morris, the toy cigarettes looked too much like their well-known Marlboro brand (The Smoking Gun, 2006).

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