



Project Eos

**A study of illicit cigarette consumption in
Latin America and Canada**

Executive Summary

January 2017



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Nothing in this Report constitutes legal advice. Information sources, the scope of our work, and scope and source limitations, are set out in the Appendices to this Report. The scope of our review of the contraband and counterfeit segments of the manufactured cigarette market within 18 Latin American countries and Canada was fixed by agreement with the Beneficiary and is set out in the Appendices.

We have satisfied ourselves, so far as possible, that the information presented in this Report is consistent with our information sources but we have not sought to establish the reliability of the information sources by reference to other evidence.

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Introduction to this report

Project Eos is a study which estimates the scale of the illicit cigarette market in selected countries within Latin America and Canada (“LA&C”)

This independent study was commissioned by Philip Morris International Management SA in 2016. The study includes 19 markets from the LA&C region: Argentina, Bolivia, Brazil, Canada, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Venezuela and Uruguay.

In addition to estimating the scale of the illicit cigarette market, the study aimed to identify the nature and dynamics of the illicit flows, such as the key origins and the main brands involved.

KPMG LLP’s anti-illicit tobacco measurement experience

KPMG LLP has extensive experience in the measurement of illicit tobacco consumption across a number of markets. As well as Latin America, our work has covered markets in Europe, the Middle East, Asia and Australasia.

Our work was pioneered in Europe where we have published an annual report on illicit cigarette consumption since 2006. The report, “Project SUN”, is commissioned jointly by British American Tobacco plc, Imperial Tobacco Limited, and Philip Morris International Management S.A. The study includes all 28 European Union member states, and more recently both Norway and Switzerland.

KPMG’s approach

We have applied our existing illicit trade methodology, as refined in the EU through Project SUN, to measure the size of the legal, contraband and counterfeit markets for tobacco products in the selected markets. This study uses an iterative data driven model which incorporates reported domestic sales, Empty Pack Survey and Pack Swap Survey results, travel trend analysis to calculate the volume of outflows and non-domestic inflows to and from each country of study, and to quantify the non-domestic legal and the remaining counterfeit and contraband cigarettes consumed in each country.

Glossary of terms

Average daily consumption	Daily average consumption by the population of the legal smoking age
bn	Billion
CAD	Canadian dollar
C&C	Counterfeit and Contraband, including Illicit Whites
CAGR	Compound Annual Growth Rate
Cigarette	Any factory-made product that contains tobacco and is intended to be burned or heated under ordinary conditions of use
Cigarillos	A short, narrow cigar, which, like cigarettes, is often machine-made and sold in packs
Consumption	Actual total consumption of cigarettes in a market, including Reported domestic consumption (LDC) and illicit products as well as those legally purchased overseas
Consumption gap	The difference between total consumption and Reported domestic consumption
Contraband (CB)	Genuine products that have been either bought in a low-tax country and which exceed legal border limits or acquired without taxes for export purposes to be illegally re-sold (for financial profit) in a higher priced market.
Counterfeit (CF)	Cigarettes that are illegally manufactured and sold by a party other than the trademark rights holder. For the purposes of this analysis, data relating to Counterfeit is not included within the definition of Contraband. This study's ability to identify counterfeit packs of non-participating manufacturers is limited (as described further in the appendix methodology)
Country of origin	Country from which the packs collected are deemed to have originated. This is determined by either the tax stamp on the pack or in cases where the tax stamp is not shown, on the health warning and packaging characteristics
CTMC	Canadian Tobacco Manufacturer's Council
Domestic non-duty paid	Cigarettes which have been produced domestically but no duty has been paid. These packs are often manufactured by companies which are not registered locally or do not declare these volumes. Where required, packs may have no tax stamp or a counterfeit tax stamp
Duty Free	Cigarettes sold at a country point of entry (land borders, ports or airports) that have no state, local or provincial taxes, federal import duties or any other type of taxation added to the cost of the item purchased. Subject to purchase volume restrictions
EPS	Empty pack survey – a survey which collects discarded cigarette packets from the street or easy access public litter bins. The packs are analysed in order to determine their brand and country of origin, alongside whether they are counterfeit or not

Glossary of terms

Flows Model	The primary methodology for measuring consumption in a market. The model details the volume of inflows and outflows of product for a given market by country of origin (the model only specifies flows to Latin American countries included in the scope of this study)
Free trade zone / Special customs zone	An area that is “a part of the territory of a [country] where any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the Customs territory” (Revised Kyoto Convention*). In practice, such zones have often become an area within which goods may be landed, handled, manufactured or reconfigured, and re-exported without the intervention of the customs authorities. In many countries, products illegally pass through the free-zone border into the duty-paid market without duty being paid.
First Nations	According to the Aboriginal Affairs and Northern Development Canada department, First Nations refers to Status and non-Status "Indian" peoples in Canada
First Nations Status	The Aboriginal Affairs and Northern Development Canada department defines First Nations Status as an individual recognised by the Federal Government of Canada as being registered under the Indian Act
Illicit Whites	Cigarettes that are usually manufactured legally in one country/market but which the evidence suggests have been smuggled across borders during their transit to the destination market under review where they have limited or no legal distribution and are sold without payment of tax
Illicit Whites with no country specific labelling	Packs of Illicit White Cigarettes which have “duty free” or no identifiable labelling on the packs
IMS	In Market Sales (the primary source of reported domestic sales volumes)
Inflows	Inflows of non-domestic product from a market of study into another market of study
ITCAN	Imperial Tobacco Canada Limited, a wholly owned subsidiary of British American Tobacco
ITL	Imperial Tobacco Limited
LA&C	Latin America and Canada. For the purposes of this report, LA&C refers to the collective group of countries within the scope of the study, including Argentina, Bolivia, Brazil, Canada, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela
LDC	Legal domestic consumption, worded in the report as reported domestic consumption, is defined as reported domestic sales (LDS) net of outflows
LDS	Cigarettes which have been sold legally in the country of study. In the report they are also often described as reported domestic sales. These cigarettes are all sold through legitimate, domestic channels based on In Market Sales (IMS) data
LTM	Last twelve months
m	Million
Most sold brand	Most popular price category – this also equates to the most sold brand
MYO	Make your own tobacco products

Glossary of terms

ND	Non-Domestic product – product that originates from a different market than the one in which it is consumed
ND(L)	Non-Domestic (Legal) – product that is brought into the market legally by consumers, such as during a cross-border trip
NDI	Non-Domestic Incidence – proportion of total consumption which is comprised of non-domestic cigarettes
NMA/TMA	National Manufacturers' Association / Tobacco Manufacturers' Association
OTP	Other Tobacco Products (RYO/MYO, cigarillos, portions, rolls and cigars; excluding smokeless tobacco and water-pipe tobacco)
Outflows	Outflows of product from the country of study to other countries as determined by EPS or PS results in other countries
Pack Swap Survey	Pack Swap Surveys are a system of obtaining cigarette packs from smokers, the results of which are used to estimate the share of non-domestic and counterfeit packs in each of the markets
PMI	Phillip Morris International
Province	An administrative district of Canada
RBH	Rothman's Benson and Hedges, Philip Morris International's affiliate in Canada
Reserve	Ontario Ministry of Finance says that this is land that qualifies as a First Nations reserve land under the Federal Indian Act (Canada)
RYO	Roll your own tobacco products
Smoking prevalence	The percentage of smokers in the total population of the legal smoking age
TMO	Trademark owner – the legal owner of an identified brand
Tobacco taxes	The sum of all types of taxes levied on tobacco products. This includes indirect taxes such as value added tax, excise tax or other taxes specifically for tobacco as set by the treasury
Unreported domestic consumption	Domestic consumption includes consumption from brands which are identified in the survey but not recorded in the Legal domestic sales data and therefore the legal status of these products is unknown
Unspecified	Unspecified market variant refers to cigarette packs which do not bear specific market labelling or Duty Free labelling
UNWTO	World Tourism Organization
WHO	World Health Organization

Executive Summary

Consumption of illicit cigarettes

On average, 15.6% of cigarettes consumed in Latin America and Canada were illicit, representing a volume of almost 40bn cigarettes

- Whilst Panama and Costa Rica experienced the highest incidence of illicit consumption at 56% and 33% respectively, the highest consumption by volume was Brazil, equating to 19 billion cigarettes (50% of total illicit consumption in Latin America and Canada)
- The main source of illicit cigarettes was from illicit whites and domestic illicit consumption
- A limited amount of contraband came from genuine brands which had been legally purchased in one country but sold illegally in another, whilst identified counterfeit was less than 0.1% of illicit cigarette consumption
- If the illicit cigarettes identified had been legally purchased they would have raised an additional USD4.6 billion in taxes in the LA&C region

Source of illicit whites

At a regional level the overall source of many illicit whites cigarettes can be traced to a limited number of country specific trademark owners

- These trademark owners operate, in the main out of Paraguay, China and India
 - Two thirds of total Contraband (or C&C) came from Paraguayan trademark owners, representing 20 billion cigarettes, just over half of the total illicit consumption
 - 86% of Paraguayan contraband was identified in Brazil
 - Brands produced by Indian and Chinese TMOs constituted over 2 billion cigarettes each
 - The most brands produced by Indian TMOs were identified in Chile and Mexico whilst Costa Rica and Colombia experienced the highest volume of Chinese TMO produced brands
- Whilst the report did not focus on illicit trade supply chain routes, it appears that a high volume may have been imported into Panama through free trade zones and then diverted into destination markets
- These cigarettes had limited or no legal distribution in the countries in which they were identified

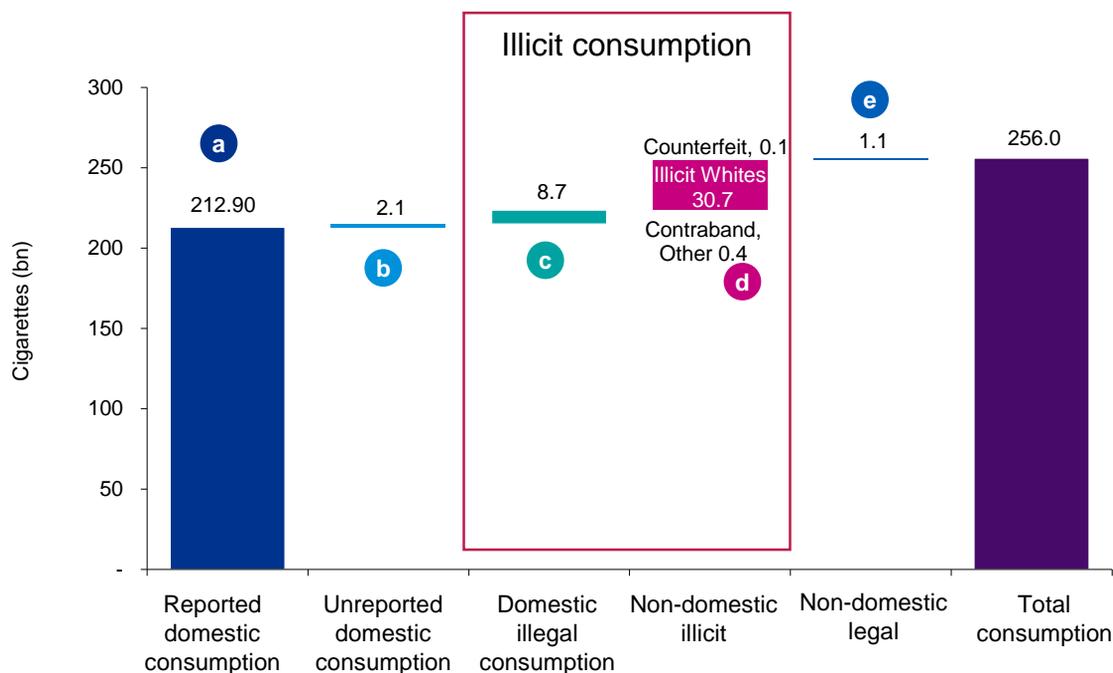
Sources of domestic illicit consumption

In some countries, domestic illicit consumption was a major issue, constituting 8.7 billion cigarettes

- These products are manufactured by local trademark owners but sold illegally, the largest example being Canada with the sale and distribution of native manufactured, non-duty paid cigarettes both on reserve and off reserve via a large criminal network
- There was an additional 2.1 billion of unreported domestic consumption. As these products did not appear on recorded legal domestic sales information, it is not known if taxes were paid on these cigarettes and if they were legal or not

Executive Summary (2/2)

LA&C manufactured cigarette consumption by type



Throughout the report, our analysis has focussed on following categories of cigarette consumption:

- a Reported domestic consumption**
 - Cigarettes legally purchased and consumed within the country of study, based on LDS data
- b Unreported domestic consumption**
 - In some Latin American countries there is also some 'Unreported domestic' consumption. These products are not included in the reported domestic sales but do have genuine domestic labelling. It is not known if these products are sold legally or not
- c Domestic illegal consumption**
 - Product with domestic labelling but which is illicit. These products are identified in many different ways. In Argentina they are sold with fraudulent tax stamps. In Brazil they are sold at below minimum price. In Mexico domestic illegal brands are identified by Cofepris (The Mexican Health Authority) each year, whilst in Canada they are manufactured in First Nation enclosures but then illegally sold in the rest of Canada
- d Non-domestic illicit – divided into three components**
 - **Illicit Whites:** Manufactured legally in countries like Paraguay and China, but distributed illegally
 - **Contraband (Other):** A low volume of product where tax was paid legally in one country but evaded in another
 - **Counterfeit:** Counterfeit was generally only identified for PMI products
- e Non-domestic legal**
 - ND(L) is low in Latin America as travel between countries tends to be infrequent, which results in low volumes of cross-border sales

Regional overview

Cigarette consumption by type in the LA&C region

Total regional manufactured cigarette consumption by type, LTM June 2016^{(1)(a)(b)}

LA&C Region	Consumption	% of TC
Reported Domestic Consumption	212.90	83.1%
Domestic Illegal Consumption	8.68	0.7%
Unreported Domestic Consumption	2.10	0.8%
ND(L)	1.14	0.4%
C&C	31.27	14.9%
Total Consumption	256.04	100.0%

The profile of manufactured cigarette consumption in the LA&C region differed across the countries of study, with overall illicit volumes estimated at 15.6% of total consumption

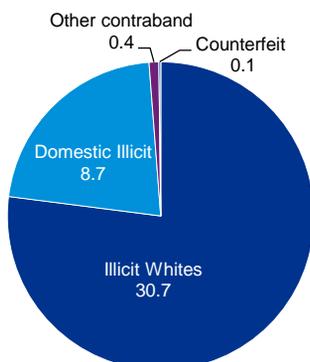
- There were five countries where illicit volumes exceeded 20% of total consumption: Brazil, Canada, Costa Rica, Dominican Republic and Panama
- Across the LA&C markets of scale^(c), illicit cigarette consumption was highest in:
 - Brazil (23.1%) – due to the significant inflow of Paraguayan labelled cigarettes
 - Canada (20.8%) – owing to the issue of widespread consumption of First Nations cigarettes
- ND(L) volumes were very low due to limited travel between each country, with the exception of Panama and Bolivia
- Domestic illegal consumption was most prevalent in Argentina, Brazil, Canada and Mexico
- Unreported domestic consumption was identified in Brazil and Mexico and in small volumes in Costa Rica, Guatemala and Honduras

- Notes:
- (a) For Peru and Paraguay due to lack of data availability the chart represents the total of C&C and ND(L), without separating the two
 - (b) For Canada the share of overall illicit volume (20.8%) comprises First Nations (domestic non-duty paid) and C&C
 - (c) Defined here for the purposes of this overview as any country with total consumption over 5bn cigarettes p.a.
- Source:
- (1) KPMG LA&C Flows Model and analysis of the data sources provided by PMI

Regional overview

Illicit cigarette consumption in the LA&C region

Illicit consumption by type, LA&C Region^{(1)(a)}



The illicit cigarette market dynamics differed across Latin America and Canada. However, the main type of illicit consumption within most countries was illicit whites brands

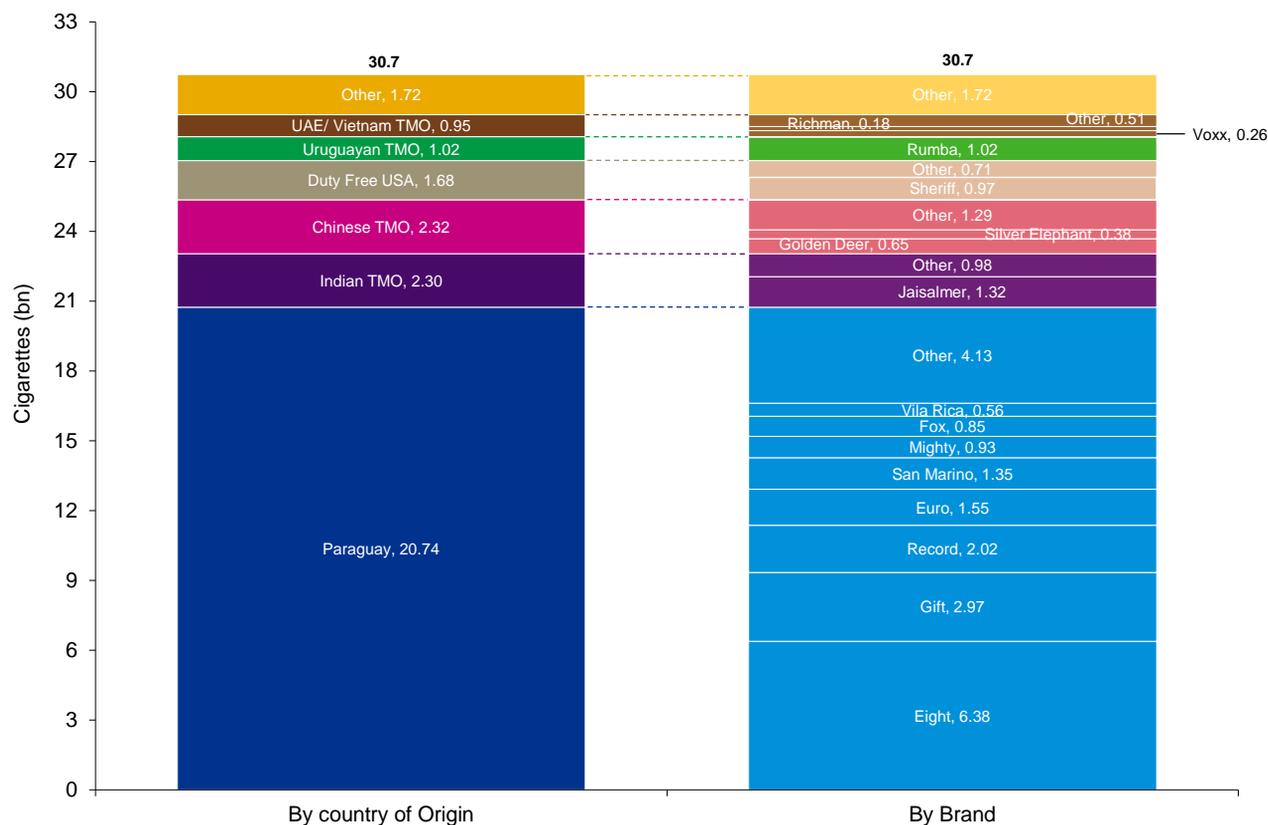
- Illicit whites brands had limited or no legal distribution in any country within the study and are sold without payment of tax in the country where the product is consumed
- Domestic illicit consumption was accounted for by illegally distributed cigarettes from local manufacturers
- Other contraband was represented by brands which were legally sold within the country of origin but then moved into other countries without the payment of tax in that destination market
- Counterfeit cigarettes are negligible as a share of consumption in the LA&C region
- In some countries there is also an 'Unreported domestic' market of brands which are not included in the reported domestic sales volumes, but are identified in the survey results as domestic brands. It is not known if tax was paid on these products. The result is that a small proportion of the domestic market was not included in the Reported domestic sales volume and the legal status of many of these products is unknown

Note: (a) Other contraband includes brands trademark owned by PMI, BAT, JTI and Imperial as collected in the EPS and Pack Swaps
Source: (1) KPMG LA&C Flows Model and analysis of the data sources provided by PMI

Key non-domestic flows and other regional issues

Illicit whites consumption in the LA&C region

C&C by country of origin and brand in Latin America, LTM June 2016⁽¹⁾



- The largest component of illicit cigarette consumption was illicit whites, accounting for over three quarters of illicit cigarette consumption
 - There is no evidence that these brands are available legally in the destination markets within the countries of study, meaning that the entire brand flow was categorised as illicit
 - Brand data was not available for Bolivia, Canada, Paraguay and Peru and therefore these countries have not been included in this analysis
- Over 40 brands were identified from Paraguay, the largest of which was Eight, trademark owned by Tabesa
- Jaisalmer, seen in many Central American countries is trademark-owned by Godfrey Philips, an Indian company
- In addition to the flows where it was possible to identify the TMOs, there were some unidentified TMOs which may add to the volumes from the main countries included

Source: (1) KPMG LA&C Flows Model and analysis of the data sources provided by PMI



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Free Trade Zones

Free trade zones are thought to operate as key transit hubs for cigarettes that make their way into Latin America

- The main Free Trade Zones are in Belize, Panama and Colombia. Here cigarettes are imported without the payment of any customs duty. They can be purchased by distributors without the payment of tax and then can be smuggled across borders where they are sold as illicit product

Latin American Free Trade Zones⁽¹⁾⁽²⁾



Belize: Corozal Free Trade Zone

- Founded in 1994, the Corozal Zone has 314 registered companies operating in it, of which 30 are tobacco companies
- GTIS data from 2015 indicated that 2.1 billion cigarettes were imported into Belize but there is no or obligation to report the amount that is exported
- More recently in 2016, shipments from India equated to approximately two billion cigarettes, with many being brands identified as illicit whites within this study. Those brands not identified in the study are likely to have been exported to other countries including the USA
- Geographically, Belize sits close to Mexico where a high volume of the product is thought to be destined

Panama: Colon Free Trade Zone

- The Colon Free Trade Zone is the most established in Latin America
- GTIS data from 2015 indicated that 7.1 billion cigarettes were imported into Colon, but only 3 billion were reported to leave
- Shipment data from India indicated that one billion cigarettes were exported to Panama in 2016, many of these brands that were identified as illicit whites in the study, including Jaisalmer and Gold City
- Whilst it is believed that the Colon Free Trade Zone still serves as a transit point for cigarettes, there has been a reduction in Panama manufactured or packaged cigarettes after Panama's customs (the SIG) temporarily revoked Overseas United International's licence to manufacture cigarettes in April 2016⁽⁵⁾

Colombia: Maicao 'Special Customs Regime Zone'⁽³⁾

- Goods are introduced into special customs zones and illegally introduced into the national customs territory
- Goods imported to the Special Zone are subject to 4% entry tax on the merchandise's customs value. They are subject to an excise tax as per law 223/1995, except goods to be re-exported. Advantages defined herein shall be applicable exclusively to goods imported into the Special Zone through customs approved entry points.
- There is evidence of over-use of such advantages. According to publicly available records, most of the volume entering the Special Zone is not re-exported or nationalized. An important part of the contraband cigarettes found in the national territory enter through Puerto Nuevo and get into Maicao.
- It is estimated that 2 billion units are illegally exported each year. A study by Invamer revealed that 75% of all illegal cigarettes consumed in the country came from Uruguay (Montepaz), China (China Tobacco) and Paraguay (Tabesa/Hernandarias).

- Source:
- (1) American Chamber of Commerce in Costa Rica, 'Illicit Cigarette Trade in Central America', October 2016
 - (2) GITS Database, 2015
 - (3) Invamer, Q4 2015
 - (4) KPMG analysis of shipment data from Zaubia
 - (5) Removal resolution of SIG, 4 April 2016



Charlie Simpson

Partner, The Global Strategy Group, London

charlie.simpson@kpmg.co.uk

+44 (0) 7500 857 332

Nick Hodsman

Associate Director, The Global Strategy Group, London

nick.hodsman@kpmg.co.uk

+44 (0)7795 306 903

Edwin Kemp

Manager, The Global Strategy Group, London

edwin.kemp@kpmg.co.uk

+44 (0)7733 308 169



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