STATEMENT OF JOE NICOLAUS

Good morning. My name is Joe Nicolaus, and I am the National Sales Manager at Xcaliber International. I have been employed by Xcaliber for a little more than 3 years. Before that, I worked with Tantus Tobacco, a cigarette company that was acquired by Xcaliber. All told, I have nearly 10 years in the cigarette industry, with just at 20 years of experience working in the tobacco industry.

In my current position with Xcaliber, I manage our entire sales staff, as well as our marketing department. In a brief description, my responsibilities related to sales include directly managing our Regional Sales Managers, accounts they are calling on, approving promotions and rebates they extend to those accounts, as well as a variety of administrative responsibilities related to sales and marketing.

I would like to provide you with a basic description of how 4th tier cigarettes go to market in the United States. Basically, there is one common path to distribution, which is through a wholesale account. A wholesale account is a supplier to retail outlets that would supply anything from cigarettes, to candy, to drinks, and any other items that would be sold in a convenient store or like trade outlets. From the wholesale account, the product is sent to two basic types of outlets: an independent retailer or a chain account. A chain account is a group of two or more stores operating uniformly, while an independent retailer is one store. Xcaliber, directly or indirectly, deals with all three of these types of accounts: wholesale, independents, and chains alike.

I would like to make two main points about these channels of distribution. First, we compete against KT&G throughout these channels. Second, there are distinctions between the channels of distribution for 4th tier, and non-4th tier cigarettes.

KT&G sells to many of the same wholesalers we do, and are constantly targeting the same national, and regional accounts we sell to. I would emphasize that both wholesale, and retail customers are extremely price sensitive. There was a time when this was not always the case, but as lower prices were introduced, the market started to demand decreased prices. Xcaliber has fulfilled that market demand with quality products, at an affordable price to adult consumers. Other 4th tier companies have done so as well, but with manufacturing, production, and taxation costs very similar, if not at parity across all lines, it is hard to understand how a 4th tier manufacturer can sell at some of the NET costs we see in our markets throughout the U.S. And, to be perfectly clear, KT&G is the low-price leader. They even mention this on their company webpage. In addition to these points, I hear from our trade partners on a near daily basis about KT&G and their low-priced offerings.

My second point is there are differences in the channels of distribution between 4th tier, and non-4th tier cigarettes. The non-4th tier cigarettes are sold largely through national chains, such as national convenience outlets like 7-11 or Quik Trip. In addition, there are wholesalers that only sell non-4th tier cigarettes. In fact, Philip Morris and RJ Reynolds, which I will refer to as the "Majors," often block 4th tier cigarettes from being sold through wholesale accounts with their sales to share programs, or at retail outlets with their EDLP (Every Day Low Price) contracts. These programs involve the Majors offering large incentive monies to distributor partners for limiting their sales of 4th tier brands to an agreed upon number. Briefly described, should a distributor partner sell more of the 4th tier offering than established by the Majors during a designated time period, they would not receive their incentive monies. Those incentive monies offered to the distributors is often substantial, and so substantial that the principals of these accounts monitor those sales almost daily. On the retail side, EDLP programs force retailers to sell no brand lower than the Major's lowest priced offering. So in essence, if a retailer is on an EDLP program, and chooses to offer a 4th tier brand, they would be forced to sell the 4th tier products at a non-4th tier price, which is unlikely.

4th tier brands are predominantly sold through independent operations, such as regional retailers or wholesalers. Just as there are wholesalers that only sell non-4th tier, there are also wholesalers that only sell 4th tier product. Hub, one of the nation's largest tobacco wholesalers, is an example of such a company.

Not only are 4th tier brands offered through different channels of distribution, but they are also perceived as different products by consumers. This fact is true for our wholesale partners, retail outlets, and the end user or consumer. Wholesalers look at and treat these brands as two different types of products. In addition, the National Association of Convenience Stores, or "NACS," the industry's leading trade association, has 4th tier segmented as a separate product category. Retailers have a different perception of 4th tier as well. They see their customers asking for different products every day. Non-4th tier consumers are brand loyal and will stick with their favorite brand no matter the price. 4th tier consumers are extremely price sensitive and are willing to switch brands to save pennies on a cheaper pack of cigarettes.

Now with all this said, let me be very clear: I love my job, I am very fond of my customers, often forming a long-lasting friendships with many of them, and I love and respect the owners of my company. The owners of Xcaliber empower us to do what we need to do in the trade, and they have always tried to provide us with the resources we need, giving us every opportunity for success. However, it is frustrating to see what is happening in the market, and more importantly, to the landscape of the 4th tier industry. It is discouraging to see the lost sales and lost revenue that we have incurred over the past several years, even more so to imagine the sales potential, and what could have been accomplished. And this is all due to the practices of KT&G.

I first noticed KT&G when I was working with Tantus Tobacco. They were selling Timeless TIME, which is another KT&G brand, at a very low price in the market. This is how they operate, introducing a brand at a low price, disrupting the market, all while taking share from U.S. producers. In some areas, their brands can be as much as $4.00 per carton cheaper than competitive brands, including our own. With these practices by KT&G, most manufacturers are forced to react to protect share and sales. In order to protect what we have already established, we are forced to implement a program known as a "TPR," or temporary price reduction. This proves effective in some cases but always proves to be expensive, impacting our bottom line.

The threat of lost share, and lost revenue due to Korean imports is only growing. U.S. 4th tier manufacturers traditionally operated regionally. Xcaliber and Cheyenne sold primarily into the middle of the country, mostly focused on Missouri and the surrounding states. Dosal was focused on Florida, Texas, and parts of the southeast. Native Trading sold predominantly in the Northeast. Different manufacturers were successful, and their success was limited to certain geographic regions. Sometimes that success was so marginal, it was limited to a state or two.

KT&G started its US operation selling in the same region as Xcaliber, focusing heavily on Oklahoma, which is where Xcaliber was founded and still produces tobacco products today. But KT&G is now competing on a national level, often targeting our strongest accounts with industry data. This industry data is provided to a company named "MSAi" from wholesalers. KT&G is using this information to target our existing customers, negatively impacting our sales. KT&G is broadly distributed throughout the country and now advertises that they operate in 40 states.

We too are trying to diversify beyond Missouri. KT&G is, however, frustrating these efforts. If KT&G continues with their current practices, and I understand this might sound pessimistic, our ability to maintain our current business will be severely and possibly irreparably impaired. We have proof that KT&G is trying to get further into the national accounts that we partner with. Should KT&G find success with these retailers, that success, combined with their current pricing strategy, is almost guaranteed to further impact our market share. From there, we would need to be concerned about a snowball effect where we could possibly lose payroll and personnel. If they continue selling at their current prices, and with their current strategy, the impact it will have on 4th tier domestic manufacturers is unimaginable.

Everything boils down to price, and as I have already stated, this is a price sensitive industry. Production costs are essentially the same for all 4th tier manufacturers. Tobacco costs are similar, material costs are similar, and taxation is certainly similar for every 4th tier company operating in the United States. KT&G is selling at prices so low, I am not sure they can cover their operating costs. We are often reducing our prices just to retain existing customers. This is not a path to growth or profitability, and should imports continue at this pace, all at constantly lower prices, the outlook is bleak.

Which is why we are here today.

Thank you.