BRAZIL COFFEE TO 2010:

Implications for global coffee players

Management Summary

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MANAGEMENT SUMMARY

World coffee overview

- The world coffee market, after experiencing a period of strong prices from 1994 through 1999 that spurred expansion in production, has entered a period of extremely weak prices, near 50 cents a pound in mid-2001, the lowest level since the early 1970s. The low prices reflect a surge in production, led by expansion in Brazil and Vietnam that has outpaced demand growth.
- With coffee demand growing but highly price inelastic, the prospect of several years of weak prices is a major concern for producers in Latin America, Africa, and Asia. Importers share the concern, fearing prices have gotten so low that growers will have no incentive to produce the significant volumes of higher quality coffee that consumers are demanding.
- In 2000 and 2001 producer groups sought to boost prices through retention of stocks equivalent to 20 percent of each participating country's exports. Twenty countries signed on but the initiative failed as only Brazil and Costa Rica certified retained stocks, and several signatories paid only lip service to the effort. Producers in Central America are now developing a triage system to cull defective beans from the export market. A study by the International Coffee Organization (ICO) predicts that this system, if fully employed, could raise prices 2 cents for every 1 million 60 kilogram bags removed from the market.
- In the final analysis, only reduced production can stimulate a coffee price recovery. With prices in mid-2001 below the cost of production for most, if not all, countries, the rationalization of production will occur gradually over several years. A serious frost in Brazilian coffee growing areas is the only scenario for a short-term shock to prices, and the potential for that to happen in 2001 is rapidly receding.

Coffee in Brazil

- While the days of Brazil producing over 50 percent of the world crop are long gone, Brazil remains the key player in the world coffee market with production for the 2001/02 crop (harvested May-August 2001) estimated at 33.7 million bags, nearly 30 percent of the total world crop as forecasted by the United States Department of Agriculture (USDA).
- Brazil's coffee sector remains a vital part of the country's diverse agricultural economy and is a key contributor to GDP, employment, and export earnings. However, industrial products and agricultural exports such as orange juice and soybean meal have joined coffee as leading export products. Coffee is not only an export crop, but is an important part of the daily lives of Brazilians whose country ranks second in coffee consumption after the United States.
- Coffee is tied to the history and development of Brazil. Before 1990, the government held a tight reign over the coffee sector, as well as other important segments of the national

economy. However, with the opening of the economy in the early 1990s and the abolition of the Brazilian Coffee Institute (IBC), the coffee economy was restructured on free market principles. Today, the greatly reduced governmental role is overseen by a Coffee Policy Council with high level participation of coffee grower groups, domestic industrial users of coffee, and exporters as well as key government agencies.

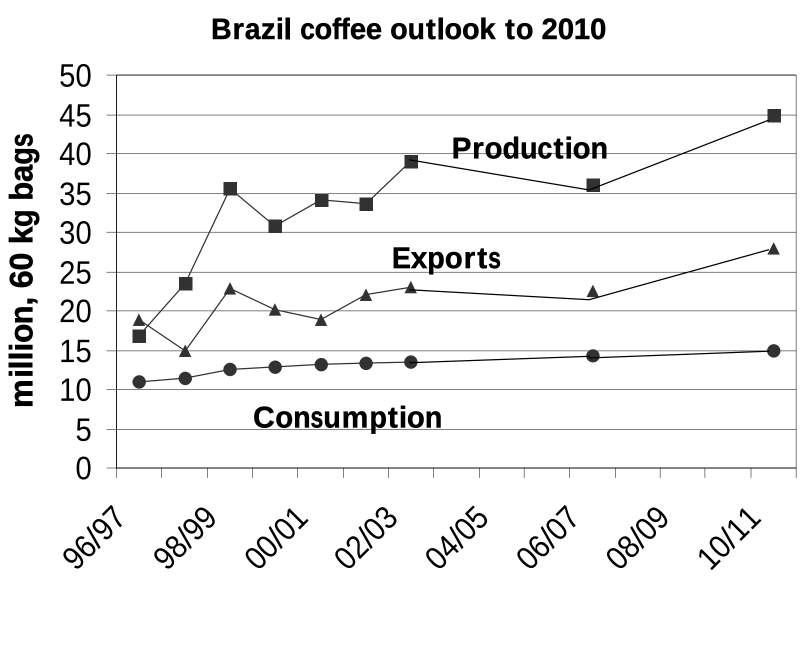
- Brazil's coffee sector used the decade of the 1990s to shift a large share of its production out of frost prone areas, employ new technologies for planting such as high density plantings, plant millions of new Arabica and Robusta coffee trees, develop mechanized harvest systems, and invest in new processing techniques such as pulped-natural systems. These efforts have helped to raise yields, reduce costs, and provide the market with a wide array of coffee types.
- Despite the shift of production away from the southern state of Paraná, the Brazilian coffee sector remains vulnerable to both freeze and drought. A combination of the two specters caused production to fall 40 percent between 1994/95 and 1995/96. Fifty-four percent of Brazil's average 1998-2001 total coffee production was grown in areas subject to frost, and 68 percent of Arabica coffee production was grown in frost prone areas. However, expansion of coffee production into the states of Espirito Santo and Bahia is reducing the frost risk.
- For Brazilians, coffee is not just a crop for export, it is a national beverage. Breakfast in Brazilian Portuguese is café da manha— morning coffee. However, in recent decades the high levels of per capita use had fallen off and it was not until the 1990s that domestic coffee consumption and per capita use levels began to grow again. This growth is due in part to improvements in the Brazilian economy, but it can also be attributed to programs undertaken by the Brazilian Coffee Industry Association (ABIC). ABIC undertook a "coffee purity" program to assure consumers that adulterated coffees were not acceptable, and launched a coffee quality program to improve processing and roasting techniques. The freeing of the market after the demise of the IBC permitted coffee roasters to produce a wide array of coffee products for the full economic spectrum of coffee consumers. The public has responded and per capita use levels are on an up-trend with goals for further growth in the years ahead. A key development to watch will be the level of success the industry has in encouraging coffee consumption among the younger generation in Brazil.
- About 160 firms export Brazil's coffee. The ten largest exporters control less than one-half of shipments. Foreign investment in the export sector is increasing. Coffee export logistics have been modernized with increased preparation of the coffee for export done in the interior growing areas rather than at port side. Modes of bagging and containerization have been radically altered resulting in reduced costs. And port privatization and modernization has made Brazil's ports, especially the key port of Santos, less costly to use and more efficient in their operations.

- Brazil during this period of transition has remained the leader in export volume and this is expected to continue. But the sector also is improving quality and its officials are on the road around the world touting the increased availability of quality as well as volume product from Brazil. In addition, development of specialty coffees and increased availability of coffees with certification of origin, such as from the Café do Cerrado program, are positive responses to a growing consumer market. Brazil is in an excellent position to capture a large share of the growth in the high quality coffee market in the years to come.
- Segments of the Brazilian coffee sector are pushing for the country to regain market share lost over the past two decades. With lowered production costs, Brazil will compete strongly in world markets and capture increased market share. No sudden advance in market share is likely in the short run but there are prospects for nibbling a bigger chunk of the world market by 2010 when production and exports are projected to be significantly higher. Given its history, Brazil also can be expected to be a good citizen of the world coffee community by providing leadership as the global industry moves through this period of crisis.

Projections for Brazilian coffee

Summary

- Long-term prospects for Brazilian coffee production and exports appear strong. By 2010, production is expected to be approximately 45 million bags, with exports hitting 28 million bags and accounting for a larger percentage of global coffee trade.



- We project consumption growth will slow from the 2%-3% annual figures seen in the 1990s to a more moderate 1% – largely to match population growth. Domestic consumption should be approximately 15 million bags by 2010.

Production

- Given recent production trends, existing physical capacity, technology levels as well as market conditions of world overproduction and resulting weak prices, Brazil's coffee production is likely to evolve as follows:
  - 2002/03—barring a significant frost in August 2001, or serious drought later in the season, coffee production is expected to approach 40 million bags.
  - 2006/07—in the years following 2002/03 weak market prices and sector indebtedness will provoke a decrease in harvested area, but yield improvements, driven by higher density plantings, irrigation, improving management practices, and uprooting of low-yielding plantations will boost yields despite restrictions on the use of fertilizers and crop protection chemicals.
  - 2010/11—by the end of the decade the cycle of overproduction will have run its course and a more efficient and lower cost Brazilian coffee production sector will reap the benefits of the technical advances in production pioneered in the 1990s.
  - Year-to-year during this upcoming period the Brazilian coffee sector and the world coffee market will still pivot on major weather events in Brazil and to a lesser degree on the biennial coffee production cycle.

Trends in domestic coffee

- The Brazilian Coffee Industry Association's overly ambitious goal is to push domestic ground and roast coffee consumption to 4.2 kilograms per capita for a total of 15 million bags by 2003, up from 10.1 million in 1995 and 13.1 million in 2000. We think it will be the end of the decade before that level is reached.

Exports

- Given Brazil's expected exportable surplus and marketing ability, an expansion in export volumes to meet market opportunities and to regain market share appears likely.
  - 2002/03—exports are expected to expand to the level of 1998/99 reflecting a moderately aggressive effort to expand market share. Green Arabica coffee exports are expected to account for about 85 percent of total exports. With growth in Robusta production, Brazil's presence in the world green Robusta coffee market also is expected to grow. Green Robusta exports are forecast at 2.3 million bags in 2001/02. With an

export projection for 2010 at 28 million bags, Brazil's Robusta exports can be expected to climb to around 4.2 million bags, 15 percent of total exports.

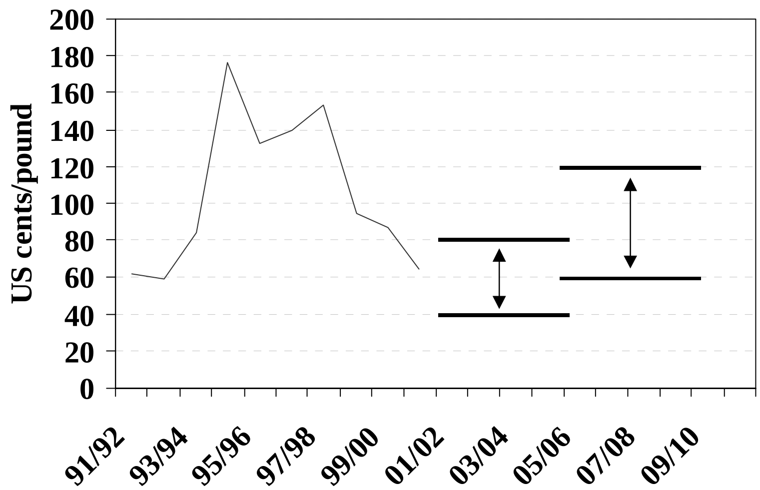
- 2006/07—exports will decline given smaller expected production and growth in domestic demand. However, exports will be maintained partly by drawing down on stocks from previous years.
- 2010/11—exports are projected to expand to a record 28 million bags as Brazil captures a large share of the expected increase in international market demand including a significant share of the growth foreseen for specialty coffee. Exports are expected to account for about two-thirds of production, somewhat higher than a decade earlier.
- Soluble coffee exports from Brazil are expected to grow from 2 or 3 million bags to about 4 million bags (gbe) reflecting growth in exports to China and Russia (1.21 and 3.45). Efforts to increase R&G exports will be more difficult and the target to reach 1 million bags by 2005 appears overly optimistic. The main area for growth is expected to be the neighboring Mercosul countries, which do not produce coffee, primarily Argentina.

Brazil in a global context

- Over the next decade, total world coffee trade is projected to expand by approximately a million bags per year. Barring exceptional weather events, Brazil will pick up volume and market share during the next couple of crop years but then not capture much of the subsequent near term growth, as production stalls somewhat due to low world prices. However, later on in the decade, as prices recover, we expect that Brazil will be in a position to capture most of the volume increases in world trade.

- While world trade expands from approximately 90 to 100 million bags from 2000-2010, Brazil's share of this trade is expected to grow from roughly 22% to 28%.
- Because of the expected growth in supply from Brazil (and Asia) in the future, lower prices are likely to be the norm in the medium term, barring unusual shocks.

Price forecast: Brazilian Naturals (July-June)



- In the chart above we indicate that season average prices for Brazilian Arabicas are likely to stay in the 40-80 cent range for the next 3-5 years before production adjustment worldwide pushes value back up to a more normal range of 60-120 cents.

Implications for coffee players

Implications for other exporting regions

- Other coffee exporting areas must be ready to weather a decade of low prices. In years of oversupply, the lowest quality products will suffer. Hence a way to reduce the adverse effects of oversupply will be to tailor production towards the growing global segment of specialty/certified coffees (as Brazil itself has been doing). To the extent that lower labor costs discourage a shift to higher quality, they could prove a liability in this process.

- By region, exporting countries face the following:
  - Colombia, Central America and Mexico – these areas have limited expansion opportunities and should focus on improving quality and creating coffee niches;
  - Africa – lacks resources and is a price taker, so there is little that can be done

- Asia – regions in Asia have expansion potential; nevertheless, they ought to at least develop 'pockets of quality'

Implications for importing consuming countries

- Importers can expect growing volumes of more consistent, higher-quality coffees. These are likely to create branding opportunities for large retail chains, for instance, that are interested in capturing value created by the expanding quality/foodservice coffee markets.

Implications for multinational coffee companies

- For global roasters, increasing supplies of higher quality coffee may create room for some of the large global roasters to build new, higher quality coffee brands.
- For companies with a presence in Brazil, there are likely to be opportunities to develop, market, and export premium brands.
- For foodservice operators, the expected low prices for coffee over the medium term should be good for foodservice operators that source coffee from Brazil. In addition, they may find increased opportunities to offer premium Brazilian varieties as well, as these expand in volume. However, larger players may wish to develop industry relationships early, as premium varieties are likely to be sought by many companies in the key coffee consuming countries as these shift to higher-quality varieties.
- For domestic foodservice, (i.e., coffee bars), the market is small yet relatively competitive, and opportunities there are far more limited.

Implications for the international organization community

- For international organizations, Brazil will be seen as both part of the problem and part of the solution. Its aggressive production sector will keep world prices under pressure, while its push for higher quality and willingness to work cooperatively with other countries to foster orderly marketing will be a positive influence.