

Globally, coffee is a \$70 billion annual retail industry. With rising consumption in developing economies and increased revenues in the specialty coffee sector, the industry is one of the most dynamic, with McDonalds, Wal-Mart, Coca Cola and others entering to compete for market share. Parallel to this growth has been a proliferation of ethical sourcing certifications such as Fair Trade, Rainforest Alliance, Utz, the Ethical Trade Initiative and others. The rapid growth enjoyed by these certifiers implies a genuine commitment from the roaster, retail and consumer communities to ethically source and consume coffee.

Yet a glance at the farming communities in coffee growing countries tells us that on the whole, the 25 million small holder families producing over 50% of the world's coffee remain bound within the poverty trap. So while these certifications offer a credible third party confirmation of social and environmental standards to the end user, the system appears to be having little to no impact on the quality of life for the poorest people in the supply chain, the farmers.

The need to address this imbalance goes beyond any sense of social responsibility, but rather forms part of the climate change issues that we collectively face as a global community. It is glaringly obvious that if we fail to change the way we acquire, consume and discard, we face an unprecedented global disaster.

If we in developed communities have the tools to initiate the required changes yet struggle to find the will, how can impoverished communities be expected to adopt change? One cannot demand or dictate terms to someone who lacks food security, has a life expectancy of less than fifty years and will lose half their children before they reach their fifth birthday. When everyday is a struggle for survival, you engage a different set of priorities.

The challenges we face are global, requiring a global response. One half of the world cannot embrace positive change and carry the other half. The nature of the challenges that lie before us require that all communities participate.

Poverty is a spoke in the wheel of change. By creating the opportunity of a better life, you create the leverage to negotiate better social and environmental practices and better governance. Change must be incentivised and rewarded, not demanded.

Coffee has the potential to be a significant catalyst for change in addressing poverty. Hundreds of millions of people across Africa, Asia and the Americas rely on coffee as their primary source of income. Coffee is the economic backbone to many of these producing countries, creating jobs, foreign currency and government revenue. Grown throughout the tropics, coffee either detracts from or contributes to the protection of forests, water sources and eco systems.

This need and opportunity is recognised by a Gates Foundation sponsored program that seeks to double the income of 1 million smallholder coffee farmers in East Africa over the next decade and beyond.

There is second driver of this need to change the way we conduct ourselves in the supply chain and engage the people at origin. I believe this second driver threatens to affect the coffee community in a more direct and immediate manner.

Global consumption is rising dramatically, predominantly in the developing world. The increased wealth of growing middle classes in Asia, Africa and the Americas, combine with the globalization of brands to drive this trend. Brazil is now the second largest consumer of coffee after the US, having overtaken both Germany and Japan in recent years.

By 2050 we will be twelve billion people on earth. Almost double the number we are today. Putting aside the questions this figure raises about food security in the future, this sets the scene for a bull market trend for all commodities. Putting the implied price impact aside, you are faced with potentially dire supply problems (keeping in mind that small holder coffee farmers are currently unable to respond in the same way as sugar or soya farmers, due to the difference in their economic

profile). At best, roasters will reach a point where the raw material will simply no longer exist in the volumes that are required, particularly the higher quality range.

In Zambia, Colin and Greg Street of Terranova coffee farm produce in excess of 600 tons of high quality Arabica coffee from 187 planted hectares of land. With an intensive replanting cycle, the Streets average over 7 tons of coffee per hectare on the lands with the most mature trees. In stark contrast to the 300 kg per hectare produced by small holder farmers in Tanzania and Rwanda, battling leached soils, erosion and old trees.

The differences are easy to spot. Education means that Colin and Greg understand the science of farming. Access to long and short term credit makes invest in infrastructure, agri chemicals and research possible. Direct links to the both the roaster and supermarket who buy their coffee mean maximum return on a price paid well above their cost of production . Terranova farm is a thriving business. The profits sponsor a school on the farm for the local community that has no access to education. A third of the farm is a managed game reserve for breeding indigenous antelope. Farm dams are stocked with Talapia each year so that the labourers and local community can supplement their diet with protein.

Terranova is both Rainforest Alliance and CAFE Practices certified, in keeping with their clients' requirements.

In stark contrast, small holder farmers usually have no land tenure, little to no access to credit, limited education and are forced to liquidate their crop to a local middle man. They and their coffee lose their identity before the coffee has left the district. Coffee is the only cash in a life of hard labour spent subsistence farming.

By ensuring a these communities link up with final clients, pay a reasonable price for milling and export services and pocket the bulk of the FOB price, we instantly create the resource, the ability and the motivation to drive change. Increased yields and increased revenues means greater belief in coffee by the younger generation. In Tanzania it is startling to see the advanced average age of coffee growers as the young see it as a “mugs game” offering a lifetime of toil for very little reward.

## WHERE THE CHANGE NEEDS TO START

The coffee supply chain comprises of three distinct components; Production, export and trade and roasting and distribution. Each is a highly specialised field, requiring its own infrastructure and skills set. It is this middle component that I would like to focus on as it has the roll of the middle man that has shown the most inertia in what is today a very dynamic industry.

The role of the trade houses is to act as the conduit between farmers in producing countries and roasters in consuming countries. Both farmers and roasters are clients of the trade, as the trade is the contractual principal to both ends and therefore the risk taker. The trade risk in coffee is multi faceted and the stakes are high. Profit margin, as a percentage of cargo value, is on average very low.

Coffee is a perishable food commodity, grown in politically and climatically volatile regions. The time between picked from the tree and delivered to roaster is months to over a year. The distance travelled overland can be thousands of kilometres, through neighbouring countries before embarking on a sea voyage of weeks to months between continents. During this journey time, the coffee changes hands numerous times, is stored and transported in varying climatic conditions. All pose a potential risk to a commodity sensitive to its environment and whose value is defined by the quality of its taste. Poor handling and storage means diminished quality translating to loss of value.

## THE FUTURES MARKET

In parallel to the physical business of coffee trades the futures market, against which all coffees are priced and traded.

The coffee futures exchange is a tool used to indicate the daily base price of all coffees against the supply and demand, projected into future deliveries of coffee to beyond a year from the present. This tool can and does fail. (coffee crisis 1999 to 2005)

Today, public companies and hedge funds have more money than some governments and in the world of global macroeconomics, this pricing model has become complex, with currency movements dictating the ebb and flow of money into these markets on a daily basis. The cash muscle of these “non coffee” players dwarf’s the resources of the actual physical coffee traders, allowing market movements to be magnified beyond the fundamental supply and demand scenario.

We, the physical traders, the conduit between farmer and roaster, trade into this sea of liquid cash, using the futures market as a hedge against the risk of price movement from time of purchase to time of sale or delivery. Participation in the futures market requires significant financial resources, thus excluding many coffee people from participating. The high value of coffee and its price volatility potential, translate into a second arena of risk for the trade.

I believe it is the perceived high risk / low margin of this commodity that has defined the behaviour of the green coffee trade houses over time.

## BUY LOW / SELL HIGH

The traditional coffee supply chain represents a push pull of price negotiation that repeats itself over and over again as the coffee changes hands up the supply chain. Coffee farmer sells cherry or parchment to wet miller or intermediary. They then sell on locally to each other or exporters. The exporters sell on to the trade who in turn, sell to roasters or other trade houses established in different consuming markets. Roasters in turn compete for market share, shelf space, private label and institutional contracts.

The price pressure is down and the person with the least tools to negotiate is at the very bottom. Lack of access to finance, lack of market knowledge, lack of infrastructure and lack of product quality knowledge all combine to place the farmer in a hugely disadvantaged position. The pressure to turn the crop into cash without understanding the intrinsic value of the commodity at that point in time results in the coffee changing hands for a value dictated by the buyer. It is not unusual for larger buyers within the origin country to agree a buying price between them so as not to escalate the internal price.

One of the largest coffee roasters in the world buy coffee using an inverted auction system. They publish their coffee requirements in vast volumes projected over a period of delivery times, inviting trade houses to compete in a downward race where the cheapest wins. . Very often the suppliers (trade houses) are required to sell coffee forward they are yet to buy. Thus they have to project how cheaply they believe they can secure the coffee in the future. This results in price pressure all the way back down the supply chain to farm level.

## OWNING THE PROCESS

A real value add in coffee is the ability to convert your cherry to exported green coffee. This translates to “owning” the processes from picking off the tree, pulping to separate the beans, fermenting to increase quality, drying, milling to grade by quality, stuffing export containers, with all required export documentation in place. These are all the processes that take place within the country of origin yet only a tiny percentage of small scale farmers retain ownership of their coffee

through these procedures. Most sell the coffee to wealthier individuals and organisations that have the ability to add the value that these processes offer.

I am not implying that these people/organisations are villains. Far from it. In many countries they assume the role of creditor in the absence of banks. Unfortunately, this also results in degrees of “loan sharking”, where coffee is owed for money lent at exorbitant interest rates. The price is decided by the lender at the time the crop comes off the tree.

Exporters are often a combination of buyer, miller and exporter. The larger the infrastructure of that company, the larger the fixed overhead cost. In order to pay for this fixed overhead, the exporter adopts a combination of two strategies. The first is to buy the coffee as close to the tree as possible, thus adding the maximum value. The second is to charge farmers a fee for each component in the value chain up to export. These fees are charged at well above the real cost, resulting in profit centres over and above that of the traded coffee.

As an example, a roaster may buy a Fair Trade certified coffee at the benchmark minimum price, believing they have paid a sustainable price to the farmer. In reality, the farmer absorbs costs and deductions of 20% to 50% of the price paid by the roaster, netting significantly less than perceived. It is vital to recognise that by empowering the farmer to own these processes or access them at close to cost; we immediately increase the farmer’s income in two areas. The first is the direct quality value add. The second is the power to negotiate with a far wider range of buyers on a “finished” product. In this scenario, the export price has remained static. It is the distribution of this export price that has dramatically changed.

Without the ability to export, you can only sell to internal buyers. With the ability to export, you can sell to anyone in the world.

The existing internal supply chains and buying strategies are in conflict with the idea of a sustainable supply chain where we are all working towards a vibrant and robust industry focused on the needs of the future.

On a larger scale, local and national economies are also compromised as the bulk of exporting companies in origin countries are owned by a handful of multi-national companies. The ownership of these internal value added processes, results in less money circulating within these communities and after tax profits are unlikely to remain within the country of origin.

## CHANGE YOUR HEADSPACE

I believe that it only requires a change in approach and a change in thinking to make a massive change in the lives of millions of farmers, without demanding a higher price than is already being paid.

We all ultimately share the same client, the consumer. Every one of our businesses is reliant on the survival and success of other businesses in the supply chain. Therefore a sustainable supply chain is one where each of the supply chain components, from farmer to exporter to trader to roaster to supermarket, operates at a profit.

To establish this sustainable supply chain requires collaboration. Rather than treat each other as supplier and buyer, bargaining down and up respectively, we establish a partnership focussed on servicing the consumer.

We are able to apply the real cost of every element, without fat. Each participant negotiates a required margin above the cost of his/her role. This level of transparency engenders both trust and goodwill in all directions. (We have experienced this in reality.)

This supply chain carries significant credibility. With the growing focus on CSR issues, this credibility is a bankable asset in terms of brand building and consumer confidence.

## MARKETABILITY

Coffee is highly marketable due to its allure. The story of the people in coffee, not coffee the commodity, remains largely uncaptured.

This supply chain creates relationships with coffee communities, allowing the last person in the supply chain to tap into a vivid and remote world. To be able to serve a high quality product, truly ethically sourced and to be able to build and support your brand with arrestingly beautiful imagery and a story of hope and contribution is an opportunity for the company as a whole, not only for its bottom line returns on coffee.

## HOW DO YOU DO?

I am not dreaming blindly of a coffee Utopia where all men are brothers, toiling for the common good. This is sound business practice, reducing risk, guaranteeing profit and responding to the demands of a changing world and more enquiring generation of consumer.

Falcon has done and is doing this as the core strategy to our green coffee business. We act as service provider to a range of small holder farmer groups and sell to a host of roasters around the world, using a transparent business model as the key strategy for our future growth and profitability.

By declaring our margin up front, we reduce our risk as our role has shifted to financier and service provider for a declared fee. We can now openly engage both sides with credibility. Our role is justified by our contribution to the supply chain.

This idea or proposal represents the next step. We have the farmers, we have the roasters, and we have the human resources and the market tools.

We believe we can deliver a consistently high quality product to the supermarket at a highly competitive price, with a fully transparent supply chain that makes a real and quantifiable difference to the communities that farm the land.

I would like include an excerpt from a speech made by Bill Gates at the World Economic Forum in 2008 that really sums it all up.

***“As I see it, there are two great forces of human nature; self interest and caring for others. Capitalism harnesses self- interest, but only on behalf of those who can pay. Philanthropy and government aid channel our caring for those who can’t pay, but the resources run out before they meet the need. To provide rapid improvement for the poor, we need a system that draws in innovators and business in a far better way than we do today.***

***Such a system would have a twin mission; making profits and also improving the lives for those who don’t fully benefit from market forces. To make the system sustainable, we need to use profit incentives whenever we can.***

***At the same time, profits are not always possible when business tries to serve the very poor. In such cases, there needs to be another market-based incentive – and that incentive is recognition. Recognition enhances a company’s reputation and appeals to customers; above all, it attracts good people to the organisation. As such, recognition triggers a market based reward for good behaviour.***

***The challenge is to design a system where market incentives, including profits and recognition, drive the change.”***

Thank you

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