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COFFIDENTIAL

YOUR BEST SOURCE OF INFORMATION ABOUT THE BRAZILIAN COFFEE BUSINESS. THIS ISSUE:

CLIMATIC FACTORS ANTICIPATE HARVEST AND AFFECT QUALITY

Harvesting has already started in South Minas, the largest coffee producing area in Brazil; out of season rains in August 2018 caused early flowering and consequently the premature development of cherries. The Arabica crop is suffering from higher heterogeneity than usual with cherries at different ripening stages in the same tree – green/unripe, ripe and dry/overripe which will affect overall quality and lower prices to growers. It is estimated that Arabica production will reach around 26.4 to 27.6 million bags in Minas Gerais state. Total Brazilian Arabica production is projected at 36 million bags, 19% lower than the in previous crop.

Sources: Agrolink, EPTV Sul de Minas and G1 Sul de Minas

LONGER PAYMENT PERIODS FOR BARTER DEALS

Given the persistence of low coffee prices, companies and cooperatives are extending the payment terms to attract growers to barter operations with future crops. Whereas payments for inputs in exchange for coffee usually take place one year after the deal in the traditional system, new barter operations offer payment terms between two to three years, with large cooperatives like Cooxupé having extended the period for up to five years. Bartered coffee accounted for 20% of the total volume delivered to the cooperative in 2018, the equivalent of 1 million bags. Companies like Bayer expect that 50% of their sales to the coffee sector in Brazil will be made using barter deals.

Source: Valor Econômico

EXPORTER TERRA FORTE FILES FOR JUDICIAL RECOVERY

Terra Forte, one of the largest coffee exporters in Brazil, is going through judicial restructuring of its debt after defaulting on about R$ 1.1 billion (US$ 288 million). A request for judicial recovery, the Brazilian equivalent of US Chapter 11, was approved and the company will have 60 days to submit a restructuring plan which may include an equity sale. According to Terra Forte, the objective of the plan is to find a new partner. Terra Forte moved about 6.5% of Brazil coffee exports in recent years.

Source: Bloomberg

BSCA AND APEX BEHIND GROWTH OF SPECIALTY COFFEE EXPORTS

Coffee production in Brazil has registered an annual average growth of 15% since 2008 when the project “Brazil The Coffee Nation” was implemented. Revenues from specialty coffee exports increased an astounding 600% since then pushed by the sectorial project developed by BSCA in partnership with the Brazilian Trade and Investment Promotion Agency (Apex-Brasil). More than 9 million bags of specialty coffee were produced in Brazil in 2018.

Source: BSCA (Brazil Specialty Coffee Association)

BAHIA COOPERATIVES BET ON SPECIALTY MARKET

Cooperatives of family farmers in Chapada Diamantina region in Bahia have been investing in the production of specialty and organic coffees for exports. Coopiatã, for instance, has consistently placed its coffees among the finalists of Cup of Excellence. The state government has used World Bank funds to invest R$ 3.2 million (US$ 810,000) in the coffee production chain to improve quality and to boost access to market for small growers. Cooperatives are directing resources to technical assistance, coffee processing equipment, storage facilities and coffee quality labs.

Source: CCCMG

COFFEE DEMAND GROWS TOGETHER WITH THE QUALITY OF THE PRODUCT

Domestic coffee consumption should not repeat the record growth of 4.8% in 2018 when 21 million bags were consumed in Brazil. Consumption is expected to increase a maximum of 3.5% this year as a result of the unfavorable economic scenario. Consumption is increasing faster for higher quality coffees whose retail prices are R$ 55/kg (US$ 14/kg) on average according to the Brazilian Coffee Roasters Association (ABIC). Consumers are becoming more demanding when it comes to quality.

Sources: Valor Econômico and Editora Gazeta

NESTLÉ ENTERS R&G IN BRAZIL AFTER 66 YEARS IN SOLUBLE

Nestlé is entering the roast and ground coffee segment in Brazil with the Nescafé and Starbucks brands. This new business will receive investments of R$ 300 million (US$ 76 million). Coffee, Nestlé's third largest business in the country after chocolate and milk, may become the company's second most important one in 4 to 5 years. According to Euromonitor, the 3 Corações Group leads the coffee market in Brazil with a 22.3% share, followed by JDE (18.9%) and Nestlé (14.2%).

Source: Valor Econômico

SPECIALTY BRAND LAUNCHES HOPPY COFFEE

Franck's Ultra Coffee, a brand from Curitiba, Paraná state, has launched a line of "hoppy coffees" developed with beans infused with Centennial hops in bloom and recommended for filter preparations. The company's connection to artisanal beers dates back to 2015 when it started to age coffee in barrels previously used for distilled beverages.

Source: Revista Cafeicultura

FUNCAFÉ OUTLAYS EXPANDED TO R$ 5 BILLION

A record budget of R$ 5 billion (US$ 1.3 bi) has been approved for the Brazilian Coffee Fund (Funcafé) in 2019. Such resources represent an increase of 2.2% compared to 2018. The financing lines used for production, stocks and coffee acquisition were increased while interest rates remained the same as in 2018.

Source: CNC

Brazilian Prices

Main Producing Regions / Farm Gate — **April 30, 2019**

Arabica Naturals (R$/ 60 kg bag)	
Cerrado MG	365,00 ↓
Mogiana	360,00 ↓
South Minas	360,00 ↓
Arabica Pulped Naturals (R$/ 60 kg bag)	
Cerrado MG	385,00 ↓
South Minas	380,00 ↓

+ 6.9%

Conilon / Robusta (R$/ 60 kg bag)	
Colatina-ES fair average price	268,00 ↑

BM&F (US$/60kg Arabica bag)	
Jul 2019	109,90 ↓
Sep 2019	112,35 ↓
Dec 2019	115,45 ↓

Real R$ / Dolar US$	
Apr 30, 2019	3,92 =

Source: www.qualicafex.com.br

POOLING EFFORTS TO FACE THE PRICE CRISIS AND TO INCLUDE YOUNGSTERS

It is estimated that 80% of the world's coffee is produced by small growers. If the coffee market is concerned with the sustainability of its supply chain and if 80% of the world's coffee is produced by small growers, the key question here is if the small grower will be economically sustainable in the mid and long run, let alone with today's record low prices. On the one hand, the tendency is for the average coffee holding size to fall as a result of generational changes. On the other hand, not only the cost of living grows but, most importantly, growers' aspirations also grow as a natural result of development. To make matters worse, we know that with current coffee prices most growers are losing money. Not a promising scenario at all!

The diseconomies of scale involved in "small farming" are huge, specially in access to technology, a subject we know well in what regards post-harvesting of coffee. The price of coffee wet milling equipment only doubles when capacity is increased four fold. A large coffee drier costs only twice the price of a small drier with one-tenth of the former's capacity. A similar process happens with other types of equipment, e.g., sprayers, tractors and even irrigation. Attempts to develop specific equipment for small growers often succeed on the technical side but fail as often on the cost/price side, sometimes miserably. This phenomenon is compounded by lack of access to credit for small growers to acquire equipment and inputs too.

The issue of credit brings up another problem that pesters small coffee growers: their limited bargaining power not only when buying equipment and inputs but also when selling their crop. It does not take a PhD in economics to know and understand that on average a small grower pays more and sells for less than a mid-size or large grower in the same way that goods often cost more in a corner store of a low income neighborhood than in a middle-class supermarket.

All in all, small growers are left with their own low-cost labor as a comparative advantage, even though they are often forced to "consume" their meager savings or their own limited capital. Truth is that this labor is not low-cost but only "sold" or computed (or not) at a rate below market level. Without exaggeration, the prospects seem bleak for small growers even after prices recover. Is there a way out?

The recipe may be simpler than one thinks: to reverse the process. Instead of making technology compatible with small coffee farming and subsiding credit to small growers, the focus should be on bringing growers together to benefit from economies of scale in technology and to gain bargaining power by buying and selling as a group. Equipment sharing, joint processing facilities, group purchasing, a cluster approach to sustainability, and pooling of coffee to be marketed are some useful paths. Easily said than done, of course, but are we trying hard enough?

Cooperatives have existed for well over 100 years and growers' associations are not that new either but their use is not as widespread as desirable. Perhaps these traditional forms of association have to be complemented by innovative forms of association, country and culture sensitive, that cater for the needs of micro and small coffee growers and empower them lest they will disappear in the long run. The real barriers to do this may be more behavioral and sociological than technical and should be dealt with accordingly. This is the challenge for governments, agencies and companies concerned with the plight of the small coffee grower.

The inclusion of youngsters, i.e., their retention in the coffee business, will result from the access to technological change enabled by central milling, better insertion in the supply chains for inputs and coffee, and a modern approach to the business from seed to parchment or even green coffee. Change is a *sine qua non* condition to retain youngsters because they will only stay if they are challenged to and can do things differently from their parents and grand-parents!

CENTRALIZING ON-FARM MILLING TO EMPOWER GROUPS OF COFFEE GROWERS

There are indeed huge economies of scale in on-farm coffee processing. Let's address another example besides those found in the Outlook section of this Coffidential. If a small handpulper priced at X is supplied to 100 small coffee growers the total bill will be 100X. If this small pulper is driven by an electric-motor the bill doubles to 200X. If each grower produces an average of 50 bags, a single pulper to process the coffee produced by all 100 growers as a group will cost only 14X! A central Pinhalense wet mill, including not only a pulper but also an unripe cherry separator, a rotary screen to separate unpulped cherries, and a mucilage remover will cost about 50X and endow growers with latest technology.

In summary, a modern eco-friendly wet mill with a mucilage remover, able to process high quality washed coffee, costs only one-fourth (25%) of what it would cost to equip each grower with a conventional highwater-consumption small pulper. If one compares pulpers alone, the cost of the central milling alternative falls from 25 to 7%, not including the further benefits of modern vs. old technology and a water-intensive vs. a water-saving system.

Investments in Pinhalense central mills benefit from large economies of scale, as per the example above, because these mills are not an “agglomerate” of individual small pulpers put together, one next to the other, which clearly does not enjoy economies of scale. Much to the contrary, each and every Pinhalense central wet mill is specifically designed according to the specific features of the coffees to be processed coming either from a group of small growers or an estate.

From left to right: small, mid-size and large wet milling and drying facilities in Guatemala, El Salvador and Colombia, respectively

In reality, the technical requirements to process coffees produced by groups – small, mid-size or large – of small growers are more complex than those typical of coffees coming from a single estate. Coffee variety, degree of maturation, impurity content, size distribution, etc. may all be different from one lot to the other. Pinhalense has lengthy experience in responding to all these differences and variations because it has the unique ability to select and combine the components of its wet mills according to both the characteristics of the incoming cherries and the requirements of the markets to which the coffees will be supplied, from micro lots to differentiated coffees for large quality-consistent blends to commercial coffees.

The quality of harvesting is falling, even at the realm of the small grower, and markets are becoming more diversified, with the growth of consumption in the producing countries themselves and in emerging markets and new forms of preparation. Therefore it becomes ever more important to process properly all cherry fractions that reach the wet mill, irrespectively of their degree of maturation, in order to preserve their intrinsic quality. Pinhalense equipment is very well known for doing exactly this. It is no wonder that Pinhalense was behind the development of honey / pulped natural coffee and pioneered the pulping of partially ripe and over-ripe coffee cherries with great gains to farmers and processors, let alone the full preservation of quality of the ripe cherries that are perfectly separated from pulp and not damaged.

Pinhalense excels in helping small growers to benefit from economies of scale in processing and to enjoy the same technology, quality and profit advantages available to large growers and estates. Even greater economies of scale apply to central drying , as hinted at the Outlook section, and dry milling can be an added possibility that is clearly not available for individual small growers.