

Esmeralda Coffee. Taking Advantage of Having the World's Best Coffee

So what? Said Price Peterson, I produce the most expensive coffee in the world, but it is only a small proportion of my total production. In the last internet auction he had obtained the world record-of-records price: US \$ 130.00 per pound, for 0.1% of his production. About 6% of his production was sold to Peet's, a very sophisticated coffee shop, at \$11.00 per pound; the remaining of its production was sold to Starbucks at a price about 50% superior to the standard C contract of New York, which oscillated between \$1 and \$1.2 in the previous year. There was a wide variation in commodity prices, in some years he had faced prices of \$ 1.2 per pound when market prices were as low \$ 0.70.

Price Peterson was not happy with the overall financial results for the company from his current portfolio of products. He estimated that in the current year the company would only break even. The accounting cost and the cost of capital were high, so he needed to find a way to increase the farm's revenues to be able to create value.

Peterson was thinking about auctioning directly his high value coffee, to the world's most sophisticated buyers, in a private auction, organized by his farm; "just like the Rothschild wine, which is auctioned in 2008, to be produced in 2009, to be delivered in 2011", he said. A CBSN news program said that coffee was becoming the new "wine", in the sense that there is a sophisticated market of connoisseurs paying huge prices for extraordinary coffees. The coffee to be privately auctioned in the 2008 harvest would be the all the Gesha coffee: the coffee previously sold in the SCAA auction and the portion previously sold to Peet's.

The world coffee markets and problems

Coffee is one of the most important traded commodities measured by the value, it is the main export product for many underdeveloped countries and about 25 million families depend on its trade. The coffee market deteriorated at the end of the 1980s. The main reason was the rupture of the International Coffee Agreement in 1989, due to the withdrawal of the US. This agreement controlled the coffee supply and inventories to keep the prices at the level of \$1.20 to 1.40 per pound. The current price was \$0.73 per pound or lower. Besides, due to the great increment of the world coffee supply, prices fell down to levels of \$0.50 per pound, which affected many low income families. Exhibit 1 and Exhibit 2 show the evolution of the coffee production, supply and prices.

Hacienda La Esmeralda

The hacienda is located in Boquete, Chiriquí, Panama; in a beautiful, fresh, high mountains volcano territory, which was attracting many Europeans and North American immigrants.

Peterson's father, Mr. Rudolph Peterson, former President of the Bank of America, purchased the farm in 1964 before retiring. Price Peterson, a PhD in neurochemistry and retired professor of Biology in the USA, started to work in the farm in Panama in 1973. He manages the farm with the help of his wife, Susan. Daniel, his son, is the COO and Rachel, his daughter, manages the marketing activities.

They bought a second, lot, the Jaramillo farm in 1997, mostly for the quality of coffee and its altitude. It was always known for a very slightly citrus flavor, but not much more until the 2003/4 harvest.

The extreme rains brought on by 1998's La Niña weather pattern left a fungus infection on many of Boquete's coffee farmers. On Hacienda Esmeralda, "half the farm was devastated," said Peterson. Only three varieties of plants had survived from among all those that the Petersons had planted. One of those was the "Gesha" variety.

Hacienda La Esmeralda in Palmira has 134 ha of coffee in production. Pequeña Suecia in Jaramillo (50 hectares, about half in production) this is jointly owned with the Peterson family and a Bennett cousin. La Lorenita (18 ha. in production) is jointly owned with the family of their friend, Roberto Motta. The farms employ about 45 people on a permanent basis, growing to 300 during the coffee harvest. Including their families, this means that over 1,000 people depended directly on the farm. The management of the farm has been in the hands of the Peterson family for the past 35 years and was into its third generation.

Though not "organic," the Petersons take the waste from their coffee processing areas and use it to fertilize the plants, Daniel Peterson said. Every year the Petersons find ways to use less and less water in production, he added.

"All the overland migratory birds have to come through Panama's coffee highlands to get between the Americas," Peterson said. On Hacienda Esmeralda they don't trim the trees that grow over the coffee areas until the birds have moved on, which comes at the risk of fungi that grow in the shade and a general reduction of sunshine for the plants. When they do trim the trees, they leave enough green to allow them to survive.

The influx of Europeans and North Americans into the Boquete area, where most of Panama's coffee is grown, was causing a rapid rise in land value, and in the taxes that go with it, said Peterson. "It's part of development," he added. Hacienda Esmeralda, like most of its neighbors, depends on the labor from the indigenous Ngobe to pick coffee. If that less expensive labor were not available, Hacienda Esmeralda might only be able to produce the Special, and not the Premium coffee which currently accounts for much of their business, Peterson said.

The Petersons decided to replant the whole farm with these three varieties. It takes coffee plants about five years to reach their full potential, and the Petersons "needed something special to pull the farm back up to its potential". What they got was much more than they had hoped for. The beans from different parts of a small farm, even if they are from the same genetic stock, can produce coffees that taste very different. A little patch had just the right conditions for the world's best coffee.

Eureka

In January, 2004 Daniel began cupping coffees from various parts of the farm testing the notion that rather than a general good cup, there might be an area with an intensely fine cup, which was flavoring all the output of the farm when it was all mixed together. It turned out he was right. At the upper extreme of the farm there was a very small valley which had

the cup known as Jaramillo Special and this was providing much of the flavor for the rest. When he separated out the upper quality coffee (about 3% of the total), he found that that part was very especial. The remainder was very good, but not with that intense cup.

The SCAA auctions

Hacienda Esmeralda tried to be represented by one of the Petersons in as many international coffee events as possible. Daniel Peterson was also President of the Specialty Coffee Association of Panama, and a member of the larger Specialty Coffee Association of America.

Due to the current low market prices, many NGOs had oriented the coffee farmers to produce special coffees: organic, "fair", bird friendly, strictly height, etc. Organic and "fair" coffee receive premium prices of 72% to 144% above conventional. Organic only coffees receive premium prices of 12% to 122%. There is a group of coffees specifically called "special" which receive quality premiums of about 35% above the standard C contract of the New York Board of Trade. Central American countries had done a good job in penetrating the gourmet and niche coffee markets. In particular Costa Rica and Guatemala managed to sell a high proportion of their coffees (about 35-50%) into differentiated and specialty markets. Exports to organic and fair-trade markets is limited (less than 1% of the total market) but growing. Peru has become the leading exporter of organic coffee in the world reorienting its small farmers' coffee plantations.

The Cup of Excellence is an international competition that allows small coffee farmers' production to be evaluated by national and then by international judges; the coffee lots that get the highest scores enter into international electronic auctions like the one held by the Specialty Coffees Association of the Americas, SCAA.

Success

Peterson's coffee placed first in the 2004 "Best of Panama" cupping competition in April with a score of 95.6 out of 100 and first in the Rainforest Alliance "Cupping for Quality," on March of 2004.

In June of 2004, the specialty coffee market industry was shocked. The international specialty coffees auction had reported an all time world record high price. Jaramillo Special coffee, from Hacienda Esmeralda in Panamá, had been sold in the auction at US\$21 per pound. The current market price of the commercial grade coffee was \$0.73 per pound; the price of the special coffees was about \$1.50. One specialized international publication commented that "A Panamanian brew called Esmeralda had brought the coffee-drinking world to its knees" and commented that one buyer, the Roasterie, in Kansas City even "hired an armored truck to deliver it, presumably for protection against over-caffeinated fanatics".

Mr. Peterson commented later that in 2004 they had hoped for a price of \$4-5 per pound, thinking that \$7 would be a miracle. When the price hit \$15 in the auction, Mr. Peterson called the auction director, who also was in shock and convinced he had a hacker who had penetrated his computer system and "was frantically trying to do a fix". They shut down the bidding for several minutes. When Mr. Peterson called back later, bidders from different countries had already confirmed that they actually wanted to pay those prices. "From that

moment on, I just sat down in front of my computer to see the price rising,” said Mr. Peterson.

The price was increasing every year, and in 2007 it grew to \$130 per pound. The auction computer system was designed only for transactions at prices lower than 99.99; hence the auction had to be continued by phone

The Hacienda la Esmeralda’s Private Auction

Mr. Peterson had an idea to attempt to increase the company revenues. He decided that the coming 2008 high value lot would be divided in small lots, to be auctioned separately. They planned to auction all their Gesha coffee in ten batches including 101 lots, each lot had 6 bags of fifty-pounds each. It was probably the first time in agricultural history, that a single small farm would organize its own private Internet auction. Mr. Peterson wondered how complicated would be the implementation of such strategy, and what were the risks.

For a small farm in Panamá, it looked like very difficult to be able to organize efficiently all the required software, computer systems and security technology and logistics. It was a very unique strategy which was very novel in the farm sector.

But the coffee was so good and appreciated that it might be a reasonable risk. These were the comments in a evaluation report from a Judge who was also a sophisticated coffee trader. “The dry fragrance has very refined floral qualities, citrus blossom, sweet lemon, and jasmine. Gladly the wet aromatics are super dynamic, floral, and sweet, ... with guava and passion fruit brightness, and jasmine floral sweetness. It seems so perfume-like, a distillation of flowers, but with unique piquant fruited high notes. There is both lemon blossom and lime-like touches paired with tropical fruit essences. For such a light bodied, effervescent, perfumey, almost ethereal flavor profile, it has surprising "staying power" on the palate. But it is difficult to price this sort of cup character. And when it is as exotic ...no, extraterrestrial ... as the Esmeralda Gesha, it is even more hard to quantify. In tasting the Gesha coffees, the cup flavors might seem less intense than the extreme aromatics. As the cup cools, perceived intensity and brightness will increase exponentially”. Its score was the highest 97.5/100; the valuation of a lot of Blue Mountain coffee, a well known brand was only 85.6/100.

Exhibit 3 shows the revenues he had obtained from his 3 products portfolio strategy. Exhibit 4 shows an example of the segmentation in the wine market.

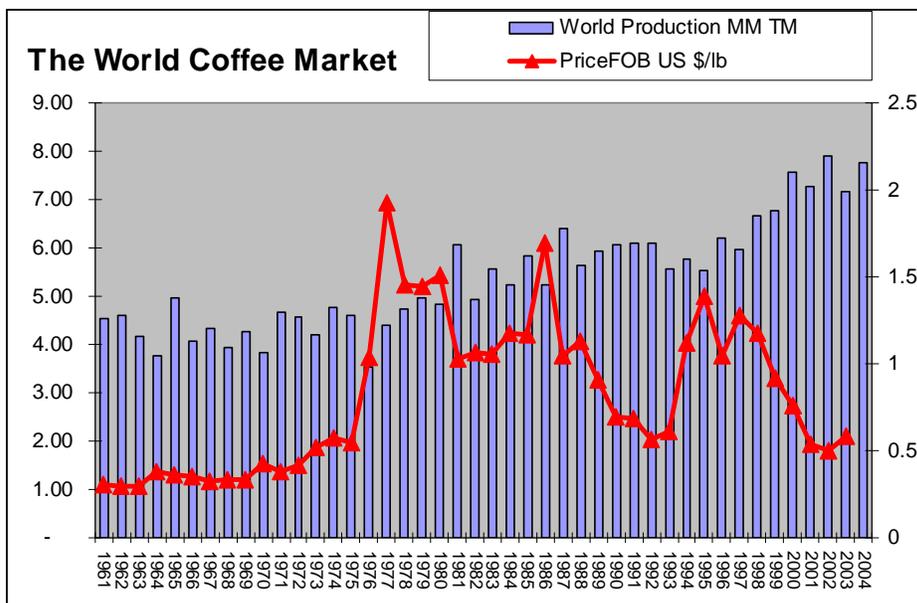
It would be very difficult to let the world wide sophisticated buyers to taste the product in advance, in order to be able to bid so high prices. He also needed to be able to preempt buyers’ collusion. Another operative problem was how to deliver so many small shipments to so distant buyers. The invited buyers were located in many countries.

A family member, who was the CEO of a venture capital, was concerned about losing Peet’s account, who had faithfully purchased all this years the high value Gesha coffee not sold in the auction at so high price, paying \$11 to \$13 per pound, about 8 times the price paid by Starbucks for all other the Gesha coffee produced.

Peterson expected that the marginal revenues of such unusual marketing strategy for a small farm in Panamá, would pay the costs of such sophisticated selling strategy and still be greater than the revenues obtained in 2007.

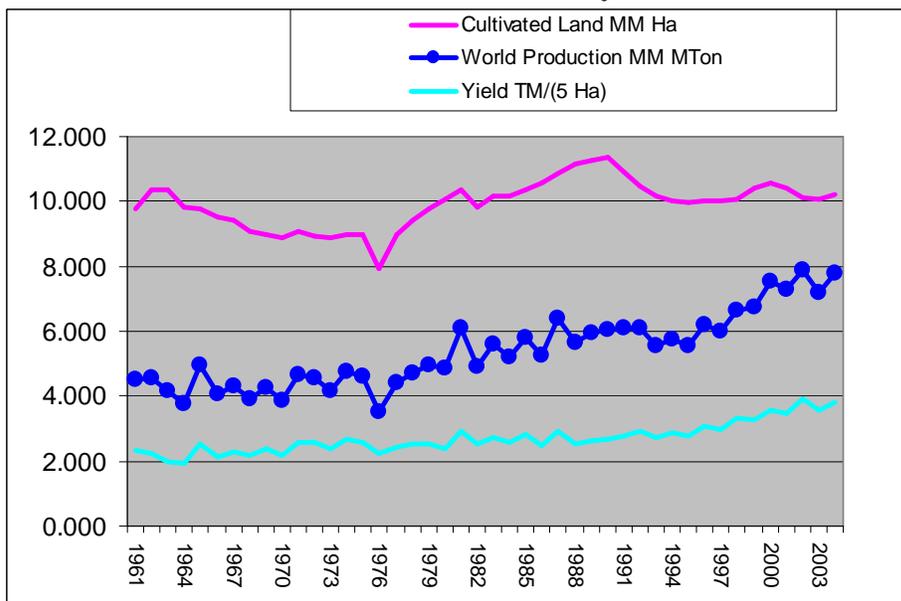
As time to sell the lot was over, and the Panamá auction was already advertized, Price had to decide what to do.

Exhibit N. 1. Evolution of World Coffee Production and Prices



Source: FAOSTAT

Exhibit 2 Coffee Production and Productivity



Source: FAOSTAT

Exhibit 3 Panama Auction Results

Best of Panama 2004 - Final Results

Bags	HighBid*	Price	Description	Winning Bidder
7	\$21.00	\$19,445.16	Jaramillo Special	The Roasterie, inc; Public Market Coffee Co.; Groundwork Coffee Co. *
16	\$2.30	\$4,867.90	Café Leru	Stumptown Coffee
9	\$2.04	\$2,428.66	Cafetales Doña Berta	Time's Club, Inc. & C-COOP
P8	\$1.92	\$2,031.82	Café Don Pepe	Wataru & Co., Ltd.

Source: http://auction.stoneworks.com/includes/pa2004/final_results.html#

Best of Panama 2007 - Final Results

Bags	HighBid*	Price	Description	Winning Bidder
1001	\$130.00	\$ 65,000	Hacienda a Esmeralda	The Roasterie, inc. ;Intelligentsia Roastmasters.com (Willoughby's Coffee & Tea); Zoka Coffee Roaster; 49th Parallel Roasters; Groundwork Coffee Co.; Coffee Klatch Roasting.
16	\$11.80	\$9,440	Mama Cata MCGC	Sweet Maria's coffee

Source: http://auction.stoneworks.com/includes/pa2007/final_results.html#

Composition of Hacienda la Esmeralda Revenues. 2007

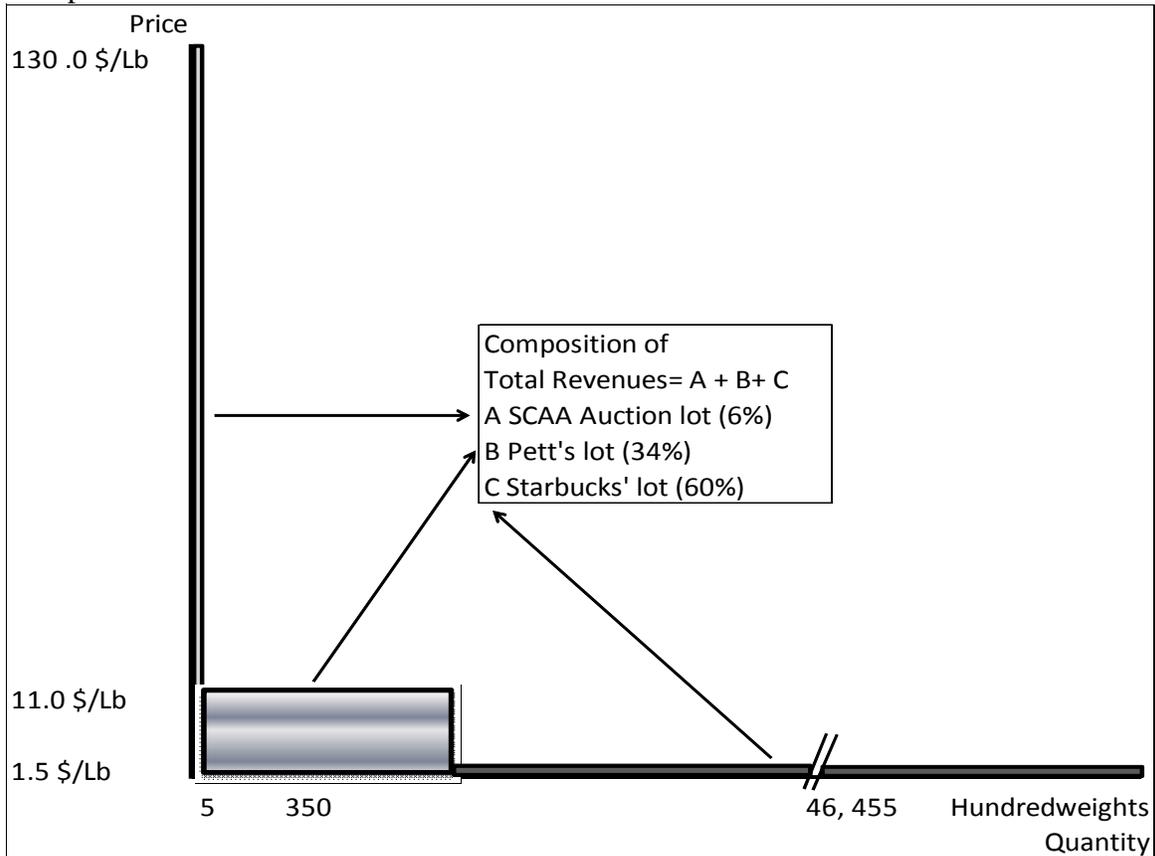


Exhibit 4. Sample of wine market segmentation

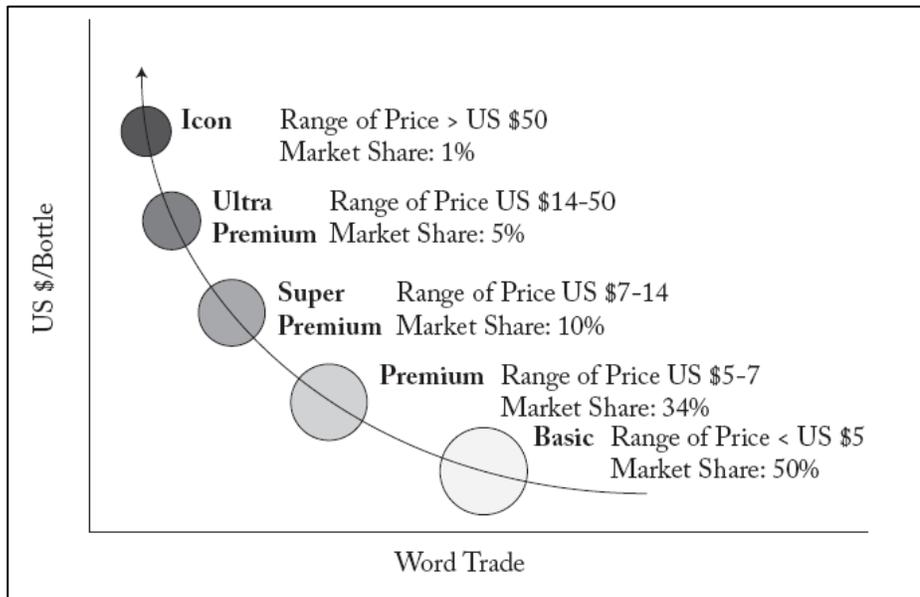


Exhibit 5. Sample of Land Lots Offerings in Boquete. As seen in the trade.

Sell Price: 1,500,000

Location: Boquete
Chiriqui
Panama

Property Type: Lots/Land

Property Details: It is around 16 Hectares (38 acres), full title, with a river in between. It is already everything set up for a development, with master plan and it needs just a few weeks to have the final improvement from the government. I have the plans with me and all the documentation you need to have a idea what I am talking about.

Teaching Note

Relevance: This case describes the operations of the world's best coffee, which is rather sophisticated if compared with other farms of the world. Its marketing strategy through public auctions and the by its own private auction are quite unique in the agribusiness. Behind this strategy there is a deep knowledge of the microeconomics foundations of marketing and strategy, and its practical application would increase farm's revenues. Besides this case is perfect to apply EVA concepts to evaluate the financial results from the operation and rises a polemic question. Farm or firm?

Target Audience: Senior undergraduate, master students and executives.
Depending on the audience the case can be addressed in different ways.

Objectives.

- 1) Learn how to apply new metrics in business decisions
EVA vs. Profits (Firm vs. Farm approach)
- 2) Evaluate the potential of some business strategies.
Market Segmentation and Umbrella Branding.
Auctions, Reservation Prices and Revenues
- 3) Apply New Logistics Paradigms B2B and B2C to this kind of trade.

Questions for the team work previous to class

- 1) What is Peterson's problem?

Value Creation/Destruction Based on Accounting Figures

In spite of having the most expensive and the world's best coffee, Mr. Peterson cannot be happy with the current financial results. Breaking even in one year means that the firm is actually destroying economic value. The farm is not generating the cash flows required to pay the cost of capital of the year; even if the accounting results show an "even" situation. Modern financial analysis include, in addition to the accounting rules, the deduction of a subjective (but real) cost of capital from the accounting profits, to measure value creation.

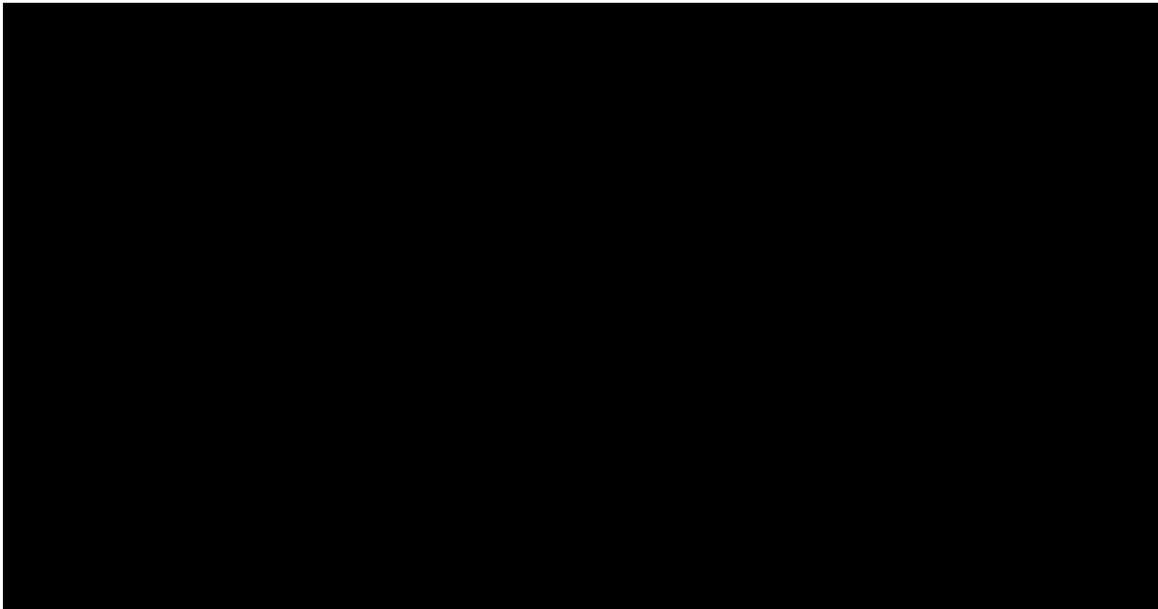
In a simple way we can say that the Cost of Capital is the cost of the resources required to manage a level of assets. Those resources are the debt, which costs are already considered in the accounting systems; plus the cost of the equity, the part of the assets not financed by debt. The cost of equity cannot be accounted by accountants, because it is subjective, though real; but it is currently accounted by financial managers. The accounting profits must be bigger than the cost of equity, $Ke \cdot K$. Ke is the return required by investors, and K is the amount of equity invested. Profits bigger than the cost of capital: $P > Ke \cdot K$, indicate value creation for the investors in the current year. $P < Ke \cdot K$ indicate value destruction.

Breaking even, meaning that the farm has zero profits, means that the farm is currently destroying value.

Value Creation/Destruction based on Market Value of Assets

Peterson's financial problems worsen when we apply the EVATM model to the firm. The problem comes from the actual value of land due to the migration of Europeans and American to the region. The market value of land is much bigger than the accounting value of it. In that case, the breaking even means a much bigger level of value destruction for the shareholders, as seen in Graph TN.1. With higher values of land, and contractually fixed values of debt, the value of equity increases, increasing the cost of capital. Comparing it with the profits from business operations, which remain constant, it leads us to worst levels of value creation/destruction.

Graph TN1 EVA Creation/Destruction



2) How can Peterson take advantage of having the world's best coffee?

Price Discrimination and Segmentation

Having the "world's best coffee" and breaking even in finance, or value destroying from an EVA point of view does not look like sustainable for a firm. May it be acceptable for a farm?

As we see in exhibit N.3 of the case, 40% of the revenues come from 7% of the volume, represented by extremely high value coffees. The remaining 60% comes from 93% of the production sold to Starbucks at a rather good price. But the whole portfolio of products does not generate sufficient revenues to cover the accounting and capital costs.

The question is how to increase the revenues from the farm to increase the profits to a level compatible with positive EVATM, or economic value creation for shareholders. A question that we must analyze at the end is which EVA metrics we should use; based on the accounting value of the assets or based on the market value of land.

In any case the farm must maximize its revenues from the given lot of production, knowing that there are different segments of the market willing to pay different prices for given lots of production.

First of all, we should ask ourselves if there are some market segments between the Panama Auction buyers who pay \$130 and Peets' who pay 11; willing to pay intermediate prices for some lots, like 80, 65, 25, or 16 \$/pound, as a decent demand curve for normal goods would suggest.

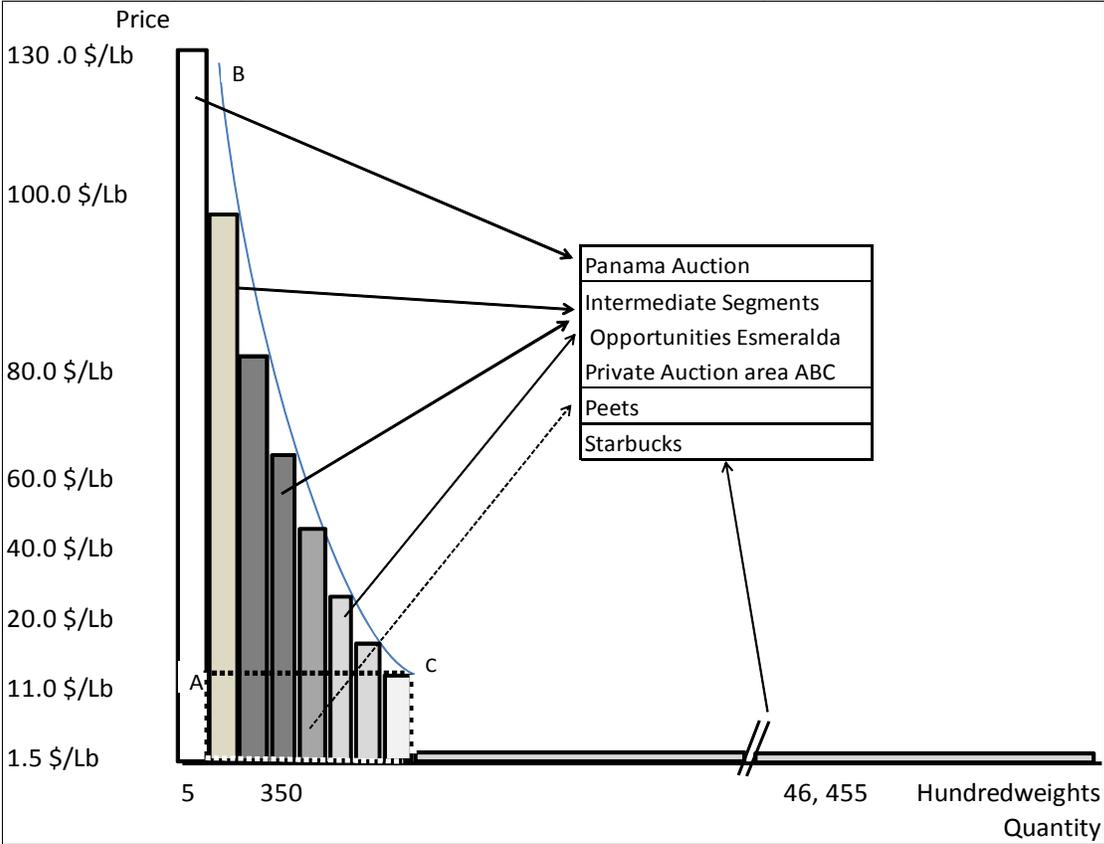
The rationale for the auction is to capture the willingness to pay of the segments of buyers assumed to be located between the 130\$ Panama Auction Buyers and Peet's. The magnitude of the opportunity is described by the A-B-C triangle in Graph TN 2, representing the value that might be caught by a private auction of 101 lots of coffee. The rationale is to try to capture most of the revenues described in the triangle A-B-C, if the demand is like the described in the graph. The most convex to origin the curve is, the smaller the opportunities for price discriminating.

Exhibit 4 suggests that there are many segments within the high value wines market, the auction suggests that something similar might be in the coffee market.

The auction of 101 lots is a price discriminating strategy attempting to charge to single buyers their individual reservation price, or the maximum price that a given buyer in the market, is willing to pay for each single lot. The auction has the virtue of forcing the buyers to reveal and pay their reservation prices.

Hence, in theory, the marginal revenues of a private auction would be bigger than the revenues obtained by selling the Panama auction and to Peets' only. The area A-B-C is the value of the marginal revenues. We need also to know the cost of the auction to evaluate the marginal profits of such strategy.

Graph TN 2 Expected Market Segments for Gesha Coffee within the Total Demand



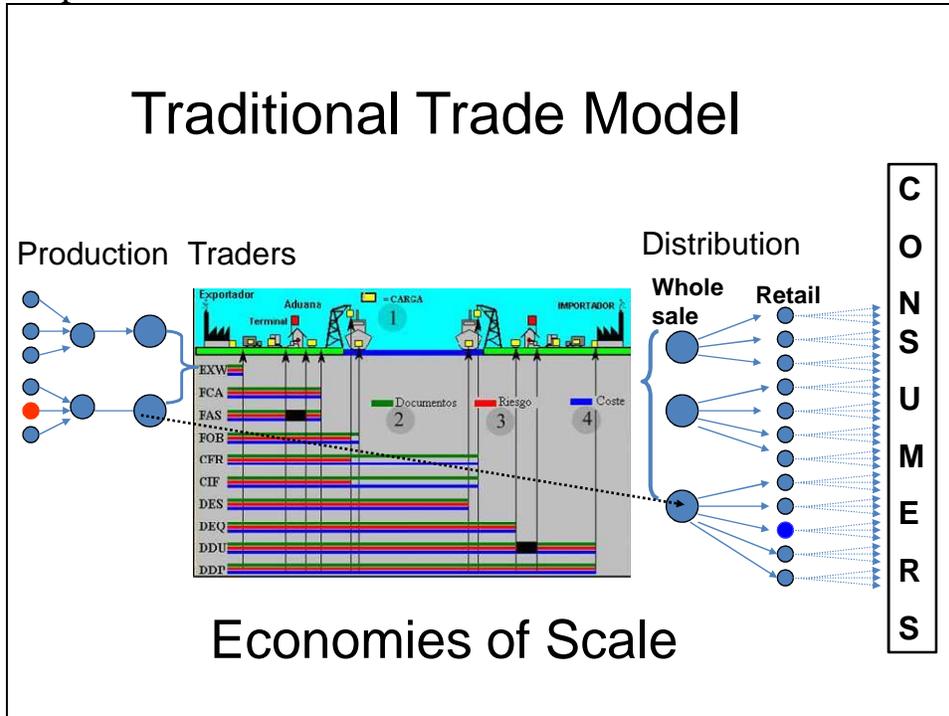
3) What problems will Peterson face by selling 101 small lots to too many different buyers?

Price Peterson will face very complicated logistics operations to distribute the many small shipments to all the worldwide scattered buyers.

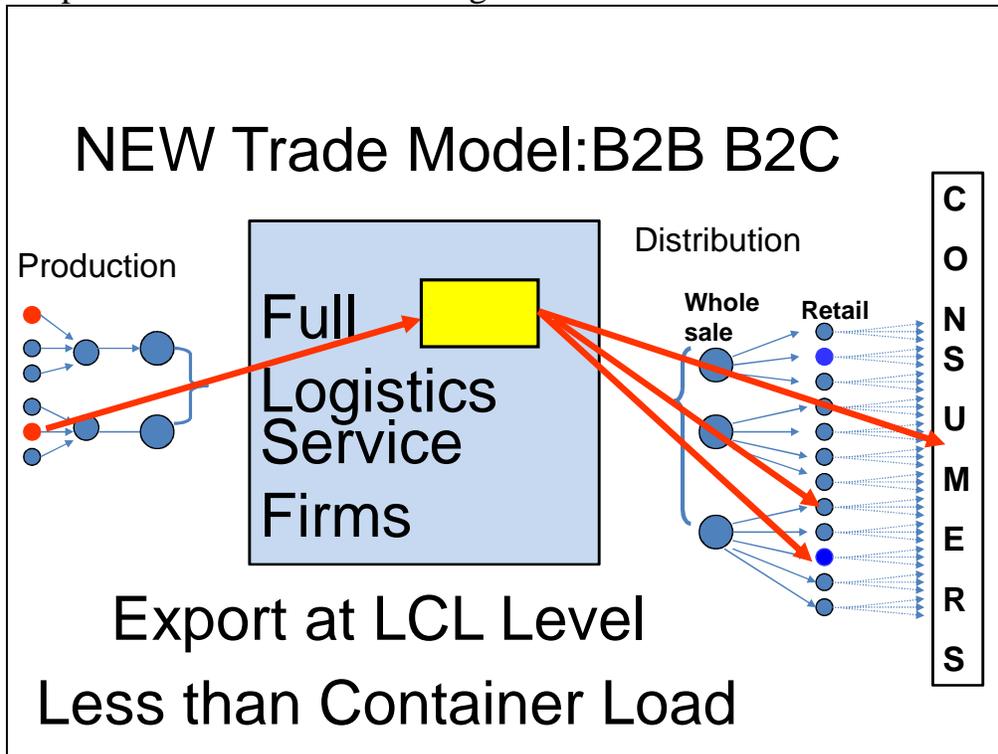
B2B is the solution, he will need to charge FOB prices, however the full cost for the buyer is the DDP (Buyer's Store). The price of the product delivered to buyers' doors, after coverings all the local and main freight costs, plus the costs of clearing of both customs, in Panama and in the destination country, and the freight costs to the buyers store; all those cost will increase the actual price paid by the buyer.

The traditional trade model will not work here for such small shipments, however, the new full logistics service companies, which used to operate as couriers, now also give cargo services to firms, for products with value per pound. Those companies, have expanded to serve the increasing B2B and B2C operations under the Internet platform, those base their competitiveness in putting together many small shipments in single consolidated shipments. Those firms have similar economies of scale in the logistics as in traditional trade, charging freight prices a bit higher than the traditional freight. Those seller freight costs are more than compensated with the higher prices they can charge, selling directly to the retailers and consumers.

Graph TN3 Traditional Trade Model



Graph TN 4 The New B2B Logistics Model



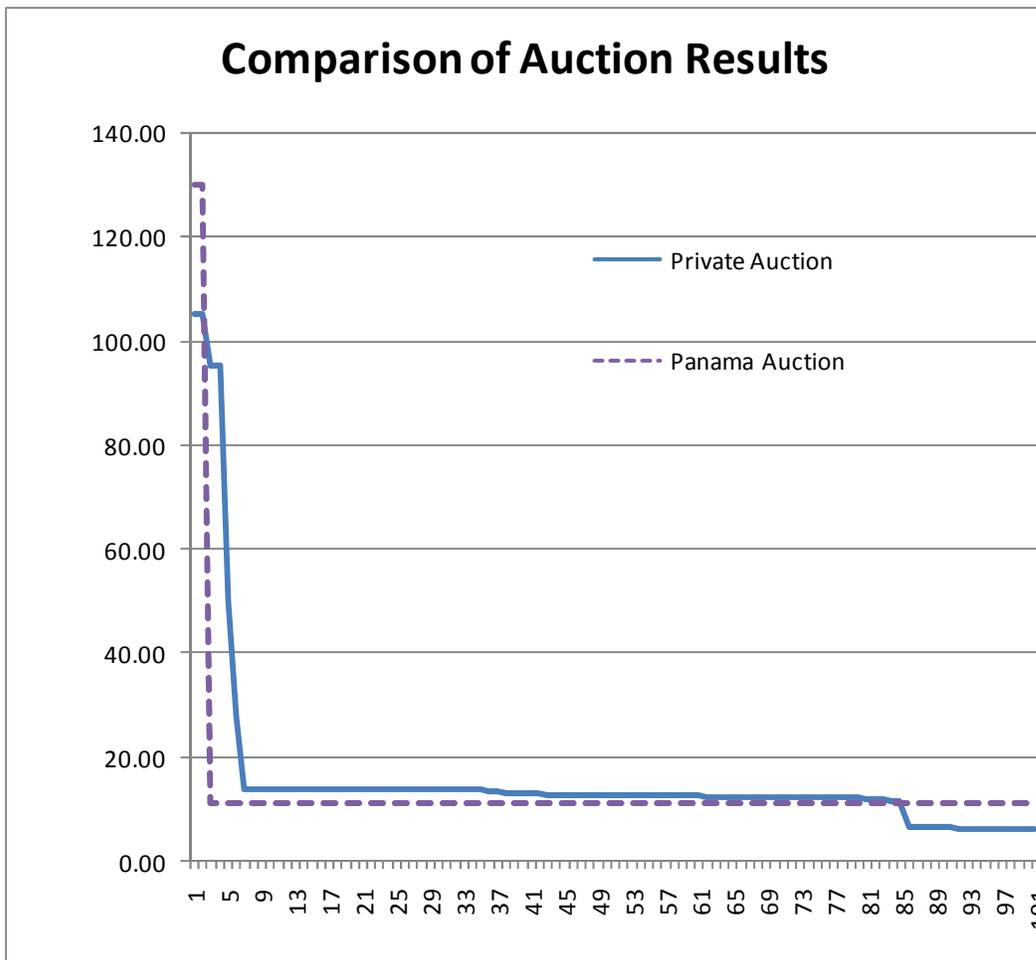
Full Service Logistics Companies do all the logistics and customs clearing activities. The Graphs TN3 and TN4 compare the traditional model and the B2B B2C logistics models.

Follow Up

The actual demand curve for the coffee, observed in the auction of the 101 lots revealed in the auction showed to be much more convex than it was assumed.

The difference between the two areas below the continuous and dotted lines in Graph TN 5 shows the gains from the price discrimination strategy of the auction. The total revenues from the private auction were \$476,787, if Price had sold those lots at the same prices as the last year, part in the Panamá auction and a big lot to Peets', the revenues would have been \$383,976; hence he generated extra revenues of \$92,811. This amount should be compared with the cost of the auction to see the actual marginal profit from this strategy. In general, given the characteristics of the demand curve, this strategy is not as profitable as expected, but it is very interesting to understand the demand curve as a set of reservation prices.

Graph TN 5

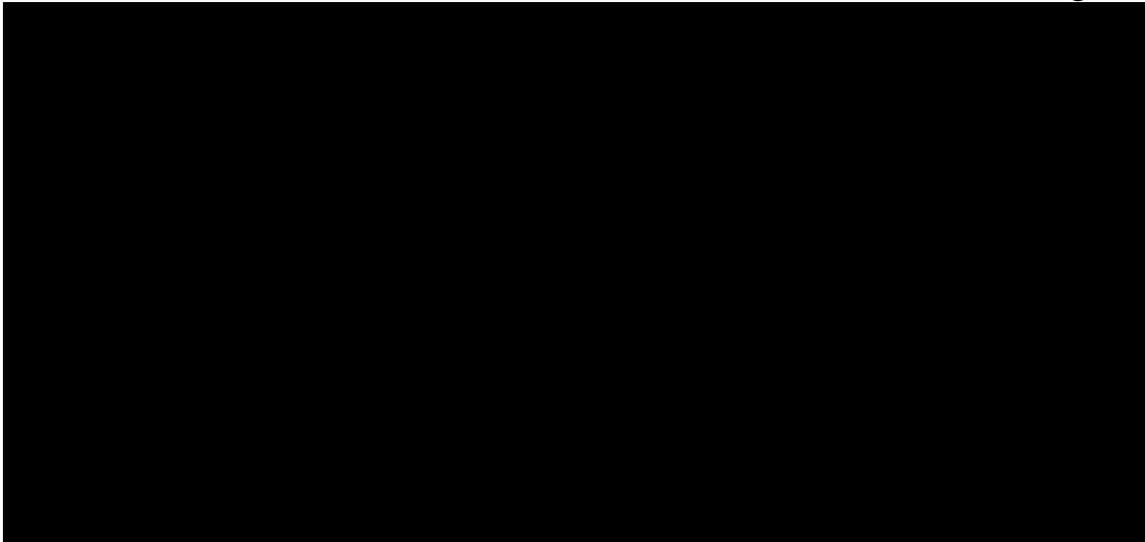


Umbrella Marketing

Most of Peterson's coffee (93%), is sold at about \$1.5 to Starbucks' as seen in Exhibit N 1. They might try to sell part of his coffee under B2B or B2C strategies to retailers and consumers under the umbrella brand of Hacienda Esmeralda, the world's best coffee, trying to increase their revenues in 93% of its production, which might generate important extra revenues.

A plausible result from selling the bulk of its production under the Esmeralda umbrella brand might generate important extra profits. This strategy is used by wine companies which have about 5 categories as seen in Exhibit 4. Table TN 1 show the increase in total revenues if he can get one more dollar more per pound for the lot of production already sold to Starbucks'

Table TN1: Revenues from Price Discrimination and Umbrella Branding



Class approach (75 minutes class).

1) Description of the firm's areas:

Family Farm. 5min.

Operations. 5 min.

Marketing. 5 min.

Auction Historical Results. 10 min.

2) Addressing Petersons' Problem. 10 min.

The problem is that the profits do not generate EVA, i.e the farm is not paying the cost of capital of firm assets a valuated at market prices.

3) Alternatives to generate more value

a) Maintain the portfolio of 3 lots: 2 Geshas: Auction, Peets and the remaining for Starbuck's. 5 min.

b) Portfolio of 2 lots. A private auction of all the Geshas, and the remaining for Starbucks'. 5 min.

c) Umbrella branding to sell part of Starbucks' lots to retailers and consumers, increasing the average price. 5 min.

4) Decision. 10 min.

5) Action Plan 5 min.

6) Alternative Strategies. Tourism. Britt, Costa Rica Case Example. Sell the farm for housing.

7) Traditional Farm Values and the Future of Agriculture 5 min.