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Creolé Coffee

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Abstract

Creolé Coffee had just started to achieve regional and national success. However, recent volatility in the world coffee market resulted not only in price instabilities, but also created difficulty in procuring the high-quality product customers had grown to expect from Creolé. In examining this situation, Jim Brewer determined that the company must adapt their relationships with producers to ensure the availability of the quality and quantity of coffee needed to produce the premium blends consumers now associate with Creolé. In turn this would allow the company to provide consumers with a high quality product at a stable price.

Key Words: vertical coordination, strategic alliances, risk management, international trade, commodity procurement.

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The Dilemma

As Jim Brewer sat in his office overlooking the packaging facilities of Creolé Coffee, his thoughts returned to the date last Spring when he had assumed corporate responsibilities for green coffee procurement at one of the largest family owned coffee processors in the United States. The last twelve months had been a very difficult time in Jim's life; there had been dramatic swings in the price of green coffee. Although his superiors assured him they were satisfied with his performance, Jim couldn't help but wonder if he was cut out for this type of work. He knew that if Creolé Coffee were to continue its recent successes on the regional and national levels, a long-term green coffee procurement strategy had to be developed to guarantee a sufficient supply of quality coffee at stable prices.

Although Creolé Coffee had a long and rich history in the Louisiana coffee market, it had only been in recent years that it had started to achieve success on the regional and national levels. An influx of investment capital from the New Orleans business community combined with a creative marketing campaign that focused on the heritage of Creole culture served to launch Creolé Coffee onto the national scene in the early 1990s. The honeymoon was short-lived, however, as dramatic volatility in the world coffee market resulted not only in price instabilities, but also created difficulty in procuring the high-quality product customers had grown to expect from Creolé.

Jim knew that the problem facing the company involved more than simply minimizing the price paid for coffee beans. As Creolé Coffee grows, it must develop relationships with producers if it is to ensure the availability of the quality and quantity of coffee needed to produce the premium blends consumers now associate with Creolé. From Jim's viewpoint, price stability was the key issue. Creolé Coffee had to guarantee stable, profitable prices to coffee bean producers in return for a reliable supply of quality coffee. In turn this would allow the company to provide consumers with a high quality product at a steady price.

While this plan made sense to Jim, there were many details to be resolved before Creolé Coffee could develop the type of procurement program he envisioned. As he began to sort out the issues and potential solutions, his thoughts went to the core of the problem: the instability in the world coffee market. Jim determined that to develop a successful solution to this problem he must first familiarize himself with previous attempts to mitigate coffee price fluctuations. Given their lack of success, he knew he had a long road to travel.

Background

The dynamic nature of the global coffee commodity market directly impacts decisions made by procurement specialists such as Jim. Price changes and production quantities have historically been extremely volatile and can be heavily influenced by factors such as inclement climactic conditions, trade policies of producing nations, and various consumer/producer preferences. As Figure 1 demonstrates, retail roasted coffee prices were dramatically low during the early 1980s and early 1990s (USDA/FAS 1999 and 2003). According to Figure 1, price is negatively correlated with world coffee stocks, supporting the expectation that price is directly affected by supply.

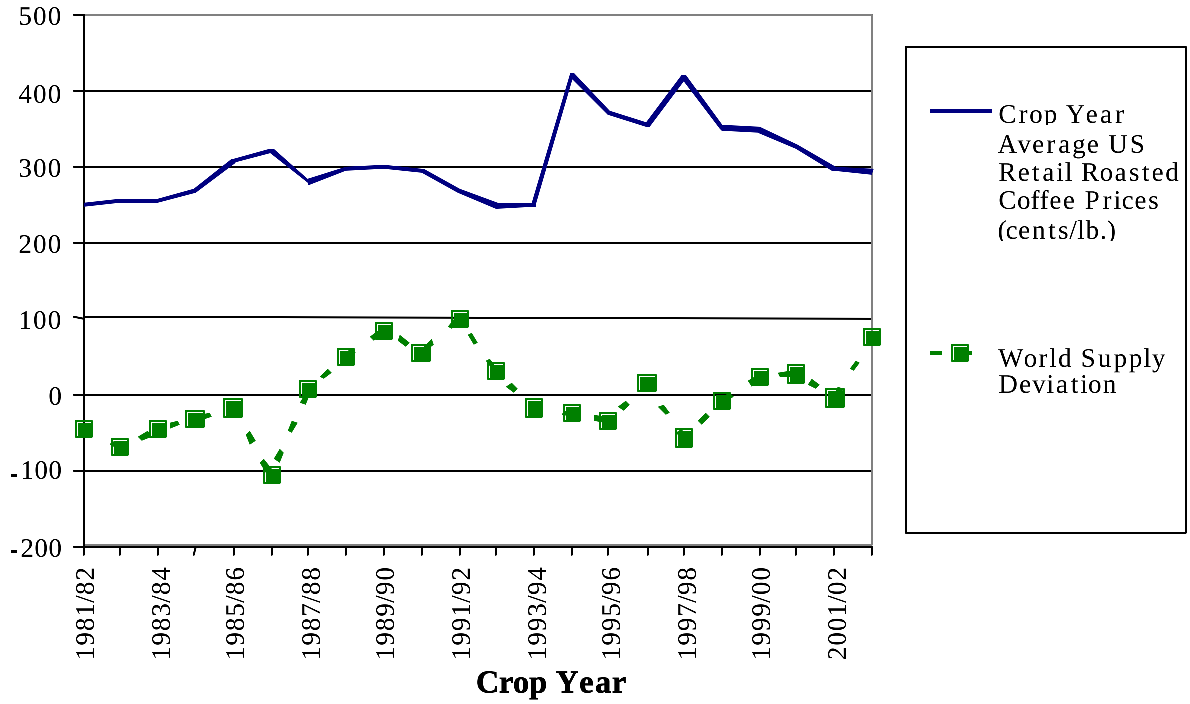

Figure 1: Coffee Retail Prices* vs. Deviation in World Coffee Supply**

*The Coffee Crop Year is July-June. The corresponding average prices were used.
Source: USDA/FAS Tropical Products: World Markets and Trade December 1999 (1980-1984 retail prices) and December 2003 (1985-2002 retail prices and all total supply values)
**World supply deviation is the deviation from the mean of 135.9283 times 1000.

In order to fully comprehend the situation faced by the company's procurement division, it is important to understand the historical coffee futures situation and the impact changes in such prices would have upon a company utilizing futures and hedges to minimize price fluctuations. Figure 2 provides a comparative analysis of coffee futures prices, specifically Coffee "C", and world ending stocks (USDA/FAS 2003 and NYBOT/CSCE). One should note that the relationship between the two variables graphed is very similar to the relationship shown in Figure 1. However, variation in futures prices is often more pronounced when its relationship with other factors is examined. This may be due to the highly influential role speculation plays in the determination of the futures price.

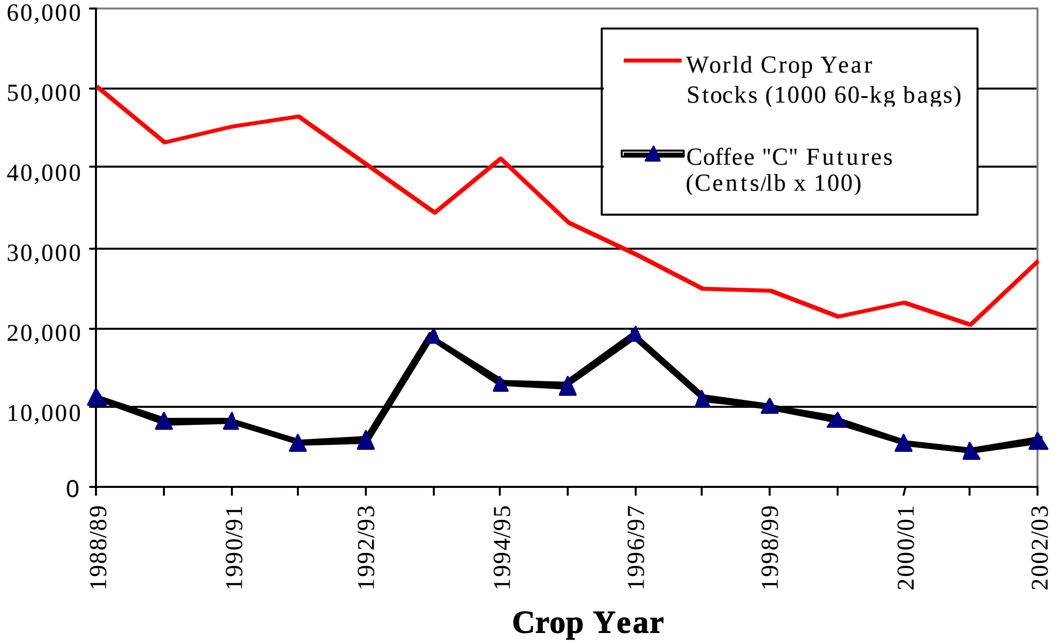

Figure 2: Coffee "C" Contract Price Quotes* vs. World Ending Stocks

*Futures Prices are multiplied by 100 for presentation. The Coffee Crop Year is July-June. The futures price presented is the closing quote for final Friday of June for each year.
Source: Futures Prices obtained from NYBOT/CSCE; Ending Stocks obtained from USDA Tropical Products: World Markets and Trade December 2003

Price volatility in the world coffee market is not unique to the latter part of the twentieth century, and neither are attempts to regulate such fluctuations. Export quotas have been utilized periodically since the 1940s by a conglomeration of nations working together to reduce excess supplies or minimize the impact of falling prices (Akiyama and Duncan 1982).

To better understand how such actions work, consider the tactics utilized by the International Coffee Council during 1980. Faced with plummeting prices, the Council implemented a policy of export quotas. Price ceilings and floors were established in addition to these quotas. Quota levels had to be reduced from 58.19 million 60-kg. bags to 51.8 million 60-kg bags when the floor price of 1.15$US/lb. exceeded the market price. Despite all of these efforts, the price continued to plummet until colder than usual weather destroyed a large portion of Brazil's 1981 coffee crop. The resulting reduction in world supply simultaneously generated an increase in price (Akiyama and Duncan 1982). Brazil, because of its comparatively high level of production (USDA/ERS 2002), is a country whose coffee situation directly impacts that of the entire global coffee market.

It is difficult to understand why, despite intervention on the part of the ICO, coffee prices never rebounded between 1980 and early 1981. It has been hypothesized that there were numerous factors that played a role in this scenario including speculation regarding production quantities during the following year and the indecisiveness of the organization related to quota establishment (Akiyama and Duncan 1982).

The International Coffee Organization, often referred to as the ICO, is a multi-national agency dedicated to coffee. Still in existence, its current focus is much different than that of the organization initially conceived in the early 1960s. According to the organization's website, six global coffee-related agreements have been signed since 1962. Initially, these agreements were concerned with the implementation of quotas designed to reduce price volatility. After 1989, when the ICO eliminated these economic policies, the organization became more focused on market analysis and related activities (International Coffee Organization 2004). In analyzing the effectiveness of this organization, it is critical to note that the elimination of quotas and price restrictions resulted in a drastic decline in the price of coffee within less than one month. This may reflect the potential effectiveness of the ICO (Bates 1997).

Coffee Varieties

As it operates within this volatile international environment, Creolé Coffee must tailor its line of coffee products to meet the demands of two distinct consumer groups. Gourmet consumers enjoy the pleasant flavors produced by delicately roasted Arabica beans. They will be willing to pay higher prices for these beans, which directly corresponds to the beans' luxurious characteristics. On the other hand, customers who prefer a quick jolt of caffeine will be pleased with the coffee brewed from Robusta beans imported from foreign markets. Jim realizes that Robusta beans can be effectively marketed to price-conscious consumers because, although they are considered to be of an inferior quality, when properly roasted, these beans can be used to create a hearty cup of coffee ("History of Columbian Coffee: Coffee Beans" 2002).

If Creolé Coffee is to maintain its reputation and continue supplying consumers with a high-quality product, then they will need to establish reliable relationships with producers in major coffee growing regions of the world. The company has developed a menu that has become extremely popular with their clientele and, because of its diversity, manages to attract new customers. This menu includes varied roasts of beans purchased from growers in Columbia, Costa Rica, and Brazil, as well as various African and Pacific island nations. The company has also developed a very popular blend known as Creolé Supreme which consists of a mixture of Viennese roasted Brazilian and Costa Rican Arabica Beans. Since the company roasts the beans themselves, they are able to be innovative and experiment with various roasts and blends, thus providing their customers with trendy, new beverages that increase sales and customer satisfaction.

Since Creolé is required to provide their suppliers with the quantities they will need in future months, the company attempts to minimize the impact of price fluctuations with hedges and options in the futures market. Coffee futures and option contracts are sold at a quantity of 37,500 pounds and prices are quoted in cents per pound. Delivery is only specified for the months of March, May, July, September, and December ("Coffee "C": Futures and Options Contract Highlights" 2002). Table 1 indicates the coffee futures prices for 2002[2].

Table 1: Coffee Futures Prices* (cents per pound)

Prices Shown for July 31	Cents/lb	Cents/lb	Cents/lb
Specified Contract Months	*Open*	*Close*	*Change*
March 2002	86.34	87.25	0.91
May 2002	78.41	77.28	-1.13
Jul 2002	81.43	81.25	-0.18
Sep 2002	76.59	75.42	-1.17
Dec 2002	84.75	85.49	0.74

*Futures prices listed here are hypothetical. Coffee futures are typically sold for the months of March, May, July, September, and December ("Coffee "C": Futures and Options Contract Highlights" 2002). These prices are in no way intended to represent actual futures prices for any specific day. This information is intended for use in the facilitation of classroom case study discussion only.

Course of Action

A considerable amount of time and effort had been spent compiling the proposal that was about to be submitted to Creolé Coffee's Board of Directors. Jim Brewer was confident that the specific points he had outlined in his recommendation would serve the company well, provided they could be implemented. The proposal involved three main areas that were felt to be of critical importance to the long-term success of the company: coffee acquisition through contracts; coffee acquisition through the free-market; and the development of new varieties and production techniques.

[2] Values in Table 1, the company's balance sheet, and the income statement are all fictitious.

Coffee Acquisition Strategies: Contracts

As Creolé Coffee had gone through its recent expansion, one of the most limiting factors was the availability of the type and quality of coffee necessary to consistently provide the product coffee drinkers had come to expect. In order to guarantee that the company has access to the type of product needed to uphold its reputation, Jim proposed that Creolé develop a network of producers throughout the prime coffee producing regions of the world. Contractual arrangements would be establish with these producers whereby Creolé would guarantee a lucrative price and provide technical assistance to the producers in return for the supply of a specified quantity and quality of coffee beans.

Coordination of an activity of this type would entail more than the simple development of contractual arrangements: it would involve the establishment of trust between Creolé and the producers. Yet, if this trust could be established in the long-run, much more would be achieved than supply management goals. Enhanced producer relations and the resulting stability in both input prices and qualities would, in turn, enhance consumer relations as the company is able to provide a consistent quality product at a stable price.

Coffee Acquisition Strategies: Free-Market

Despite his willingness to acquire all green coffee through known suppliers, Jim knew that the volatility of the world coffee market would make contracting all of their input risky, both for the company and the producers. Unusually low world prices would hurt Creolé Coffee as competitors acquiring coffee on the world market would be able to sell at lower prices, causing the company to lose money and/or market share. On the other hand, unusually high world prices would appear to benefit the company. Yet problems could arise as producers are tempted to violate their agreement in favor of the higher world prices.

Given these potential difficulties, the proposal involves striking a balance between coffee procured through contracts and the free-market. For example, depending on the technical specifications of the blends produced, some percentage of coffee requirements could be contracted while the remainder could be acquired on the free market.

Additional tools are available that have been, and will continue to be, used by the company to minimize price volatility in the world market. Primary among these is the use of futures contracts to mitigate price uncertainty. Company expertise in hedging could also be provided to producers as an incentive to participate in the company's contracting program, another means of increasing the level of trust.

New Product/Variety Development

The final point of Jim's proposal is contingent upon the company contracting with producers. The development of superior, proprietary coffee varieties for use in specific blends developed and marketed by Creolé Coffee would allow the company to enhance its product quality relative to its competitors. Although product development is not a specific component of Jim Brewer's job description, he realizes that all functions within the company are interdependent. In this case, the procurement of a high quality input at a stable price allows the company to create new high quality products, and thus guarantee the consumer superior value at a consistent price. The development of new techniques and varieties that help achieve these goals will ultimately contribute to the primary objectives of the company.

Final Considerations

Jim Brewer realized that much of the incentive for developing the proposal he was about to give the Creolé Coffee Board of Directors resulted from high volatility in the world coffee market during the mid-1990s. One question Jim asked himself was "What if these recent fluctuations in coffee prices were short term phenomena?" Although he firmly believed that the nature of the coffee market would result in continued price volatility, he knew that the recommendations he was proposing would benefit the company regardless of the level of price volatility. The development of improved relationships and better coordination would enhance the quality of the product and the efficiency of the process. Procuring inputs from reliable suppliers as well as from the free-market would guarantee diversification for the company. Finally, working with producers to enhance the quality of inputs would allow the company to enhance its product quality relative to competitors. What began as a reaction to price volatility resulted in a proposition that would reshape the way Creolé Coffee did business, and potentially enhance the image of the company. Jim would present his proposal to the board and await their decision.

Questions

1. Creolé Coffee will need 40,000 pounds of coffee beans during the month of December. What tactics would the company employ in order to minimize their risk? The company purchases the December contracts at 100.60 cents/pound. What are the implications for the company if the cash price rises to 110.60 cents/pound or if the price falls to 90.60 cents/pound?
2. There is a high demand for high quality Hawaiian Kona and Jamaican Blue Mountain beans[3]. What could Creolé Coffee do in order to ensure that they

[3] There are limited quantities of both Jamaican Blue Mountain and Hawaiian Kona produced in highly concentrated, specific areas (Nolan, 2002). Potential natural disasters could drastically reduce a year's crop making it difficult to fill orders and satisfy consumer demand.

obtain the beans needed to satisfy their customers' demand even if a natural disaster should affect production levels in the next few years?

3. Given the balance sheet (Table 3) and income statement (Table 2), what is the company's position concerning potential future international and domestic expansion of their current operations? Are future expansions feasible given their financial situation?
4. Given the information provided to you in the balance sheet and income statement, as well as the current world coffee situation, which alternative would you recommend to Creolé Coffee in terms of production contracts, free market access, or continued product diversification based upon available inputs? What are the positive and negative attributes of each possible position?
5. Creolé has decided to introduce two new beverages to their consumers. One is an iced coffee smoothie and the other is a cinnamon flavored coffee liqueur. Your job is to gather market information based on your knowledge of the company's two main target markets. Identify the steps you would go through in developing an appropriate marketing plan for introducing these new products into the existing market.

Table 2: Creolé Coffee, Income Statement for Year Ending December 31* (in thousand dollars)

	1999	2000	2001	2002
Net Revenues	432,331	388,928	392,426	522,718
Cost of Goods Sold	127,655	112,274	118,945	132,551
Gross Margin	304,676	276,654	273,481	390,167
Operating Expenses	42,513	39,523	38,475	45,211
General Expenses	10,623	9,586	9,623	12,458
Operating Income	115,748	112,456	110,648	118,354
Interest	25,688	21,232	22,564	32,589
Earnings Before	110,104	93,857	92,171	181,555
Income Taxes	23,146	19,785	19,485	24,653
Net Earnings	86,958	74,072	72,686	156,902

*This information is hypothetical and intended for use in the facilitation of classroom case study discussion only.

Table 3: Creolé Coffee Balance Sheet for December 31 (thousands of dollars)*

	1999	2000	2001	2002
ASSETS:				
Current Assets:				
Cash	15,080	12,652	14,597	15,623
Accounts Receivable	14,541	11,482	15,872	16,333
Inventory	76,230	77,864	83,962	81,652
Investments	9,872	7,458	8,210	9,715
Depreciation and Amortization	6,598	5,820	5,741	8,006
Total Current Assets	122,321	115,276	128,742	131,329
Property, Plant, and Equipment	125,982	115,023	121,478	156,927
Total Assets	293,983	262,805	290,664	340,566
LIABLITIES:				
Current Liabilities:				
Accounts Payable	80,946	79,861	83,089	83,672
Current Notes Payable	32,648	30,624	29,487	33,221
Payroll	54,126	57,975	52,162	60,234
Taxes	16,589	10,489	12,357	15,489
Other Expenses	15,687	14,678	18,234	28,608
Total Current Liabilities	207,531	198,412	201,118	230,019
Long-Term Liabilities	86,452	64,393	89,546	110,547
Total Liabilities	293,983	262,805	290,664	340,566

*This information is hypothetical and intended for use in the facilitation of classroom case study discussion only.

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