

Cooxupé and the World Coffee Industry: Strategies to Increase Producer Income

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Abstract: Founded in 1954, Cooxupé was the largest coffee marketing and exporting cooperative in the world. In 2005, it generated sales of R\$ 1.2 billion, positioning the cooperative among the top-300 businesses in Brazil. Recent growth was largely based on direct coffee export sales to more than 150 clients in 30 countries. Despite Cooxupé's growth, Joaquim L.F. Leite – the Export Director – pondered about Cooxupé's main challenges for the future. Given recent changes in the world coffee industry, it was imperative that Cooxupé continued to grow to remain a viable player. But what growth strategies should the cooperative pursue? In addition, growth strategies should be able to enhance members' income as Cooxupé is a member-owned organization. Another challenge was to identify mechanisms to strengthen the relationship with a growing and diverse membership. Finally, Cooxupé's would need to acquire risk capital to finance growth. This teaching case offers information about Cooxupé and the world coffee industry and invites the reader to take the position of the decision-maker. In addition, it offers a teaching note for instructors to apply the case in class discussions. This teaching case is suitable for undergraduate or graduate level Strategic Management and Agribusiness Management courses.

1. Introduction

It was dusk of a cool winter day in July 2006 as Joaquim Libânio Ferreira Leite – the Export Director of Cooxupé – was driving along a two-lane highway crossing the rolling hills of southeastern Minas Gerais, Brazil. Joaquim Libânio had just arrived from another business trip to visit coffee buyers in Europe and the long journey home allowed him to take stock of the cooperative's evolution and challenges for the future. Founded in 1954 by 24 coffee producers, Cooxupé was the largest coffee marketing and exporting farmer-owned cooperative in the world. In 2005, it had more than 10,000 producer-members and generated sales of R\$ 1.2 billion, positioning the cooperative among the top-300 businesses in the country. Recent growth was largely based on direct green coffee export sales to more than 150 buyers in 30 countries.

Despite Cooxupé's successes and recent growth, a great deal of change was going on in the world coffee market. World prices were at historic lows because of considerable supply growth especially in Brazil and Vietnam. Additionally, the Brazilian currency, the real, had strengthened significantly since 2003. A strong balance sheet and internal cash flow were necessary to insure against volatility in world coffee markets. Earnings from the cooperative were retained to provide new equity for growth as cooperatives are not allowed to issue financial securities in Brazil. Low coffee prices were approaching production costs in 2006 and this meant that earnings were lower.

As he was about to reach his home in Guaxupé, Joaquim Libânio pondered about Cooxupé's main challenges for the future. Given the competitive forces in the world coffee industry, it was imperative that Cooxupé continued to grow to remain a viable player. But what growth strategies should the cooperative pursue? In addition, these growth strategies should be able to enhance members' income as Cooxupé is a member owned and controlled organization. Another daunting challenge was to identify mechanisms to strengthen the relationship with a growing and increasingly diverse membership. And, finally, Cooxupé's leaders would need to find new ways to acquire risk capital to finance growth.

2. The World Coffee Industry

Coffee is one of the world's most valuable commodities and among the largest food import in many developed countries. There are two different species of coffee, Arabica and Robusta. Arabica coffee beans are used for higher-grade, specialized coffee and accounted for

60 percent of total world production. Robusta is a lower grade coffee with a heavier flavor and stronger caffeine content. Robusta coffee beans are grown at lower altitudes, between sea-level and 2,000 feet, and are more resilient to disease and weather, while Arabica coffee beans are usually grown at higher elevations and mature more slowly. Arabica coffee bean production is concentrated in South America and Central America, while Robusta coffee bean production is concentrated in Asia and South America. Brazil is the only leading country to produce both Arabica and Robusta coffee beans. Even though Robusta and Arabica coffees have different characteristics, their markets are highly interdependent because roasters use both types of coffees from different origins in their blends.

Brazil was responsible for 30 percent of total world coffee production in 2004. This was composed of 34 percent of Arabica coffee beans and 22 percent of Robusta coffee beans. Coffee production is highly concentrated. The top two countries produced 51 percent of Arabica (Brazil and Colombia) and 58 percent of Robusta (Vietnam and Brazil) coffee beans in 2004. Total world coffee production doubled in the last 3 decades, from about 59.3 million bags in 1976 to 121.9 million bags in 2002 (Figure 1). As supply growth (estimated at 2% each year) has outpaced consumption growth (about 1.5% per year), stocks estimated at over 40 million bags were built up and world coffee prices fell to a 30-year low in the late 1990s and early 2000s, leading to a serious crisis in many coffee producing countries (Figure 2).

Production and Processing of Coffee Beans

The global supply chain for coffee involves producers, middlemen, exporters, importers, roasters and retailers. The cultivation of coffee beans is a time consuming and labor intensive process. Although production advancements have been made, most of the 25 million coffee farmers work on small farms (with less than 6 hectares) and do not have access to information on improved cultivation techniques. In larger, wealthier coffee producing countries such as Brazil and Colombia, farmers are organized into cooperatives that provide and share information and resources for improving production.

Coffee is grown on trees that thrive in tropical to subtropical climates, usually 1,000 miles from the equator or less and at altitudes up to 7,000 feet above sea level. Coffee trees begin their lives in a nursery and are transplanted to farms about a year later. The coffee tree then matures for another four to five years before it begins its annual cycle of production, starting as small white flowers and developing into small green cherries. The green cherries ripen to a deep red color and inside the ripe cherries are two coffee seeds. These seeds are eventually used to plant more coffee trees or processed into green coffee beans that are later roasted and ground into coffee ready to be brewed. In the 1970s and 1980s, in an effort to raise production volumes, coffee growers developed and adopted higher-yielding hybrid plant varieties and open-sun cultivation techniques.

Once coffee cherries are red and ripe, a series of processing events take place before the green coffee beans are moved to the next stage of the commodity value chain. The manual labor needed for these processing events is rigorous. Coffee beans must first be harvested from the trees. Most of the world's coffee is grown on small farms and harvesting is done by hand in an effort that can require up to seven pickings as not all coffee cherries ripen at the same time. In countries with flat land and larger farms, such as Brazil, mechanical harvesters are commonly used to pick the crop. Most specialized coffees are picked exclusively by hand and only taken from the middle part of the harvest for the highest quality of bean.

In addition to genetics and cultivation techniques, coffee quality is largely dependent on post-harvest handling, which differs significantly across countries. In Brazil, coffee plantations are located in subtropical areas with no marked rainy seasons. As a result, coffee trees usually present several flowerings during spring and thus coffee beans mature at different times in the fall. Since harvesting is carried out once a year to save costs – coffee

harvesting is the most expensive item in total production costs – cherry beans are harvested along with unripe (*café verde*) and dried (*café seco*) beans. Following harvest, the producer needs to perform several coffee handling operations (known as *beneficiamento*) before shipping the coffee to a cooperative or warehouse, where it will be stored and marketed. These coffee handling operations include separating impurities from the coffee beans, drying, de-pulping and bagging. Brazilian coffees are first dried under the sun in patios known as *terreiros* and subsequently in driers before being de-pulped. This process is known as the “dry method” (*via seca*) because coffee beans are not washed and fermented. The Brazilian coffee is thus known as “natural” to distinguish it from the washed coffees produced in Colombia and elsewhere.

Supply and Demand Drivers

In 1962, 66 countries created the International Coffee Agreement (ICA). The agreement set an export quota on each coffee-exporting national to restrict coffee trade. The result was an increase and stabilization of international coffee prices. However, in 1989, the ICA disintegrated and large foreign buyers began to purchase coffee directly from farmers. With no controls over supply, the coffee industry saw a large production boom. The world’s two largest coffee producing countries, Brazil and Vietnam, drastically increased production in the late 1990s, which depressed world prices.

Since the end of the ICA, the supply of coffee beans has grown beyond its demand, driving prices downward. Taking inflation into account, the real price of coffee beans has fallen to just 25% of the 1960 level. Industry consultants estimated that the price of coffee in the early 2000s did not cover production costs of either robusta or arabica growers. Producers also have pressure to maintain quality and production despite minimal earnings or losses because the roaster’s cost of switching suppliers is low. With billions of coffee drinkers and a handful of companies controlling the international coffee market, producers have little bargaining power.

The world price of coffee is set according to the New York “C” Contract Market for arabica and the London International Financial Futures and Options Exchange (LIFFE) contract for robusta. The single most influential factor in world coffee prices is the weather in Brazil. Droughts and frosts denote coffee shortages and cause prices to spike, as was the case in 1994 and 1997. The world price has hovered around 50 cents per pound and has fallen by nearly two-thirds since 1997.

In addition to the end of the ICA and subsequent supply growth, many industry analysts argued that coffee industry consolidation has increased price spreads between the retail and farm gate levels of the value chain. According to International Coffee Organization (ICO) data, producer countries earned USD 10 billion from a coffee market valued at about USD 30 billion in 1993. A decade later, they received less than USD 6 billion of export earnings from a market that has more than doubled in size. This resulted in a drop in the producers’ share from over 30% of the market to less than 10%.

Five main roasters – Kraft, Nestlé, Sara Lee, Procter & Gamble and Tchibo – buy 45% of the world total production and shape its retail market. For example, the three largest U.S. coffee marketers are Procter & Gamble, Kraft, and Nestlé. These firms accounted for about 33 percent, 28 percent, and 8 percent of the U.S. coffee market in 2003. Their widely recognized brands include Maxwell House, Nescafé and Folgers, which command significant premiums over the actual cost of the coffee they sell. In addition, their ability to mix and match coffee beans from different sources to adjust their blends gives the roasters even more buying flexibility.

The U.S., Germany, Japan, France and Italy consume more than half of the world coffee exports. The U.S. has long been a large consumer of coffee. In the 1940s, over 80

percent of the world's coffee was consumed in the U.S. compared to 20 percent today. The total market for coffee has increased as more consumers began drinking coffee in other countries. There is a positive relationship between average income and coffee consumption in that consumers in higher income countries drink more coffee. However, coffee consumption in developed countries has declined on a per capita basis. U.S. coffee consumption, for example, is about half of what it was in 1945 on a per capita basis. Although coffee consumption has peaked in the U.S., the specialty coffee market has boomed since the early 1990s.

The worldwide coffee market is experiencing shifts in demand at opposite ends of the product spectrum. An increase in the demand for low-grade, low-cost Robusta coffee reflects new roasting technologies that remove the harsh taste of the typically low-quality bean. Coffee roasters are now able to buy low-quality coffee beans at very low cost and produce coffee at the same level of quality. On the other end, demand for premium specialty or gourmet coffees is also on the rise.

The Specialty Coffee Segment

Over the 1990 to 2002 time period, specialty coffee sales more than quadrupled in the U.S. Specialty coffee marketers developed gourmet coffee blends and flavors that appealed to new coffee drinkers. These firms pay close attention to the quality of the coffee bean, in addition to its origin and how it was processed. These specialty coffee marketers also developed unique roasts and grinds which appealed to a premium coffee market.

The consumption of specialty coffee has expanded to 8 percent of the total worldwide coffee market. In the U.S., specialty coffee comprises \$1.7 billion of the \$5 billion national coffee industry or about 35 percent. The fastest growing segment of the U.S. specialty coffee market is certified fair trade coffee.

The growth of the specialty coffee segment suggests emerging opportunities to coffee producers. Specialty coffee is often imported at price over the C market, considered a "quality premium." Quality premiums vary according to the origin, coffee bean quality attributes and the production process (e.g., organic, fair trade, shade grown, etc.). For certified fair trade coffee, the price is set at a minimum of \$1.26 per pound in 2005, and the premium is returned to the farmers. Over 85 percent of all fair trade coffee is also certified organic. In November 2005, the floor price for Arabica coffee was \$1.26 a pound and \$0.15 cents more for organically certified beans.

3. Cooxupé: Roots and Evolution

Cooxupé (Cooperativa Regional de Cafeicultores em Guaxupé Ltda.) was formed in 1957 by 24 coffee producers. According to Isaac Ferreira Leite (called Dr. Isaac) – one of the founders and first President of Cooxupé – "a cooperative is a good organizational structure for individuals to solve common problems." In the case of coffee producers in Guaxupé, located 300 km north of São Paulo city, the common problem was dependence on coffee buyers (intermediaries, dealers, and exporters) and lack of fair value for their commodity. The idea to form a cooperative came from Dr. Isaac, who at that time was working as an engineer in São Paulo. Dr. Isaac's motto was "trust and work."

In the beginning, Cooxupé was headquartered in a small country store that sold farm inputs to members. In March 1965, Cooxupé acquired a coffee warehouse with capacity for 200,000 bags of coffee (a coffee bag has 60 kg). The warehouse built in 1929 was owned by CASEMG (an agency of Minas Gerais). As the cooperative did not have enough capital to buy the warehouse, Dr. Isaac arranged a financing agreement with the Brazilian Coffee Institute (IBC). The warehouse purchase was an important breakthrough because without it coffee producers had to sell coffee after harvest to exporters and dealers at very low prices as

they did not have enough storage space on farm. Storage is an important marketing function and one of the reasons why the cooperative was formed. With the cooperative warehouse, coffee producers did not have to immediately sell all their production after harvest and thus could wait for the best market conditions to sell. This service was an integral part of the cooperative's business strategy.

With the warehouse purchase Cooxupé entered the coffee marketing business. From the inception, Cooxupé leaders made a decision to provide members "total flexibility" to market their coffee. First, the cooperative would be a service (storage and marketing) provider and would not take ownership of the delivered coffee. It was the member's decision when to sell the coffee. The cooperative would provide "full liquidity" to members in the sense that it would always purchase coffee upon a member's sell order. In addition, the cooperative would not require member loyalty and members did not have to store all their coffee in the cooperative warehouse and could market (all or part of) their coffee with competitors.

At that time, the cooperative created a coffee marketing unit which would sell the coffee to domestic coffee roasters, dealers and exporters. Cooxupé did not engage in direct export activities during this time. From the start, Cooxupé adopted the cooperative principles of democratic control, service at cost and limited return to members' capital. In fact, Cooxupé had a policy of reinvesting all net income to build a strong equity capital base. Dr. Isaac's vision was that the cooperative would have to balance traditional cooperative principles with an entrepreneurial spirit. He believed that for the cooperative to succeed it would have to be run as efficiently as a for-profit business.

In contrast to other Brazilian cooperatives, Cooxupé's management would be professional. In other words, members and elected officials would not have executive responsibilities. Members elected nine directors to the cooperative Board – following the democratic principle of one member, one vote. The Board then elected the President and a Vice-President who indicated an Executive Director appointed by the Board of Directors. The main management functions such as administration, warehousing, and marketing were run by hired professionals. Dr. Isaac also believed that the cooperative performance would depend on efficiency. The cooperative's net income would be used as non-allocated reserves (i.e., retained earnings) to increase the equity capital needed to reinvest in the cooperative and grow the company.

Starting in the late 1970s, Cooxupé started to develop direct coffee export efforts. Dr. Isaac believed that to enhance the value of members' coffee, Cooxupé would have to build relationships with coffee importers and roasters in Europe and other importing countries. It would have to learn their specific coffee quality needs and develop a reputation for coffee quality, consistency and volume. These efforts were the responsibility of Dr. Isaac's son, Joaquim Libânio, who became the cooperative Export Director. Cooxupé invested in an export office in Santos, the main Brazilian port. Since the early 1980s, direct exports grew to almost 1.4 million bags of coffee, equivalent to R\$ 460 million or 30% of total revenues. During the same period, the number of coffee bags received from members increased from 270,000 in 1980 to 2.5 million in 2005 (Figure 3).

Another important development during Dr. Isaac's tenancy was geographical diversification with mergers and acquisitions and the development of regional warehouses. Between 1977 and 1990, Cooxupé acquired five coffee cooperatives in the states of Minas Gerais and São Paulo. Such acquisitions were very uncommon in Brazil. It also established regional centers – called *núcleos* – including coffee warehouses and country stores to source coffee from other important regions.

During the 1990s, and especially in the late 1990s and early 2000s, when grain prices were high in Brazil and coffee prices were at a historic low, Cooxupé fostered diversification among its membership. The cooperative thus invested in its grain marketing division and

increased the amount of credit for producers to acquire inputs such as seeds, fertilizers and chemicals. The cooperative invested in three grain reception units (elevators) in the state of Minas Gerais and received 100 thousand tons of corn and soybeans in 2004.

However, the diversification strategy has not been a solution to the coffee price variability issue. First, grain prices started to fall since 2004 and current prices are below production costs. Secondly, the topography of Southern Minas is not ideal for grain production. Grain marketing activities are responsible for less than 2% of Cooxupé's gross revenues. The current situation is that coffee is planted on roughly 20% of members' area but is responsible for 80% of their revenues.

Direct Coffee Exports

Direct coffee exporting is at the core of Cooxupé's strategy to add value to members' coffee. According to Joaquim Libânio, over 80% of the coffee produced in Southern Minas has export quality. Cooxupé's coffee export efforts were successful for two reasons. First, since its foundation Cooxupé had standardized coffee produced in Southern Minas. Over the years, the cooperative developed a complex system for grading and standardizing coffee. This was due to Dr. Isaac's vision that process and standardization were central to the cooperative's mission of adding value to members' coffee. By the 1980s, when Cooxupé started to export coffee directly to buyers in Europe, its coffee quality standards were already established. In addition to coffee standards, consistency and volume were also deemed as necessary conditions for success in export markets. With quality standards, consistency and volume Cooxupé earned trust and respect in export markets as a reliable coffee supplier.

Until the late 1980s, when the International Coffee Agreement was abolished, coffee exports were under control of a quota system. According to this agreement, coffee producers had export quotas based on their historical export volume and coffee inventories. In Brazil, each exporter had its own coffee export quota also based on historical volume. By the early 1980s, private traders and dealers controlled Brazil's coffee exports.

A breakthrough occurred in 1982, when coffee cooperatives were granted 8% of the total national export quota as a result of successful lobby efforts by the National Coffee Council with the federal government. Since coffee cooperatives did not have a history of exports, their export quota was based on coffee inventories. Many cooperatives were unable to fulfill their export quotas as they did not have knowledge and access to export markets.

In the early days, Cooxupé developed an export agreement with a bank (known as Comind) that had a coffee trading division. Comind had access to buyers in Europe but the agreement allowed Cooxupé to export with its name in the coffee bags thereby building brand awareness among buyers. Dr. Isaac, Cooxupé's President, believed that to be successful in direct coffee exports, the cooperative would have to understand buyers' needs and build long-term relationships with them. In 1983, Cooxupé hired Saul Eliezer, a veteran in coffee quality from a large exporter (known as Tristão), who would be in charge of the cooperative export office in Santos, Brazil's largest port.

In order to build knowledge and relationships with buyers, Joaquim Libânio moved to Hamburg, Germany in 1984. Using the Brazilian Coffee Institute (IBC) office network in Europe, he was able to contact and develop relationships with major buyers in the continent. In 1985 he returned to Brazil as he was appointed to the Export Director position at IBC. In 1987, his office was moved to London and in 1990 he became the Brazilian representative at the International Coffee Organization (ICO). During this time, Joaquim Libânio visited all coffee producing countries and developed personal relationships with the main coffee roasters and importers. At the end of 1990, he moved back to Brazil and took the Export Director position at Cooxupé. At that time, Cooxupé was exporting an average of 200,000 coffee bags per year.

When Mr. Eliezer retired, Joaquim Libânio hired Mr. Justino Gonzaga from another large exporter (known as Esteve) to run the Santos office. While Mr. Gonzaga dealt with all the export process at the port, Joaquim Libânio continued to develop relationships with buyers. His export strategy was to always deliver coffee that surpassed expectations and also to follow up with the buyer with post-sales service efforts. He visited his clients at least once a year. With his personal efforts, backed by the cooperative's operations that delivered consistent quality and volume, Joaquim Libânio developed a diversified portfolio of buyers that included agents representing small roasters, small and large importers and the large accounts of the main roasters in Europe, the U.S., and Japan.

Cooxupé is located in Southern Minas, a region that produces coffee beans with specific quality attributes. With regional growth, Cooxupé started to originate coffee beans from Cerrado Mineiro and Mogiana, with different and complementary coffee attributes. Regional diversification is a necessary strategy to sustain the direct export program as importers and roasters like to blend coffees from different regions and quality attributes. The success of Cooxupé's export program is shown in Figure 3, which shows significant growth in coffee bags received and direct coffee exports since the early 1980s.

4. Cooxupé in 2006

In 2006, Cooxupé was the largest coffee marketing and exporting cooperative in the world. In 2005, it generated sales of R\$ 1,191 million which is about USD 500 million. Its total assets reached R\$ 862 million with net equity of R\$ 190 million (Figure 4). It received 2.5 million bags of coffee in 2005 – equivalent to 11% of total Brazilian production – from 10,616 members in 171 counties located in three main regions (Figure 5). The largest 20% of members deliver 80% of the coffee marketed by the cooperative. There are economies of scale in coffee production. Medium-sized producers tend to be more disadvantaged than small-scale producers because they have the cost structure of large producers, with high fixed costs, but do not have the volume; small producers are low cost because they invest little in fixed assets and use family labor.

Technical Assistance

Cooxupé provides free technical assistance to members. This can be a problem because most members do not value a free service. In addition, it represents an additional cost to the cooperative that competitors (exporters and dealers) do not have. However, the cooperative has historically provided technical assistance to members. Technical development is considered a "trust business" as the agronomists develop close relationships with members. In doing so, a valuable communication channel is established between the cooperative and the membership.

The service is funded from retained surplus in a special equity reserve account known as FATES (Fundo de Assistência Técnica, Educacional e Social). Following the Brazilian cooperative law of 1971, net earnings from non-member business must be retained in this specific reserve account. Funds retained in the FATES account can only be used for activities related to education, technical assistance and capacity building of cooperative members and their families, employees and managers. In other words, retained earnings from non-member business may not be used to provide financial returns to members but rather to benefit them with education and technical assistance services.

Cooxupé's technical development team is composed of thirty-two agronomists. The cooperative is currently hiring twelve more as the membership keeps growing. Given the relative small size of the technical development team, Cooxupé cannot provide personalized technical assistance to all members. Most of the technical development efforts are conducted in group meetings and technical demonstrations at experimental fields. Best agronomic

practices are shown to interested members in several “field days” during the year. In addition to providing technical assistance to members, the technical development team provides internal services and information gathering that are used by other business units, including crop forecasts and technical analysis of members’ crops for credit purposes.

Technical development efforts comprise the whole coffee production cycle, from planting to harvesting and post-harvesting. The focus is on “economical production” techniques and practices that enhance coffee quality, especially after the coffee beans are harvested. Coffee is a very intensive crop in terms of agronomic practices, but harvesting is the most costly item in the producer’s spreadsheet – equivalent to 40% of total production costs. Even though the topography in Southern Minas is not conducive to mechanical harvesters, Cooxupé is helping farmers adopt smaller harvesters to substitute for expensive labor.

Coffee Grading

Coffee grading is central to Cooxupé’s strategy of adding value to members’ coffee. Without a consistent coffee grading system, Cooxupé would not have been successful in developing direct supply relationships with coffee importers, dealers and roasters in major import markets. Over the years, Cooxupé has developed a complex grading system with sixteen “basic” grades based on eight quality attributes (crop year, visual aspect, humidity, quality, quantity of defects, impurity, flavor/drink, and aroma). The sixteen basic grades are broken down into specific quality variations serving two purposes: (1) to determine the price to be paid to the member; (2) to offer buyers a broad variety of consistent coffee grades every year.

Coffee grading at Cooxupé is conducted by a team of four quality experts (graders) with the help of four trainees. When grading a sample, the final grade assigned to a coffee sample by a grader must be approved by two other graders. In other words, at least three of the four graders must agree on the grade assigned to each sample. These four graders have been working together at Cooxupé for 20 years.

The grading process is organized in three stages at Cooxupé. The first stage – known as pre-classification – occurs when the truck with a load of coffee bags arrives at a Cooxupé warehouse. At this stage, about 30% of all coffee bags are sampled (*picote*) and the grader determines a “pre-grade” based on visual inspection and aroma. This “pre-grade” will determine the location on the warehouse where the truck is to be unloaded and the coffee bags to be stored in piles.

The second stage is coffee reception. Upon unloading from the truck, each coffee bag is sampled (*picote*) and an identification card is issued with the grower’s information, number of bags, and the exact location of the coffee bags in the warehouse. Each sample, along with the identification card, is sent to the grading department where it will be assigned a grade based on the eight attributes mentioned above.

The third stage is the final grading of each coffee sample. The team of graders must issue a final grade to each sample within 24 hours. After the grading process is finalized, a warehouse receipt is issued to the member with grades for each coffee sample. When the member wants to put a sell order, he/she does so in the marketing department and the coffee price is based on the grade found in the warehouse receipt. All samples are stored in the cooperative until the member puts a sell order.

Coffee Pricing and Risk Management

Coffee is a crop with pronounced price cycles and high price variability. Perhaps not surprisingly, Cooxupé increasingly uses financial derivatives to hedge against price risk. Over the last ten years, the average coffee price received by Cooxupé producers was USD 90 per

bag, with the highest average price of USD 181 in 1997 and the lowest of USD 39 in 2002. According to Cooxupé's analysis, coffee production costs in Southern Minas total R\$ 312 for an "average" producer (with productivity around 20 bags per hectare). Production costs are lower (R\$ 273) for high-productivity (30 bags/ha) growers and as high as R\$ 575 for low-productivity growers (10 bags/ha).

Financial Management

Cooxupé's social (allocated) equity capital is divided in quotas valued at R\$ 1.00, which are non-transferable and thus non-appreciable. There is no upper limit to the amount of quotas an individual member may hold, but each member must invest in quotas proportionally to the "economic importance" of her farm. The minimum equity investment is R\$ 550 plus a value proportional to farm size. In addition to this minimum amount, new members must invest R\$ 100 per hectare planted with coffee; R\$ 10 per hectare used in crop or animal production; and R\$ 24 per hectare used in other activities.

Social capital is redeemable when the member leaves the cooperative. It is the board's decision when and how to retire members' equities, but the cooperative bylaws state that the total equity capital of a retired member must be redeemed in monthly installments not exceeding 36 months. Cooxupé allocates net savings to the legal reserve fund and FATES accounts as mandated by the national cooperative law. Any net savings above these legal requirements are also retained as cooperative equity capital. Thus, Cooxupé does not pay patronage dividends despite the fact that the bylaws allow for patronage dividends up to 12% of a member's equity investment.

Cooxupé currently has R\$ 189 million in total equity capital, equivalent to 22% of total assets. During the last five years, equity capital more than doubled, up from R\$ 90 million in 2001. Social capital – i.e., equity capital in the form of quotas (allocated) – is currently valued at R\$ 85 million (or 45% of total equity), while the remainder is unallocated capital in various reserve accounts (Figure 4).

Challenges for the Future

Sipping a freshly brewed cup of coffee, Joaquim Libânio felt good to be back at home. He was proud of the fact that over the years Cooxupé was able to build a strong presence in the world coffee industry. Total export volume reached 1.4 million bags in 2005, positioning the cooperative among the top-five coffee exporters in Brazil. Perhaps more importantly, Cooxupé had developed a valuable intangible asset in the market as its name was recognized by major buyers as synonymous with quality and consistency. It had reputation and enjoyed "open doors" in international markets. The goal for 2006 was to reach 1.8 million bags in direct exports as the cooperative expected to receive 4.5 million bags from members.

Yet Joaquim Libânio felt that Cooxupé had many challenges to address. The main challenge ahead was to grow with consistency. In other words, the cooperative needed to grow to remain viable but this growth had to occur without jeopardizing the cooperative's tradition as a quality and consistent coffee exporter. Additionally, growth strategies should also contribute to the cooperative goal of increasing members' incomes. He wondered what strategies the cooperative should pursue to provide income growth opportunities to its members and to build on its reputation in the marketplace.

Another challenge was to continue to earn members' trust. Cooxupé's principle of "full liquidity" was very important to members. The cooperative warehouse was the "member's bank" where members deposited all their savings. As such, the cooperative had to provide liquidity every day. But this strategy created a heavy burden on the cooperative balance sheet as it required increasing amounts of working capital. To finance its working capital needs, the cooperative had access to low-cost sources of short term funds, including

export credits (known in Brazil as ACCs) and funds from the rural credit system. On the other hand, the “full liquidity” strategy, coupled with other efforts (technical assistance, the country store, and short-term credit provision), were instrumental in developing a close relationship with coffee producers. Originating high quality coffees from different regions with low transaction costs was a core competence and a source of competitive advantage for Cooxupé in the marketplace.

Finally, Cooxupé has grown over the years with the same, traditional organizational structure. If the cooperative continues to expand and adopts new strategies to cope with an increasingly complex, unstable and competitive environment, Joaquim Libânio wondered whether the traditional cooperative structure should be adapted to these new internal and external contingencies. More specifically, how could the cooperative ownership structure be changed to provide the business with additional sources of risk capital?

5. Teaching Notes

This case discusses the evolution and challenges of Cooxupé – a farmer-owned coffee marketing cooperative located in southern Minas Gerais, Brazil. Founded in 1954 by 24 coffee producers, Cooxupé has experienced significant growth particularly since 1990. Total number of members surpassed 10,000 while annual sales reached R\$ 1.2 billion in 2005. This growth was largely due to efforts to increase direct coffee exports that were implemented since the early 1980s by Joaquim Libânio, the cooperative Export Director and case protagonist.

Despite this successful evolution, Cooxupé leaders face increasing challenges ahead. The main challenge is to grow with consistency. The world coffee industry has evolved in such a way – with industry deregulation, consolidation, globalization, and declining prices and margins – that growth is deemed essential for survival in the future.

The growth imperative, however, poses many challenges to Cooxupé’s leaders. First, as the cooperative grows and increases its direct export volume, it becomes increasingly difficult to originate coffee beans in the volume and quality consistency expected by clients. Second, the increased size and heterogeneity of the cooperative membership may have negative impacts on cohesion if adequate policies and practices are not put into place to increase member commitment. Third, growth may be constrained by the availability of both working and risk capital required by the current business model. Financial constraints may create the need to evaluate and possibly change the cooperative traditional ownership structure.

The case is organized as follows. The introduction briefly presents the case protagonist and basic information about the cooperative and the challenges confronting its leaders. Section 2 describes the world coffee sector in depth, including production and processing of coffee beans, supply and demand drivers, and the emerging specialty coffee segment. Section 3 describes the origins, evolution, and current situation (as of October 2006) of Cooxupé with a focus on its marketing activities, services offered to members, direct coffee export efforts, financial management, and governance structure. The last section presents the main challenges facing Cooxupé’s leaders and invites the reader to wear the decision-maker’s hat.

Teaching Objectives

This case may be used in competitive strategy and agribusiness management courses. A 90-minute discussion session is sufficient to analyze the case and identify potential strategic alternatives. In particular, this case may be used to explore the following concepts: industry analysis; strategic positioning; resources and competencies to create value; growth strategies; ownership structure of farmer-owned cooperatives; and strategy-structure alignment.

Discussion Questions

The following discussion questions may be posed by the case instructor to guide the students' analysis:

- How would you describe the world coffee industry? What are the main opportunities and threats in Cooxupé's changing business environment?
- Describe Cooxupé's current business model and ownership structure. What are its strengths and weaknesses?
- Do you agree with the view that growth is essential for Cooxupé's survival in a deregulated, concentrated and global coffee industry?
- What are the strategic options for growth? Identify the advantages and disadvantages of each strategic option.
- What changes in the current ownership structure might be needed to align structure with the proposed strategy?

Class Plan

The proposed class plan to organize the case discussion would comprise four main discussion topics: the organization; the business environment; the strategic options; and strategy-structure alignment.

Part 1 – The Organization

In this first part of the case discussion, the instructor should elicit from the students information about Cooxupé's business model and ownership structure. The objective is to highlight the main characteristics of a farmer-owned cooperative and the business model pursued by Cooxupé and the consequent weaknesses and strengths.

- Describe the ownership structure of Cooxupé.

Cooxupé is owned and controlled by 10,616 coffee producers that market their coffee and use the cooperative services. To become a member, each producer must invest R\$ 550 plus a value proportional to farm size in Cooxupé. Each member has one vote independent of his ownership stake and level of patronage. Here it is important to notice that residual claim and control rights are not aligned and are not proportional. This leads to the free-rider problem (Cook, 1995).

Another important characteristic is that ownership rights are restricted to members and are illiquid (i.e., not tradable). There is no secondary market for residual claim rights and thus they are non-appreciable. These restrictions mean that equity capital acquisition in Cooxupé is restricted by the wealth and risk-bearing capacity of its members (Fama and Jensen, 1985). In addition, members have little incentives to invest as a result of portfolio and horizon problems (Cook, 1995).

Because each member has only one vote and equity capital investment is not proportional to patronage, members have no incentives to monitor management. Managers may therefore pursue their own self-interest instead of maximizing returns to members, giving rise to the control problem (Cook, 1995). The control problem is exacerbated when membership increases – i.e., as the group size increases so does the free-rider problem (Olson, 1965). Finally, heterogeneity of members' interests and political decision-making due to the non-separability between decision management and decision control suggest the potential for high collective decision-making and influence costs (Milgrom and Roberts, 1992).

- Describe the business model of Cooxupé.

Cooxupé is basically a coffee-marketing cooperative. Its main activities include origination, standardization, grading, and merchandising of coffee beans. In addition, Cooxupé offers many services to its member such as free technical assistance, coffee storage, short-term credit, and risk management tools. The main characteristic of Cooxupé's business

model is the “full liquidity” policy. This means that the cooperative does not take ownership of the coffee bags delivered by members and provides them liquidity whenever they place a sell order. This policy has been followed since the cooperative was formed in 1954 and has been very important to gain members’ trust. However, it generates the need for increasing amounts of working capital and thus stretches the cooperative balance sheet to the limit. Another distinguishing characteristic of the business model is the emphasis on direct coffee exports including the operational requirements to originate high quality coffee beans with consistency and volume, and also the close relationship with coffee buyers.

Part 2 – The Business Environment

- Describe the world coffee industry.

To guide this discussion the instructor could use the commodity systems approach (Davis and Goldberg, 1957; Zylbersztajn, 1996) to identify the main stages of the world coffee sector and the vertical coordination mechanisms between the stages. The first stage is coffee production, with millions of generally small family farms scattered in many production regions around the globe. The second stage is coffee origination by domestic coffee buyers, trading companies, cooperatives and exporters. The third stage is coffee roasting, dominated by a handful of multinational companies such as Nestlé, Procter & Gamble, Kraft Foods, and Sara Lee. The fourth stage is distribution, including retailers and food services. The last stage is coffee consumption of both regular coffee but increasingly of specialty coffee. Two issues deserve particular attention. First, tightly coordinated supply chains – with contractual agreements between producers and downstream agents – are increasingly organized to cater to the specialty coffee segment. Second, per capita consumption has been declining in the major import markets (i.e., in developed countries) while income growth and “westernization” of food habits suggest the potential for import growth in some developing countries.

- Identify the opportunities and threats in Cooxupé’s business environment.

Here it would be useful to use Michael Porter’s five forces model to describe the world coffee industry.

Industry rivalry: There are many cooperatives, trading companies, exporters and intermediaries competing with Cooxupé in both input (i.e., coffee origination) and output (i.e., coffee marketing) markets. There are thus many players in the industry and Cooxupé has only 10% of the domestic market and less than 1% of the global market. It is thus a price-taker, despite its efforts to build a reputation with coffee buyers.

Barriers to entry: Low in the domestic market, but high for direct coffee exporters. Access to importers (both roasters and traders) in the major importing markets (US, Europe and Japan) requires competencies in coffee origination with volume and quality consistency, and relationship building, which are not trivial.

Substitutes and complements. There are many substitutes to coffee in the competition for the consumer “share of stomach”, including juices, soft drinks, mineral water and tea.

Power of suppliers. Low, because coffee producers are relatively small and large in numbers.

Power of buyers. High, coffee roasters and importers have considerable bargaining power because they are more concentrated and buy coffee beans from different qualities and origins to form their blends.

Given this industry analysis, the main threats to Cooxupé include: declining coffee prices and margins due to lack of supply control, coffee production growth particularly in Brazil and Vietnam, bargaining power of buyers and per capita consumption decline of traditional coffees.

Main opportunities include: potential coffee consumption growth in developing countries (including Brazil), the growth of the specialty coffee segment, Cooxupé's reputation of a consistent supplier and access to the major import markets.

Part 3 – Strategic Options

In this part of the discussion, the class participants should identify strategic alternatives for growth and weigh their advantages and disadvantages. The instructor could present contingency theory, which suggests that changes in the business environment elicit changes in strategy as organizations attempt to adapt and achieve external fit (Donaldson, 2001).

- Should Cooxupé continue to pursue growth or has it achieved an “optimal” size?

The answer here is “it depends” as the decision to grow (or not to grow) must be based on the organization mission and vision. Cooxupé was formed to provide market access and more favorable terms of trade to coffee producers. Over time, it has evolved as a service provider to members. As discussed in the business model section, Cooxupé not only markets coffee on behalf of members but offers them storage, grading, technical assistance, risk management and credit services. In other words, Cooxupé's original mission is “defensive” in nature, i.e., it exists to protect farmers' incomes from appropriation by downstream agents. If this mission is still valid, Cooxupé might choose not to grow despite the changes in the business environment unless it can only continue to fulfill its mission with increased size and scale. Growth is particularly risky in cooperatives because as membership grows so do free rider, control and influence costs. However, Cooxupé's mission might be changed to “add value to members' incomes,” i.e., to capture rents that are found in downstream stages of the coffee sector. Such an “offensive” strategy would require growth in scale and scope to be successful.

- If Cooxupé needs to grow, what are the strategic alternatives?

If growth is pursued, then it can be horizontal (i.e., increasing scale of operations) or vertical (i.e., downstream vertical integration into coffee roasting). Another alternative is to form strategic alliances with downstream partners.

- What are the advantages and disadvantages of these alternative growth strategies?

See table below.

Growth Strategy	Advantages	Disadvantages
Horizontal growth	- Use increased scale to generate monopoly rents or countervail downstream bargaining power - Leverage existing competencies in coffee origination and relationship management - Access to large “accounts”, i.e., retailers, roasters and traders operating on global scale demanding scale of suppliers	- Maintain quality consistency on higher volume - Requires coffee origination from increased number of producers possibly in different regions - Increased membership size and heterogeneity leads to higher costs of organization
Vertical growth	- Higher margins in downstream stages (coffee roasting and retailing) - Develop closer relationships with end consumers	- Requires resources and competencies such as large capital investments and brand development - Requires scale to operate

	- Add value to coffee delivered by members	on a national or global basis - Requires coffee origination from other regions (and possibly countries) to form blends
Strategic Alliances	- Form strategic alliances with downstream partners (roasters or retailers) to have access to downstream profits - Strategic alliances may also be used for entry in international markets (e.g., China, India, etc.)	- Leverage existing resources and competencies - May require additional capital investments in case of equity alliance - Choice of strategic partner is key to alliance success

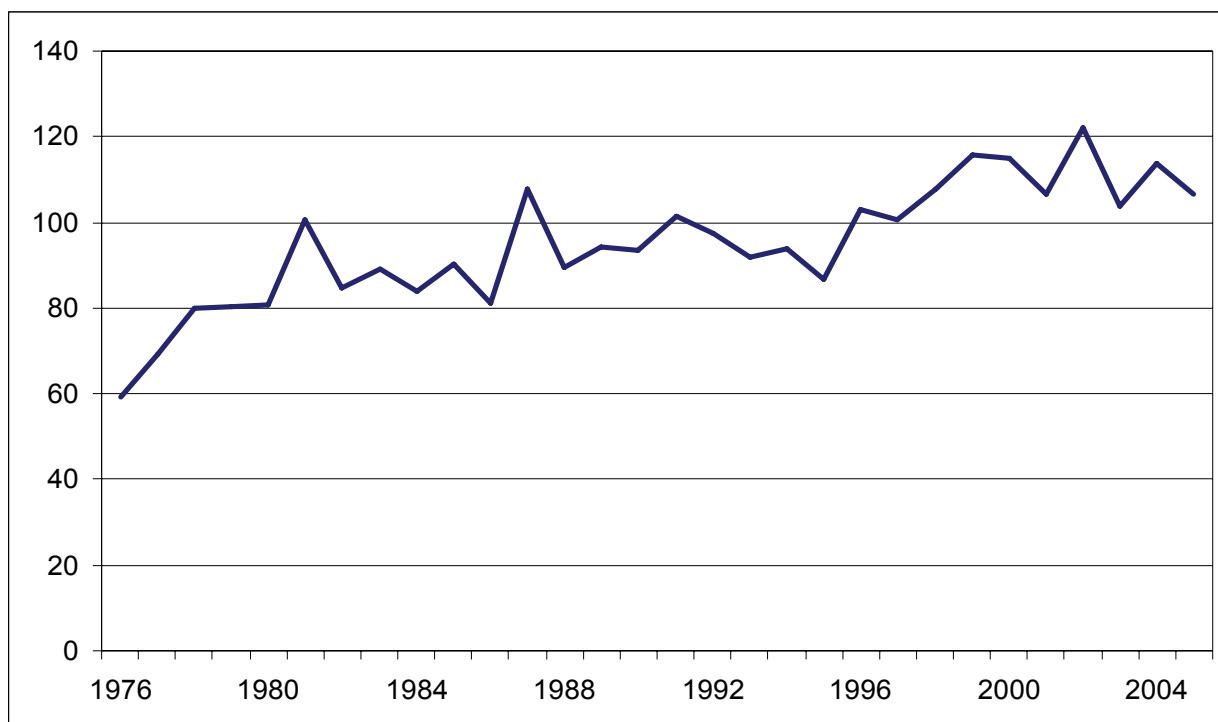
Part 4 – Strategy-Structure Alignment

Depending on the choice of strategy, Cooxupé may need to change its organizational structure – in particular its ownership structure – to promote internal fit. If the strategy is to maintain the status quo, the current traditional ownership structure may be optimal. Theory suggests that the traditional cooperative structure is aligned with “defensive” strategies in cooperatives (Cook, 1995). The successful evolution of Cooxupé corroborates this hypothesis. If horizontal or vertical growth strategies are pursued, then Cooxupé’s ownership structure will have to be changed particularly to generate more risk capital to fund growth. The typology of alternative ownership structures for cooperatives pursuing offensive strategies is found in Chaddad and Cook (2004) and can be used to inform this debate.

6. References

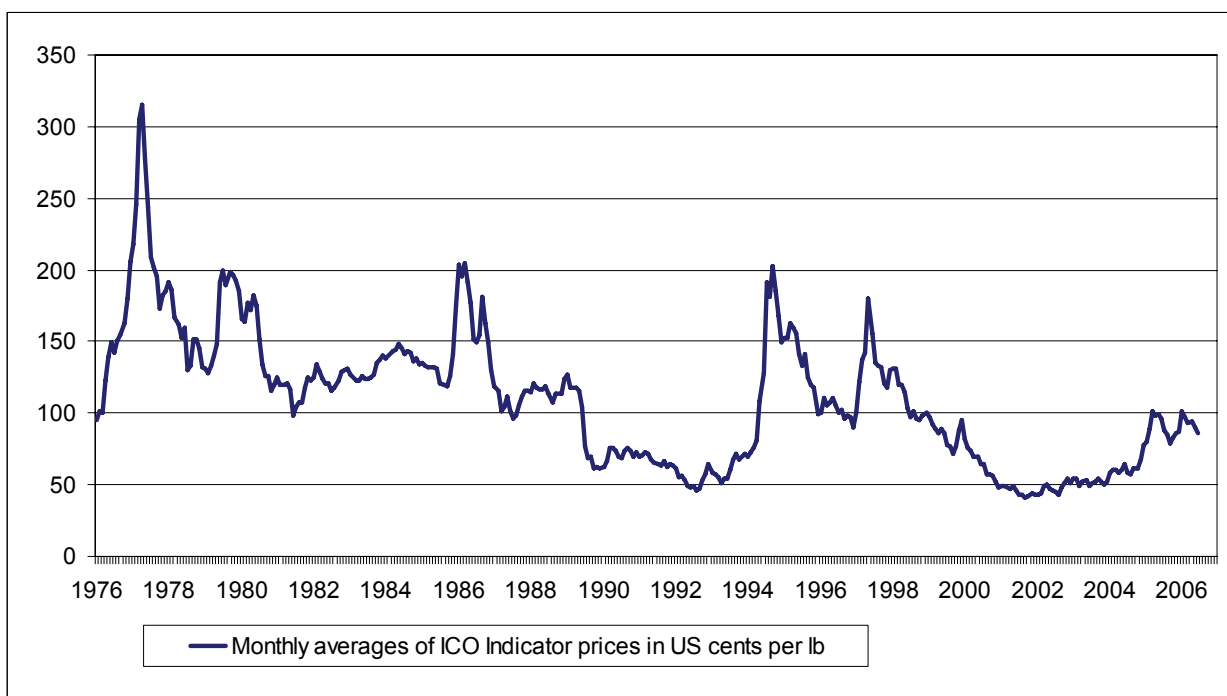
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Figure 1. Growth of Coffee Production (Millions of 60Kg Bags)

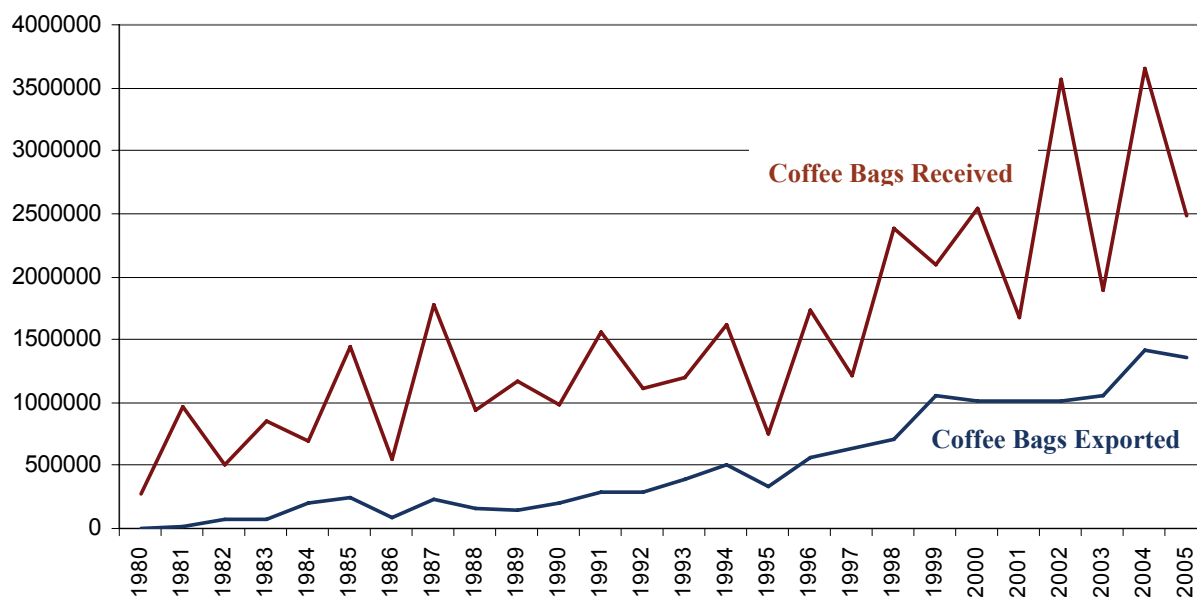


Source: International Coffee Organization (ICO).

Figure 2. Average Nominal Price Received by Coffee Beans Producers (US cents/pound)



Source: International Coffee Organization (ICO).

Figure 3. Cooxupé: Coffee Bags Received and Direct Coffee Exports (1980-2005)

Source: Cooxupé's annual financial reports.

Figure 4. Selected Income Statement and Balance Sheet Information (R\$ Million)

	2001	2002	2003	2004	2005
Sales	466.39	530.24	635.34	934.58	1,190.57
Net Income	12.01	16.00	18.54	21.09	30.08
Current Assets	279.42	405.67	436.75	578.36	710.49
Fixed Assets	36.58	39.24	44.66	89.69	93.78
Total Assets	321.43	516.29	567.41	713.94	861.86
Current Liabilities	154.01	223.80	235.74	445.18	519.13
LT Liabilities	77.07	188.18	214.41	98.10	153.15
Equity	90.34	104.30	117.25	170.64	189.57
Social Capital	45.90	54.77	61.84	71.97	85.20

Source: Cooxupé's annual financial reports.

Figure 5. Cooxupé: Membership by Region in 2005

Region	Counties	Members
Southern Minas	70	7,989
Cerrado Mineiro	44	721
Mogiana	30	573
Other	27	1,333
Total	171	10,616

Source: Cooxupé's annual financial reports.