

2nd ICO World Coffee Conference

Salvador, Bahia, Brazil

24th September 2005

LESSONS FROM THE CRISIS

"SEIZING THE OPPORTUNITY"

presented by

Gordon S. Gillett

**Senior Vice President
Nestec Ltd., Switzerland**

Mr President, Mr Chairperson, distinguished guests, ladies and gentlemen,

I am especially privileged to be with you today. Firstly because I return to the same city that welcomed me on my very first visit to Brazil 30 years ago. The second reason why I feel honoured is that this is the second consecutive world coffee conference at which I have had the pleasure of speaking. I can only assume that I must have made a remark in May 2001 in London which was of interest to you. Perhaps it was the forecast that within 5 years global coffee consumption would reach 115 millions bags. Few believed me then and yet with a year still to go it is generally accepted that 115 millions bags has already been reached. I shall not disappoint you today as I intend to share with you Nestlé's estimate of world consumption in 2015 at the end of my presentation. I share with you, openly and transparently, our analysis because by doing so I want to underline and reinforce a key element of our expanding industry : Producers need consumers or to put it another way coffee lovers depend on dedicated farmers. We are all inter-dependent stakeholders in a global business. The first lesson therefore from the recent "crisis" is that we need to make greater efforts to better forecast what the world's consumers will need and when it will be needed. Is this perhaps the foundation for a more realistic debate on supply management ?

If the definition of a crisis is a period when prices fall below the cost of production then lets not forget that the years 1999-2003 represent the second crisis in just 15 years. The fact that no one talks about 1989-1992 is that the first collapse in market prices came after 15 years of historically high prices which cushioned the producer and the governments of exporting countries from the realities of market economics.

The 15 years also gave a false sense of security to the grower who came to believe that interventionist mechanisms to shore up prices were a permanent feature of the market place.

It is interesting to note that consumption, during the 1975-1990 period of high prices created first by the 1975 Brazilian frost and then by market intervention, increased by 16% while in the last fifteen years the rate of increase has approached 25% or half again as much as in the preceding 15 year time span. During the last 15 years there has been a close correlation between global economic growth or the purchasing power parity of its inhabitants and coffee consumption. The 1990-2005 period witnessed an increase in consumption of 23 millions bags largely in emerging economies and must therefore be classified as NEW demand and supplemented the extra demand from consumers in coffee cultures that were already mature. However, difficult it is to accept, the fact remains the low prices of 1989/92 and 1999/03 stimulated consumption growth. This was the positive aspect offset unfortunately by considerable hardship amongst many producers particularly during the recent crisis.

Enough of the past. I would like to spend the next 15 minutes addressing two subjects : the recent crisis which I shall examine from the perspective of CAUSE-EFFECT-RESULT-CORRECTION and then spend the rest of my time presenting various aspects of consumption namely :

- Impact of low prices
- Where the growth has occurred
- What type of products, where they are consumed, and by whom
- Consumption in 2015

Let's start with the second crisis of the last 15 years.

The period 1993/94 through 1997/98 saw 5 straight seasons when the ICO Composite Indicator exceeded US cents 100/lb. It was also a time when for 5 consecutive seasons world coffee consumption exceeded production with the consequent drawdown in world stocks assisted by 2 frosts in Brazil in the winter of 1994 and tight overall supply availability in 1997. These causes had a dramatic effect and supply boomed in the coffee years 1999/2000 through 2001/02, the price incentive for farmers was very real and they responded accordingly. The result was the decline in prices which then triggered a correction through:

1. Production declining in those origins with high production costs and inefficiencies
2. Consumption continuing to grow and more importantly at an accelerated pace before the long awaited price recovery gathered momentum.

I am under no illusion that to most of you these comments are self-evident but to a major degree the same elements also applied to the 1989-92 period, yet no one at the time wanted to learn the obvious lessons and which, in hindsight, could have better prepared us all for the recent crisis. We need therefore to learn from the past and the political attention that the recent crisis has generated is hopefully a sign of a new determination to take action before a cure is urgently required by preventing with planning and foresight the worst effects of a period of low prices before it takes place. The second part of my presentation addresses consumption:

The following chart shows what has actually happened to consumption as a result of the market prices experienced. In our economic model we correlate GDP and price with actual consumption and use the relationship to simulate and project forward. The result is the green shaded area. We also plot over an extended period of time the linear progression of coffee consumption. This is shown as the dotted red line. The unbroken red line reflects actual consumption as a result of consumption being stimulated by the recent low prices. As you can see, there is a very close correlation between the results from our model and actual world coffee demand.

Let us assume that "real" prices had never dropped below US cents 100/lb. The result is clearly shown on this chart. Our model suggests that coffee demand would have continued at or close to the linear path of close to 1% per year. Almost all the difference between the shaded green area and the unbroken red line is NEW demand for coffee beverage products from consumers in emerging economies. This increase equates to approx 11 millions bags of additional demand in 5 coffee seasons... I would suggest to you that unless we had experienced a period of low prices when GDP and purchasing power growth were relatively strong it would have been unlikely that our industry could have attracted so many new and now hopefully permanent loyal consumers. There is too much polemic during periods of low prices on the margins of roasters in developed economies and insufficient acknowledgement of the opportunity presented to attract new consumers in emerging markets and producing countries themselves. I want to emphasise that Nestlé is very conscious that the same period created hardship for many growers but the overall industry's demand base is now at a higher level than would have been

previously attained had prices remained underpinned at the upper end of the last 15 year price bracket.

I have said that much of the increase in the last 5 years has been generated from NEW consumers. To illustrate my point I show this rather busy chart which is correlating the number of cups of coffee drunk per day with the countries' consumers annual income expressed in US dollars.

The most spectacular increase in coffee consumption between 1999-2004 has occurred in many countries with low PPP, and which are to found in this quadrant of the chart. The percentage increase in most countries has been spectacular and even if it was from a low base these are essentially NEW consumers attracted to coffee as a beverage for the first time.

This slide highlights one such group "Eastern Europe" where "liberalisation" of their own economies has resulted in a strong increase in income and consequently coffee consumption, assisted also by the "depressed price effect". Contrast this with Western Europe where as you would expect from the income/consumption curve demand is broadly flat.

This table breaks down both retail and foodservice coffee consumption and shows the percentage change between 1994-2004. We at Nestlé measure coffee consumption in the number of cups drunk not in the number of bags roasted because at the end of the day we need to recognise that we are competing for share of throat. New technologies and processes form part of successful economic development and

our challenge is to be able to offer the consumer with a quality, affordable, appealing coffee beverage that he or she chooses in preference to any other drink.

Total coffee consumption has increased 16% in 10 years to reach 824 billions cups in 2004.

"In-home" consumption dominates with 72% or 595 billions cups an increase of just 12% in 5 years. Out of home has presently only 28% market share but has jumped 26%, or more than double the rate of increase of in-home, during the same period to reach 229 billions cups, with Starbucks amongst others leading the growth and popularity of this segment.

The last line on the chart shows the split between Soluble and Roast&Ground. Your attention is drawn to the dramatic rates of increase in the 1999-2004 period of soluble consumption. 5 times the rate of growth of Roast&Ground "in-home" and more than twice as much in out-of-home.

Soluble coffee has therefore been the catalyst for this expansion because it is in soluble form that a NEW consumer is usually introduced to coffee and has been therefore the engine in growing and accelerating demand.

I hope I have demonstrated to you the strong correlation between consumer income and coffee consumption. If I may express it in another way, this table dramatically emphasises the significant consumption opportunities for our industry. Less than 1/5 or 20% of the world's population, who, in turn, represent the category of consumers

that drink at least 1 cup of coffee per day, absorb nearly $\frac{3}{4}$ of the world's coffee, and incidentally, this includes Brazil, proving that there are exceptions to the GDP/Income and coffee consumption correlation. A further 20% of the global population consume 22% of the world's coffee at a rate which varies between 1 cup per day to 1 cup per week.

Finally, there are well in excess of half of the world's population that consume less than 1 cup per week and consequently account for just 5% of the world's coffee demand.

It is not my intention to convince you where the greatest opportunity to expand our industry lies but I do suggest that the many millions of potential "starting" and "intermediary" consumers will demand their cup of coffee pleasure at a price which they can afford and which nevertheless satisfies their expectations of quality and value. The spectacular increase in domestic consumption in Brazil is I believe partly due to the much improved quality of the products on sale. At the other end of the consumer spectrum are the coffee connoisseurs who having enjoyed, and been part of, the lifestyle of the coffee house experience, where a menu of coffees is offered, are now demanding the same palate of choice at home. Nestlé's contribution to, and participation in, this sector is through our Nespresso coffee system which delivers the ultimate cup of coffee and emphasises the passion and romance the Nespresso consumer has with his or her coffee experience. The success of this approach in the last 15 years is shown on this chart. We are not alone in driving the growth in the gourmet / speciality coffee sector but the point I want to leave with you is that these products whether they are destined for in home or out of home consumption are

relatively highly priced and are therefore only affordable by the few not the majority. They nevertheless have brought a new and welcome dimension to coffee drinking and have arrested the coffee consumption decline that threatened and was even witnessed in certain developed economies.

Let me close on an optimistic and hopefully, for you all, encouraging note :

Assuming world GDP continues to grow at an average of 3.5% and coffee prices as reflected by the Composite Indicator average US cents 80/lb, with any spike above this level being short lived and therefore of minimum consequence to the underlying trend there is a high probability that coffee consumption in 2014/15 will reach 130 millions bags. We need to appreciate that world consumption will not grow at the extrapolated rate of the solid red line because depressed prices have, and would continue to, negatively impact production, resulting in insufficient supply to satisfy the higher rate of consumption growth.

For those of you who challenge the GDP forecast as too low, I can answer that at 4% GDP and maintaining an ICO Composite Indicator at US cents 80/lb consumption will exceed 130 million bags. This figure is therefore not a pipedream but an attainable objective.

I close with three lessons from the last crisis :

- Recent low prices have accelerated consumption growth in emerging markets. This is positive because the industry is now working off a higher consumption base.
- Many producers have become more efficient and effective as a result of the period of lean prices. I would venture to suggest that those producers who survived the low priced period are today better equipped and better placed than ever before to respond to the demands of the future. For some they have also learnt that their future is not in supplying a commodity but rather marketing a product.
- Heightened sustainability awareness is now a reality and there is a genuine commitment to work together. The last crisis, in this respect, has triggered a determination that lessons have not only been learnt but solutions are being actively pursued.

We are part of long lasting, dynamic and expanding industry. Hopefully by learning the lessons from the past we can build a stronger and more stable future.

Thank you for your attention.