UNIVERSITY OF NOTRE DAME
Mendoza College of Business

Catholic Relief Services

Empowerment vs. Profit: Filipino Coffee Growers

Early in the morning, Joe Curry, the country representative for Catholic Relief Services (CRS) in the Philippines, sat at his desk scrolling through several of his emails. He wasn't too surprised to find one particular email from the President and founder of Rocky Mountain Arabica Coffee Company, Pierre Yves Cote. Rocky Mountain is a fast-growing coffee roasting company that has been trying to convince CRS of a partnership over the past several months, in an effort to capture CRS's ability to organize small scale coffee farmers and create a stable supply chain to serve the high end coffee market in Manila and abroad. Attached to the email was a draft of a formal partnership proposal that Pierre would be prepared to sign, should Joe be willing to agree to the suggested terms.

Background

CRS has been working with poor farmers in the marginal areas of the Philippines for many years using a development approach known as agroenterprise. Agroenterprise is designed to address the needs of small-scale rural farmers in developing countries who are competing in a global commodity market but are equipped only with the tools of subsistence farming:

> Typically these communities produce low value commodities which have experienced declining real prices over the past decades and increasing competition from medium to large-scale producers. As such, the majority of smallholder families are stuck in a production "treadmill" whereby many producers all produce the same undifferentiated commodities, using traditional, low input systems. Inevitably these farmers are price takers in the market.[1]

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[1] Mark Lundy, Carlos Ostertag, Maria Gottret, Rupert Best, and Shaun Ferris (2005), "A Territorial Based Approach to Agro-Enterprise Development," *International Center for Tropical Agriculture* (CIAT), <http://www.fao.org/sd/erp/toolkit/BOOKS/CIAT_Agro_Enterprise_Strategy_Paper.pdf> accessed April 19, 2011, p. 3.

Agroenterprise relies on a theory of collective action called clustering; through farmer organization, cooperation, and participation, farmer groups build economies of scale, increase yields and the quality of their products, attract investment, strengthen negotiating power, and reach new markets.[2] Such changes in behavior and organization will increase farmer profitability, decrease food insecurity, and empower communities. CRS often links farmer clusters with buyers, but the Rocky Mountain proposal was something new and untested.

The Decision

Joe sat back in his chair and let out a big sigh as he weighed the opportunities against the implications that such a proposal could have on the agroenterprise clusters CRS had formed. More than a century ago, the Philippines was the fourth largest international exporter of coffee in the world. However, due to a coffee rust outbreak in 1889, over-supply in the 1960's, and volatile international commodity prices during the 1980's and 90's, current coffee production amounts to merely half of domestic market consumption. A proposal by a large premium coffee buyer, such as Rocky Mountain, would have the potential to jumpstart a dormant, but very profitable market for Arabica coffee. Such a market could provide a much better livelihood for the small farmers CRS serves.

Joe still has some reservations and wariness of Rocky Mountain's true intentions as a profit-generating institution and is unsure of whether the company's closed system of production, need for long term contracts, and the vastly disproportionate bargaining power is ultimately beneficial to the farmers. To complicate things further, he is also considering an alternative partner that offers a profitable, yet more empowering outcome. Joe understands the substantial impact CRS's advice could have on the farmers. Joe slowly turns his chair and gazes out the sun-filled window and wonders how to proceed.

The Filipino Coffee Market Landscape

The majority of Filipino coffee drinkers consume inexpensive, low quality instant coffee produced by Nestle from Robusta coffee beans. Approximately 50% of the beans Nestle

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[2] Estelle Biénabe and Denis Sautier, "The role of small-scale producers' organisations in addressing market access," *Beyond Agriculture – making markets work for the poor: proceedings of an international seminar, (28 February–1 March 2005).* Department for International Development (DFID), London, UK, <http://www.dfid.gov.uk/R4D//PDF/Outputs/CropPostHarvest/BeyondAgric.pdf#page=21>, accessed April 19, 2011, p. 70.

purchases come from local farmers, while the remainder is imported from Southeast Asia. However, in the larger cities, and especially in the metropolitan Manila area, there is increasing demand for high quality Arabica coffee. This trend is evident from the growth of high-end cafés such as Starbucks. Even though the soil, climate, and elevation are perfect for producing excellent Arabica, Filipino coffee is not "on the map" of world coffee producing regions. The dramatic decline of the coffee industry of the last century has resulted in extremely uneven agricultural and processing practices among Filipino coffee farmers. In many cases, farmers are producing low quality Arabica beans that are unsuitable for the premium market. To produce top quality Arabica coffee in volume, the soil must be fertilized, the trees properly cared for, the coffee "cherries" picked only when completely ripe, and the beans processed using a special procedure called "wet processing" that washes the beans as it removes the skin and pulp. Compounding these issues is that Catimor, the coffee rust resistant variety of Arabica brought to the Philippines in the 1950's, is currently the most prevalent form of Arabica in the Philippines, but does not meet the contemporary taste standards of the premium market.

The Rocky Mountain Proposal

Rocky Mountain Arabica Coffee Company is a rapidly expanding business incorporated in the Philippines with a French Canadian CEO, Pierre Yves Cote. Pierre's former career was as a successful financial advisor and investment banker. His sophisticated financial background has helped provide Rocky Mountain with a strong capital structure and a compelling growth strategy. The company is financed by outside capital as well as Pierre's own money. Rocky Mountain's goal is to revolutionize the Philippines coffee industry and put the country back on the map as a source for high quality Arabica. FY2010 saw a 400% increase in sales, a 428% increase in profit, 80% reduction of debt, and 70% increase of assets. Currently 70% of profits are generated in the Philippines, while 30% are through exports to Canada. Rocky Mountain's coffee grown in the Benget region of the Philippines has earned international awards for taste and quality.

Rocky Mountain currently owns and operates 3 coffee plantations and 3 processing facilities. Over the next year Pierre intends to open 7 more of each. However, even all 10 plantations running at full capacity will not be enough to meet demand, so Pierre must engage and contract directly with "satellite farms," which are owned by small-holder farmers in the mountains of the Philippines, where the best Arabica grows. These farmers tend to be extremely poor indigenous people who have been marginalized, first by the Spanish colonists, then by the American colonists, and finally by the Philippines government in Manila. They mostly live in areas without access to electricity, decent roads, or elementary education. They have had trouble getting their crops to market, and thus CRS has recently begun working with them to organize agroenterprise clusters.

In light of the substantial barriers to producing top quality Arabica in the Philippines, Rocky Mountain developed an innovative closed system of producing coffee from "soil to cup" that limits human error and the amount of processing done by the farmers. Pierre believes tight centralized control of the entire coffee value chain is critical to ensure top quality. The process is as follows: farmers are uniformly trained in agronomy practices and are taught to harvest beans only when 100% ripe. As opposed to most systems of coffee production where farmers deliver pulped and hulled "green" beans, Rocky Mountain farmers deliver the beans in cherry form to a central processing plant, minimizing any chance that the beans will be processed incorrectly, get soaked with rain, or be allowed to ferment. The processing facilities use high volume machinery to wet process, dry, and package the beans. The beans are roasted and shipped all over the country for retail or for use in Rocky Mountain Café branded point-of-sale machines in hotels and restaurants. Even the point-of-sale brewing machines are completely automated, reducing the possibility of human error in making a cup of coffee and obviating the need to train baristas.

Rocky Mountain pays farmers PhP140, despite the company doing all the processing. Pierre argues that farmers should not be involved in processing; all they need to do is grow and harvest. He states that in addition to ensuring quality, his system reduces the farmers' labor expenses, frees up their time, and lets them concentrate on agricultural issues. However, Rocky Mountain also requires that the farmers incorporate under Filipino law into cooperatives with legal liability, and that each farmer sign an exclusive contract with a ten-year commitment. Rocky Mountain also requires that farmers rip out any Catimor trees on their land and plant only strains approved by the company. CRS is concerned that the farmers are not entering into the agreements as equals and fears what will happen if they are locked into a single buyer, or if Arabica prices fall significantly. On the other hand, Rocky Mountain also has a substantial CSR investment in the farming communities in which they opperate, providing healthcare, education, emergency assistance, and promotion of indigenous culture.

Rocky Mountain wants to partner with CRS because some of CRS' agroenterprise clusters are in areas with excellent Arabica potential for satellite farming. If CRS were to recommend that these farming clusters contract with Rocky Mountain, most farmers would follow the advice.

Alternative Approach - Bote Central

Bote Central is a company that was started in March 2002 by dynamic husband and wife entrepreneurs Basil and Vie. The company was started in order to empower farmers and preserve the environment through agro-business. It deals directly with coffee farmers to avoid middle-men and believes in using technology to promote efficiency at community levels as a means to improving and sustaining business. Basil manufactures his own coffee processing equipment by hand—this all-in-one equipment includes a huller, dryer and roaster—in his backyard garage. When asked where he learned how to build the equipment, Basil responds, "the internet ... where else?"

Bote Central is focused on deploying community roasting business units (CRBU) all over the country, most especially in the countryside. These units strive to propel local economies by providing different models of retailing Philippine brewed coffee. Bote's all-in-one processing equipment that is used within these CRBUs is very expensive as it sells for PhP 500,000. This price is much too expensive for coffee farmers, and so the equipment is donated to them through government grants. The equipment does not include wet processing, which reduces the quality and likelihood of reaching the most high end and profitable markets. The coffee farmers produce coffee beans and use the processing equipment to process coffee beans and roasted coffee. The farmers are then able to roast, brew and sell individual cups of coffee. This empowers farmers to capture 100% of the value "from soil to cup," by circumventing the entire supply chain. As a result communities will not have to buy packages of Nescafe instant coffee, but will be drinking coffee produced from their own local beans. Moreover, the price of a cup of coffee is much less volatile than the price of Robusta coffee on the commodities market. Enabling farmers to sell a 'finished product' cup of coffee will help stabilize their income over time. The only imposed condition on the farmers is that the beans which they are unable to sell to the local community will be sold to Bote Central under contract.

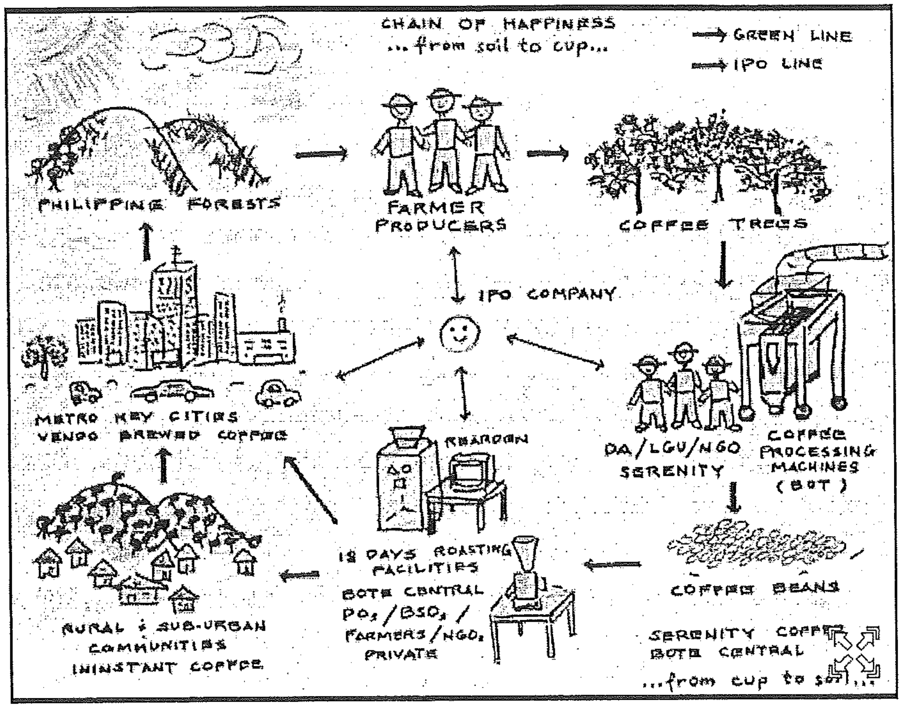
Bote Central relies on the farmers to deliver in "green," meaning the farmers process the beans which often results in poor quality. But they currently buy all varieties of beans at varying levels of quality from the farmers: "the good, the bad, and the ugly," as Basil puts it. The following table demonstrates the prices Bote pays farmers for each variety, along with their relative percentage of its total revenue:

Bean Varietal	PhP/kg	% of Revenue
Civet	1,100	30
Arabica	170	50
Robusta	85-100	10
Exelsa	85-100	10

PhP 45 = $1

After purchasing the beans, Bote processes the coffee in metro Manila through its own private labels and sells its coffee both domestically and internationally. The company has termed its business model the "Chain of Happiness," to connote farmer empowerment, a clean environment and profit generation. However, it is unclear how much the lack of consistent quality impacts profitability and the long-term sustainability of the business.

Below is the "Chain of Happiness" business model that hangs on the wall of the living room in the head office (Basil and Vie's house):



The company is currently dependent upon government grants and small revenues from its retail stores to stay in business. This grant-dependent strategy is risky and stymies growth and impact. Basil and Vie's ultimate "pie in the sky" idea is to eventually sell CRBUs as a business-in-a-box around the world to gain profits for the company, and to empower poor coffee farmers globally. Bote Central would then scale up by hosting a website where consumers could purchase roasted coffee online from small farmers anywhere in the world. This will increase demand for Bote to begin selling, not donating, CRBUs globally.

As with Rocky Mountain Café, CRS could be a key component to Bote Central's business model. Bote Central would prefer to not deal with the farmers themselves, but to have a trusted partner that understands farmer group creation and has a keen understanding of the coffee industry's landscape in the Philippines.

The Call

As Joe muses over the risks and returns that come with each partnership, he decides that getting an outsider's perspective could be valuable. He calls over to his secretary and requests the phone number of an NGO/business consultant named Ben, who he knows from his college days at the University of Notre Dame. Joe picks up the phone and dials in the number. As he hears the phone ring, he hopes Ben hasn't retired for the evening as it is now getting late in the States where he currently resides.

Discussion Questions

1. Given what you know from the case, can/should CRS work with either/neither/both of these companies and why?
2. From Joe's perspective, which model would benefit the farmers the most?
3. For farmers, what is ultimately the quality of life differential between the Rocky Mountain model and the Bote Central Model?
4. How much paternalism on the part of CRS or the businesses is appropriate?

Really good guys. Maybe HBR needs some new staff writers. We are also supposed to provide Viva with a separate "Learning document" that essentially has the answers. She may not want it for this case since there isn't necessarily an answer but I'd check with her.

Aspects to Consider

Rocky Mountain's Proposal

High Customer Concentration- Within Rocky Mountain's proposal, farmers will be exposed to a high degree of customer concentration: Rocky Mountain being their sole buyer of coffee. This places farmers in a precarious situation, especially because they would be entering into long-term contracts. With no alternatives of accessing the market, farmers would instantly lose bargaining power. Furthermore, almost all of Rocky Mountain's risks will be passed along to the farmers as the company would be their only revenue stream. If Rocky Mountain doesn't survive as a business, the farmers' already dire financial position would be in jeopardy.

Strong Management- Mr. Pierre Cotes, the company's CEO, has an investment banking background and abundant experience in the coffee industry. His sophisticated financial background has helped provide Rocky Mountain with a strong capital structure and a compelling growth strategy. The company is financed by outside capital as well as Pierre's own money. He is positioning Rocky Mountain by year-end 2011 to be poised for accelerated growth. He has a clear strategic plan and has raised capital to fuel expansion.

Increased Compensation- Farmers will be paid for cherries at "green coffee" prices. They would be compensated as if they were forward integrating, yet avoiding the additional expense and time constraints of de-pulping, washing, and hulling the beans. This allows farmers to focus on increasing yields.

Education- Rocky Mountain desires to have complete control over the entire supply chain to mitigate risks of poor quality and yield. Rocky Mountain would train farmers how to produce the best beans with the highest yield. Under Rocky Mountains tutelage, farmers could quickly produce beans that meet international coffee standards.

Social Benefits – The farming community will benefit from Rocky Mountain's CSR initiatives. For many communities, Rocky Mountain's programs may be the only access to basic medical care, education, or emergency livelihood loans at non-usury rates.

Bote Central Approach

Sluggish Growth Model- Bote Central's model is currently dependent upon grants. The process of securing this type of funding is lengthy and unpredictable. To grow quickly, it will either need to increase its customer base substantially or look outside the grant revenue model. CRS may want to grow faster than Bote Central can support to make a greater impact. Due to a lack of strict quality assurance, reaching the top tier Arabica export market is unlikely.

Limited Empowerment- Small farmers are currently obtaining Bote Central's expensive all-in-one coffee production equipment through donations. This arrangement deprives the farmers of the opportunity to gain increased confidence and empowerment that would come through obtaining the production equipment through their own effort. The company could create a solution to partially involve farmers in the process of procurement. Moreover, once the equipment is acquired, the farmers are obligated to sell to Bote Central any surplus of unsold coffee beans to the local community. As is the case with Rocky Mountain, this agreement forces the farmers into an adverse circumstance of dependency and subordinate bargaining power.

Forward Integration- Bote Central's "soil to cup" model leads to farmers' ability to capture almost all of the value of coffee production through forward integration. Farmers would finally gain access to hulling and roasting, which is where most of the value is found along the supply chain.

Innovation- The management team is very innovative in the way it approaches business. The vision Basil and Vie have is one that is risky, but if successful, has the potential to impact the coffee industry domestically and internationally.