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Weekly Briefing

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Barely Worth a Bean

For millions of impoverished farmers worldwide, coffee has become a cruel business. Producer prices have plummeted in recent months to an all-time low, while prices on the retail end are mostly at an all-time high

FINAL COLLAPSE OF THE COFFEE CARTEL

If you walk into your local branch of Starbucks or Costa Coffee, you could be forgiven for failing to notice the crisis brewing in the global coffee industry. Coffee is an global industry worth over $50 billion a year - but only $8 billion of this finds its way to producers of Robusta and Arabica beans at the bottom of the supply chain. Indeed the share of revenue generated from the second most traded commodity in the world going to coffee bean producers has collapsed from 30% ten years ago to less than 15% now. This week the London-based Association of Coffee Producing Countries (ACPC) announced that the fourteen member cartel was closing its operations. Many countries within the ACPC cannot afford to pay their dues to the cartel organisation. The eight year history of the ACPC will come to an end in the New Year.

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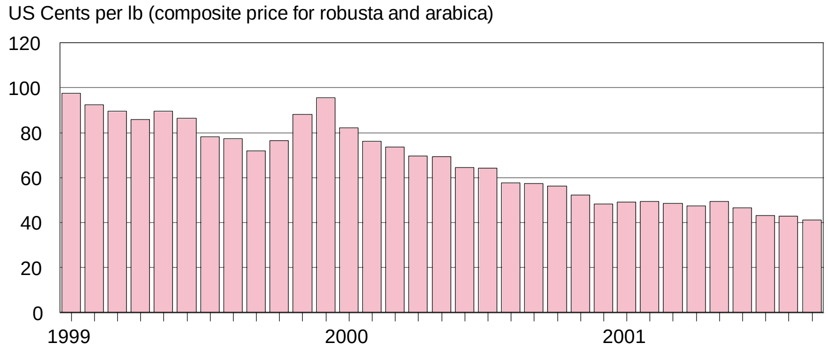
WORLD COFFEE PRICES ON THE SLIDE



Special Report: Will De-merger Breathe Life into mmO2?

On Tuesday, shareholders of BT Group plc voted to approve the de-merger of mmO2. In November, the de-merged business will begin life as a separately quoted company on the London Stock Exchange. What is this business and what issues will it face as a newly independent company?

What is mmO2?

mmO2 is a leading provider of mobile communications services in Europe. By 31 March 2001, mmO2's businesses served 16.5 million mobile phone customers in the UK, Germany, Ireland, the Netherlands and the Isle of Man. The combined group turnover for the year ended 31 March 2001 was £3.2 billion, on which it made a loss, after exceptional items, of some £3.1 billion.

In the UK, mmO2's best-known business is BT Cellnet, alone accounting for £2.7 billion of mmO2's total turnover. At 31 March 2001, Cellnet had approximately 11.2 million customers, representing an estimated market share, by number of customers, of some 26%. Further data on BT Cellnet is set out in the table below:

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ACPC STATEMENT

Despite efforts made by some member countries in implementing the Retention Plan and the positive effects achieved in the first months of operation, prices have not reacted as expected. Hence, the ACPC Council has issued Resolution 02/2001 to suspend the Retention Plan from 1st October 2001. The resolution frees members and signatories to the London Agreement from the obligation of retaining 20% of the volume of coffee exports

ACPC Statement

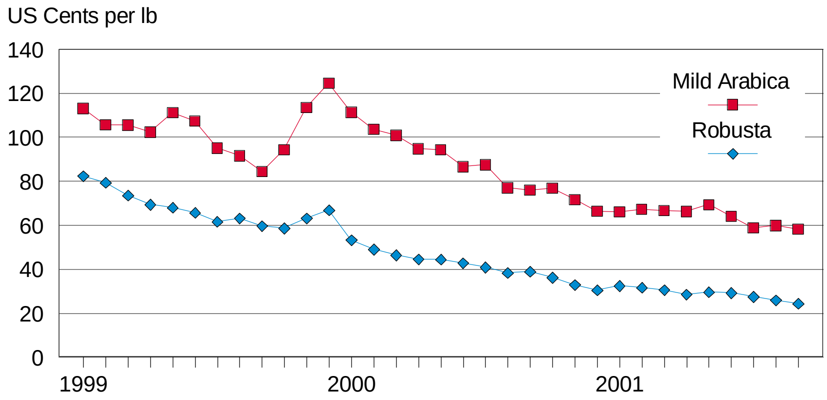
October 2001

The final straw for ACPC was the breakdown of the export retention scheme in April of this year. In a desperate final attempt to halt the decline in wholesale coffee prices, the ACPC called on its members to agree to a 20% cut in export supply to international markets. But in a classic example of a producer cartel unable to male production quotas stick, total coffee production has continued to expand. The main finger of blame is being pointed at Vietnam, now the world's second largest producer of raw beans - but which is not even a member of the cartel. Average prices for arabica and (cheaper) robusta coffee beans have continued to slide during 2001.

Explaining the collapse in prices

There is little mystery to the sustained decline in international coffee prices. total global supply has expanded more rapidly than global demand, leading to a sharp rise in coffee stocks and downward pressure on price levels. The imbalance between demand and supply is shown in the third chart opposite - the data comes from Commodity Expert a leading commodity analyst business.

COFFEE PRICES BY BLEND



Vietnam becomes a major producer

On the supply side, the glut of raw coffee beans has come from large-scale increases in production in several countries. Vietnam in particular has invested huge sums in boosting its coffee industry. Boosted by loans from the World Bank, Vietnam has now overtaken Indonesia to become the world's second largest coffee supplier. Capital investment in the industry and improvements in growing techniques have raised coffee yields. Supply has also been enhanced by favourable climatic conditions. Brazil, for example, has avoided a severe frost for three years.

Failure of the Export Retention Scheme

Market supply has also been supplemented by the failure of the ACPC export retention programme this spring. Poorer countries, heavily reliant on coffee exports as a major source of foreign exchange earnings have found it increasingly difficult to hold back production from export in a bid to support prices. As supply has grown, so the market price has fallen.

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"Post-pay" customers represent the number of SIM cards activated and ready for use that are subject to a customer contractual obligation to BT Cellnet for a specified period.

"Pre-pay" relates to SIM cards activated for pay-as-you-go customers. "Churn" is the proportion of customers who disconnected from BT Cellnet's network in the relevant year

	Units	Year ended 31 March		
Customers		1999	2000	2001
Total	000's	4522	7404	11162
Post-Pay	000's	3613	3813	2455
Pre-Pay	000's	909	3591	7707
Average Revenue per Customer				
Blended	£	411	332	256
Post-Pay	£	431	455	485
Pre-Pay	£	148	112	104
Churn				
Blended		n/a	30.4%	26.8%
Post-Pay		31.8%	40.9%	43.5%
Pre-Pay		n/a	11.8%	15.7%

Table Source: mmO2 Listing Particulars, October 2001

The City's Reaction

"We see the demerger of MMO2 from BT as a positive step, despite our reservations about the overall group valuation,"

Goldman Sachs

View from the FT

Forcing an adolescent business to stand on its own two feet is a harsh decision at the best of times

Expectations of future growth prospects for mobile operators are already the lowest they have been for much of their short history

Dan Adams

Financial Times

22 October

Recent Developments in mmO2's key UK market

With a population of almost 60 million people and total mobile-phone customer base of 42.8 million at 31 March 2001, the UK is the third largest national market in Europe for mobile customers. This customer base represents a "penetration rate" of some 72%. The UK market as a whole has been expanding rapidly, growing by some 16.2 million customers between 1 April 2000 and 31 March 2001. The biggest impetus to growth was the introduction of pre-paid or "pay-as-you-go" phones. However, in recent months the rate of new mobile phone connections has begun to slow as the market has become more saturated and consumer confidence has declined.

The UK market has proved receptive to new mobile data services such as text messaging and (more slowly) mobile Internet services. For example, the number of text messages sent in the UK in the month of March 2001 alone was 864 million, which represents a 132% increase on the same month last year.

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BT FINANCIAL PERFORMANCE—FALLING PROFITS / RISING DEBT

	31 Dec 2000	31 March 2001	31 March 1999
	£billion	£billion	£billion
Total Revenue	5.25	18.7	16.9
Net Income	-1.8	2.1	2.9
Profit Margin (%)	-5.05	18.26	27.50
Debt/Equity (%)	219.71	69.67	29.00
Turnover/Assets	0.37	0.50	0.61

A key market change has been the development of a substantial retail distribution channel in the UK. BT Cellnet participated in this by taking a 40% stake in The Link and developing strategic relationships with major mobile phone retailers such as Dixons and The Carphone Warehouse and, increasingly, supermarkets and general retailers who sell large volumes of Pre-Pay phones. BT cellnet also owns 349 of its own high street stores.

The Competitive Position

There is intense competition in all of mmO2's markets. BT Cellnet competes increasingly with other mobile operators, virtual private network operators, mobile local network operators and resellers of mobile services. New competitors are also likely to enter the market following the sale of the 3G mobile licences.

Vodafone, Orange and One2One are BT Cellnet's key network competitors in the UK, having an estimated market share of approximately 28%, 25% and 21% respectively. Overall, therefore, the four market leaders account for the entire market.

Faced with intensifying competition, mmO2 has to develop a strategy that deals with falling consumer prices for its main services, increased subscriber acquisition costs (as the market is more saturated, there are fewer new customers who can be found) and lower customer retention rates (higher "churn"). The need to rapidly deploy the new 3G technologies and to upgrade the existing mobile network is also a major challenge to mmO2 and its competitors.

Short-term prospects for mmO2

Now that BT shareholders have given approval for the de-merger, attention is focusing on the likely price of mmO2 shares and the prospects for investors. BT shareholders have already been on a roller-coaster ride that has taken the value of their investments to a peak of 1,358.5p and a trough of 342p over the last five years.

As the countdown to the start of trading in mmO2 has progressed, the float price of the new stock has been steadily revised down by analysts. Goldman Sachs has recently issued a research note valuing the stock at 70p, almost half the level originally bandied around by analysts. However, the majority of analysts and institutional shareholders have given the de-merger the thumbs-up.

Among the advantages, mmO2's senior management will be able to focus exclusively on the mobile phone strategy, and the company will have a freer rein to compete in the UK. mmO2 will also start out on a firm financial footing with just £500m of debt, giving it one of the strongest balance sheets in the mobile industry.

One of the greatest unknowns is whether the new brand will appeal to customers. And mmO2 does not only need to create popularity, it must also prove that it can generate an acceptable level of revenue per user. As the mobile phone market becomes saturated, the amount of money squeezed out of each customer is a crucial factor in the profitability of operators.

The relatively small size of mmO2 - and its ability to survive alone - is also a potential worry. While Vodafone and Orange have aggressively built up pan-European positions, mmO2 can only boast a small market share in both Germany (6%) and the Netherlands (8%) alongside its strong positions in the UK and Ireland. And the limited European presence will mean that mmO2 will not be able to take advantage of the economies of scale or offer roaming services in the same ways as its bigger competitors.

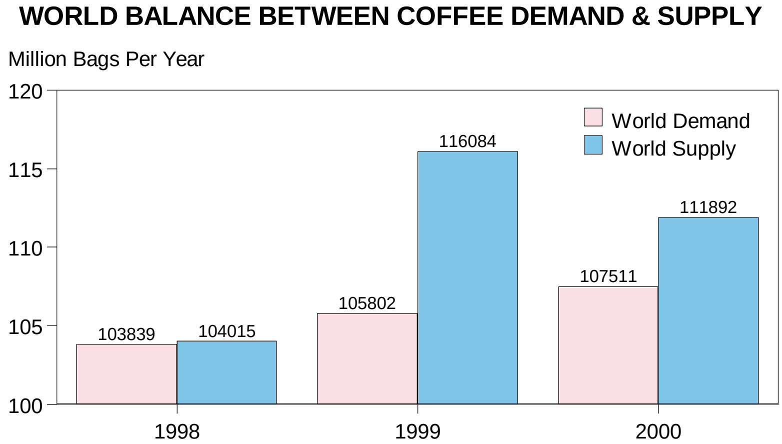
This Week's Best of the Web

You can find all these resources and more at Tutor2u Resources: Find us at www.tutor2u.net/default.asp

CBI Business Confidence Survey:	www.cbi.org.uk
BT Demerger Details:	www.bt.com/index.jsp
Association of Coffee Producing Countries:	www.acpc.org

Slow Growth of Demand

The global demand for coffee has expanded, but at a slower pace than supply. The trend growth of demand for coffee is little more than 1.5% - 2% per annum. Indeed in many countries, annual per capita consumption of coffee is falling. Partly this is because coffee itself has a fairly low income elasticity of demand. As real incomes rise, the demand for coffee grows, but less than proportionate to income. This is not true for all consumers. Demand for higher grade coffee has a higher income elasticity - one reason why major coffee retailers such as Starbucks continue to open new outlets and keep retail prices high.



But the combined effect of a huge increase in coffee production and relatively slow growth of demand has left international coffee markets with a structural surplus of coffee beans. Prices can only move in one direction when this happens. And falling prices spell disaster for producers and countries heavily reliant on coffee output as a source of output and income.

The stark reality facing many coffee producers is that prices have now fallen below the costs of production. Some suppliers are now abandoning their crops, others are slashing capital investment projects and making thousands of workers unemployed. Some Columbian producers are reported to be switching towards other cash crops that will generate higher revenues such as heroin. But we must remember that the majority of coffee producers are small-scale. Nearly three quarters of coffee output comes from plantations less than five hectares in size. Limited credit facilities and unfavourable geological conditions make it virtually impossible for these producers to switch supply to crops that might bring a higher average income.

Total Coffee Production Among Leading Countries

	1998/99	1999/00	2000/01	2001/02
Vietnam	*6,995,000*	*11,055,000*	*14,850,000*	*14,850,000*
Brazil	*4,590,000*	*4,420,000*	*6,400,000*	*10,000,000*
Indonesia	*6,465,000*	*6,695,000*	*6,300,000*	*5,400,000*
Ivory Coast	*2,189,300*	*5,670,000*	*4,333,000*	*4,666,000*
India	*2,800,000*	*2,900,000*	*3,280,000*	*3,166,670*
Uganda	*3,375,000*	*2,790,000*	*2,720,000*	*2,890,000*
Cameroon	*1,250,000*	*1,250,000*	*1,100,000*	*1,000,000*
Thailand	*731,600*	*1,070,000*	*1,130,000*	*870,000*
Top 8 total	**28,395,900**	**35,850,000**	**40,113,000**	**42,842,670**
Others	**4,232,750**	**4,534,650**	**4,685,500**	**4,577,500**
TOTAL	**32,628,650**	**40,384,650**	**44,798,500**	**47,420,170**

Barely a ripple in the retail price of coffee

The collapse in world coffee prices has created barely a ripple in the coffee houses of London or Milan, but for millions of coffee farmers, it is leading to poverty on an enormous scale.

Retailers can claim with some justification that the price of raw coffee beans is now a small percentage of their total costs. Rising wage costs and soaring rents for prime city centre sites have increased the costs of supplying coffee products to final consumers.

But there is little doubt that the inelastic nature of demand for coffee among higher-income consumers is a major factor behind the continued high price of coffee products in supermarkets and coffee houses. Retailers can use their market power to extract higher prices from consumers.

Monopsony Power

For small-scale farmers in the poorest coffee growing countries, the balance of power in the market could hardly be more different. Low output plantations must sell their output at the best price they can and the monopsonistic power of the major coffee roasters such as Suchard, Nestles and Sara Lee is a major reason why suppliers of raw beans see their incomes fall further in a market where is there a global glut of beans.

COLLAPSE IN MANUFACTURING CONFIDENCE

The latest Confederation of British Industry Quarterly Trends Survey finds business confidence has collapsed in the wake of the terrorist attacks on the United States in September. Growing uncertainty about the strength of demand both in the UK and International economy has hit business sentiment in a huge way.

The index of business optimism has fallen to minus 54 (–22 in July). The percentage balance of manufacturing firms expecting an increase in total orders in the next four months has fallen from +1 in July to –25 in October. 80% of businesses say that a shortage of orders or sales will hit short term production for the rest of the year and into the New Year period. And in a response to a clear downward shift in expectations, manufacturing firms are expecting to make thousands of workers redundant in a bid to control costs and retain some degree of profitability.

CONFIDENCE FALLS OFF THE CLIFF

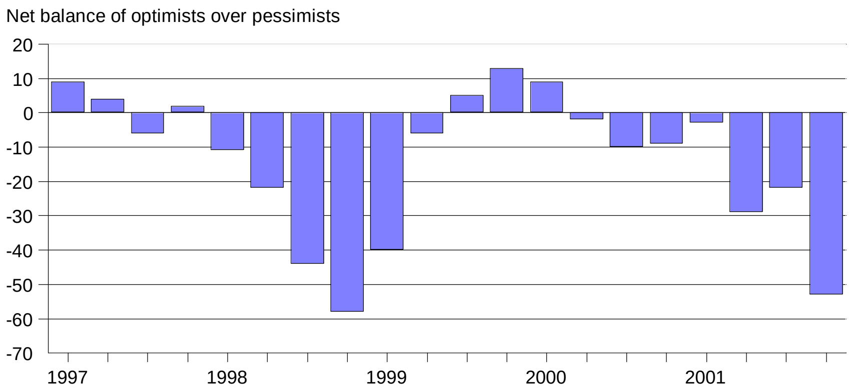
The same quarterly CBI industrial confidence measure reached -58 in 1998, which did not see an economy-wide recession, -51 in 1991, which did, -70 in 1980 and -75 in 1974, both of which also saw recessions.

This is the lowest balance since 1980 It is lower than the trough in 1998 or 1990

CBI Survey

October 2001

CBI MANUFACTURING BUSINESS CONFIDENCE



67% of manufacturing firms say that uncertainty about demand going forward will limit their capital expenditure plans. This compares with 44% in the corresponding survey in October last year. There has undoubtedly been a revision in expectations of the rate of return on planned capital spending. And this will lead to a fall in investment spending by manufacturing despite recent cuts in nominal interest rates by the Bank of England. Export orders have fallen sharply over the last three months, and, as the chart below indicates, optimism about future export sales has fallen to the lowest level since the early 1980s when the British economy was stuck in one of its worst post-war recessions.

EXPORT OPTIMISM HITS A 21 YEAR LOW