SOUTH TOO BIG

BY DOUG BURN

Seven years ago it appeared that South America might emerge as another growth market like South Korea or Taiwan for Canadian food and beverage manufacturers but instead it has turned into another major competitor like Australia. Our $1.9 billion in two-way trade in bulk, intermediate and consumer-oriented agri-foods went from a rough parity in 1998 to a trade deficit of over $800 million in 2003 as financial crises knocked two thirds of the value off the Brazilian and Argentine currencies.

Our exports plummeted, our imports soared and our trade shifted. Our exports of processed foods and beverages dropped almost 80 per cent while those of our agri-food commodities, such as wheat, fell by only half as much. In 1997 the value of our food and beverage exports to South America totalled $145 million, tying the continent with Taiwan as our seventh largest export market. By 2003 our food and beverage exports to 10th place Denmark were three times greater than our exports to all of South America.

AN AGRI-BUSINESS POWERHOUSE

Canada isn't alone in running an agri-food trade deficit with South America. The continent has emerged as a global agri-food powerhouse in the last decade led by Brazil. Free market economic reforms have totally restructured the sector in Brazil, which dominates South America with half the land area, population and economic output. Today the country is the world's largest producer of coffee, sugar and orange juice and has now become the largest producer of beef cattle and second largest producer of soybeans, corn, fruit and pork. In 2002, its agricultural surplus topped Cdn$30 billion. According to a *2003 Exporter Guide* of the United States Department of Agriculture (USDA), "the arrival of multinationals and the growth of domestic companies has also contributed to an intensification of competition, and the food industry is among the most vital sectors of the Brazilian economy." Overall sales of the Brazilian food processing industry now exceed Cdn$70 billion with the domestic mar-

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ket absorbing about 80 per cent of the output with sales split roughly 75:25 between retail and foodservice channels.

Canadian food and beverage manufacturers have shifted gears in their approach to South America. Instead of relying on exports to service this market of 360 million consumers they are buying companies and building plants in the region, especially Chile and the member countries of Mercosur, the free trade area encompassing Argentina, Brazil, Uruguay, Paraguay – a market of about 230 million people.

McCain Foods and Heritage Salmon were the forerunners of this trend and are now joined by Molson Inc. and Saputo Inc. Their experiences may provide a guide for others planning to invest.

FOUR COMPANIES – FOUR STRATEGIES

It would be surprising if McCain Foods were not in South America as it produces a third of the world's french fries and has 55 plants on six continents. In 1994 the company built a $38 million french fry plant in Balcarce near Buenos Aires. The site was chosen for its ideal soil and growing conditions for potatoes. The plant was designed to serve the needs of the Mercosur countries and Chile and through steady reinvestment over the past decade now employs more than 500 people.

George Weston Limited, through its Heritage Salmon subsidiary, acquired the Fiordo Blanco SA fresh-farmed salmon operations in Puerto Montt, a busy port city in southern Chile, in 1995. At the time, investment analysts placed the value of the acquisition and subsequent upgrades at US$25 million. As North America's largest aquaculture company, Heritage Salmon sought to diversify its sources of supply. Geoffrey Wilson, Weston's vice-president, industry and investor relations, explains that Chile was a natural choice for Heritage Salmon due to its water and climate, which are similar to those of the world's best aquaculture regions: Scotland, Norway, the Pacific northwest, the east coast of Canada and New England. Weston's first quarter report this year shows the value of the diversification strategy. The company reported a Cdn$2 million inventory loss as a result of the extremely cold weather experienced on the east coast of North America that would have been all the worse were it not for its Chilean operations.

Saputo Inc. made its first offshore investment in South America with the US$60 million acquisition last October of Molfino Hermanos S.A. of Rafaela, 500 kilometres north of Buenos Aires. With approximately US$90 million in annual sales the company is Argentina's third largest dairy processor employing 850 people at two plants to produce a wide variety of cheeses as well as fluid milk and butter under the brand names La Paulina, Molfino, Ricrem and Taluhet. Saputo explained that the acquisition was in line with its goal of becoming a world-class cheese company, adding that the raw material (milk) is accessible at competitive international prices. Argentina provides a good base for servicing the neighbouring Mercosur countries and Chile. Currently, Molfino exports 40 per cent of its products, mostly milk powder and cheeses, to 30 countries.

Molson may provide the cautionary tale for would-be investors. Unlike McCain, Heritage and Saputo, Molson gambled a significant portion of its assets on its US$765 million acquisition of Sao Paulo-based Cervejarias Kaiser Brazil S.A., Brazil's second-largest brewer in February 2002 (the net investment later reduced to US$547 million with the sale of a 20 per cent interest to Heineken). Aside from its much smaller acquisition (US$98 million) of Rio de Janeiro-based Bavaria S.A. from Companhia de Bebidas das Américas (AmBev) in December 2000, this was Molson's first significant foray into offshore production.

Strategically it made sense. Molson could leverage its solid position in the mature Canadian beer market to buy a foothold in the fast growing Brazilian market. The acquisition raised Molson's market share from 3.1 per cent (Bavaria) to 17.8 per cent (Bavaria + Kaiser). The Brazilian market is four and a half times as large as Canada's, and beer consumption there was growing more than four times as fast.

Since then Molson's Brazilian volumes dropped 23 per cent, knocking it into third place behind privately-held Cerveja Schincariol. Molson failed to reckon with the sales and distribution challenges and couldn't anticipate the US$11.4 billion merger of local brewer AmBev (with a 65 per cent market share) with Interbrew (parent of Labatt Brewing). While Molson controls sales and distribution in Canada, in Brazil it relies on Coca-Cola distributors who earn better margins on soft drinks than beer. Schincariol took advantage of the ownership transition at Kaiser with a very aggressive marketing campaign and relaunch of its re-christened Nova Schin brand. Molson subsequently doubled its own sales force to visit bars and promote Kaiser and take orders for the drivers.

In hindsight Molson might have been wiser to have spent more time developing Bavaria before taking the plunge with Kaiser or foreseen the unique sales and distribution challenges of Brazil but maybe not. All we know for sure is that a big gamble can maximize both profits and losses.

Whether Canadian manufacturers seek to diversify their sources of supply (Heritage Salmon), produce for local markets (McCain), access low cost raw materials (Saputo) or establish themselves in growth markets (Molson), South America is the place to be.

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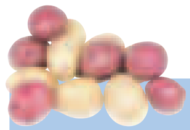

Canada/South America
Agri-Food Trade and Exchange Rates 2003 v. 1997

	1997 Million	2003 Million	Change Per Cent
Agri-Food (1) Exports	$932	$507	- 46%
Agri-Food (2) Imports	$974	$1,309	+ 34%
Food and Beverage (3) Exports	$145	$39	-73%
Food and Beverage (4) Imports	$558	$834	+50%
Exchange Rate: Cdn$: Brazil New Real	$1.2797	$0.4570	-64%
Exchange Rate: Cdn$: Chilean Peso	$0.003304	$0.002032	-38%
Exchange Rate: Cdn$: Agentinian	$1.3847	$0.4747	-64%

(1) Agricultural commodities such as wheat as well as processed food and beverages
(2) Agricultural commodities such as bananas and grapes as well as processed food and beverages
(3) Processed food and beverages including milk powder, pet food and canned vegetables
(4) Processed food and beverages including frozen beef, wine and confectionery.

Source: Strategis – Trade Data Online

South America As Compared To Other Large Emerging Markets

	Population	GDP(1)	GDP(1) Per Capita	Land Area	Arable Land
	Million	US$billion	US$	Sq. Km.	Sq. Km.
South America	364	$2,580	$7,084	17,819,000	971,000
China	1,287	$5,989	$4,700	9,597,000	1,277,000
India	1,050	$2,664	$2,600	3,288,000	1,787,000
Russia	145	$1,409	$9,700	17,075,000	1,274,000
Mexico	105	$924	$8,900	1,973,000	260,000
Reference: Canada	32	$934	$29,300	9,985,000	493,000

(1) Gross Domestic Product, Purchasing Power Parity, US Dollars
Source: The World Fact Book 2003, Central Intelligence Agency

OUTLOOK FOR EXPORTERS AND INVESTORS

South America emerged in 2003 from a period of economic crises to post a positive but modest growth rate of 1.2 per cent led by Brazil and Argentina. According to the April 2004 *Global Economic Forecast of Export Development Canada* (EDC), economic growth in South America will top 4.1 per cent this year due to the U.S. economic recovery and will then slow slightly to 3.6 per cent in 2005. The economic upturn is already showing up in the latest trade data. Canada's food and beverage exports to South America in the first quarter of this year are double the level of the same period last year with the strongest growth coming from Brazil and Argentina.

The substantial devaluations of Brazil, Argentina and to a lesser extent Chile have priced most Canadian commodities out of the market. But Myles Frosst says there are significant opportunities in certain niches. Frosst, executive director of the Ottawa-based Canadian Agri-food Marketing Council (CAMC), notes, "the relatively young and affluent segment of the Sao Paulo and Rio markets offers opportunities for the export of frozen, dehydrated vegetables and other low fat or health-oriented products. The growth in food processing in that country also opens the way for Canadian exports of edible oils, tomato concentrates, food flavours and potatoes. Though a difficult market to penetrate, there is a growing demand as well for processed organics: jams, fruit juices and ready-to-eat frozen products."

Sao Paulo and Rio are frequently mentioned as the best entry points to the Brazilian market. Fabio Costa explains, "These two cities concentrate most of the Brazilian wealth and aggregate something around 30 million people." Costa, a Sao Paulo-based food and beverage advisor for Rabobank International Brazil, agrees with Frosst that this region holds great promise. He also recommends Chile with its "friendly and less bureaucratic business environment plus long-standing experience in the consumer goods industry." Claudio Escobar agrees. "Chile is the country with the lowest risk in Latin America. Chile's investment climate is the most transparent in the continent and most closely resembles that of Canada," says Escobar, the EDC's Sao Paulo-based regional director for Brazil and the southern cone of South America. According to the *2003 Transparency International Corruption Index*, Chile's score is comparable to that of the U.S., France and Germany. Brazil, Colombia and Peru rank lower on a par with Mexico, Poland and China.