Pacari: Premium organic chocolate from tree to bar

Track: Management Education and Teaching Cases

Key Words: Shared-Value, Emerging Markets, Value Added

Pacari: Premium organic chocolate from tree to bar

Abstract

This case portrays the story of Pacari to analyze the chocolate industry's global value chain. Pacari is an Ecuadorian mid-sized company whose chocolate bars have earned countless international awards. Even though the case starts with an apparent decision over the product’s price, it was designed to discuss the concept of shared-value in undergraduate, graduate and executive education programmes. Pacari is a perfect example of a business vision that does not favors financial results, but rather economic and social improvement of social actors in Ecuador.

Pacari: Premium organic chocolate from tree to bar

Santiago Peralta, General Manager at Pacari, arrived at his office located in the traditional neighborhood of La Floresta in Quito early in the morning, as was his custom. The day before he took part in a meeting where the consequences predicted in Ecuador for the 2016 El Niño phenomenon were explained; El Niño is an erratic climatic event that affects the Ecuadorian Pacific and generates, on some occasions, heavy rains due to temperature changes in the sea. For the mentioned year, a particularly strong 'Niño' was expected, with superior intensity than that experienced in the 97-98 period, which brings unpleasant memories to the country due to damage suffered.

With his distinctive optimism, Santiago sat down to ponder in his office. There was no doubt that cacao crops, mostly present in the coast of Ecuador, would be affected, complicating the buying process of quality seed. Obviously, the farmer-level prices would skyrocket, unless the industry pushes in opposite direction or transfers that increase to the consumer, as was customary in the country, especially in the agro-industrial area, for decades.

"The country does not need any more bad news now. We are not going to increase the price of our bars in the local market", he told Carla Barbotó, the company's President, Santiago's wife and partner. *"We are not in this business for the money. We will continue to pay farmers the best price and produce the best Ecuadorian chocolate. We will not change our philosophy no matter how hard El Niño is."*

Cacao in the world[1]

There is evidence that the first cacao trees grew naturally under the shadow of tropical jungles on the basins of the Amazon and Orinoco rivers, some 4000 years ago; while the most ancient traces of cacao as a drink are dated 1100 A.C. 'The golden seed', as commonly referred to in Ecuador, was subject for stories, legends, myths and rites associated to different cultures.

Given that cacao trees grew best in humid conditions, they were produced predominantly in the geographic band between 15 and 20 degrees north or south of the equator, where a tropical climate of 25 degrees with rainfalls between 100 and 200 centimeters annually is experienced. By the end of 2014, the world market was dominated by Cameroon, Indonesia, Ghana, Brazil and Ecuador, along with groups of small farmers from Belize, Venezuela, Costa Rica and the Dominican Republic. All of them added up to more than 5.5 million cacao farmers by the end of the 20th century.

According to the International Cocoa Organization (ICCO), in the 2011-2012 period, nearly 4 million tons of seed were produced worldwide. Africa was responsible for 70%, Asia and Oceania for 16% and America for 14%. The leaders for each contintent were Ivory Coast (35% worldwide), Indonesia (12.5%) and Brazil (4.6%). Ecuador, with an annual production of 170 million, reached a volume close to that of Brazil, representing 4.3% worldwide.

Traditionally, the price of cacao had been subject to daily changes. For example, in April 2014, the ton fluctuated between $2,999 and $3,091. In general, the price depended upon the supply and demand as well as all other basic goods exchanged in stock markets called 'commodities' in London's and New York's Futures Market; but it also depended upon other variables such as grinding performance, expectations over cultivated areas and tons harvested (affected by weather and other local regulations), global price of certain foods and consolidation or fragmentation in the cacao trade and its processing. In Ecuador, official prices set in different stock markets served as general reference, even though in practice the market was affected by countless complementary variables (such as purchase volume and bargaining power of the buyer).

Cacao in Ecuadorian economy[2]

Ecuadorian cacao was one of the most exported products in Ecuador since 1789. Since 1830, wealthy families from areas surrounding Vinces, in Los Ríos province, promoted its cultivation and used the money to open the region's first banks. Cacao supported the growth of Ecuadorian economy and held the country as the world's first producer between 1880 and 1915. In 1920, diseases like Monilia and Witches' Broom that affected the fruit's quality, make sales went down 30%, affecting thousands of farmers. In fact, the farming area had varied plenty throughout Ecuadorian history, since many times there were seemingly more profitable and less risky products, so small parcel owners leaned towards different fruits and vegetables. Towards 2014, cacao was the fourth agricultural export product, after banana, shrimp and flowers.

By the end of 2013, Ecuador exported 79% of harvested cacao to industrialized countries as raw material, that is to say, as fermented dry grain. Only 21% of cacao exports were semi-finished as liquor, butter, powder, chocolate, etc.

Ecuadorian cacao was considered special due to its organoleptic characteristics. Seemingly, many years ago, certain cacao trees grew naturally in the Ecuadorian Amazon; although they were lost or they mixed with cacao trees from countries like Venezuela throughout the years, the original strains were recovered. Arriba cacao, dominant in the country, had a sweet floral taste like fresh perfume from jasmine, roses and lilacs. This type of cacao, coming from creole and trinitarian cacaos, was quite different from the acid and astringent taste, typical of foreign cacao very common in Africa. As such, the International Cocoa Organization designated Ecuadorian arriba as fine or flavour cacao, which represented only 8% of global production. Towards 2014, Ecuador lead this segment with nearly 61% of global total.

This year, partly due to local government incentive as well as public and private venture initiatives, there were several fine Ecuadorian cacao companies that competed in the market. Some were looking to position the Ecuadorian chocolate industry as world leader and focused their production towards international markets. Along with Pacari you could mention República del Cacao y Caoni.

República del Cacao was a business associated to Ecuadorian Confiteca, local leader in the candy and chocolate industry. With owned stores in tourist destinations within Ecuador, including airports, some tourists associated this brand with chocolate "Made in Ecuador." Looking for exponential growth abroad, in 2013 it sold 50% of the company to Soparind Development of France, company that owns La Maison du Chocolat and has stores in Paris, New York, London, Tokyo and Hong Kong. Ownership over the company's remaining 50% was held by Chiriboga family, owners of Confiteca, although by late 2015 there were rumors that suggested the amount held by the Ecuadorians was less. The partnership expected to open opportunities in hotels, restaurants and mass consumer products, for which a plant was built in 2014 on Ecuadorian soil aimed at pastry fine cacao. By the end of 2012, it reported sales over $300,000.

Caoni belonged to an agro-industrial and livestock conglomerate with mainly Ecuadorian investors, BLK Corporation, and represented for the main arm in chocolate production and marketing. Since 2008, Caoni produced bars with original recipes and quality raw material from privileged ecosystems in Manabí, Esmeraldas and Los Ríos provinces. Caoni brand chocolate production was a responsibility of Tulicorp, a company from Guayaquil that owns a plant with a monthly capacity of 50 metric tons of chocolate; where other local businesses' brands were produced as well. Data reported to the Corporate Supervisor showed that BLK Corporation topped $400,000 in sales for 2012. Similarly, Tulicorp, after overcoming an idle period in 2012, closed 2013 with sales that topped $900,000.

Income statements from Tulicorp, República del Cacao and BLK Corporation are shown in Annex 1.

Cacao's industrialization[3]

Cacao travelled through a complex international network of stakeholders from various continents: From cultivation by small farmers, usually located in developing countries, to large industrials and multinationals located in developed countries where consumption of end product was larger.

This international network started in cacao *growth*, one of the most delicate processes in the industry given that quality of plantations was very susceptible to climate, certain diseases and insects. Towards 2012, most of this crops came from small plantations with 5 acre areas, managed by over 5.5 million small farmers and their families, whom on many occasions implemented outdated practices through a limited organizational structure. With due care, they could reach a tree's maximum production level in the fifth year and make it last for ten years.

Although a cacao tree could produce ripe fruit throughout the year, farmers usually planned two *crops* per year to ensure a peak in production. Through cautious pruning, the tree could reach lower heights, easing harvest. The fruit was cut in half, pulp and shell were disposed and the seeds were kept. A farmer could expect an average of 20 to 50 seeds per pod.

Afterwards, the seed entered the *fermentation and drying* process. In Santiago Peralta's words: "*The biggest challenge for a producer is the proper fermentation, it is there where cacao gets its taste. If there isn't a proper environment for the drying phase, great part of the crop may be lost."* During this stage of the industry's value chain, cacao was packed in boxes or piled up in bunches covered by mats or banana leafs. There they lay for a few days where they heated up and chemical reactions occurred through which sugars from the pulp transformed into products such as water, ethyl alcohol and acetic acid, among other substances. Every 24 hours it was stirred, or for better results, it changed box to free produced carbon dioxide. The fermentation process took between 120 to 144 hours, after which the drying process started. Here, the bean was spread out over a surface to sit several days under the sun or under solar dryers, preventing that temperature exceeds 60 degrees Celsius with only 7% humidity, to avoid fungus.

In September 2015, *Cocoa Barometer*, an organization founded by the members of *Barometer Consortium* –a group of non-profit organizations including Oxfam, Solidaridad, HIVOS and Voice Network– estimated that farmer's costs for each ton of end chocolate produced reached $664[4].

Regardless of harvesting country, dry cacao was usually sold through *intermediaries*. First, there were small businessmen, who visited each plantation to purchase beans. Second, wholesalers, who stockpiled various merchants' production (mixing cacao from various origins). Lastly, exporters who put cacao in international markets. In 2015, on average, shipping costs for these intermediaries, between local and foreign transport, reached $7,612 per ton of end product. After leaving country of origin, taxes, tariffs and others added $4,764 per ton.

Dry cacao was purchased to be *industrialized* through additional processes such as roasting, grinding or pressing, adding $3,038 per ton of end product. Once every bean was inspected, they were roasted and grinded, producing various byproducts such as cacao mass[5], if kept at room temperature or cacao liquor if it exceeded 35 degrees. Both could be refined and sold as unsweetened chocolate for baking or to produce chocolate. Cacao liquor was later pressed, ending up in cacao butter and cacao cake. From these byproducts came couverture chocolate, normally used by chocolate-makers and bakers as raw material. This product had up to 30% cacao butter.

In 2012, five companies captured over 50% of the global market for chocolate byproducts. Cargill captured 14.5%, ADM 13.9%, Barry Callebaut 12.2%, Petra Foods 7% and Bloomer 5.3%. These five companies were direct suppliers of cacao liquor for large multinationals that produced chocolate.

The many byproducts of cacao, purchased mainly by developed countries, entered a production stage, involving chefs, bakers and large multinationals. To become chocolate, essentially, cacao liquor was mixed with cacao butter, sugar, milk and, occasionally, with other ingredients such as fruits, nuts or fillings. It was estimated that between production and marketing, chocolate manufacturing companies added $4,434 per ton of end product.

In 2012, chocolate production was also concentrated in five large companies: Kraft captured 14.9% of the market, Mars 14.5%, Nestlé 7.9%, Hershey 4.6% and Ferrero 4.5%. These companies sold their products to stores, supermarkets and others, who in the retail sale process added $10,858 per ton (see Annex 2 where retail values and values captured in each stage of the chain are shown).

In the 2009-2011 period, the market witnessed healthy competition between four large initiatives to promote certified cacao production: Fairtrade Labelling Organization, Rainforest Alliance, Organic and UTZ. All of them tried to satisfy the growing social demands for fairer, more sustainable and environmentally responsible value chains. However, while chocolate producers claimed that certified cacao offer did not cover demand, certifying organizations had data that backed the opposite[6].

Finally, even though these initiatives tried to protect small farmers, evidence concerning extra captured value at this stage of the chain, as well as nutritional quality of products that used certified or organic cacao, was inconclusive[7].

Along this line, consumer trend aimed clearly towards more socially responsible and more value-added products. Proof of this was the inclination towards chocolates of certified origin, associated with the cacao's land traits and with its cultivation and harvest process; demands similar to those experienced by the coffee industry. Certain companies like Nestlé thought of Ecuador as the basis for development of gourmet products, traditionally absent in its portfolio[8]. Despite the effort, the Swiss multinational did not obtain chocolates with the same quality as some local companies.

Chocolate consumption[9]

Chocolate produced by several companies around the world used to be classified in bagged selflines/softlines, boxed assortments, countlines, tablets, countlines and chocolates with toys. The market had high seasonal components, with consumption peaks in dates like Valentine's Day, Easter and Christmas. Europeans and US citizens purchased more chocolate per person than the rest of the world (see Annex 3).

Final prices used to fluctuate at the pace of cacao prices, but normally these increases were borne by the end consumer. In the greatest consumer markets, since approximately 2010 there was a trend towards products manufactured with certified cacao, towards bars with certified origin and towards gourmet products. However, Santiago Peralta calculated that even in those years, 60% of chocolate consumption was still of products mixed with milk, the remainder was dark and pure chocolate.

In developing countries, such as those where cacao was cultivated and harvested, consumption reality was different, since price was preferred over quality. For example, while the European palate distinguished and valued dark chocolate, in Latin American countries milk chocolate bars or bars with milk, nuts, fillings and fruits were more successful.

In Ecuador, with a population of 16 million inhabitants, the chocolate market in 2014 sold 4,340 tons, valued in 93 million dollars. In contrast, that same year Switzerland reached 73,276 tons, valued in over 1.9 billion dollars; while in the United States 1.4 million tons were consumed, valued in over 17.6 billion dollars.

Pacari business model[10]

The company's first sale was in April 2002, when Santiago delivered 50 grams of cacao to a German company. To complete the transaction, Santiago went to a store that offered international phone calls located across the street from his small office. Since then, along with Carla, they built a company that originated in their dream of heightening the finest excellence product owned by the country: cacao. At the same time, they wanted to build a company that represented their personal values of wealth creation and non-exploitation of the land that gave them birth.

In Kichwa, “Pacari” means nature or sunrise. According to Santiago, “(…) *the company is committed to produce quality chocolate with only the finest quality ingredients from Ecuador*” including arriba type cacao. For that, he took good care of each step in the value chain.

Relationship with farmers

Since its beginnings, Pacari bought raw material only from farms with organic certification, be it under *USDA Organic* regulation or under organic regulation 2091/91 in Europe. These purchases were made to small farms located in Los Ríos, Manabí, Guayas and Esmeraldas provinces. In June of 2014, these farms employed approximately 3,500 families. Some of them also had biodynamic certification. According to Santiago, certified farms produces 20% more than traditional farms.

By working directly with small farms, Pacari could keep tighter bean quality control. For example, it could ensure maturity level or cacao’s natural pollination to protect genetics and bean taste, and also to separate it from cacao with different origin. Also, Pacari sought that farmers use the concept of natural limitation, which implies balancing environmental responsibility with profit through sustainable exploitation of the land.

In many cases, Pacari ensured helping producers control humidity during the fermentation process and even offered microcredits to allow farmers perform this task properly. These microloans were commonly used in drying houses.

The company also offered support to farmers. For example, it provided technical education services, such as grafting in cacao plants. This method avoided, in a natural way, the appearance of “lazy trees”, large fruit plants with a relatively low production index.

Also, Pacari supported agricultural schools in both Ecuadorian regions where it purchased its cacao, delivering a curriculum with organic methodology and computer labs. Technology donations were possible thanks to the support of clients and company's associates. With time, these processes helped farmers achieve better product quality and receive better price for it. Once, a farmer called Santiago to tell him that another Ecuadorian company had reached him to purchase his cacao. *“Sell them, but ask them to pay you (...) that is a fair price for your product. If they pay it means they want to do things right and they value quality”*, answered Santiago. Months later he found out that the competitor paid the priced asked by the farmer.

Pacari sought to create economy for local communities and all involved in the value chain process. That is why it based its business relationships on trust and commitment, paying farmers a premium to ensure they maintain sustainable and organic practices. The company preferred to work with small farms with 2-5 acres. No contracts were signed with farmers to ensure contractual relationship and fulfillment of price and production quantities. *“Among Ecuadorians the ‘*gallero *word’ is worth more than a contract. A good hand shake, look into the other’s eyes, keep their word is what matters”*, assures Santiago. Usually Pacari paid these farmers in cash. For them, selling cacao to this company created a sense of pride: their raw material was used to produce the best chocolate in the world, from Ecuador.

Although, in the beginning Santiago and Carla were involved in the seed purchase process, with time, other people from the organization were trained for it. Purchases were made directly from the farmer, with own transport and the result was transported and stored in the company's warehouses. Despite the appearance of companies seeking quality cacao, Santiago considered that bean offer still exceeded largely its demand.

Industrialization and production

In mid 2015, Pacari was the only Ecuadorian company that roasted and grinded cacao with owned equipment, creating cacao paste and other byproducts. To that date, its portfolio was comprised of bars (70%), chocolate powder (15%) and pastry and chocolate-maker products (15%). In 2015, important Italian and Croatian actor in the third category, were awarded for using coverings produced by Pacari on their ice creams, chocolates and pastry.

In the bars market, Pacari chose to concentrate on the premium segment with emphasis on designation of origin, aromatized with typical flavours of Ecuador such as chili, golden berry or roses. Such is the case of lemongrass, known as a favorite of North American presenter Oprah Winfrey, says Santiago.

In this end, Pacari formed, among other initiatives, a credit union in Cotacachi with 100 kichwa women from an economically isolated community to whom they taught how to cultivate golden berries and dehydrate them. This fruit was used in bars and coverings in one of their most accepted and sold products.

Unlike other ecuadorian companies that chose to create recipes for chocolates, bars and truffles to be produced in third-party production plants, Pacari manufactured its products in its own plant. *"To compete in gourmet chocolate world leagues you must have control over the entire process. That's the difference between being a marketer, a business or an industrial. What does this country needs most?"* said Santiago.

Commercialization

Even though Pacari's intention was to export its products to the demanding international market, since 2012 one could find their bars and powder in Ecuador's main retailer, Supermaxi. Both sales topped 2.5 million dollars by the end of that year. Back then, the dark chocolate segment was practically non-existent; towards mid-2015, Pacari represented 57% of the sections sales, followed far behind by República del Cacao y Caoni. In September of 2015, the average sale price paid by customers in this retailer was $2.01 for a 50 gram Pacari bar, $2.27 for a similar Caoni bar and $6.73 for a 75 gram bar from República del Cacao.

In September 2015, Pacari exported to 32 countries, being Europe its main market. Countries with greater acceptance were Italy, Netherlands and Switzerland. Carla calculated that international sales accounted for 80% of the company's annual turnover, leaving the remainder for local consumption. Both markets left the same gross profit margin (around 26% by late 2012), although cash cycle in the local market was smaller. Similarly, the price drawn by Pacari for each chocolate bar was the same if sold in Ecuadorian soil or if sold abroad.

In the 2012-2015 period, Pacari chocolate bars accumulated over 116 Gold, Silver and Bronze awards from the prestigious International Chocolate Awards, a private institution created by expert chocolate-makers and *conoisseurs*, who formed a panel where they blind tasted products from different places. Besides, in 2014, the company won for fourth time in a row the award from the Ecuador Exporters Federation in the Mid-size Export Business category and was recognized for being an active player in shifting the country's productive matrix.

Considerations

While enjoying a lemongrass chocolate bar, golden-award in the 2014 Internacional Chocolate Awards, Santiago and Carla thought about what they had achieved and the challenge 'El Niño' would bring to Pacari. *"People that start companies to make money lost their way a long time ago. They are like the Portuguese that travelled to Paris and, fixated on arriving quickly, didn't realize he had passed through Coimbra, Salamanca and Orleans, all beautiful cities. For us, the important thing is to enjoy the path, not making money. And every day that goes by we enjoy working in Pacari."* □

Annex 1 Income statement of some industry's actors.

	Tulicorp			República del Cacao	BLK Corporation		
	2010	2011	2013	2013	2010	2011	2012
Operating Revenues	$493.496,86	$513.919,27	$993.594,58	$ 372.295,00	$ 287.334,15	$ 226.258,88	$432.050,85
- Cost of Goods Sold	$447.010,82	$457.036,49	$726.727,27	$ 49.943,99	$ 164.516,00	$ 153.959,79	$291.300,84
Gross Profit	$ 46.486,04	$ 56.882,78	$266.867,31	$ 322.351,01	$ 122.818,15	$ 72.299,09	$140.750,01
- Sales and Administrative Expenses	$ 69.182,63	$ 85.407,76	$215.628,85	$ 1.944.938,61	$ 329.604,58	$ 189.550,45	$169.400,95
Operational Profit	$ -22.696,59	$ -28.524,98	$ 51.238,46	$-1.622.587,60	$-206.786,43	$-117.251,36	$ -28.650,94
+ Other Revenues	$ -	$ -	$ -	$ -	$ 41,63	$ -	$ -
- Other Expenses	$ 40.105,06	$ 51.167,48	$ -	$ -	$ 28.952,85	$ 49.968,63	$ 15.053,68
- Financial Expenses	$ 4.160,25	$ 7.225,24	$ -	$ -	$ 34.805,75	$ 37.078,66	$ 21.212,40
EBITDA	$ -66.961,90	$ -86.917,70	$ 51.238,46	$-1.622.587,60	$-270.503,40	$-204.298,65	$ -64.917,02
- 15% employees	$ -	$ -	$ 7.685,77	$ -	$ -	$ -	$ -
- Local Taxes	$ -	$ -	$ 12.481,75	$ -	$ -	$ -	$ 2.207,74
Net Profit	$ -66.961,90	$ -86.917,70	$ 31.070,94	$-1.622.587,60	$-270.503,40	$-204.298,65	$ -67.124,76

Source: Superintendencia de Compañías, 2015.

Elaboration: The authors.

Notes:

- In 2012, Tulicorp presented Corporate Supervisor an activities suspension act, which were resumed in 2013.

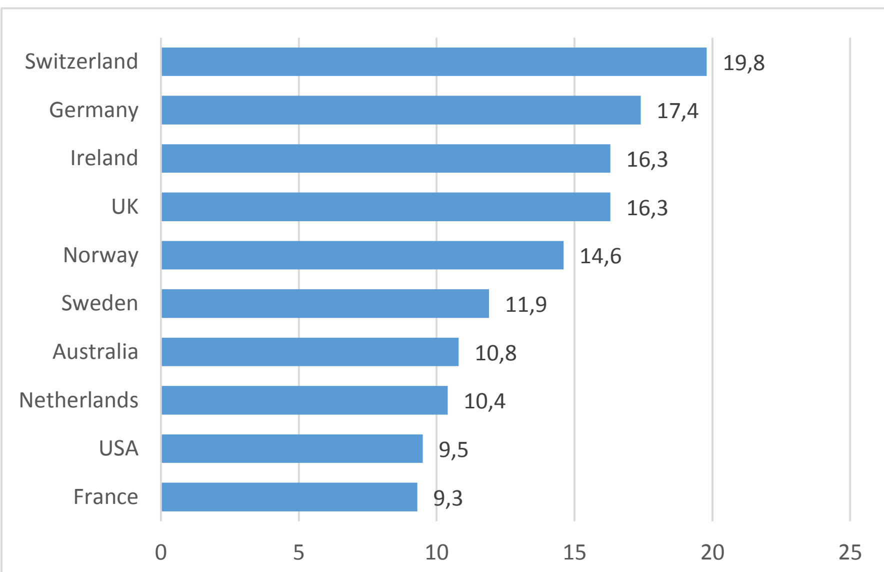
Annex 2 Sales value and captured value by cacao chain actors (per ton of sold chocolate)

	Sale Value	Captured Value
Farmers	$1,874	$1,210
Tariffs and others	$5,738	-
Transporters and Intermediaries	$7,802	$15
Industrials	$4,434	$211
Manufacturers	$10,858	$870
Retail	$18,917	$473

Source: Fountain, A.C. and Hütz-Adams, F. (2015)

Elaboration: The authors.

Annex 3 Biggest chocolate consumers (pounds per person per year)



Source: Euromonitor International (2015)

Elaboration: The authors.

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Pacari: Premium organic chocolate from tree to bar

Teaching Note

Summary

This case shows the story of Pacari –an Ecuadorian mid-sized company whose chocolate bars have earned countless international awards as the world's best chocolate bars– to present the chocolate industry's global value chain. It starts with the founders' concern over potential impact from 'El Niño' phenomenon, an erratic climate event that affects the Ecuadorian Pacific and generates, on occasions, heavy rains due to temperature changes in sea temperature. Since mid-2015, a 'Niño' more devastating than the one from 1997-1998 was expected in Ecuador.

Even though the case starts with an apparent decision over the product's end price, it was designed to discuss the concepts of shared value in undergraduate, graduate and executive education programmes. Pacari is a perfect example of a business vision that does not favors financial results, but rather economic and social improvement of social actors within the chain on Ecuadorian soil and positioning the country as world leader in the quality dark chocolate segment. For many students coming from traditional programmes, this business vision may seem odd, creating interesting debates in classrooms over the purpose of private companies.

Teaching Use

The case was designed to be employed in undergraduate, graduate amd executive education programmes for the following subject areas:

1. In Strategic Management, General Management and Strategy courses. Pacari's history can serve as a channel to present and discuss shared value concepts and the purpose of the firm (economic vs. social). Depending on the audience, certain messages may be emphasized over others. The case allows to illustrate concepts such as an industry's value system, vertical integration, added value in the agro-industrial sector, added and captured value, shared value, among other common subjects in the strategy area.

2. In International Business, Foreign Trade and Corporate Responsibility courses. The case allows to discuss over reasons for succes in international growth for mid-sized companies from emerging countries, over the difference between competitive and comparative advantage, over differences in consumer profiles on an international scale and over specific social responsibility initiatives. Similarly, depending on the audience's profile, certain type of insight may be emphasized over another.

This teaching note considers a 90 minute class session, for use in master's level strategy courses, to reflect over shared value concepts in companies competing in emerging markets.

Learning objectives

The case's main goal is to understand what is shared value and what could be its limits for companies from emerging markets that compete in a global environment.

Specifically, by discussing the case it is intended that students be able to:

- Explain what 'shared value' means and how companies can create it;
- Argue what could be the limits on this type of strategic thought for mid-sized companies from emerging markets competing in a global environment.

Questions for preparation of students

1. What would you recommend Santiago Peralta over the end price of his bars? Should he raise it? In which markets? How much? Why?
2. What consequences over Pacari's business model would your suggestions have?

Times

1. Introduction.	10 minutes
2. Price decision.	15 minutes
3. Industry's value chain.	20 minutes
4. Pacari's business model.	20 minutes
5. Back to the decision.	15 minutes
6. Closing.	10 minutes

Suggested readings

Parallel to the case, it is recommended to ask students to read Michael Porter's 'Creating Shared Value', 2011.

Teacher's preparation

It is suggested that teachers visit the company's website beforehand, www.pacarichocolate.com as well as various international news found on the Internet. Also, they must be familiar with Porter's mechanisms to create shared value, which are included in the abovementioned note.

Teaching Plan

Introduction

It is recommended to open the session with a comment on world chocolate and the indulgence that represents its consumption. After, it can be briefly explained the importance of Ecuadorian cacao's quality, using as example data provided in the case regarding world supply percentage of quality cacao and the amount covered by Ecuador: the country is undoubtedly world leader in a demanding segment.

Lastly, the instructor can explain briefly 'El Niño'phenomenon and use one of the company's videos. The brief story aired by Ecuadorian TV channel Ecuavisa, made by América Economía is recommended: https://www.youtube.com/watch?v=YiELSdBFfWI since it allows to view the entire chocolate manufacturing process, meet Santiago and learn his philosophy and motivations to build an organic products company and get som advice from him about entrepreneurship and innovation.

Video from Ecuadorian TV show 'La TV' also obtains the same results, even though this last one ends up showing other companies' roles in the industry. https://www.youtube.com/watch?v=wF4ZPPJWQ3w Some of these videos can be required as preparation for students, but viewing both delivers important information for certain discussions in the session. Opening the session with at least one of them has excellent results grabbing the auditorium's attention and enthusiam.

Price decision

Question: Should Pacari raise prices for its bars? In which markets? How much? Why?

Opening discussion with a decision focused on a managerial decision raises interest in the auditorium and generates quick responses. Perhaps some could say information is lacking, in which case one must encourage them to make a decision with existing information. It is suggested to discuss price decision for local market first and then for international market. It is noted, for now, that the basic premise of keeping same prices entails assuming the extra cost from potential increase in seed price.

Voting over price for local market usually has a majority inclined towards keeping the same price. Those inclined towards this decision argue that the Ecuadorian market is not used to paying that price premium, that 'El Niño' phenomenon is temporary and does not justify raising prices, that the costs of raw material is not representative in production costs, that the international market should subsidize the local market and prices should be raised there and that price increase could possibly affect demand negatively. Those who suggest raising prices argue that Pacari has superior quality product and, its prices does not reflect that. Another arguement along this line is if local market generates cash flow, due to business cycles, a slight increase in price could help finance international growth, helping to fulfill faster the desire to position Ecuadorian chocolate as the best in the world. Someone may vote for transferring increases in raw material's costs to end consumers (business-as-usual).

The next suggested step is to ask how much should the price be raised. Data provided in the document allows to conclude that Pacari charges $0.04 per gram of chocolate, while Caoni charges $0.05 and República del Cacao, $0.09. If Pacari represents 57% of Supermaxi's shelves, it is probably not by chance or due to a tight relationship with the channel: most likely it is due to the public's acceptance of the product and due to larger turnover. Also, due to the number of international awards recieved by Pacari's bars, it may be assumed that its product should have the same, if not better, quality as República del Cacao. Even sales level suggests that: Pacari sells over 6 and 5 times what República del Cacao and Caoni sell, accordingly. Therefore, Pacari could charge $4.50 for its 50 gram bar ($0.09 x 50), a 123% increase in retail price.

Some people may argue that an increase of the sort could endanger demand, given that Pacari's sales are not comparable to the marketing level that has boosted República del Cacao's sales (see Annex 1). Intermediate stances usually appear, of the sort "let it rise until it reaches equal or slightly higher levels as Caoni", "implement a price discriminatio system: slightly higher for most awarded products and equal for those without awards."

Once discussion is closed over local market, it is convenient to start discussion over international prices. Value perceived by Pacari, if it remains on Ecuadorian soil or if it is sent abroad, remains the same. The case shows evidence to conclude that international markets, especially European, consumes more and better quality chocolate. While Ecuador consumes 0.6 pounds per person (4,436 / 16 million = 0.000277 tons per year per person = 0.6 pounds per person per year), levels in Europe are, at least, fifteen times higher. Similarly, in Ecuador $20,964 are paid on average for a ton of chocolate (93 million / 4,436), in Switzerland $26,097 are paid (1.9 billion / 73,267) and in the United States $12,571 (17.6 billion / 1.4 million).

According to preceding arguements, apparently there is room to slightly increase prices in the international market. In the various occasions this case has been used in class, most of the auditorium favors an increase in prices. Few people favor keeping prices for both markets and suggest strategies to emphasize local brand to increase sales levels and alleviate extra costs proceeding from an increse in raw materials. Without more precise information, it is inconclusive whether raising prices will have an impact on demand, or not. But it allows to understand the international market's nature and possible limitations to Pacari's business model: The United States, geographically closer and more familiar to Ecuador, does not seem to be the best markef for gourmet quality chocolate.

Discussion for this first part can be reflected as suggested in the Blackboard Plan at the end of this note.

The previous analysis reflects a pricing process according to consumer's perceived value and price ceillings set by the competition (Zeithaml, 1988). It is convenient to move on to a broader discussion and think about how competitors will react to this price increase in raw material. This discussion allows to link the starting general decision with the industry's value chain and shared value concepts.

Industry's value chain

Question: We've reflected on Pacari's answer to potential changes in the cost of cacao seed. What reactions do you expect from competitors?

Caoni es the flagship brand for an Ecuadorian agro-industrial conglomerate. República del Cacao belongs to french investors whose strategy is inclining towards byproduct sale to pastry chefs and the like. It is expected that República del Cacao will transfer this cost to the end consumer. But Caoni, and perhaps other local seed buyers, will try to transfer that pressure to the farmer. That has been done for years in the agro-industrial area in emerging markets (Cook et. al, 2001). Most of the auditorium usually agrees with this vision.

Question: Is it convenient for Pacari to sail upstream? Why?

After watching the videos and understanding the philosophy and purpose of Pacari's founders a little bit better, it is clear that the company will pay a price it considers fair depending on seed quality, even in times of less abundance: it will not bargain. This philosophy aims to construct a sustainable value chain from the start, paying farmers what is fair. Here the cases' evidence regarding pressure imposed by Pacari in the market to head into this direction, may be discussed.

There may be those who think it is unsustainable to pay more for raw material and keeping prices and that it is not worth it for Pacari to sail upstream. The teacher's role is not to convince the auditorium that one stance is better than another, but to reflect them on the board.

To try and combine both stances the following transition question may be asked:

Question: How important is the farmer to the industry's value chain? What do you say we build and understand the world's chocolate manufacturing chain?

In this stage of discussion, the teacher's role is to make sure all relevant information from section "Cacao's industrialization" and from Annex 2 comes out. A summary table may be elaborated like the one in the Blackboard Plan at the end of this note. It is recommended to lean on the concept of created value, that simply referrs to the difference between a good's or service's sale price and costs incurred (Brandenburger, 1996).

Question: Supported by the table's results, do you think the industry is sustainable?

Table is not easy to interpret. On one hand, it is evident that farmers add merely 2.1% to chocolate manufacturing costs, but represent 6.6% of created valued. Industrials, on their end, represent nearly 10% of the end product's manufacturing cost with only 7.65% created value. However, farmers capture 100% of created valued, which doesn't happen with other actors in the chain. But farmes are fragile, lack of enough technical skills and face inefficient price markets, which does not guarantee their permanence in the chain (therefore if Ecuadorian farmers perceive there is less risk or that another crop is more profitable, they shift their lands to other products).

Those with greater sensitivity towards social role of companies will interpret these numbers in favor of farmers: industry pushes by paying low seed prices, explaining the low costs; giving so little money to farmers, long-term, is unfair and will end up discouraging cultivation of a high-risk, low-profit product.

However, those inclined to support the role of private companies to create benefits, employment and to satisfy consumer needs, will see this as sustainable: *"multinationals with the size of Cargill or Nestlé can backwards integrate, have access to their own raw material and provide stable employment to farmers"; "nobody forces the farmer to invest", "farmer incurrs in lesser risk than manufacturers or industrials", etc.*

The economic vision of strategy suggests that the desirable thing is that an actor that creates value, captures it. Or viceversa: to capture more value, it is necessary to create it, contributing to the system with an extra. From this perspective, the actor that creates less value, behind transporters and tarifss, is the farmer, and captures 100% of it. Other agents, instead, add more value and capture a smaller percent. In this 'game', if the farmer wishes to capture more value, he must create it. It is this economic vision of the business world that has been questioned recently (Michelini & Fiorentino, 2012).

The teacher's role is to create a debate and allow all possile interventions, without assuming any stances. When interventions have ceded a bit, the teacher may move on to reconcile both points of view. The discussion may be summarized as suggested in the board plan at the end of this note.

Question: Is there a way to reconcile both points of view?

In more difficult auditoriums there will always be people that insist on saying the only obligation for companies is to gain profits, alongside Milton Friedman's (1970) line of thought. However, if they have read the assigned reading, interventions will emerge trying to reconcile the business world with social welfare.

One path is Corporate Social Responsibility. From Porter's point of view, these initiatives focus esentially on a company's reputation and have little connection to a company's core business. These programs are made based on outside pressure and are usually separated from profit maximization. Example cited by Porter are fair trade purchases. In contrast, shared value creation seeks to greate economic benefit at the same time it seeks social welfare: transforming the raw material acquisition process to improve performance and quality. While the first model is not connected to the business core, the second one is.

Question: Under this perspective, what is Pacari doing?

Porter suggests that companies have three paths to create shared value: a) redefining productivity; b) redefining products and services; c) strengthening cluster development.

There is evidence that Pacari is moving in the third direction to create shared value: through chocolate cluster strengthening in Ecuador.

<u>Pacari's business model</u>

Question: What specific actions has Pacari performed to strengthen local cluster development?

Pacari is seeking to resolve some limitations around Ecuador's chocolate manufacturing cluster. First of all, historically, exporting raw material has been welcomed. Pacari is the first company that bets decisively on finished product export, including bars as well as byproducts for pastry, chefs and the like. This means it is seeking to change the cluster's mindset towards value added markets. This discussion is critical in historically agro-industrial countries.

Second of all, with its effort to demand prices paid to farmers according to bean quality, it is taking the first steps towards building a more efficient market. The case mentions that international commodity prices serve as a reference for paid price in Ecuadorian soil, but other variables also usually intervene. From the experience told by this document, it is concluded that the industry used to establish trading processes on a case-by-case basis to determine to-pay-value and that Santiago and Carla are the ones navigating in the opposite direction. This effort may prevent in medium term, exploitation processes on farmers; whom, in turn, will have an incentive to become more productive, creating more trustworthy suppliers for the entire national value chain.

Third of all, Pacari is contributing to the cluster's construction, creating a virtuous success cycle: while its chocolates are awarded internationally, farmers feel proud that their raw material was part of that award and both build a country brand around the end product, not only around the raw material. It is expected that, with time, this virtuous cycle creates more employment, farmers with greater skills, and spreading and transference of better practices (drying, fermentation, harvest, etc.).

These three ways of supporting the chocolate cluster in Ecuador, go beyond social responsibility initiatives mentioned in the case (grouping of female farmers for golden berry sowing). Along the line of Porter's (1991) model, these practices are integral part of Pacari's way of making business.

Once demonstrated that the initiative creates social benefits, it is important to think about its power to create economic benefits.

Question: Is it generating economic benefits? How is it compared to other models?

Results from República del Cacao are difficult to interpret. Maybe they are associated with the stores launch in main tourist areas of the country. Also, a gross margin of 87% does not make sense. Therefore, comparison must be made with Tulicorp and Caoni, even though they are not entirely comparable. Pacari reaches a 26% gross margin against a 33% for Caoni and 27% for Tulicorp. Being 1% more expensive than a company that does no buy or process raw material sounds pretty good. Being 7 points more expensive than Caoni should be analyzed thoroughly. On one hand, one would expect that Pacari's raw material be more expensive, mainly for being organic. On the other hand, it is not the same to perform the entire value chain process than simply delivering the recipe and processed raw material to Tulicorp for marketing processes. Thus, apparently, the company generates more economic benefits than other business models.

The difference in final profits will come from data of administrative and marketing expenses. Caoni presents 39%, which is natural if it must make large marketing efforts, while Tulicorp presents 22%. Assumptions can be made about this amount for Pacari. Nothing can be said regarding administrative expenses, but I would bet marketing expenses are lesser or, in worst case, equal to Tulicorp's (this company almost does not incurr in marketing expenses, given that it only manufactures chocolate on order, by recipe).

Even so, it may seem that a full vertical integration business model in Ecuador for chocolate manufacture is not necessarilly more profitable than specializing in any part of the chain (Tulicorp in manufacture, Caoni in recipe manufacture and marketing).

This is the time to discuss about the types of businesses that will change the country's agro-industrial reality in a developing country. Those who follow a legitimate model of benefits growth, focusing on the chain's link with more profitability (arriving to Paris); or those that seek to build industry, improve the national reality and are willing to leave their assets, time and money in the process (enjoy the ride).

Back to the decision

Let's go back to the initial decision.

Under this business model, any 'key' that is stricken can complicate the creation of simultaneous economic and environmental benefits.

Obviously, changing prices is not the most relevant matter.

Question: What other things can Pacari do to avoid that El Niño phenomenon affects it negatively? What must it do to strengthen its business model?

Among suggested initiatives there are:

- Support susceptible farmers that might be affected by the phenomenon. They are probably doing it: in a trusted relationship, these threats are discussed openly;

- They could try to improve their raw material inventory. Most likely what they could have done is already implemented: cacao harvest happens in fixed dates; Santiago surely knows it;

- Increase number of suppliers. It is also probable he does it all the time. On the other hand, if the cacao bought is organic, it doesn't seem there is much more space;

- Remain faithful to their philosophy and continue to do what they are doing. As stated by Santiago himself in one of the videos, “have blind faith in the country”;
- Emphasize byproducts sale, which apparently are also well-regarded and it seems to be a market where there is room for growth.

Closing

The teacher may close the session, referring to shared value concepts, presenting them as a valuable alternative for companies from emerging markets that aspire to change the national’s agro-industrial reality through value added and shared value processes. Pacari’s experience shows that profitability can be generated parallel to a positive impact on society.

Blackboard Plan

<u>Should we increase local market prices?</u>

YES:
-It has superior quality product.
-Local market generates cash flow: it can finance international growth.
-"Business-as-usual".

NO:
-It may endanger local demand that generates cash flow for international operations.
-What does it do when the 'El Niño' phenomenon is over? It is a temporary subject that cannot force it to make a strategic decision of the sort.
-Raw material price is not significant.
-Local market does not pay mucho for a quality product.

<u>If raised, how much could I do it?</u>

Pacari: $0,04 per gram.
Caoni: $0,05 per gram.
República del Cacao: $0,09 per gram.

If I want to equal República del Cacao, I must increase 123% and charge $4.50 for my bars. If I want to continue being perceives as gourmet and keep my demand, perhaps I can raise it a bit (at least as much as Caoni).
I can separate prices according to award level.

<u>Should we raise international market prices?</u>

YES:
-International markets value quality chocolate, especially Europe.
-International market may subsidize local market.

NO:
-There is insufficient evidence to justifiy that demand will not be affected.

<u>How will competitors react?</u>

República del Cacao: Will probably transfer the cost to consumers.
Caoni: Probably will press farmers.
Other locals: Probably press farmers
(it has been common in this market)

<u>Is it worth sailing upstream?</u>

If you want to be consistent with your business model, yes.
It's not worth it.

<u>Industry's value chain</u>

Actor	Characteristics
Farmers	5,5 millones Emerging Markets Particularly fragile
Transporters and Intermediaries	Small traders Wholesalers Exporters
Industrials	Dominated by 5 companies Developed countries
Manufacturers	Dominated by 5 companies Developed countries
Retailers	Towards concentration

	Costs	Sale	Value Created	Value Captured
Farmers	$ 664	$ 1.874	$ 1.210	$ 1.210
Taxes	$ 4.764	$ 5.738	$ 974	$ -
Intermediaries	$ 7.612	$ 7.802	$ 190	$ 15
Industrials	$ 3.038	$ 4.434	$ 1.396	$ 211
Manufacturers	$ 4.434	$ 10.858	$ 6.424	$ 870
Retailers	$ 10.858	$ 18.917	$ 8.059	$ 473
Total	$ 31.370	$ 49.623	$ 18.253	$ 2.779

Reconciling both points of view

Corporate Social Responsibility:
-Initiatives associated with the company's reputation.
-Program's logic is propelled by outer pressure (reports, auditing, etc.).
-Not associated with benefit maximization.
-Not always associated with core business.

Shared Value Creation:
-Seeks to create economic benefit as well as greater social welfare.
-Intrinsic to the company's business model.

a) redefining productivity;
b) redefining products and services;
c) strengthening local cluster development.

What is Pacari doing?

Solving some cluster's limitations:

-mindset of selling raw material to value added (end product).
-creation of more efficient raw material markets (according to bean quality).
-success virtuous cycle: we are all building a more renowned country brand.

Summarizing: social benefits, better society.

Does it create economic benefits?

	Caoni	Tulicorp	Pacari
Utilidad Bruta	33%	27%	26%
Gastos Administrativos y Ventas	39%	22%	¿12% - 22%?
Utilidad Operacional	-6%	5%	¿14% - 4%?

Other actions to strengthen position/avoid El Niño's impact?

- Support susceptible farmers that may be affected by the phenomenon.
- Improve their raw material inventory.
- Increase number of suppliers.
- Remain faithful to their philosophy: keep working hard as they have done so far.
- Boost byproducts.

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[1] Most of statistical data in this section comes from The World Cocoa Foundation (2014). The fruit's history was extracted from the National Association of Cacao Exporters – Ecuador (2015).
[2] Information in this section comes, mainly, from the National Association of Cacao Exporters – Ecuador (2015) and El Agro magazine (2015).
[3] The industry's structure presented in this section, as well as most of statistics –unless otherwise said– was extracted from Weiligman, B., et. al. (2010).
[4] Source for all values attributed to each stage of cacao's value chain, cited in this section, is Fountain, A.C. and Hütz-Adams, F. (2015).
[5] Altough the end byproduct, in reality, is powder, its industrial name is cacao mass.
[6] Hütz-Adams, F. & Fountain, A.C. (2012).
[7] Sidwell M. (2008).
[8] Hosafci P. (2014).
[9] Several analysis for each country from Euromonitor International (2015) were consulted to write this section.
[10] Case authors' interpretation based on information provided by Carla Barbotó and Santiago Peralta through an interview granted in October, 2015.