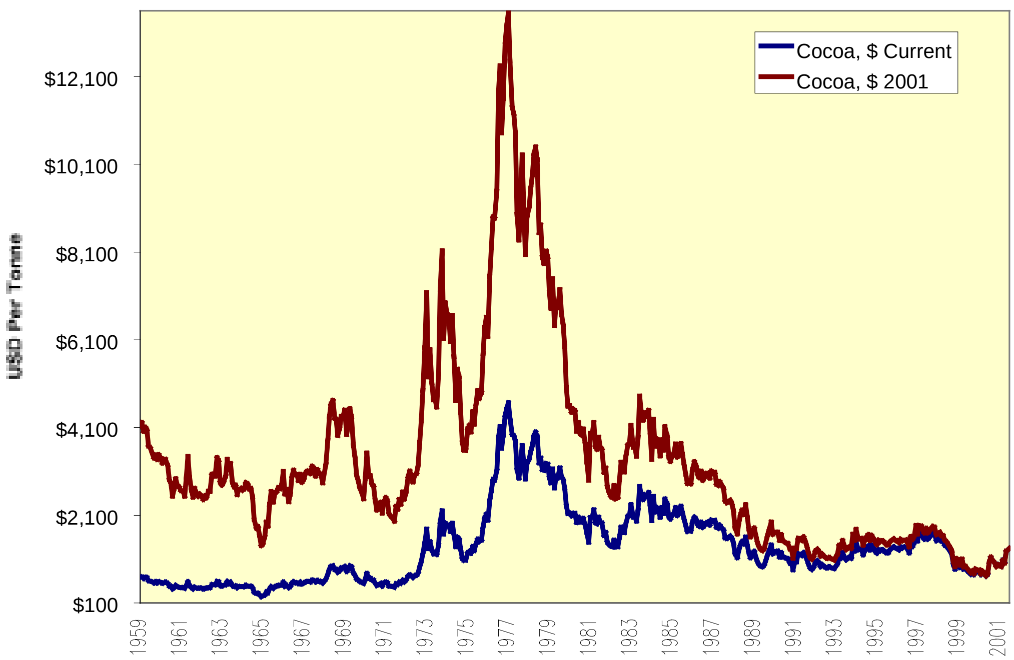
# Cocoa And Valentines: The Other Fannie Maes

Two weeks from now, millions of lovers, supplicants and wishful thinkers will exchange a box of chocolate candies as evidence of their undying devotion. Will any of these gift-givers be thinking about recent trends in global cocoa production and their implication for debt service in Ghana and the Ivory Coast? Probably not, and it's a fair bet that rising price trends for cocoa and other tropical soft commodities won't be a topic at too many candlelight dinners, either. What a shame: Romance without finance ain't got a chance, and cocoa trading is not a bad place to start. To paraphrase Rudyard Kipling's paean to cigars, love is love, but good chocolate is a torte.

**Terms Of Trade**

As stated so often in this space, primary commodity producers face deteriorating terms of trade over time. Cocoa exporters cannot add value to their production the way exporters of industrial and information-related goods and various services can. The long-term price trends for all physical commodities is lower, and significantly so. The pattern, regardless of whether we are talking about a food crop such as soybeans, a tropical soft commodity such as cocoa, depicted below, an extracted mineral such as copper, or an agriculturally-produced industrial commodity such as cotton or rubber, is the same. In all cases, a long-term secular decline in price will be punctuated by some explosive and short-lived moves higher. These price spikes will encourage new production, substitution, and conservation in demand. In short order, supply overwhelms demand, and the price reverts back to its long-term downtrend. The recent experience of natural gas, which quadrupled in price during 2000 and fell by 80% in 2001, stands as evidence. Commodity price implosions such as this can contribute to corporate implosions for those with the hubris to trade complex derivatives based thereon, as the recent Enron experience indicates.

**Cocoa: Getting Cheaper All The Time**




Not only are the terms of trade poor for the producing countries, the economics of production work against the small farmer. Cocoa pods are susceptible to all sorts of fungus and insect infestations: Commodities are not pretty. It is a simple and cruel fact of life that the small producer who has been squeezed by low prices cannot afford the agricultural chemicals needed to maintain his crop. A reduction in supply is inevitable, and data from the International Cocoa Organization, while several months after the fact, do show a growing deficit in world production. In 1999/2000, the world had a surplus of 75,000 tonnes of cocoa, and this has now swung to a deficit of 230,000 tonnes.

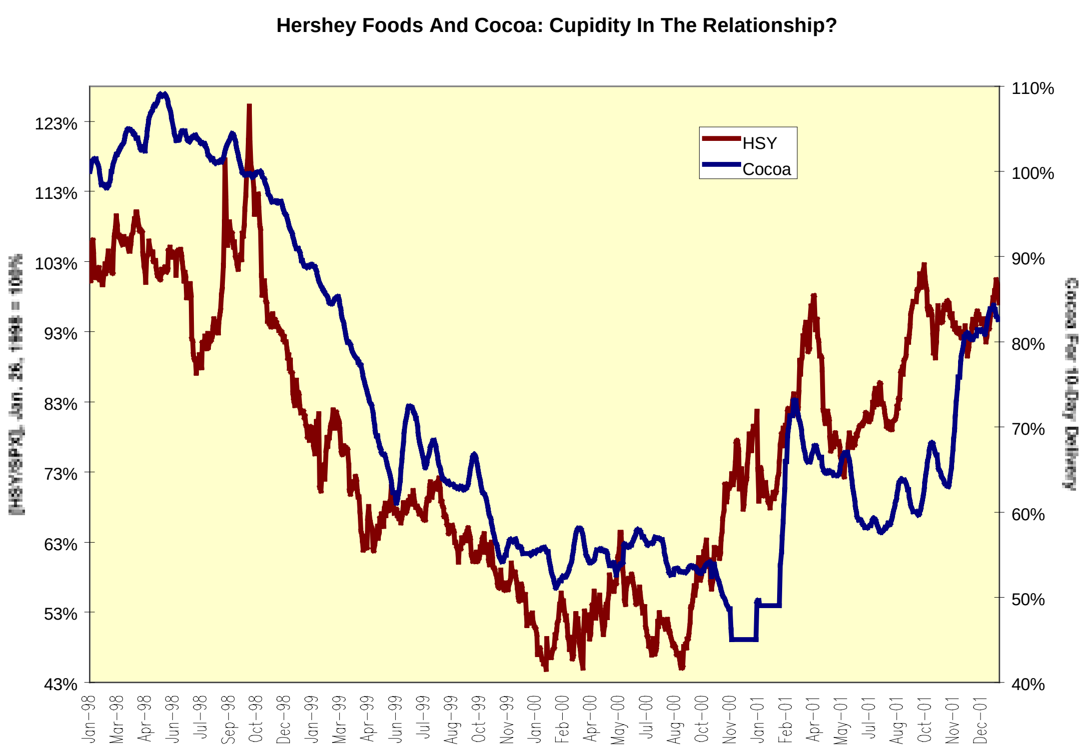
The response from the world's confectioners will squeeze the small producer further. The international confectioners are interested in increasing the quality and brand cachet of their product in the face of generally stagnant demand, and that means more rigid quality control of the source. As a result, a vertical integration of sorts is taking place as larger and more capital-intensive plantations are being financed. While this process is underway, supplies can fall short, and that creates an opportunity. We could be in the early stages of one of the aforementioned commodity price spikes here.

**Stocks In A Heart-Shaped Box**

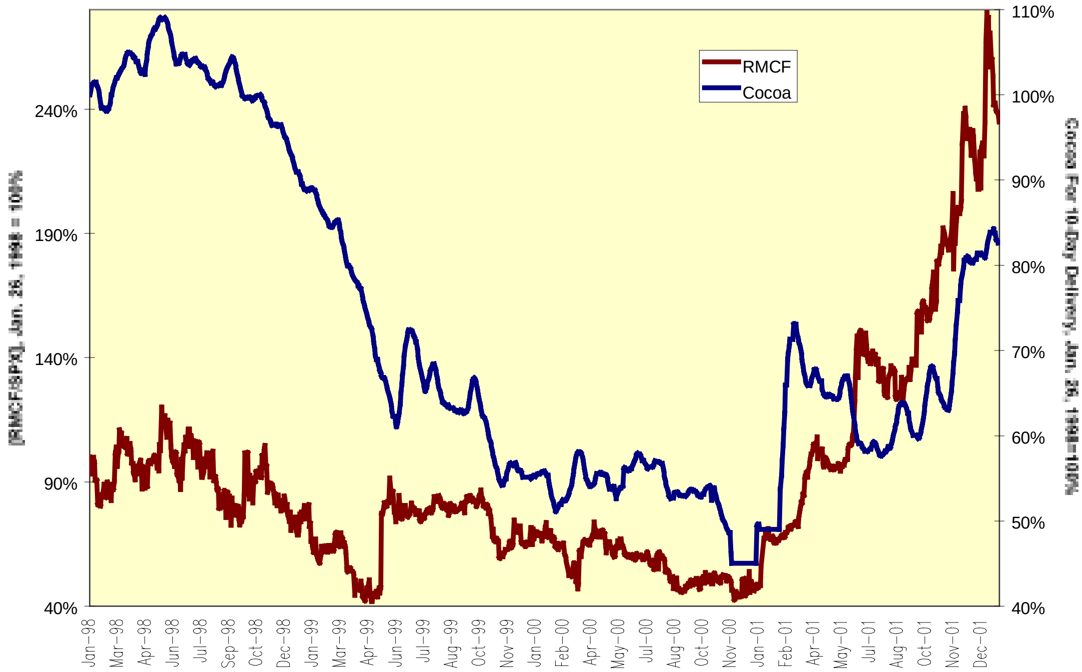
Since inflation-adjusted cocoa prices are below levels seen in both the Eisenhower and Kennedy administrations, and have risen 40% over the past five months, it's a reasonably low-risk bet that further upside may be in order. Locating pure plays on cocoa from the production side is difficult as state marketing boards in West Africa dominate the trade and the smaller producers in Indonesia and Malaysia belong to integrated plantation holding companies such as Malaysia's TSH Resources. Most of these firms are more heavily dependent on palm oil and rubber than on cocoa.

The consumption side is similarly, but not as completely, constrained. We can isolate confectioners such as Hershey Foods and Rocky Mountain Chocolate Factory. Both of these issues have done quite well recently; Rocky Mountain's shares have risen a sweet 188.4% over the past year, and shares of the much larger Hershey have climbed 19.2%. Kisses for all. Should we expect rising cocoa prices to compress their margins?

No, in a complete reversal of the expected relationship, we see the chocolate stocks outperforming the S&P 500 as cocoa prices rise and underperforming as cocoa prices fall. The implication here is twofold. First, the profitability of confectioners is linked to total candy sales, and increased sales naturally increase demand for cocoa. The second is that confectioners have little or no problem in passing their higher raw material costs onto customers.



**Rocky Mountain Chocolate Factory And Cocoa: Expect The Unexpected?**




So, there you have it, a simple to understand and straightforward commodity play. Instead of sending your sweetheart of box of bon-bons, send her or him a few shares of a chocolatier, and say that you got the idea here.