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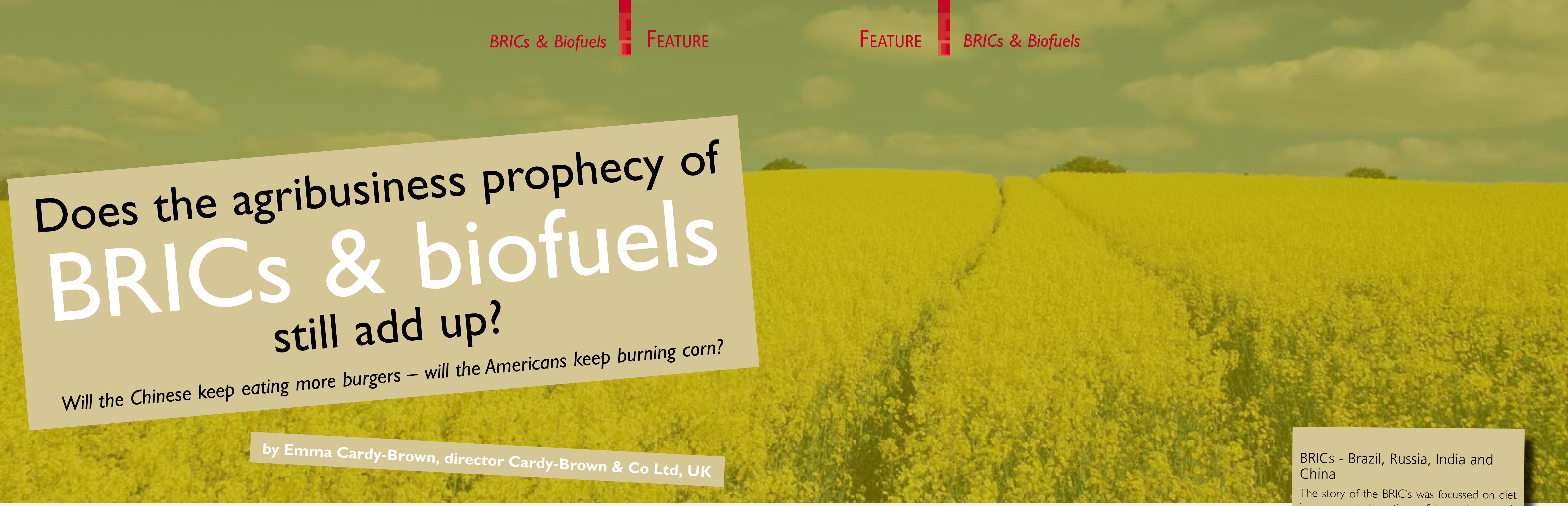

Does the agribusiness prophecy of BRICs & biofuels still add up?

Will the Chinese keep eating more burgers – will the Americans keep burning corn?

by Emma Cardy-Brown, director Cardy-Brown & Co Ltd, UK

The agribusiness boom of 2007 and the first half of 2008 was said to be driven by 'BRICs and Biofuels' which prophesised ever increasing growth in the demand for crops.

The first driver – 'BRICs' – refers to Brazil, Russia, India and China; these huge emerging markets share many common characteristics, most notably massive population growth and/or rapidly increasing incomes.

The second driver – Biofuels – refers to the growing demand in the mature markets of the US and Europe for environmentally friendly sources of fuel based on ethanol and bio diesel produced from corn and oilseed rape.

In this article we will assess how the current turmoil in the markets has impacted on these drivers.

The 'Credit Crunch' has seen unprecedented volatility in the financial markets, including commodities. The exodus of speculative trade from the front face of agri-investment of soft commodities has shown corn and soybeans prices to be coupled to the price of oil – a biofuels overhang?

During 2007 and the early months of 2008 prices reached stratospheric highs but then fell for wheat, soybeans and corn as speculators headed for the safety of government bonds and gold. Could the boom in agribusiness be at an end already or is this a readjustment following news of increasing supply compounded by a historic financial market crash? What we're left with is a feed commodities market wounded by the sudden exodus of speculators.

BRICs - Brazil, Russia, India and China

The story of the BRICs was focussed on diet improvement in a time of increasing wealth and population focussed mainly in Asia.

In India, consumption of poultry meat and dairy drove forward a demand for meat producers and feed supply. In China, pork production was rapidly industrialising away from small-scale, backyard operations, increasing the need for biotechnology through animal health, feed additives and genetics. The demand for meat was being met not only by the development of domestic production but also from increasing supplies from South America which was rapidly developing as the world's bread basket. Can the same be said today?

India and China

GDP levels for Chinese and Indian consumers will determine their appetite for high value (economic and nutritional) food. Compared with many other emerging economies, notably Brazil and Russia, which have recently suffered big capital outflows China has yet to fall into a menacing credit crunch – although there are signs it is in grave danger. Export volumes have slowed markedly; the growth of industrial production dropped to a six-year low in the 12 months to August. The government budget is forecast to remain in the black in 2009-10, following a surplus of 0.4% of GDP in 2008.

Some independent economists expect real GDP growth to moderate to eight percent in 2009, largely owing to the weaker outlook for net exports. Growth will accelerate slightly, to 8.7%, in 2010.

Meanwhile in India high interest rates and resulting higher costs - coupled with high oil prices, decelerating global growth, slowing export markets and the global financial turmoil - have taken their toll on the economy.

The government maintains that the economy grew by almost eight percent during the 2008 fiscal year and will recover to nine percent in 2009/10. Most independent estimates, however, are far less optimistic; India's economy is forecast to expand by 6.5% in each of the next two fiscal years.

India may not have escaped the global contagion, but it's not all bad news.

After all, GDP growth of around seven percent would still put India among the world's fastest-growing economies. Many of India's fundamentals remain sound. During April-August 2008, exports rose 35% in US$ terms, while imports rose 37.7%, indicating sustained demand. Finally, India's banks are well-capitalised and well-regulated; there is no domestic bad-loan crisis and Indian banks have only a marginal exposure to overseas credit markets.

However, economists and banks depending on China's and India's economic growth to bolster the global economy were shocked to see a dramatic fall in trade figures in final months of 2008.

Chinese exports to America fell by 6.1% in November; those to the ASEAN countries, which had grown by 21.5% in October, fell by 2.4% in November. The faster decline in imports meant that China's monthly trade surplus reached a record US$40.1 billion. Exports last fell in 2001.

Although India and China have not escaped the pessimistic gloom settling over the global economy these are still the most dynamic parts of the world economy. Their consumption patterns are likely to experience a tempering of the improvements witnessed over the last three years but ultimately their consumption of meat and dairy will remain hearty.

But both countries face daunting economic and political difficulties. In India's case, its newly positive self-image has suffered a double blow: from the economic buffeting and from the bullets of the terrorists who attacked Mumbai.

Brazil

One of the most relevant suppliers of grains and meat and a relative new comer to the global market is Brazil. Brazil has been hard hit by the global financial calamities; the Brazilian BM&FBovespa repeatedly closed in an attempt to stifle the hemorrhagic flow of traded values.

Brazilian meat companies were seen as the big growth tickets of early 2008, but things started to crumble when Sadia was caught out on foreign exchange hedging by BRL760 million which will damage the corporate cash flow.

Many of the Brazilian meat exporters, which also include JBS, Minerva and Perdigao, have suffered from falling demand from Russia and Japan. Falling exchange rates mean that any American dollar denominated debt is now more expensive adding further pressure. Brazilian poultry producers are already planning a 12% cut in production.

With Russia focusing on the development of domestic production and Thailand now back online after their bird flu crises, the outlook is further compounded by global recession and a lack of credit availability. Against this backdrop a cut in production is understandable.

However, on the up-side, feed prices, which constitute the majority of industrial-scale animal protein and dairy production costs, are down. Add to this that the Brazilian Real fall in value will make meat exports highly competitive and the reduction of 12% production starts to look like a play to 'encourage' higher meat prices in the coming months.

Brazilian growers of grain and oilseeds are a highly leveraged group, dependent on credit for the purchase of farming inputs.

The large ABCs (ADM, Bunge, and Cargill) have become far more selective in the growers to whom they will provide credit lines in order to mitigate their exposure to potential bad debt. The Brazilian government, aware of the importance of agricultural production to Brazil's GDP, injected US$2.6 billion directly into the country's banks in order to support farm finance. The government required that the funds be passed on to growers within a 10-day time span. If the banks failed to make these funds available to growers then the money was reclaimed by the government.

This was an attempt to fund growers to facilitate planting in the autumn months of 2008. With commodity prices looking so uncertain banks and the ABCs trod with caution as to what credit lines were sent out to growers. Fertiliser sales were down enormously (30%) for the planting season in Brazil versus the same season in 2007.

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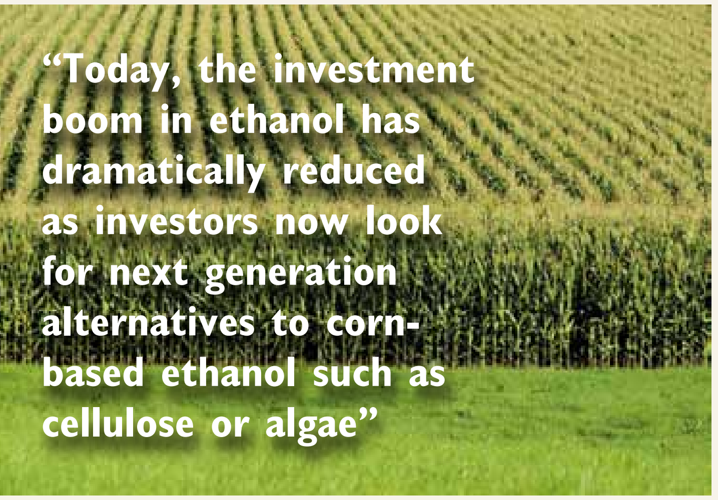
Growers around the world have experienced this shortage of credit for farm inputs. This in turn will lead to lower grain and oilseed harvests in 2009 – which could trigger a return of speculators to the feed commodities table.

Biofuels

The original promotion of biofuel mandates in Europe and the US were accompanied by the publicly stated aim of reducing carbon emissions, however the widely recognised ulterior motive was an attempt to prop up regional food production industries by increasing demand.

The benefit in terms of reduced carbon emissions of ethanol based on corn is



now widely contested. The ethanol price is intrinsically linked to the price of oil and as oil prices have sunk so has the price of ethanol. Today, the investment boom in ethanol has dramatically reduced as investors now look for next generation alternatives to corn-based ethanol such as cellulose or algae.

It is highly possible that many ethanol producers will go ‘off-line’ or rationalise production in the US if the oil price languishes below or around US$50/barrel; under this level profit margins vanish for many ethanol producers (cane or corn based).

Will the new US administration bring an end to biofuel’s hunger for food crops? The election of Barack Obama as the 44th president of the United States has raised questions as to the future of the US biofuel mandates. Biofuels policy was always a major point of difference between Obama and his republican rival John McCain.

McCain supported lowering the US import tariff on ethanol, which would potentially have led to an increase in Brazilian ethanol, and a subsequent fall in demand for domestically produced corn-based ethanol.

Brazilian ethanol is far more efficient, both economically in terms of production costs and environmentally in terms of the energy produced. In contrast, Barack Obama has repeatedly emphasised the importance of US energy independence as a driver of biofuels production in the US and is therefore likely to support domestically produced biofuels in favour of imports dashing the hopes of those banking on Brazil stepping up ethanol supply to the US.

Obama has been advised by some heavyweight names from the ethanol and grains industry including Tom Dashle who is on the board of several ethanol producing companies. Mr Dashle’s job description at the Washington-based law firm Alston & Bird includes spending “a substantial amount of time providing strategic and policy advice to clients in renewable energy”.

Barack has also repeatedly made use of corporate jets belonging to ADM, a world-leading agribusiness and biofuels producer. Although environmentally questionable, Obama’s support for a US-centric biofuels policy and a continued shunning of ethanol imports could drive some growth back into agribusiness. The new Secretary of Agriculture in Mr Obama’s administration has been announced as former governor of the corn belt state of Iowa, Mr Tom Vilsack, and is known to be a supporter of corn-based ethanol. The demand for corn for ethanol will continue.

Biofuels future

So what does this spell for the future of biofuels and agribusiness in general?

Certainly in the next two years there will be continued support of the corn-based ethanol industry, although we will see a stronger investment into ‘next’ generation biofuels such as cellulose and algae. This in turn will continue to pressurise corn supplies and have a knock-on effect on all grains and oilseed demand. When the USDA announces reduced harvests for 2009 – due to a lack of credit to fund farm inputs in 2008, commodity prices may rebound – although it is unlikely we will reach the heady peaks of June 2008 as commodity speculators, who have been hard hit are feeling ‘once bitten, twice shy’ and invest in a less ‘kamikaze’ manner.

The emergence of the ‘BRICs’ as new relevant consumers on the global economy remains relevant although currently reduced in GDP growth rate.

Consumption of quality food in Asia is likely to continue at current levels and grow at a steady pace providing Asia is not pulled down by western financial woes in the next months. Brazil and Russia – the focus of emerging food production - have been hard hit due to the relevance of commodities (agricultural and oil) on their national GDP. A pause in production development is likely.

In the short term, feed and meat companies should take the opportunity to buy forward at the current low prices. After spring 2009 feed commodity prices could lead a recovery as speculators enter the fray once more.

In the medium term biofuels investors will look for second generation biofuel production projects rather than corn-based ethanol, these could include sugar-based ethanol, cellulose or algae. The new US administration, whilst supporting ethanol producers will look to increase their supply of biofuels from second or ‘next’ generation biofuels.

The immediate future should be seen by agribusiness entities and savvy investors alike as an opportunity to buy – be it forward commodity supplies or acquisition targets going cheap!

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