What next after the cocoa decline?

Malaysia's cocoa bean sector is on the edge. The production performance in the 1990s, the decline of cocoa cultivation and bean production has been unstoppable. From a peak of 247,000 tonnes of cocoa beans produced in 1990, cocoa production dropped to a mere 5,000 tonnes in 2014, a reduction of more than 98%. The country fell from fourth place in the world as a cocoa bean supplier in the 1990s to 28th in 2014.

The sector has undergone a complete commodity cycle. It declined as fast as it grew. Also known as the "boom and bust" phenomenon, this has affected an industry that has outlived its carrying capacity. Is this the end? Is there a room for a reversal? Diagnosing past mistakes provides clues to the future.

The decline occurred despite the upward trend of prices from the late 1990s and strong fundamentals forecast by the International Cocoa Organisation. By 2020, world demand for cocoa may outstrip supply, which is constrained by problems such as pests and diseases, unstable prices, competition from other crops, threats from climate change and other structural problems. With growing influence in developing countries, the prospects for cocoa-based products have, in fact, never been better.

During the 1980s, the industry underwent a spectacular transformation. With low production costs and high prices, cocoa production was profitable venture. It attracted the estate sector to invest in cocoa plantations, taking "estate farm management technology" to cocoa smallholders. At its height, productivity here reached more than one tonne per hectare.

In the early stages, the cocoa industry enjoyed the soil fertility of prime cocoa growing new areas. However, over time, fertility decreased due to intensive application of chemical fertilisers and pesticides.

The widespread insect infestation by the cocoa pod borer (CPD), in particular in the early 1990s, was the turning point for the local industry. The increase in price of cocoa beans could not compensate for the losses caused by CPD. This occurred due to a failure to detect infestation early and the disease caused monitoring of farms and extension systems would have been able to identify early symptoms and precautionary measures could have been taken. However, these could not be done.

The above push factors were complemented by pull factors, particularly better returns from oil palm farming and non-cocoa ventures.

The grinding sector, on the other hand, saw an opposite development. Due to good foresight, the country was able to develop the grinding sector into a global player. Cocoa processing is highly profitable. Processed cocoa such as cocoa blocks and chocolate product is between 5 and 20 times the value of cocoa beans, respectively.

At the early stage of development, the local supply provided chocolate and cocoa to the grinding sector. However, by the beginning of the 1990s, the grinders had to obtain additional supply from the international market.

After production in 2008, grinders, too, began to experience a downward trend due to unstable supply.

Clearly the two sub-sectors have developed along different paths. While the cocoa bean sector struggled with local challenges, the grinding sector became a global player. They are independent of each other, particularly after the local cocoa supply dwindled. The separation of the two sectors is one of the characteristics of the domestic cocoa industry that is partially responsible for the decline in the production of cocoa beans.

Like everywhere else in the developing world, there are two distinct market systems for cocoa in Malaysia – the primary (cocoa beans) and the secondary (cocoa-based and chocolate products) markets. The two stand in stark contrast in all facets.

The cocoa bean market is largely controlled by large-scale farmers (95%) who are plagued with problems such as limited bargaining power, low productivity, low price and income, limited opportunities for further investment, inability to address pest and disease attacks and poor farm marketing arrangements. Without reforms, low income may push them out of the industry in the long term.

The secondary market is the opposite, in that the players are large in scale, well-organised, with good influence, and the cocoa bean is a highly desired commodity by large and small retailers who deal with high-value cocoa products. With the exception of cocoa SMES, the market structure of grinders and chocolate manufacturers is oligopolistic, where few players are highly concentrated.

For instance, Barry Callebaut accounted for 40% of world chocolate manufacturing, followed by Cargill (14%), Blommer (11%) and ADM (8%). Of the top four, the CR4 concentration of CNIA is 73%. In Malaysia, there are only three grinders and chocolate products are largely marketed by big brand names. The market share of top brands by CNIA (Cadbury, Vochelle, Kit Kat and Hershey's) was estimated at 71% in 2014.

If there had been a close backward linkage between the two sectors and the producers, the decline would have been minimised. The rapid development of the grinders did not trigger further development of cocoa beans, either in the form of close networking between the two or support in terms of input provisions and advisory services that could have ensured continuous supply from the producers.

Traditionally, there was a large quantity of cocoa beans, which cannot be met by the small producers, particularly after the 1990s. This has resulted in a dysfunctional marketing system as many small farmers left the market, creating a vacuum at the farm level, which demotivated the producers.

This situation seems unfair. The profits of high-value cocoa products are reaped by the large farms, while the condition of the smallholders has deteriorated. This gap has further widened, resulting in inequitable distribution of values across the supply chain. Unless this division is rectified, the fate of the smallholders will remain unchanged, if not diminished.

One is tempted to disregard the cocoa bean sector in the future on the grounds of a declining competitive advantage as other ventures give better returns. However, this reasoning has a structural flaw in that it assumes the industry and all of its components are no longer profitable.

Despite cocoa areas under cultivation and production almost collapsing, there are pockets of cocoa farming that are active and profitable, particularly in Sabah and Sarawak. With competition, resources and institutional support, the remaining cocoa farming areas have the potential for further improvement in productivity and income, and hence, livelihood of the farmers.

Besides, cocoa is an ecologically-friendly crop in that it thrives in a natural environment and habitat. In the long term, cocoa farming, particularly in a multi-crop environment, contributes more to the environment and ecology compared to mono-cropping.

In short, reviving the cocoa bean industry would yield a triple advantage: economic, livelihood and environmental benefits.

After the bad experience of crop damage and unstable prices, price instability for cocoa beans has become a problem for all and is leading to a low profit margin. The price of cocoa beans is between 5 and 20 times the value of processed cocoa such as cocoa block and chocolate product is between 5 and 20 times the value of cocoa beans, respectively.

An inclusive supply chain holds the key to better returns for producers, as proven in Taiwan and South Korea. Since profit lies in high value-added cocoa-based products, producers should expand their farming activities to include integrated processing and manufacturing that will bring better prices.

This requires institutional reform, regenerating the farmers to work collectively either through a farmers’ association or cooperative vehicle to produce and process cocoa beans. Under this business model, the farmers’ association or cooperative is expected to produce cocoa beans, either from dedicated cocoa-based products (such as chocolate blocks) by acquiring small-scale processing machines. The chocolate blocks are in high demand by chocolate manufacturers as they are the primary ingredient for the manufacturing of chocolates or related products.

This inclusive supply chain would improve the producers’ bargaining power and create added income. Price instability is then internalised and at the same time, provides opportunities for them to venture into supply businesses as well as cocoa-based manufacturing and related ventures.

In terms of marketing strategy, this model offers the possibility of maximising the "fine flavour chocolate" advantage by focusing on "single origin cocoa" or SOC from one locality, and facilitates extensive services more efficiently. The SOC characteristic is sought after by chocolate connoisseurs in advanced countries. SOC by locality is a potential "unique selling proposition" for Malaysia's cocoa production. Local farmers and chocolate manufacturers are currently using mixed beans from various sources.

However, this institutional reform requires comprehensive support. This includes increasing productivity, R&D to improve variety and value added, investment in input production to reduce production cost, training and education to increase producers’ capacity as farmers-cum-entrepreneurs, market information, financial incentives and credit facilities. With all these in place, the sector would be meaningless and the smallholders and the cocoa industry would be at risk again.

Malaysia has begun its 1990s glory but regaining the smallholders through an inclusive and integrated supply chain, equitable distribution channels and nurturing entrepreneurship may hold the key to a sustainable cocoa industry.