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THE RELATIONSHIP BETWEEN EXPORTS AND FOREIGN DIRECT INVESTMENT FOR PROCESSED FOOD PRODUCTS

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AFFI is the national trade association that represents manufacturers and processors of frozen food products, as well as suppliers of goods and services to the industry. AFFI's membership of nearly 550 companies is responsible for approximately 90 percent of the frozen food processed annually in the United States, valued at some \$60 billion.

Introduction

This paper will discuss the decision-making process that companies undergo when analyzing the costs and benefits of committing the necessary investments for processing overseas, as compared to processing domestically and then exporting from the U.S. To facilitate the discussion, the paper will focus on a single product, frozen potato products, and discuss each of the key components that a company considers when determining whether to export this product or engage in foreign direct investment (FDI).

While frozen potato products may constitute hash browns, tater tots and a wide variety of newly developed products, the overwhelming market leader for this category is the ubiquitous French fry. For purposes of this paper, the terms frozen potato fry and French fries are synonymous.

While it is true that French fries were invented in France, the U.S. has perfected them. They are a hugely successful export product and a wonderful example of a value added processed product that reaps profits for the producers and processors as well as their customers.

It is helpful to remember that the majority of frozen potato products are generated to handle the needs of foodservice providers, primarily fast food restaurants. Nearly nine out of ten frozen potato fries produced in the U.S. are destined for a foodservice facility rather than a retail outlet. Therefore, it logically follows that processors will focus on world markets that already have a significant presence of these restaurants.

International Operations Investment Criteria

U.S. companies historically relied primarily on exports to introduce processed foods into foreign markets. This has been changing as companies begin to consider the option of foreign direct investment as an alternative to exporting.

In examining the frozen potato fry industry, tariff and non-tariff barriers are significant hurdles to exporting from the United States; however, they are not the only factors relevant to a processor's decision to build processing facilities overseas. There is no absolute threshold level at which a frozen potato processor will shift production, but rather a range of variables which must be addressed.

There are essentially seven components that factor into a company's decision to process a food outside the United States rather than export the processed food. These components include an analysis of the political and social stability of the target country; the degree of a presence of global customers; the extent to which competitors are present already in the target country; the capability of the target country to provide raw materials; the target country's level of commitment to developing the necessary infrastructure to support the processing community; the extent of market base audits prospects for growth within the target country; and an analysis of existing and potential trade barriers. It is important to note that these criteria are not weighed equally, but rather are areas of consideration of varying degrees of importance when making this decision.

The Relationship Between Exports and Overseas Investment

FDI is now an important component of U.S. processed food companies' international sales and has outpaced U.S. exports of processed foods in recent years. In fact, according to the U.S. International Trade Commission (ITC) investigation, *Processed Foods and Beverages: A Description of Tariff and Non-tariff Barriers for Major Products and their Impact on Trade*, the level of foreign sales of processed foods and beverages by U.S. affiliates operating in foreign markets is five times larger than U.S. exports and is growing at a faster rate.

Studies that have looked explicitly at processed foods generally have found a complementary relationship between foreign direct investment and exports. However, in conducting fieldwork for processed foods for their report, the ITC staff found no universal pattern. Exports are often the vehicle for entry into a foreign market, and under the right conditions, an investment in overseas processing may follow. But even in lucrative markets with high barriers, processors may still choose to export rather than invest in processing facilities within the markets.

Obviously, U.S. producers would prefer exports to FDI, and efforts to reduce trade barriers have focused on the benefits to U.S. farmers and workers of increased exports.

For example, Canada and Costa Rica have entered into a free trade agreement, which will see the Canadian over quota tariff on frozen French fries drop from the current 41 percent to 0 percent over seven years (5.125 percent a year). Canada, therefore, is expected to expand market share in Costa Rica at the expense of the United States. It is known that Canada is also seeking free trade agreements (FTA) with other Central American countries. This region, which is profitable for U.S. processors, will be lost unless the United States negotiates for the same tariff rate reductions, or processors expand production to the host country.

It is important to note that as Canada aggressively seeks to reduce export barriers worldwide for its products, the more attractive it becomes as a manufacturing center.

Frozen Potato Exporters

French fries constitute big business. In 2000/01, frozen potato fry exports from the three major exporting countries, the United States, the Netherlands and Canada, are forecast at a record 2.3 million tons, which represents 2.5 percent above the previous year's shipments.

The Dutch are by far the largest exporter of French fries in the world, and trade advantages within the European Union are the largest contributing factor to this status. While shipments to non-EU countries are very small, exports to these countries have more than quadrupled over the past four years. In 1999/2000, Dutch exports totaled 1.2 million tons worldwide. The industry depends largely on export demand, as almost 90 percent of production is sold in foreign markets--mostly in the European Union (EU). The United Kingdom, Germany, and France account for 60 percent of Dutch exports.

The success of Canadian French fry processors is evident by their continuing to invest heavily in new potato processing plants in the western provinces. These Canadian potato fry processors increasingly depend on exports for additional sales. Last year, exports increased 15 percent to a record 516,240 tons, reflecting expansion of french fry capacity in the western provinces and increased production for export to the U.S. food service market. During this period, exports of fries from Canada to the United States grew 10 percent to 367,365 tons, valued at \$230 million. Canadian fry exports are expected to continue at double-digit annual growth rates for the near future. Construction of new processing facilities, contracts to supply major U.S. fast food companies, and a lower-valued Canadian dollar continue to fuel the growth in export demand. Other Canadian export markets include Japan, the United Kingdom, Venezuela, Guatemala, Chile, and Saudi Arabia. An increase in exports to the Pacific Rim countries is expected given the expansion in processing capacity.

The U.S. Industry and Export Opportunities

With the expansion of the multinational fast food companies, U.S. exports of French fries have risen significantly. In addition, enhanced product quality, rising incomes in many countries, and ongoing Market Access Program (MAP) activities have all played a role in stimulating demand for U.S. french fries overseas. Export prospects for the next decade are very promising given the sustained growth of the international fast food industry.

Approximately 28 percent of U.S. potato production is used to produce French fries, and Russet Burbank is the main variety grown for their production. Over the past five years, U.S. production of french fries has increased more than two percent annually. In 2000/2001, U.S. exports of frozen potato fries increased 10 percent to a record 520,000 tons (or 13 percent of domestic fry production). Some emerging market statistics include:

- Japan is the largest export market for U.S. frozen potato products.

- Exports of frozen potato fries to China are up 38 percent over the first three quarters of 2000. The United States has a 95 percent market share in China.
- In India, although trade concessions have been obtained, the market fell 30 percent in the first three quarters of 2001 due to the uncompetitive position of U.S. frozen potato fries.
- Exports of frozen potato fries to Indonesia are off by 90 percent, and U.S. market share is off 30 percent. Part of this decline is due to the economic situation in Indonesia.
- The Mexican market is growing. U.S. exports are up 23 percent in the first three quarters of 2001, and market share has increased.
- The U.S. is facing increased competition in the Philippines from New Zealand and the Netherlands. U.S. exports there fell by nine percent in the first three quarters of 2001.
- In Thailand, U.S. exports of frozen potato fries increased 62 percent in the first three quarters of 2001. This market is still small relative to the size of the population.

Financial Analysis/Tariffs and Non-Tariff Barriers

The extent to which a processing country can minimize barriers for its products is central to any export policy. With such an explosive growth potential, frozen potato processors recognize the competitive advantage to making the correct decisions in overseas investments and exports.

Currently, U.S. fries face a variety of trade impediments overseas. Only a sampling of barriers faced include:

- High Tariffs - Thailand currently imposes a frozen French fry tariff of 36 percent.
- Tariff Rate Quotas (TRQ) – The current tariff on U.S. fries entering Mexico is two percent for the first 3,925 metric tons. This quota is expected to be filled in March of this year. The tariff then snaps back to 20 percent until January 1, 2003, when the TRQ is scheduled to be eliminated. There is concern that Mexico may attempt to impose additional fees on French fries once the TRQ is removed. The Mexican government recently required the registration of all French fry importers.
- Phytosanitary Requirements – China issued a requirement for federal phytosanitary certificates for processed potato products. Federal certificates cannot be issued for processed foods however, because they contain no pest risk. In September, China agreed to accept a USDA/Agricultural Marketing Service Certificate of Quality and Condition in lieu of a federal phytosanitary certificate.
- Classification Confusion – South Korea requires exporters to submit their dehydrated products to the Korean Food and Drug Administration for review and tariff classification. If the product contains more than 10 percent non-dehy, it can be classified as a dehy blend and it can be imported with a 27 percent tariff and no quota. If not, the product is classified as pure dehy and must be imported under a TRQ and an over quota rate of 300 percent.

Clearly, an investment in processing facilities overseas can eliminate many of these issues. However, for any processor or manufacturer, the cost and commitment of building a facility is

tremendous. And even in the best-case scenario for expansion, a company will proceed cautiously. In the Costa Rican situation mentioned previously, for example, the market potential of that country likely does not warrant FDI for U.S. processors to remain competitive with Canada.

Building a plant overseas can offer easier access to customers, lower costs, the elimination of tariffs as well as the gratitude of the host country. However, at its most basic, in the case of a regional economic or other downturn, a processor can redirect exports, but cannot move a plant.

Political/Social Stability

In evaluating a decision to process overseas, the presence of a stable and transparent regulatory system is essential. Clearly, the food industry is highly regulated in the United States and elsewhere. Therefore, a food processor must be able to rely on a foreign government's operating in a fair and judicious manner. Lucrative markets with unstable governments are best served by exports, even when this can be inefficient also.

As an example, processors have commented on the difficulty in obtaining import permits for potatoes in Venezuela and on the politicization of the Venezuelan customs authority. Domestic processing would relieve this burden; however, the same political climate that exists for obtaining the necessary import permits perhaps would make an overseas investment too risky. In this instance, a processor might seek government-to-government negotiations to address the burdensome import permits.

Global Customers' Presence

In much the same way processors would study market demographics when choosing to place their facilities in the United States, a processor must compare strategies and growth plans with its customers overseas. If the criterion for FDI looks favorable, yet the customer expects expansion of market outlets to slow or remain flat, exports may still be the prudent choice. On the other hand, customers may have a constituency, such as a government entity or otherwise, that evaluates the share of domestic purchasing of supplies. In such a case, domestic processing may offer a competitive advantage for a processor.

In the case of French fries, if a multinational fast food restaurant has announced plans to expand significantly its presence in an emerging market, a processor must step forward with an increased supply strategy or lose that portion of the market to a competitor.

Competitors' Presence

An analysis of competitors' current market share and expected growth plans is essential to any successful business enterprise. At the same time, a business must determine the scale and commitment of the competition in a prospective market. If a processor's most significant competitors have invested in facilities within a region and the processor has not, and if your

market analysis determines there is a dramatic potential for growth, the processor may be at a disadvantage by relying on exports to supply this region.

Raw Capabilities

The essential advantage of successfully placing a facility in close proximity to a particular market rests in a company's ability to draw savings and efficiencies from that placement. In the case of an agricultural processor, a basic component is the availability of the raw produce. This analysis considers the available crops, as well as the potential to generate such crops in the amount needed. Among the concerns will be the terrain, the climate, and the growing season. These factors are quite basic, but without the appropriate environment, the benefit of processing overseas would be greatly outweighed by the costs and associated risks.

For example, today potatoes are grown around the world from countries at sea level to those with mountains of 14,000 feet. The potato is a quick-maturing plant with tubers ready for harvest and consumption within 90 to 160 days after planting. These characteristics of the potato allow it to be grown almost anywhere. As a result, the raw capability of the frozen potato product can be satisfied in many places.

Infrastructure

Infrastructure relates to the transportation, power, and labor pool of the proposed country. This factor becomes even more important when the proposed investment will take place in an emerging market country. Implicit in the analysis of the infrastructure is the country's willingness to work with a financier to create the necessary foundation for investment. Foreign direct investment can be quite profitable to the economy of a developing region of a country and often serves as the basis to provide support to a prospective investor. FDI not only creates new jobs, it can also lead to an infusion of innovative technologies, management strategies, and workforce practices.

In the case of French fries, considering infrastructure quality control, from the field to the table, is essential. Frozen fries are very fragile and must be handled carefully. Too many broken pieces result in lower yields and lost profits. In addition, fries have a particular susceptibility to absorb flavors from other foods that are stored in close proximity. The extent to which processors can control or rely on stable transportation and warehousing of their product will be important in determining whether to export or process overseas.

Market Base/ Growth

Frozen potato processors have been successful by studying the market base and growth potential of their customer's markets. This analysis relates to consumer trends, disposable income, demographics, population size and concentration. As mentioned above, potato processors have the benefit of their customers' research to guide them. As fast food restaurants expand into a region, fries necessarily will follow. Processors generally do not need to focus specifically on the individual demographics as much as they need to focus on the business

demographics. The point for them to consider is whether the business base provides a strong market for processed potatoes and whether a potential for growth exists.

Clearly, as a country develops, many of these market base criteria will change. Consumer trends will be driven in large part by disposable income levels and access to products. The demand for a product in a particular market does not necessarily mean that foreign direct investment is the answer. A market may be equally well served by exports to that country from the United States.

On the other hand, as new products are introduced and become more readily available, many of these factors will change. Building overseas processing facilities creates the possibility of expanding product lines to suit local consumer tastes. In addition, the introduction of frozen potato fries in a commercial setting may motivate consumers to demand the product at home, thereby creating a secondary market at the retail level.

Conclusion

In conclusion, tariff and non-tariff barriers are significant hurdles to exporting processed food products from the United States; however, they are not the only factors relevant to a processor's decision to build processing facilities overseas. There is no absolute threshold level at which a processor will shift production, but rather a range of variables which must be addressed.

Exports are often the vehicle for entry into a foreign market, and under the right conditions, an investment in overseas processing may follow. But even in lucrative markets with high barriers, processors may still choose to export rather than invest in processing facilities within the markets.

There are at least seven components that factor into a company's decision to process a food outside the United States rather than export the processed food. These components include an analysis of the political and social stability of the target country; the degree of a presence of global customers; the extent to which competitors are present already in the target country; the capability of the target country to provide raw materials; the target country's level of commitment to developing the necessary infrastructure to support the processing community; the extent of market base audits prospects for growth within the target country; and an analysis of existing and potential trade barriers. It is important to note that these criteria are not weighed equally, but rather they are areas of consideration of varying degrees of importance when making this decision.