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Foreign Direct Investment and the Brazilian Food Industry in the 90s

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Abstract

This work investigates the increased share of foreign direct investments (FDI) in the Brazilian food industry. In addition to conferring on Brazil the important role of attracting FDI to Mercosur (the Southern Common Market), this flow of investment has caused important changes in the Brazilian industrial organization. Increases in competition, new strategies and changes in the number of employees in the industry are a few of the more remarkable results. The main objective of this work is to investigate the reasons of entry, encountered mainly in the characteristics of the Brazilian market, and the impacts on the local industry, and to signal the long-run effects of these recent changes.

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1.Introduction

Foreign direct investment (FDI) has played a major role in the recent economic development of Brazil. Since the mid-nineties, FDI spurted and many multinationals in the food system picked Brazil as headquarters for their investments in Mercosur (The Southern Common Market). Empirical evidence shows that mergers and acquisitions (M&A) have been the most common strategy of firms interested in entering the Brazilian food market.

The paper explores the reasons and mechanisms of entry of multinationals, the impacts on the local food industry and on the consumer market. The theoretical approach developed by John Dunning (1995a) was the main guide in discussing the reasons and entry strategies of the multinational companies.

The paper shows that there were major transformations in the Brazilian food industry, but it is not possible to isolate the consequences of FDI from other causes such as trade liberalization, deregulation and stabilization that spurred competition pressures. Despite a huge M&A wave, the food real prices slumped, the variety of products increased, and there was a strong growth of productivity in the food processing industry.

2. The Importance of FDI in the Brazilian Food Industry

According to data from UNCTAD (2002), in 2000, Latin America attracted 56.8 billion dollars in Foreign Direct Investment (FDI), from which 78% went to Mercosur countries (Argentina, Brazil, Paraguay, and Uruguay).

In 2001, Brazil was, for the sixth consecutive year, the leader in bringing FDI to the region, attracting US$ 22.5 billion. This number is rather small if compared with the inflows of FDI to Brazil in the previous years. In 2000, the amount achieved US$ 32.779 billion.

The decline of FDI in Brazil in 2001 followed the world tendency of decrease of investments in all countries, except the African countries, in that year. This global downturn may be mainly explained by the slowdown of world economic growth in 2001. In addition, Brazil reduced the privatization rhythm, particularly in the services sector, such as the telecommunications industry.

From 1990 to 1995, U.S. direct investments in the Western Hemisphere expanded rapidly. Canada is the largest host country of the hemisphere, followed by Mexico, Brazil, and Argentina. The ranking is the same for total direct investment and for the food industry (table 1).

Table 1. Direct Investments of the USA in the Western **Hemisphere**

Country/Region	1998	1999	2000	2001	% 1998/99	% 99/2000	% 2000/01
	US$ billions					%	
Total FDI	1.000.7	1.173.1	1.293.4	1.381.6	17.2%	10.3%	6.8%
Food industry	35.3	34.2	35.9	35.4	-3.1%	5.0%	-1.4%
Total FDI in Canada	98.2	111.7	128.8	139.0	13.7%	15.3%	7.9%
Food industry	5.0	5.8	5.5	4.6	16.0%	-5.2%	-16.4%
Total FDI in Latin America	128.6	174.0	154.5	160.7	35.3%	-11.2%	4.0%
Food industry	9.9	8.0	7.8	8.6	-19.2%	-2.5%	10.3%
Total FDI in Mexico	26.7	32.9	37.3	52.2	23.2%	13.4%	39.9%
Food industry	4.7	3.7	4.4	4.5	-21.3%	18.9%	2.3%
Total FDI in Central America	56.0	69.3	70.5	80.6	23.8%	1.7%	14.3%
Food industry	16.8	4.2	4.9	4.8	-75.0%	16.7%	-2.0%
Total FDI in South America	72.6	77.7	84.0	83.4	7.0%	8.1%	-0.7%
Food industry	4.7	3.8	4.1	3.8	-19.1%	7.9%	-7.3%
Total FDI in Brazil	37.2	37.4	39.0	36.3	0.5%	4.3%	-6.9%
Food industry	2.6	1.3	1.6	1.4	-50.0%	23.1%	-12.5%
Total FDI in Argentina	12.3	15.6	9.4	14.2	26.8%	-39.7%	51.1%
Food industry	1.0	1.17	0.5	0.8	17.0%	-57.3%	60.0%

Source: U.S. Department of Commerce, Bureau of Economic Analysis data

Table 2 shows the importance of FDI for the Brazilian economy and for the food industry. The total FDI (inflow of investments, profits not sent abroad and the re-investments of foreign companies) represented 17% of GDP in 2000, three times higher than 1995. FDI became very important during the second half of the 90s. The foreign companies revenue was 38.5% of the GDP and 60% of the exports in 2000. Foreign companies' exports grew more than 40% in 5 years, showing that the internal market was not the only reason for FDI. Regarding food industry, the FDI grew 63%, while the foreign firms' exports more than doubled.

Table 2. Foreign Direct Investment in Brazil, 1995 and 2000

	2000	**1995**
	Total (All Sectors)	
Number of Employees	1,709,555	1,447,385
Direct Investment Position ($ Million)	103,015	41,696
GDP ($ Million)	602,206	705,449
Sales ($ Million)	231,705	188,903
Exports ($ Million)	33,249	21,744
Total Exports	55,086	46,506
	Food and Beverages Industry	
Number of Employees	136,621	153,024
Direct Investment Position ($ Million)	4,619	2,828
Sales ($ Million)	17,186	16,709
Exports ($ Million)	4,952	2,313

Source: Brazilian Central Bank, Census of Foreign Capital./ IPEA

3. Reasons for Multinational Investments

Dunning (1995a) argues that FDI may be explained by OLI factors. That is, the stock of foreign assets, owned and controlled by multinational firms (MNE) is determined by (a) the competitive advantages **(O)** of those firms vis a vis those of uni-national firms; (b) the extent and nature of the location **(L)** bound endowments and markets offered by countries to firms to create or add further value to these competitive advantages; and (c) the extent to which the market for these advantages are best internalized by firm itself **(I),** rather than marketed directly to foreign firms. As stated by the "internalization paradigm" there are advantages of internalizing the market in order to appropriate the full economic rent created by core assets. (Dunning, 1995 a: 81)

Starting by the **L**ocation factors, Brazil has unique agriculture raw-material availability and an extensive growth potential. Nearly 19% of world's arable land is in Brazil (FAO/ONU), but the country uses a small part of this area. It is possible to double the planted area without affecting any hectares of the Amazon forest. Moreover, 19% of the planet's water is in Brazil. With a wide range of latitudes and reasonably well distributed rainfall throughout the year, the country is able to produce a wide range of products varying from coffee and soybean to apples, pears, melons, grapes, and others. Consequently, agricultural production and productivity have large growth potential through the incorporation of new areas and technology adoption. (Farina & Nunes, 2002). Along with natural resources, Brazil has strong scientific research structure in agricultural products that guarantees continuous productivity gains.

Low-income countries that enjoy a greater marginal propensity to consume face significant increases in demand for food in periods of economic acceleration. This was precisely the Brazilian case, soon after the success of the 1994 stabilization plan[1]. In addition to the response of demand to the growth that followed the first Post-Real years, the redistributive effect of monetary stabilization provoked an unprecedented increase in the volume of foods sold, especially those of greater added value, such as dairy products. This behavior of food demand in these countries functions as a lure to multinationals. This is even more reinforced if we take into consideration the fact that, as a general rule, the countries of origin of these investments have slower growth in consumer demand for food. These aspects will be explored in greater detail later on, in a specific study of the Brazilian consumer market.

The economic and institutional reforms that have taken place since the late 80s offered a favorable institutional environment for FDI, reinforcing the L factor.

Brazil is, also, an important platform for Mercosur countries, with 170 million inhabitants, 8.5 million km^2 and US$ 602 billion GDP in 2000[2]. By the end of the 20th century, Brazil accounted for 78% of the Mercosur's population. Its GDP was 62% of the Mercosur's GDP although it had only half the per capita GDP of Argentina and suffered from poor income distribution. Brazil's exports were 62% and its imports 60% of the Mercosur totals, and 43% of intra-bloc exports and 46% of intra-bloc imports were Brazilian (Farina ,1999).

Multinational companies have advantages over the Brazilian companies, most of them family owned and managed (**O** factor). First of all, they have easier access to cheaper international capital for investments. Second, they have a portfolio of new food products to be launched in the Brazilian market, that had already been developed elsewhere and that requires adaptation only. For the Brazilian firms to compete in new products an important amount of resources are needed, including time. Last, but not least, multinationals can count on the Brazilian entrepreneurs when they enter through mergers and acquisitions. Most Brazilian companies were facing succession problems that weakened them as competitors in the new economic environment. High interest rates, high financial debt and exchange rate

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[1] The Real Plan was a monetary stabilization plan which was implanted in 1994. Brazilian inflation reached 80% a month prior to 1994. Real Plan was the 5th stabilization plan since mid 80´s. It brought down the inflation from 2.406% per year to almost 0%. The accumulated real inflation since the plan till April 2002 reached 103% (**Annex 1**)real income.

[2] Source: IBGE (Brazilian Institute of Geography and Statistics) *in* www.ipeadata.gov.br 05/04/2002.

overvaluation made easy the acquisition of national companies, even efficient ones (Farina, 1999: 319-320).

The **I** factor is also present, because international food trade is small, when compared to total world food consumption. In order to explore the **O** factor in the internal Brazilian market, exports are not enough. Also, the **L** factors create advantages for export from Brazil to developed countries, especially if trade barriers diminish.

Therefore, **OLI** factors are present in the Brazilian case.

4. M&A: Main strategy of entry in the Brazilian market

The main form of entry of foreign direct investments in Latin America occurs via mergers and acquisitions (M&A). This item gathers a series of data on this strategic form, focusing on the Brazilian experience.

Since 1992, the food and beverage industry has stood out among the sectors with the greatest number of mergers and acquisitions (Table 3). This increase provided the food, beverage, and tobacco sector in Brazil with concentration and denationalization of capital. By 2000, eight of the ten largest food companies in Brazil were multinationals, while in 1994 there were five. Foreign companies made 80% of the acquisitions of Brazilian food companies in 1996/97, Argentina, US and Italy were the leading countries investing in Brazil's food industry. In 1998/2000, others such as Ireland, Mexico and Chile had joined them.

Table 3: Mergers and Acquisitions made in Brazil, by industrial sector.
Period: 1992 to 1998

Sector	1992	1993	1994	1995	1996	1997	1998	Total Sector*	Part. % in General **
Food, beverages, and tobacco	12	28	21	24	38	49	36	208	**12.6**
Financial Institutions	4	8	15	20	31	36	28	142	**8.6**
Chemical and Petrochemical	4	18	14	13	18	22	25	114	**6.9**
Metallurgy and Steel	11	13	11	9	17	18	23	102	**6.2**
Insurance	1	1	8	9	16	24	15	74	**4.5**
Elétrical and Electronics	2	7	5	14	15	19	9	71	**4.3**
Telecommunications	1	7	5	8	5	14	31	71	**4.3**
Others	23	68	96	115	188	190	184	864	**52.5**
Total of Mergers	**58**	**150**	**175**	**212**	**328**	**372**	**351**	**1.646**	**100.0**

Source: KPMG (1998), *in* Faveret (1999: 03).
*Sum from 1992 to 1998.
**(Sum from 1992 to 1998)/(Total of Mergers).

2,127 M&A operations were realized from 1994 to 2000 in Brazil. Foreign capital was present in 60% of these operations. In the year 2000, 34% of the foreign investments that entered Brazil through acquisition of national firms came from the USA.

From 1994 to 2000, the food sector had a total of 269 M&As, which represents 12% of the total for all sectors. Of this volume, 57% of the operations involved foreign capital, when foreign companies purchased control local companies or had joint ventures to create a third company.

5. The Brazilian Food Market as the Main Attraction of FDI

The national market deserves emphasis as a factor attracting foreign direct capital in the Brazilian food and beverage sector. As income grew following the stabilization plan, people increased their consumption of more value-added products including such diverse products as cookies and hot dog (table 4).

The expansion of the consumer markets is the lead car for the entry of foreign firms in the food sector.

Table 4: Evolution of Brazilian Consumption

(in kilos per inhabitant/year)

	1994	1995	1996	1997	1998	1999	2000	00/94** (%)	Average annual var. ***
Hot dogs	0.53	0.74	0.79	0.94	0.98	1.0	0.97	83.02	9.40%
Milk*	11.02	13.41	13.59	13.84	13.05	13.96	13.17	19.51	2.05%
Powdered milk	0.65	0.76	0.74	0.78	0.75	0.71	0.71	9.23	0.51%
Macaroni	2.97	3.34	3.36	3.36	3.54	3.48	3.31	11.45	1.64%
Cookies	2.75	3.43	3.83	4.34	4.75	4.77	4.37	58.91	8.08%
Powdered coffee	1.56	1.81	2.01	2.09	2.07	2.09	1.93	23.72	6.41%
Chocolate	0.47	0.62	0.74	0.82	0.73	0.66	0.65	38.30	3.87%
Table wine*	0.18	0.24	0.26	0.28	0.27	0.36	0.37	105.56	10.75%
Soft drink*	34.4	46.6	48.3	50.6	54.3	57.8	59.7	73.55	7.86%
Beer*	28.5	31.8	31.3	31.9	33.3	33.3	32.6	14.39	1.99%

* in liters per inhabitant/ year.
** Percent Variation from 1994 to 2000.
*** Annual Variation from 1995 to 2000.
Source: ACNielsen.

Table 5 compares the per capita consumption of meats in Brazil and the United States, showing the growth potential in the Brazilian market.

Table 5: Per Capita Consumption of Meats (1993/1998)

(Kg)

	BRAZIL			UNITED STATES		
	Per capita		Total	Per capita		Total
	1993	1998	Growth	1993	1998	Growth
Chicken	18.	24.6	36.7%	21.9	23.04	4.9%
Beef	35.6	37.4	5.1%	27.9	29.4	5.2%
Pork	8.1	9.5	17.3%	22.2	22.3	0.6%
Total	61.7	71.5	16.0%	72.0	74.7	3.7

Source: ACNielsen and ERS/USDA (www.ers.usda.gov 04/01/02)

The Brazilian consumer pattern has been changing throughout the years. That is a reflection of a range of social and economic changes that took place in Brazil in the past few years. According to IBGE (Brazilian Institute of Geography and Statistics) data, the total resident population jumped from 119 million people in 1980, to more than 169 million in 2000. In 1990, the life expectancy at birth was at 65.75 years old. In 2001, this number shifted to 68.82 years old. During the same period, the birth rate fell from 23.5 per thousand inhabitants to 19.89. These numbers explain the changes in the composition of the age groups in Brazil. In 1980, people from 0 to

14 years old represented 38,2% of the Brazilian population and in 2000 this percentage fell to 29,6% of the population. On the other hand, people between 15 and 64 years composed 57.68% of the total population in 1980, and reached 64.55% in 2000. For the population 65 years old or over, the percentages shifted from 4.01% to 5.85% in 1980 and 2000 respectively. The urban population jumped from 67.59% in 1980 to 81.25% in 2000. These numbers justify the changes in the Brazilian consumption patterns, which affect the performance and strategies of the food industry. Moreover, between 1992 and 1999 living conditions have improved, but major inequalities still remain. (IBGE, 2001)

National income remains highly concentrated. Brazil closed the 90s with practically the same income distribution as in 1992. The poorest 50% of the population held 14% of the country's revenue whereas the richest 1% of the population held 13% of the total income. In 1992, the Gini index reached 0.571 and in 1999, 0.567. In other words, there was no significant change.

Life conditions improved. Life expectancy rose 2.1 years, the number of homes with basic sanitation increased 18.1%, the monthly average income grew 29.8%, and infant mortality fell 22.1%. It is important to point out that these numbers present great variations from one state to another, reflecting strong regional inequalities of the country. For example, the literacy rate in São Paulo, Rio Grande do Sul, and Santa Catarina is over 80% whereas the national average is 71.6%.

The consequence of inequality the for food industry in the short run is negative, as poverty means low demand. In the long run, inequality means that there is room to rapid income and demand growth. Low income-elasticity gives this industry the peculiar characteristic of being less sensitive to the economic fluctuations compared to other economic sectors.

Once the euphoria of the Real Plan had faded, the domestic market no longer presented a significant growth. Furthermore, as discussed previously, data from IBGE shows that income distribution in Brazil has not improved its profile significantly in recent years, remaining highly concentrated. Thus, in periods of economic deceleration we should expect a drop in consumption of products of higher added value that are much more sensitive to the income level, that is, there is high income elasticity. Hence, the attentions turn to products of lower added value, giving space to cheaper brands that, because they invest less in advertising, have lower costs. There is every indication that this has proven fundamental to the consumer who chooses low prices over brand names, being unwilling to pay more just for the brand name.

6. Impacts on the Food Industry of Brazil

6.1. Effects on the competitive environment

Multinationalization through mergers and acquisitions should result in higher concentration, increased market power and growing industrialized food prices. More capital-intensive techniques would diminish employment as a result of increasing productivity.

As expected, the pattern of concentration of the food and beverage changed in recent years. Table 6 shows the concentration index CR10 from 1994 to 2000, indicating that the most important change was in the increased participation of multinational firms, which in 94 were only five and in 2000, had grown to seven. The only three firms with Brazilian capital are leaders in the meat market. The degree of concentration, however, is relatively stable in contrast to other important segments related to food, such as distribution. Between 1994 and 2000, the ten largest supermarket chains doubled their share in the total turnover of the sector (**Annex 2**).

Table 6: Concentration in the Food Industry – CR_{10}

	1994		1996		1999		2000
Nestlé*	5,42	Nestlé*	5,25	Nestlé*	6,01	Nestle*	5,45
Copersucar	5,00	Copersucar	3,22	Ceval*	4,03	Bunge*	5,20
Ceval	3,53	Ceval	2,70	Sadia	4,03	Sadia	3,69
Santista*	3,28	Santista*	2,45	Cargill*	3,91	Cargill*	3,52
Sadia	2,89	Sadia	2,38	Perdigão	2,49	Perdigão	2,20
Frigobrás	1,68	Cargill*	1,92	Parmalat*	1,98	RMB*	1,68
RMB*	1,68	Perdigão	1,49	Santista *	1,98	Parmalat*	1,55
Perdigão	1,62	Parmalat*	1,47	Kraft Lacta*	1,33	Kraft Lacta*	1,09
Yolat*	1,51	Sadia Frigobrás	1,43	Arisco*	1,31	Fleishmann*	1,08
Cargill*	1,50	RMB*	1,29	Nabisco*	1,21	Aurora	0,87
Total (CR_{10})	**28,08**	**Total**	**23,60**	**Total**	**28,28**	**Total**	**26,32**

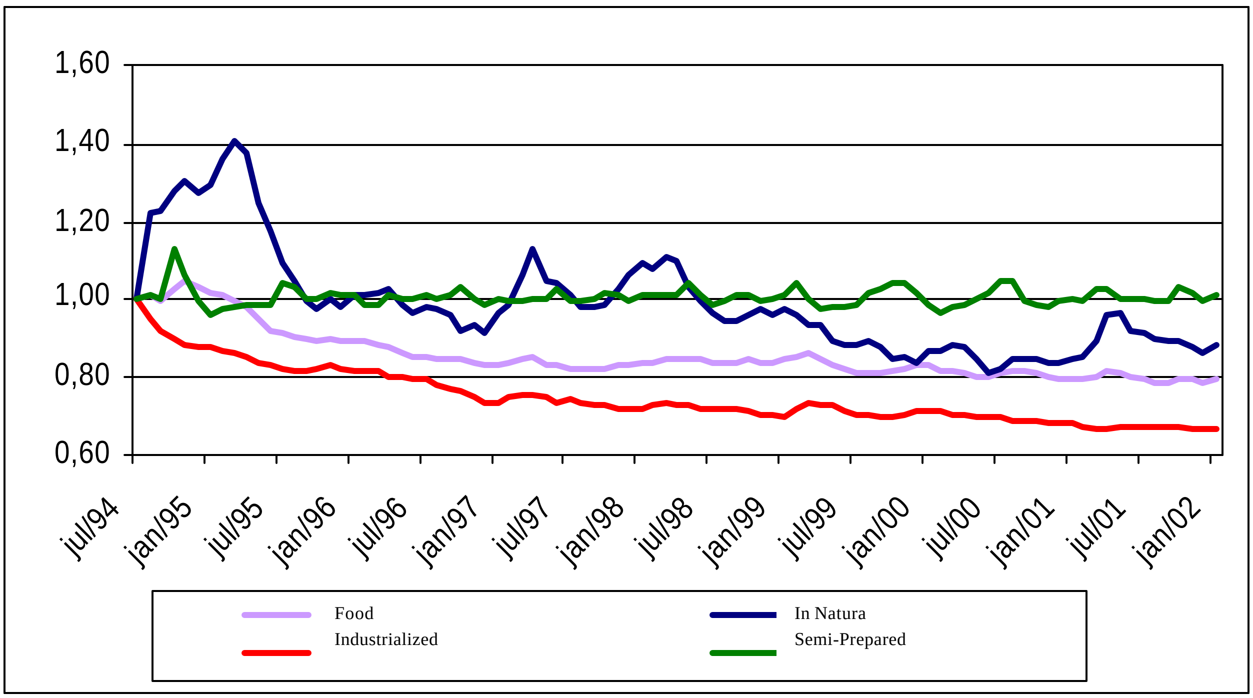
Source: Exame Maiores e Melhores (1995, 1997, 2000,2001), *in* Farina (2001, 13)
*multinationals

As a matter of fact, competition got stronger. A growing fringe of medium and small firms also spurred competition among biggest companies.

The vigor of competition in the food industry is reflected in the behavior of real prices in retail, as shown in **graph 1**. In the post-monetary stabilization period, an important drop in real prices was seen in the largest consumer center of the country, Greater Sao Paulo.

The most important price reductions occurred in industrialized foods, exactly where the multinational investments occurred with greatest intensity, and where supermarkets are most important in the distribution. The number of new product launches increased 200% according to the Brazilian Food Industry Association, and aggressive distribution strategies were implemented. Based on interviews, Farina and Nunes (2002) show that the food industry cost squeeze that allowed the consumer price reduction came from adjustments in logistics, procurement strategies, including outsourcing, higher labor productivity and the adoption of food quality programs in order to reduce industrial losses of raw material.

Graph 1. Index of Food Real Prices in Greater São Paulo -- second-degree of processing - (deflated by IPC – FIPE – basis jul/94=1,00)



Source: FIPE - Fundação Instituto de Pesquisas Econômicas (Economic Research Institute Foundation) www.fipe.com.br

7. Conclusions

The Real Plan, by stabilizing the Brazilian economy, altered the institutional environment, favoring FDI. These multinationals began to assess better the possibility of making safe investments in the country, attracted by the vast potential of the domestic market. Economic stability made it possible for a large portion of the population to enter the consumer market of several products, from lower to higher level of value added food products compared to saturated food markets of the origin countries, the growth rate in host countries is a major attraction factor. On the other hand, the stabilization increases the willingness of consumers to try new products, enhancing competition even more.

We can pinpoint the following items as being main factors in attracting foreign capital to Brazil: a) dimension of the Brazilian market; b) interest in making Brazil an export base to the Mercosur trade partners; c) economic stability, in the initial period of the Real Plan; d) fiscal incentives; e) access to raw materials; f) low cost of labor.

Following Dunning's model, the enterprises join their personal advantages **(O)**, such as the ownership of technology, their specific endowments (personnel, capitals, organization), to the advantages of Brazil's location **(L)**, such as quality and prices of inputs, specific resources, geographic location (the vast market in Mercosur), knowledge of the market, mastery of the structure of distribution and supply of the local enterprises, among others. Joining these aspects **(O+L)**, it becomes advantageous to internalize the market (**I** advantages) by means of direct production in the country. As a consequence, transaction costs in the acquisition of inputs are reduced, uncertainty is reduced and the enterprises may avoid or better explore possible government measures, not to mention establishing price policies.

New product releases and new competitive strategies granted the food industry greater vigor, showing that the FDI can have a most significant contribution to the technological and organizational development of the host country. As multinationals are not exploring gains in countries with protected markets, the competition becomes greater (in a globalized scenario), which increases the concern with efficiency gains and, consequently, with technological and organizational innovations.

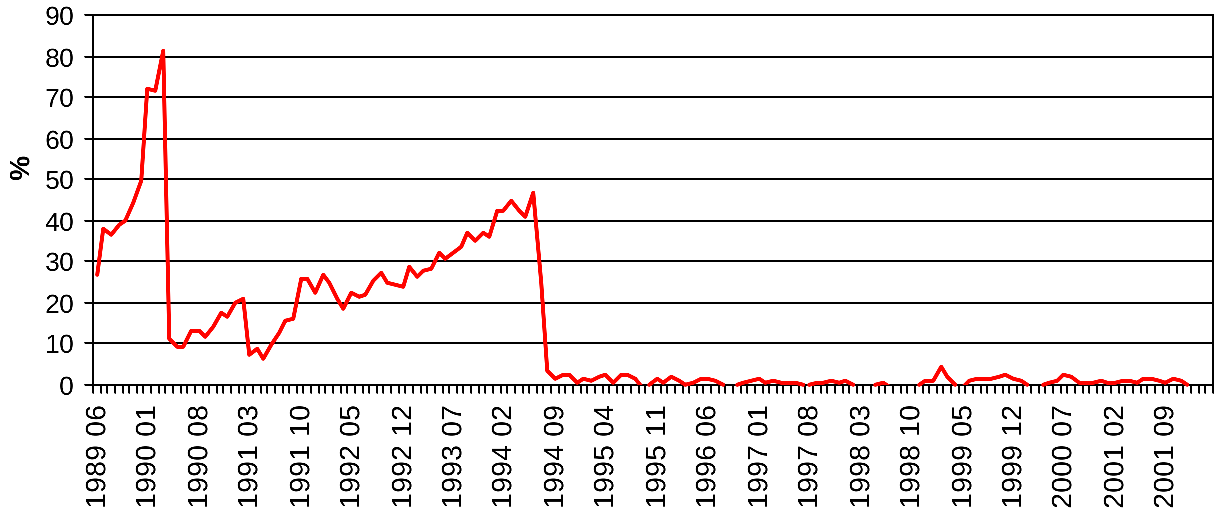
The MNE has considerable advantages over a national firm in releasing new products, because it has a real stock of products already released at world level. Entering by means of M&A allows a rapid adaptation to the local habits, facilitating the adaptation of these already existing products. Thus, the national firm finds greater difficulties in keeping up with this dynamic because it requires more time to invest in new products that the MNE, oftentimes, has already released in other markets.

Therefore, the changes in the political-economic environment, as well as the institutional, have made the Brazilian consumer food market highly attractive to the investments of multinational firms. Entering by means of mergers and acquisitions is the best strategy. These changes alter the competitive environment. The main evidence shown in the work is the increase in industry concentration, with the growing participation of multinational enterprises, and increased competition, which favors price stability and increases the need for new product releases so that firms do not lose their market share.

The difficulty in the analysis arises precisely because these modifications occur in unison, making it hard to establish causal relationships. Hence, an important precaution must be taken. We cannot attribute these transformations exclusively to multinational enterprises. That is, we have no way to verify if the national industries would have taken the paths discussed here even without the presence of multinationals, given that the domestic market potential in itself favors in large part alterations in the competitive environment (new product releases, price stability, and increased concentration). The presence of multinationals, however, is remarkable. This, without a doubt, at the very least accelerates these transformations, given the very characteristics of these enterprises (new technologies, market knowledge, international performance, vast vigor, and competitive strategies). Entering alone does not guarantee multinationals a comfortable situation. In addition to the competition of several multinational firms that entered the Brazilian market, the greater degree of liberalization of Brazil and even national firms confront the MNEs in the domestic market. Thus, the dispute for the supermarket shelves is maintained, causing firms to pursue more and more efficient strategies to at least maintain their market share. This increases the dynamism of the sector, even after the boom of multinational entry and the initial euphoria of the Real Plan passed.

Annex 1: General Price Index

General Price Index from Jun/89 till Mar/2002 (IGP-DI, FGV)



Source: Getúlio Vargas Foundation, in www.ipeadata.gov.br.

Annex 2: Concentration in the Supermarket Chains

Ranking 2000	1999	**Supermarkets**	**1994**	**1996**	**1999**	**2000**
1	2	Pão de Açúcar[1]*	6,5	7,4	12,9	14,1
2	1	Carrefour (French)*	9,4	10,4	13,1	14,1
3	4	Bom Preço (Royal Ahold – 2000)*	2,4	2,6	4,4	4,5
4	3	SONAE (Portuguese)*	-	-	4,7	4,4
5	5	SENDAS	2,6	3,4	4,0	3,7
6	6	Wal-Mart (USA)*	-	-	1,6	1,8
7	7	Jerônimo Martins/SÉ (Portuguese)[2]*	0,8	1,0	1,2	1,4
8	8	CIA Zafari	0,9	1,3	1,1	1,1
9	9	G. Barbosa & CIA LTDA	0,5	0,6	0,8	0,9
10	10	Cooperativa de Consumo	-	-	0,8	0,8
		Top ten market share (%)	**24,3**	**28,4**	**44,6**	**46,8**

Source: Associação Brasileira de Supermercados (ABRAS) – www.abrasnet.com.br
(1) 40% is owned by the french Cassino
* Multinationals

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