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MARKETS | COMMODITIES

Higher Costs Bite Chocolate Makers

The cost of chocolate's two key ingredients, cocoa butter and sugar, has risen sharply this year



A farmer in Ivory Coast moves his cocoa beans at a farm last year. *PHOTO: LEGNAN KOULA/EUROPEAN PRESSPHOTO AGENCY*

By **JULIE WERNAU**

July 11, 2016 7:41 p.m. ET

Hershey Co.'s rebuff of a \$23 billion bid by Mondelez International Inc. this month comes as rising commodity prices are making it more expensive to produce a chocolate bar.

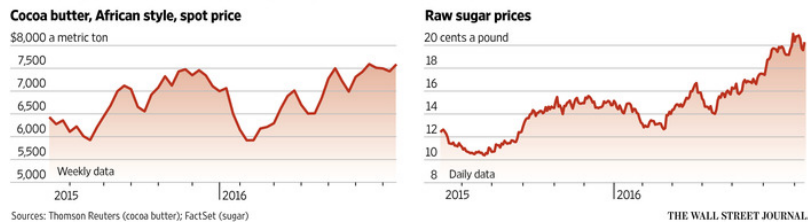
The cost of two crucial ingredients in chocolate, cocoa butter and sugar, has risen sharply this year. It is an unwelcome development for chocolate makers, who already had raised prices on candy bars and other chocolate products following previous spikes in commodities. Increasing competition from snack bars and healthier treats also is crimping chocolate makers' ability to raise prices further.

Chocolate still drives the bulk of sales at Hershey, said Erin Lash, senior equity analyst at Morningstar in Chicago. The company is by far the biggest player in U.S. chocolate, with 45% of the market, and about 88% of its net sales are in North America. The company doesn't break out chocolate as a percentage of sales, but Nielsen data indicate chocolate represents about 80% of the company's U.S. sales.

For Mondelez, 27% of its business is tied to chocolate, or about \$8 billion out of \$30 billion in annual sales. Mondelez makes Oreo cookies and, outside the U.S., Cadbury chocolate bars.

Cocoa-butter prices are at multiyear highs as cocoa-bean processors struggle with unusually small cocoa beans in West Africa, where about 70% of the world's cocoa is grown.

The key ingredients of chocolate are getting more expensive this year.



At the same time, a sharp drop in sugar production after years of glut has pushed world sugar futures up 38% year to date, driving up costs for a commodity that makes up about 50% of the weight of

most chocolate bars, according to chocolate makers and commodity-trading houses.

Today, cocoa butter, the most crucial ingredient in a chocolate bar, costs 21% more to procure than a year ago.

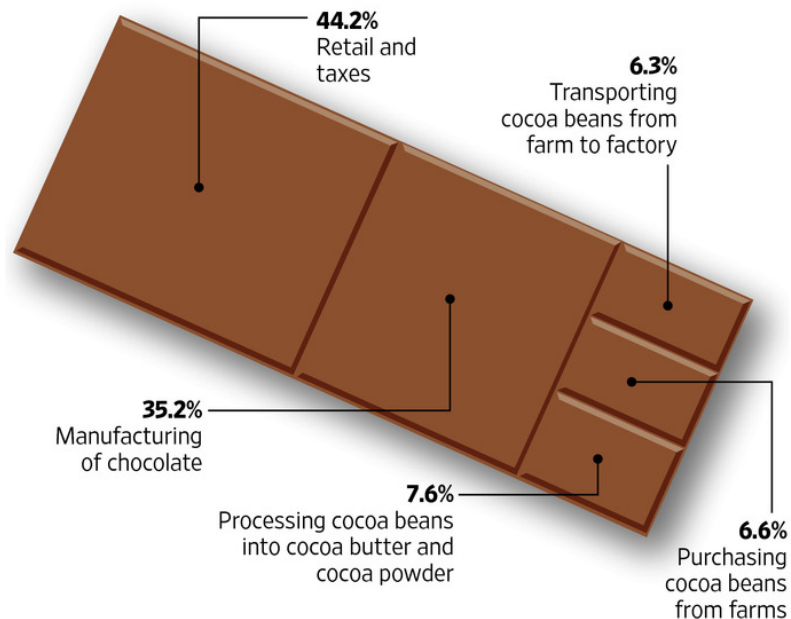
“It’s been a tough time for the chocolate guys,” said Ken Lorenze, vice president at Connecticut-based brokerage JSG Commodities.

Cocoa processors take the beans, remove the shells, cook and grind up the “nib” on the inside to turn it into a thick paste called cocoa liquor. The paste is then pressed to separate the fat (cocoa butter) from residual solids (a cake that is used to make cocoa powder).

“You really can’t make chocolate without cocoa butter, and it’s getting more and more expensive,” Mr. Lorenze said.

Bean Counter

How the costs of producing and selling a bar of chocolate break down



Note: Numbers don't add up to 100 due to rounding
Source: Cocoa Barometer

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Still, the bulk of the costs of making chocolate are in transportation and marketing costs. According to Cocoa Barometer, a consortium of nonprofit groups focused on sustainability in the cocoa sector, purchasing cocoa beans from farms makes up about 6.6% of the total costs of creating chocolate.

Sustainability advocates long have argued for price increases to farmers, most of whom live below poverty levels.

The recent rise in the price of a candy bar isn't helping

consumption, he added. Last year, Mars Inc., Hershey, Nestle SA, Lindt & Sprüngli AG and Mondelez increased prices as much as 8%.

The cocoa crop in Ghana, the world's second-largest producer, experienced an unusually high drop in 2015, after farmers there applied key pesticides late in the crop's development. Hershey said in its last earnings call that the price increases had hurt demand and were in part to blame for a 3.6% drop in sales volume in the second quarter.

Most multinational chocolate companies weren't anticipating further price spikes for cocoa butter and instead expected a recovery this year, said Jeff Rasinski, director of commodities and corporate procurement at Blommer Chocolate Co.

Merchants have been shedding short positions in the cocoa market since May, when the dollar-denominated contract had 78,810 net bearish bets, according to data from the U.S. Commodity Futures Trading Commission. As of last Tuesday, the contract had 61,208 net bearish bets as merchants abandon those positions.

“The industry has been scrambling,” Mr. Rasinski said.



About 70% of the world's cocoa is grown in West Africa. A sack of cocoa beans is carried at a warehouse in Ivory Coast in March. *PHOTO: ISSOUF SANOGO/AGENCE FRANCE-PRESSE/GETTY IMAGES*

Retail prices are expected to rise 2.2% this year in the U.S., according to Euromonitor International, the lowest year-over-year percentage increase in a decade. That modest price increase is because chocolate makers feel they have to absorb rising costs because they can't pass them on to consumers, analysts say.

Currency markets also have added to the confusion around the pricing of cocoa, one of the few commodities that is still widely traded in pounds sterling. While cocoa-futures prices recently rose in terms of pounds, prices fell in terms of euros and U.S. dollars.

Chocolate makers are also dealing with a continuing slowdown in demand in their biggest markets. Chocolate confections account for an estimated \$67 billion in sales in North America and Europe this year, compared with \$8.9 billion for snack-bar sales, according to Euromonitor International. But those so-called healthier treats have been outpacing growth of the confectionary category for at least a decade.

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