

FORWARD THINKING



Hop growers around the world are caught in a paradox, where high profitable prices lead to overproduction and lower unsustainable prices in following years. The required stability can be achieved by brewers entering into forward contracts, argues *Doug MacKinnon*

Each day that passes brings us one day closer to hop harvest and a greater certainty of what it will yield. Growers are always careful to say, "You don't know what you're going to get from a crop until it's in the bale." In recent years that has proven to be very sage wisdom. Harvest is still months away. Mother Nature poses new challenges for growers to deal with each year, and each year the drama unfolds differently.

Acreage in 2006 will be very similar to that of 2005. While that may sound dull on the surface, it means anything but predictability for the hop industry. Production estimates for the April meeting of the International Hop Growers Convention (IHGC) are down around five per cent from last year due to a combination of reduced acreage and new plantings (see table). That percentage, while seemingly small, is huge when you consider that last year's crop, which created a very tight world supply, was short by a similar amount.

Hop growers still face four months of uncertainty that can affect their crops in myriad ways. In the northwest United States, Washington growers have the mixed blessing of being able to receive a full yield in their first year of pro-

duction. Other countries' production comes in more gradually over three years. So, while hop supply may be very tight again for some varieties this year, the second year in a row, it will be a temporary shortage.

Most growers with this information anticipate that prices for hops will increase leading up to the approaching harvest because of the uncertainty inherent in harvest. This year the anticipation is particularly high because supply of many varieties from the 2005 harvest is low. Final production will not be much clearer until October or even as late as November at the Brau Beviale trade fair in Nuremberg, Germany.

By then, prices will do one of two things, either remain fairly stable due to an average to good crop or climb dramatically due to a shortage. With the current acreage and the likely production, I believe there is little chance that prices will decrease after harvest. Forecasting the future is a risky business so let me insert this caveat ... if every producing country has a bumper crop, prices will naturally fall as a result.

So how does a brewer use this information? Brewers would be wise to contract with merchants or growers now while prices are stable at lower levels to avoid a slowly rising price in the

coming months and to avoid any potential price spike in the fall if yields are below average. By doing this, the brewer guarantees, to the extent possible, their supply of hops, or at least their position closer to the head of the line. A brewer who relies upon spot hop purchases at the last minute will only get what is left, which in a shortage could be nothing.

In the fields

Growers in the northern hemisphere are twining their fields, as growers in the southern hemisphere are assessing the results from the crop year just finished. Southern hemisphere hop production represents just over three per cent of total world hop production. In 2006, production there was down by roughly 25 per cent across the board because of acreage reductions, low yields and a drought. South Africa took the brunt of the damage, its worst drought in 50 years causing a decline in production by a full one-third.

This trend is noteworthy, not for its effect upon the international supply of hops, but for the cyclical nature of the world's weather patterns and the effect they have on hop production. Some people believe that weather patterns in the

southern hemisphere are a precursor of things to come in the northern hemisphere. While there is no hard science to back up this theory, some patterns do seem to exist, perhaps by coincidence.

Fortunately for brewers, shortages in recent years, like the one this year in South Africa, have been localised. Good inventory management by merchants and brewers has meant the world's supply of hops went largely uninterrupted. That is possible with one or two years of localised shortages but will become more difficult as inventory declines, as is the trend worldwide.

In Europe, the 2003 drought caused a short crop. Surplus inventory in the US, China and several large breweries found its way into the world market curbing the threat of a more severe shortage. A European crop with excellent alpha acid yields followed in 2004, producing a surplus and absorbing the shock of another potential shortage when, in 2005, US and Chinese crops were short. Supplies are tighter than they have been for quite some time, meaning the risk of temporary shortages of varieties are much greater than in the past.

Hop prices

Toward the end of 2005 market prices strengthened a bit as it became obvious to all that the American crop was going to be short. Prices did not soar, but slowly reached \$40 per kilogram of alpha acid. This represents the world market price to the brewer for generic alpha acid. Since then, prices have softened to the mid \$30s.

Prices to growers are much lower than this as this price includes all processing costs. Grower prices are currently hovering around \$17.60 per kilogram of alpha in the bale form (unprocessed at the farm).

Price activity between now and harvest will closely follow developments of the crop as the world supply of hops is extremely dependent upon this year's harvest. For the near term, it appears there is reason to believe prices will strengthen as summer approaches. With the relative weakness of the US dollar on the world market, nearly all American hops are sold, while some European growers have been left with inventories to carry over into the following year.

Growers and brewers must walk a fine line when it comes to the hop market. Contracting provides stability and enables growers to finance their farms. Open hops offer flexibility and the opportunity to profit if the price spikes. For the brewer the opposite is true. A contract means commitment and limiting options never a good idea, but in a rising market it can also mean saving a lot of money.

Contracts also support a sustainable program of hop buying that will insure hop supply well into the future. If hops are continually purchased on a spot basis, all of the risk is placed on the grower. He can bear that risk for sometime but will eventually go out of business, leaving the future of hop production in jeopardy.

Supply and demand

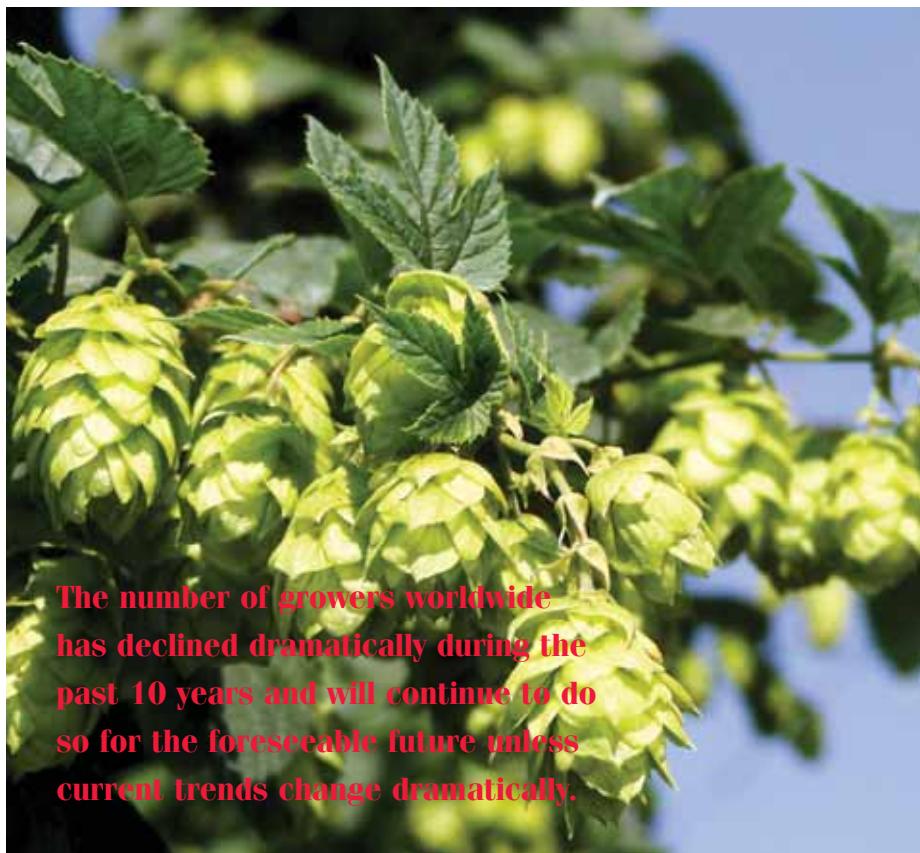
The supply of most hop varieties is dangerously close to being in balance with demand. Balance sounds great and is good in theory. Balance, however, poses a threat because agriculture is not a science. Perhaps it's the lesser

INTERNATIONAL HOP GROWERS CONVENTION

Summary of production reports - April 2006

Country	Hop Acreage 2005 (Hectares)				Hop Production 2005 (MT)			Tot. α Prod.	Hop Acreage 2006 (Hectares)				Hop Production 2006 (MT)			Tot. α Prod.
	Aroma	Alpha	Total	New	Aroma	Alpha	Total		Aroma	Alpha	Total	New	Aroma	Alpha	Total	MT
Australia	6,3	443	449	0	7	1,231	1,238	158	6	358	364	0	7	1,022	1,029	128.6
Belgium*	49	132	181	7	52	300	352	29	49	132	181	7	52	300	352	29
Bulgaria*	72	149	221	0	102	240	342	34.5	72	149	221	0	102	240	342	34.5
China*	539	3,861	4,650	250	974	9,602	10,576	644	539	3,861	4,650	250	974	9,602	10,576	644
Czech Republic	5,395	233	5,672	44	7,287	544	7,831	305	5,264	239	5,602	99	5,826	450	6,276	252
France	721,1	40,3	800.9	39.4	1,307.8	64,4	1,372.2	33	731.9	43.9	800.1	51.8	1,286.3	64.4	1,350	51.8
Germany	9,784	6,981	17,167	402	18,687	15,751	34,438	3,313	9,900	6,400	17,000	700	17,400	14,200	31,600	2,971
New Zealand	253	150	403	0	529	315	845	83	224	129	353	0	419	247	666	64
Poland	865	1,426	2,291	0	1,215	2,199	3,414	236.5	865	1,426	2,291	0	1,215	2,199	3,414	236.5
Portugal*	0	37	37	0	0	57	57	5.5	0	37	37	0	0	57	57	5.5
Russia*	280	264	544	36	141	179	320	15	280	264	544	36	141	179	320	15
Serbia & Montenegro	47	119	166	0	75	225	300	16	34	33	67	0	65	69	134	11.6
Slovakia	350	0	350	0	425	0	425	17	350	0	350	0	350	0	350	13.5
Slovenia	1,389	73	1,511	49	2,447	92	2,539	208	1,400	40	1,522	62	2,307	93	2,400	197
South Africa	0	506	506	0	0	937	937	127	0	438	438	0	0	661	661	94.5
Spain*	0	680	680	0	0	1,537	1,537	153.7	0	680	680	0	0	1,537	1,537	153.7
Ukraine*	895	569	1,464	0	904	569	1,474	59.5	895	569	1,464	0	904	569	1,474	59.5
UK - England	866	305	1,187	16	1,236	457	1,693	115.3	784	244	1,056	37	980	430	1,410	115
USA	4,311	7,506	11,817	0	6,673	16,820.9	23,494.3	2,584.4	4,392	7,520	11,912	0	6,810	17,600	24,410	2,929
IHGC Total	25,095	23,434	50,097	843.4	42,061.8	51,055.9	93,184.5	8,072.4	25,785.9	22,563	49,532	1,243	38,838.3	49,519.4	88,358	7,940.7
IHGC (previous year)	25,705	23,990	51,201	1,307	38,210.1	54,145.1	92,355.2	8,238.9	25,095	23,434	50,097	843.4	42,061.8	51,055.9	93,184.5	8,072.4
	Difference 2005 - 2004								Difference 2006 - 2005							
+/- (%)	2.43	2.37	2.20	54.97	-9.16	6.05	-0.89	2.06	-2.68	3.86	1.14	-32.2	8.30	3.10	5.46	1.66

* Did not receive April 2006 figures for these countries. Most recent figures were used instead for this spreadsheet.



The number of growers worldwide has declined dramatically during the past 10 years and will continue to do so for the foreseeable future unless current trends change dramatically.

of two evils. Historically, the market's reactions to temporary shortages have not been good. Price spikes for one or two years with hops selling for \$6.00 per pound are followed the next year by the same hop varieties selling for \$0.30 per pound. These sound like extreme examples, but the numbers are real, taken from the 1980's price spike. Many merchants and growers went out of business because of these wild price swings.

Grower reactions to temporary shortages are not conservative. For the long-term health of the hop and brewing industries, shortages should be avoided at all cost. The brewer has the ability to do this by contracting ahead for their hop needs. This enables growers to produce for the market instead of marketing what they produce.

The number of growers worldwide has declined dramatically during the past 10 years and will continue to do so for the foreseeable future unless current trends change dramatically. Farm size worldwide is growing and hop farms, like breweries, are consolidating production into the hands of a few.

The United States now has only 65 growers. Each year the German hop industry seems to lose about that many growers. While the

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number of German growers is still high, approximately 1,300 in the Hallertau in 2005, it will not be long before the German and American industries resemble one another. I believe that within 10 years the number of growers in the US and Germany will be half of what it is currently.

A chain is only as strong as its weakest link and the hop industry is only as strong as its weakest grower. Information, and the ability to correctly interpret that information, makes a grower strong. Like Pavlov's dog, too many growers react to perceived demand by planting more hops. This causes predictable and wild swings in production and price that bring down the market for other varieties for years.

An example is 2005 Hallertau Mittelfruh production in Germany. Growers planted spot Mittelfruh hops and in 2005 produced well beyond the contracted needs of the main customer for that variety. After a few months of uncertainty, the brewery bought all of the spot hops but at two-thirds the contract price. American growers are setting themselves up for a similar scenario in 2006 as they rush to plant Willamette varieties in response to perceived demand in 2005.

The very thing growers covet most, higher prices, is ironically what causes them the greatest harm. That is the paradox that has plagued hop growers for centuries. Costs of natural gas, diesel fuel and labor are on the rise, but prices remain the same. The Catch 22 this creates is that growers cannot afford to grow hops at low prices but cannot afford the consequences of high prices. They cannot get out of the industry because they are too heavily invested in equipment that has no resale value. They cannot continue with the status quo because they are losing money.

Clearly, something must change if the hop industry is to survive. The solution is a difficult one. Like Alexander's solution to the Gordian knot, it requires cunning and ingenuity. In short, the solution is that the cost of production must come down so that current prices become more profitable. Higher prices will only lead to increased production, which, in turn, perpetuates the cycle of wild price swings.

Hop price is an issue in every country in which hops are produced, but for different reasons. In countries like England, the US and Germany, where hop yields are relatively stable at higher levels the cost of production approach-

es the current market price for hops. In countries like Russia, Bulgaria, or the Ukraine, where costs of production are lower, lower yields bring about the same effect resulting in a price that is lukewarm at best for everybody. Despite this lukewarm effect, the problem of overproduction plagues the industry.

Growers may not be able to afford the cost of better prices, but contracts will benefit the industry immensely. Maintaining a relative calm in the hop market and avoiding price spikes will be the challenge for the future if the industry remains in a state of balance. As with Alexander, the growers who can loosen the proverbial Gordian knot, in this case finding a way to significantly lower their costs of production, may go on to conquer the world.

Doug MacKinnon, former executive director of Hop Growers of America, today is chairman of the International Hop Growers Convention executive committee. He publishes the MacKinnon Report, a subscription newsletter that reports developments and market activity within the hop industry. Comments are welcome via email: doug@mackinnonreport.com



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