OCCASION

This publication has been made available to the public on the occasion of the 50th anniversary of the United Nations Industrial Development Organisation.

DISCLAIMER

FAIR USE POLICY

CONTACT

Please contact publications@unido.org for further information concerning UNIDO publications.

For more information about UNIDO, please visit us at www.unido.org

UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION
Vienna International Centre, P.O. Box 300, 1400 Vienna, Austria
Tel: (+43-1) 26026-0 · www.unido.org · unido@unido.org

08894

UNITED NATIONS INDUSTRIAL
DEVELOPMENT ORGANIZATION

Distr.
LIMITED

UNIDO/EX.78
1[illegible] April 1979

ENGLISH

Expert Group Meeting on
Buy-back Agreements

Vienna, 29-30 March 1979

REPORT*

by the UNIDO Secretariat

*This document has been reproduced without formal editing.

id.79-4352

Table of Contents

I. BACKGROUND INFORMATION

On 6-8 December 1976, an Expert Group Meeting on Industrial Financing was held in Vienna in order to discuss the volume of external funds required by the Third World for industrial purposes over the medium and long-term future, the terms and conditions to be applied, and the forms in which such financial resources might be made available.[1/] Several issues were identified for further study. Amongst the more recent arrangements for industrial co-operation, the concept of buy-back agreements to finance all or part of an industrial plant, has been proved to be important since it appears to provide an impulse to industrialization with increased export earnings, new outlets and more long-term industrial co-operation without equity participation and might serve therefore as an alternative to the conventional joint venture concept by providing financing "in kind".

UNIDO is at present undertaking some investigations to determine the implications of buy-back agreements as far as partners from developing and developed countries are concerned; special attention is also being paid to their employment effects on the economics of the countries concerned. Finally, it is examining the extent to which these agreements might be acceptable to financial institutions. [2/]

II. THE PURPOSE OF THE MEETING

The objective was to bring together specialists in buy-back agreements from both developing and developing countries to exchange views on the advantages and disadvantages of such agreements, and to propose ways and means of improving them. In particular, the meeting

---

1/ See ID/WG.287/5, ID/WG.287/10.

2/ See note by Professor André Tiano on Buy-Back agreements as an instrument for industrial co-operation was to examine:

(1) The desirability of model contractual arrangements for buy-back, and the possible forms which they might take,

(2) A checklist of points which could be covered by buy-back agreements, such as:

(i) The marketing of goods produced through buy-back agreements;

(ii) Production performance incentives;

(iii) The price of the goods to be manufactured;

(iv) Others.

(3) The possible role of a neutral organization, such as UNIDO, if requested, to determine in advance and during an agreed period of time after commencement of production the price of the manufactured goods which are to be bought back by the foreign enterprise,

(4) The desirability and possibility of establishing an equalization fund to function as a "clearing-house" for transactions in manufactured goods produced through buy-back agreements with the purpose to reduce excessive fluctuations in prices for such products.

III. SUMMARY OF CONCLUSIONS

1. Definitions

The meeting considered various definitions of buy-back agreements; the following were considered to be the most acceptable definitions:

(i) Agreements of the "buy-back" type: at the present time, compensation agreements are developing fastest in this form. The exporter of plant and equipment and services accepts a payment (partial or fully) in products manufactured by means of the equipment sold (ammonia in return for an ammonia plant, methanol in return for a methanol plant).[3/]
Average rate of buy-back was given between 20 - 60% of the value of plant supplied.

3/ ID/WG.287/5.

(ii) "Pure" buy-back transactions are purchase or licence transactions in all their compounded forms, in which the purchase price or the licence royalties are, instead of payment, wholly or partially met by semi-finished or finished goods manufactured as per agreement on the plant or under the licence. It is not necessary for the supplier to take the goods himself; a third party ("trader") may assume the role of a financier.4/

2. Products suitable for buy-back arrangements

Various attempts were made to differentiate between the suitability of various products. It was however agreed that while some products are more suitable than others, it was not possible to categorize them into 2 groups.

The following product groups appear especially suitable:

- products based on agricultural inputs including food processing industry;
- process non-agricultural raw materials (e.g. coal mining equipment for China against coal supply to India, iron bars from India sold to Spain);
- intermediate or semi-finished products, (e.g. cotton yarn, petrochemical intermediates);
- capital goods for export calculated on a value rather than quantity basis; (e.g. gas pipes from Austria and FRG to USSR, against natural gas supplies);
- consumer goods (e.g. machinery for toy manufacturing in the Philippines against toys)

Less suitable are electronic products due to their rapid obsolence; such products are better for subcontracting arrangements. Similarly, products involving higher sophisticated technology such as nuclear and similar product groups would have no price quotations and would therefore be excluded.

4/ A. Mohr: "Buy-back Study"; paper submitted to the meeting.

3. Contractual Arrangements

Buy-back arrangements are probably not yet feasible for the least developed countries. Each buy-back contract would have to be drafted in accordance to the particular situation; e.g. in the case of certain technologies, adequate provision should be made for product development and adaptation, training, etc. For the same reason, it was agreed that model contractual arrangements are not feasible; one participant reported that there were 36 different kinds of business contracts including one or another form of buy-back. However, a check list of items to be covered in a buy-back operation should be prepared particularly in a North-South agreement.

4. Pricing

"Expectations are expressed in form of prices": the example was given of the dog sold for $ 10,000 in exchange for 2 cats each $ 5,000. No standard price formula can be found, but there should be a lower limit for calculated price, taking into consideration the foreign exchange cost. Products have to be priced no higher than the prevailing market price and no lower than production costs taking into account foreign exchange requirements, as illustrated in Figure 1.

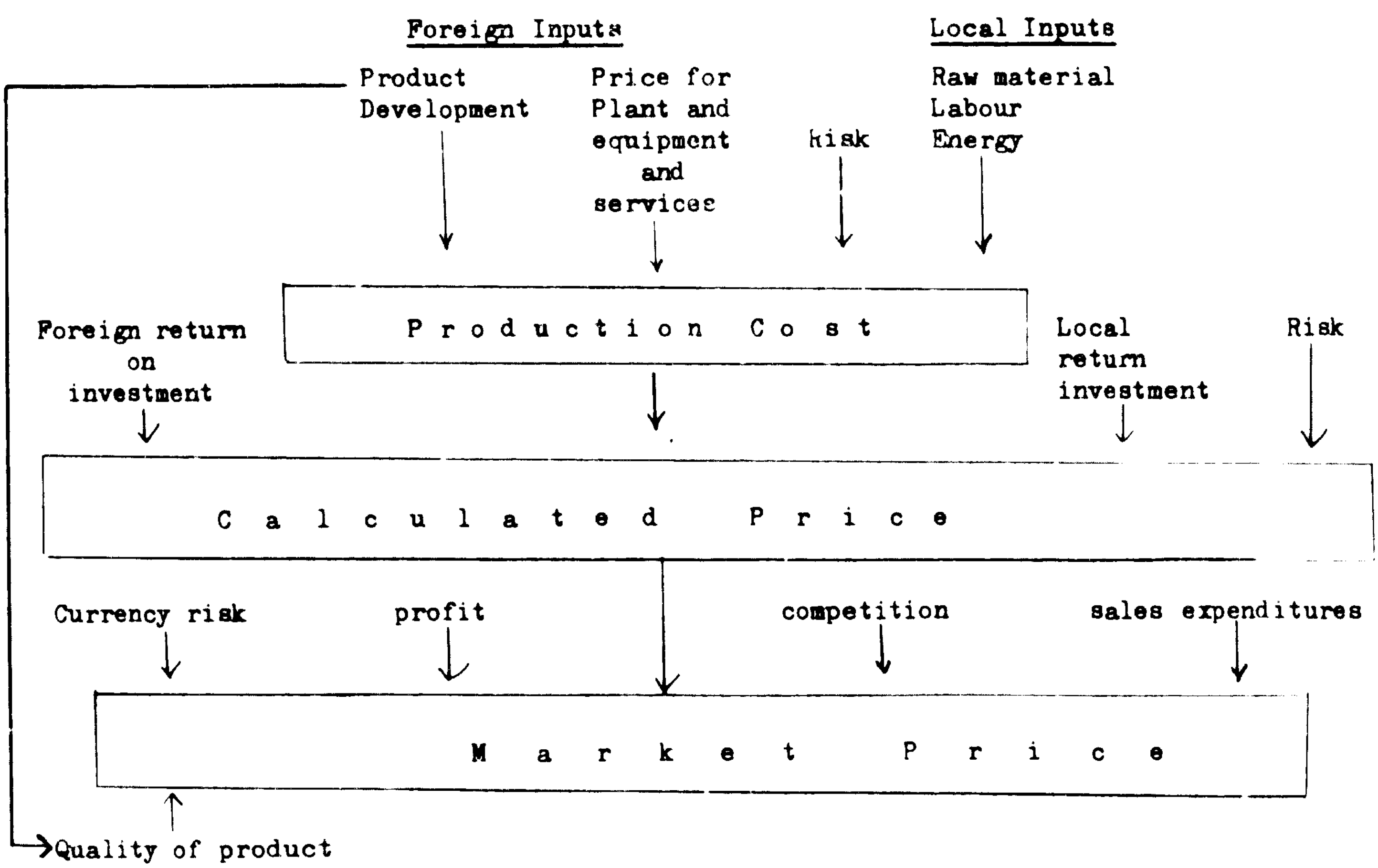

Figure 1

Its precise determination depends inter alia on the relative bargaining power of the parties concerned. Those who offer to take products have an edge over their competing plant suppliers. Several suggestions for pricing were proposed; in all cases, escape clauses for the plant supplier are considered dangerous.

(i) Products should be supplied at best market prices plus appropriate commissions;

(ii) Each shipment needs a separate agreement on pricing through negotiation;

(iii) Fix prices on the basis of the calculated price (see Figure 2) with an escalation clause which would go into force through renegotiations if the deviation would exceed, for instance, ± 10%.

(iv) Competitive bidding (offers)

(v) In combination with a joint venture, each party has a similar interest in pricing of the products.

(vi) Periodic price fixing (every 3,6 or 12 months) could be agreed upon.

It was agreed, that UNIDO would provide a panel of experts on request by the parties concerned, to assist in a neutral manner to fix prices which are fair and equitable and in conformity with the market conditions.

5. Quality

This constitutes the real problem or risk involved in buy-back agreements particularly since penalty clauses do not appear to be effective in practice. There is a definite need for certificates guaranteeing quality standards; this inevitably involves additional costs but can be effectively undertaken by special agencies and by specific provisions in the respective contracts. Traders such as BAFAG maintain their own quality inspection teams.

6. Financing

The meeting stressed the complexity of the buy-back operations and discussed under what conditions they might imply higher costs than the usual financing operations, i.e. depending on whether repayment periods are the same, the number of entities involved, the market situation in a few years' time, quality, etc. It should be borne in mind that transport costs are generally higher in North-South industrial co-operation. Nevertheless, certain countries, such as China, are attracted by the buy-back idea since it saves on foreign exchange requirements, provides for the acquisition of technological know-how, for a built in performance guarantee, and for easier product distribution.

In general terms, the cost of financing of an industrial plant through buy-back agreements was said to be higher by 10-15% than "conventional" methods of financing. For instance, 2 sugar factories were supplied (to Morocco and Spain), which required 7% "advance payment", and repayment of loan started with commencement of production. Frequently, there are conditions attanced, such as quantity and quality of sugar harvest, etc. which increase the risk and consequently the costs. There are 3 components for financing: (i) advance payments to cover interest, (ii) a "pseudo loan" for approximately 5 years (until startup) to cover the interest on "capital", and (iii) costs of risk and money. If and when total costs are higher than through conventional methods, then the extra amount paid by the developing country corresponds to the "price" of the advantages of buy-back.

It was considered preferable to have a two-contract system: one relating to the sypply of a plant; another relating to the problem of repayment. However, the problem of insuring risks remains to be solved, no matter how many partners or contracts are involved.

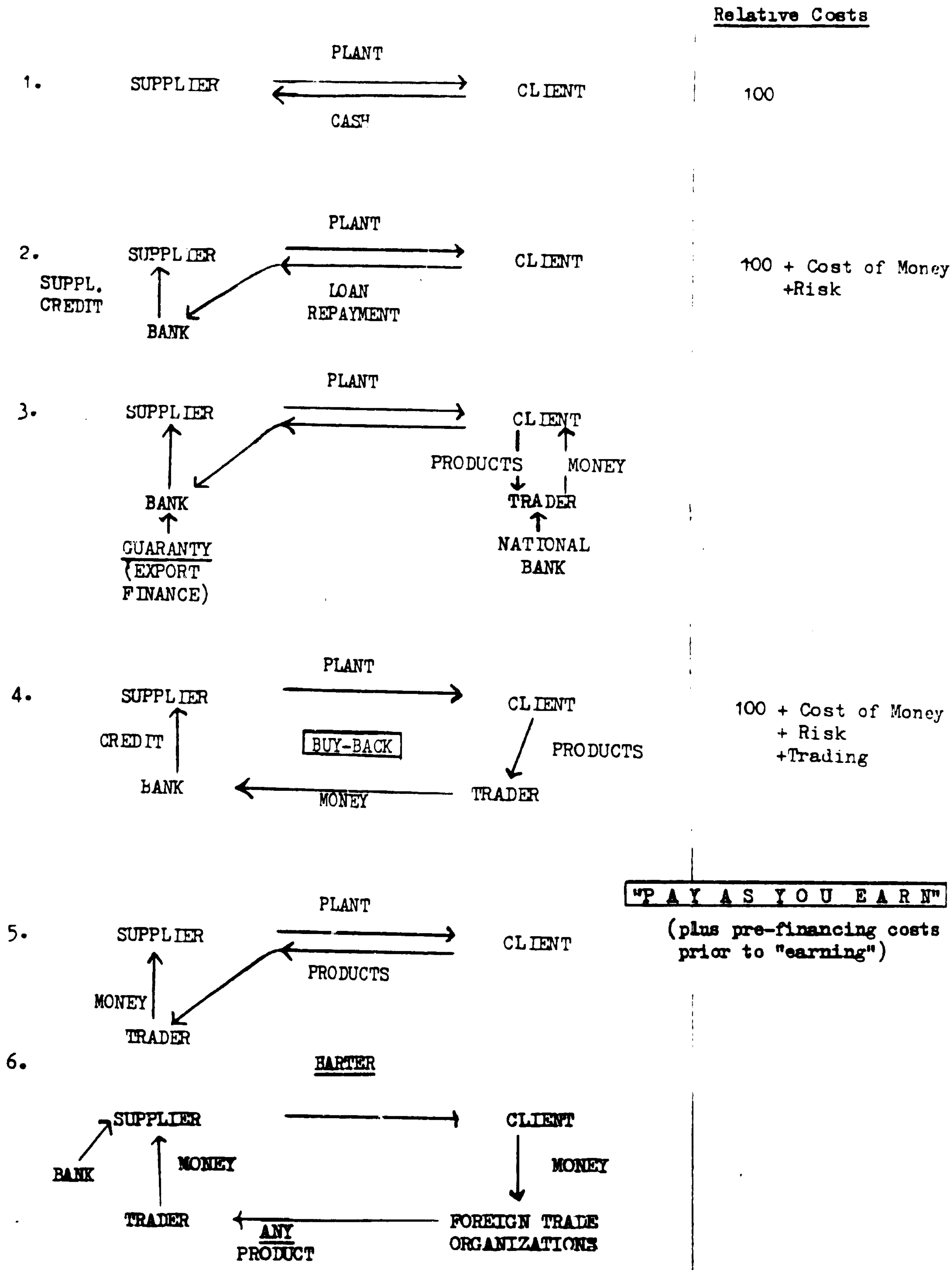
Relative Costs
1.
SUPPLIER
PLANT
CASH
CLIENT
100
2.
SUPPLIER
SUPPL. CREDIT
BANK
PLANT
LOAN REPAYMENT
CLIENT
100 + Cost of Money +Risk
3.
SUPPLIER
BANK
GUARANTY (EXPORT FINANCE)
PLANT
CLIENT
PRODUCTS
MONEY
TRADER
NATIONAL BANK
4.
SUPPLIER
CREDIT
BANK
PLANT
BUY-BACK
MONEY
CLIENT
PRODUCTS
TRADER
100 + Cost of Money + Risk +Trading
5.
SUPPLIER
MONEY
TRADER
PLANT
PRODUCTS
CLIENT
"PAY AS YOU EARN"
(plus pre-financing costs prior to "earning")
6.
BARTER
SUPPLIER
BANK
MONEY
TRADER
CLIENT
MONEY
FOREIGN TRADE ORGANIZATIONS
ANY PRODUCT

Figure 2

With regard to the problem of guarantees, it was noted that manufactured goods are generally not accepted by banks since they are not experienced in quality and pricing; the supplier of the plant has to guarantee any loan repayment, although there are no export guarantees available; the National Bank of the "client" would be an acceptable guarantor; traders or a proposed "International Guaranty Fund for Buy-back Agreements" could be used. It was made clear that conventional export guarantees were not available for such transactions.

7. Legal aspects: contractual structure

It was repeated that it is best to conclude two separate contracts, depending on the nature and degree of involvement of several partners in buy-back agreements; prices and costs should be listed by item rather than lump sum; two or more equipment suppliers are preferable to only one; appropriate guarantees should cover production, repayment, performance of plant and quality of products. Adequate provision should also be made for the settlement of disputes; the main problems here are the length of arbitration procedures and their excessively high costs, lack of expertise on the part of developing countries, and so on.[5] Other problems are: change of ownership (after full price for plant has been paid); the replacement of performance bonds by buy-back agreements).

To prevent differences, the meeting suggested that it may be useful to administer contracts through special committees would provide a forum to which problems and disputes could be referred in lieu of the International Chamber of Commerce. The role of other arbitration centres, such as that in Kuala Lumpur, was also mentioned.

8. Advantages and disadvantages of buy-back agreements

The following were enumerated by the meeting as advantages for developing countries stemming from buy-back agreements:

(i) Marketing of export products, which due to the inexistence or inadequacy of related infrastructure is otherwise difficult;

(ii) Source of financing saving foreign exchange, and possibly raising additional industrial credit lines.

5/ See also M.E. Schneider: "Report on Certain Issues Relating to International Industrial Co-operation", ICIS. 34/Rev.1.

(iii) The supplier of plant and equipment is involved and committed to the project's performance including product quality and adaptation;

(iv) Economies of scale (more production than if only for local market)

(v) Indirect market penetration; exports of other products may obtain access to new markets as a result of the success in exporting products covered by buy-back arrangements.

(vi) In case of labour shortage in the recipient's country, such as in CMEA countries, the acquisition of advanced capital-intensive technology is important.

The following disadvantages were mentioned:

(i) Possibility of limiting markets available to recipient country due to the obligation to restrict exports to a specific country or enterprise.

(ii) Tendency to overprice plant and equipment unless there are adequate guarantees covering future costs and risks (It was said that in the FRG, recommendations as to higher pricing were even published; no risk insurance is available).

9. Macro-economic implications

In the light of the above, the meeting considered it necessary to investigate further the question of built-in overpricing in buy-back arrangements and its effect on inflation; the effect of buy-back on employment in the supplier's and recipient's country; trade and trade-related policies of governments and their impact on buy-back agreements; balance of payments' effect in the country of each partner. It was stressed that through buy-back arrangements, the flow of manufactured goods would be made more "visible" in advance so that market disruptions could be avoided.6/

6/ See note by Professor A. Tiano on Buy-back Agreements as an instrument for industrial co-operation.

10. The possible role of UNIDO

The meeting agreed that there are several areas in which UNIDO could play a useful role in the future:

(i) As a catalyst, in order to find the right partner in industrial co-operation, i.e. the best supplier of technology through the diffusion of appropriate information (Technological Advisory Service)

(ii) As an adviser during the negotiation phase and during the life of the project;

(iii) As a neutral arbiter or advisor over, for example, the pricing of products.

(iv) Through the establishment of a price equalization fund or of a risk insurance scheme, or both.

(v) By preparing guidelines for buy-back agreements including information on traders, such as those which are members of FIT, (Federation of Industrial Traders).

(vi) UNIDO may follow up the idea of an international "guarantee fund for buyback arrangements".

Expert Group Meeting
on Buy-back Agreements

Vienna, 29-30 March 1979

LIST OF PARTICIPANTS

AUSTRIA

Dr. Alfred MOHR
Solicitor
Hietzinger Hauptstrasse 3
Wien, 1130

CZECHOSLOVAKIA

Mr. Milan FRANEK
Manager
Commercial Policy Section
FINCOM Limited
Vjame 1
Prague 1

FRANCE

Professor André TIANO
Université de Montpellier
39 avenue de l'Université
34000 - Montpellier

GERMANY, FEDERAL REPUBLIC OF

Dr. Peter ALADJOV
Chairman of the Board of "BAFAG"
BAFAG - 8000 München 2
Lindwurm 11
(BAFAG HOUSE)

Mr. Klaus KINDLER
Director
Deutsche Kredit und Handelsbank AG
Kurfürstendamm 136
1 Berlin 31

GERMANY, FEDERAL REPUBLIC OF (Continued)

Dr. Hans-Jurgen MOECKE
Regional Director
Legal Department
German Foreign Trade Information Office
D-5 Köln 1
Blaubach 13

INDIA

Professor Phiroze Kaikhushroo IRANI
International Legal Consultant
49 Mereweather Road
Bombay 400039

POLAND

Dr. Eugeniusz TABACZYNSKI
Associate Professor
Research Institute of Foreign Trade
00916 Warsaw
ul. Swietokrzyska 12

PORTUGAL

Mr. Mario Martin GUIA
Trade Consultant
ORVEG
69-Z-DT° Rodrigues Sampaio
Lisbon 1.100

UNIDO

Task Force on Industrial Financing:

Mr. E. Becker-Boost
Director, Investment Co-operative Programme Office

Mr. A. de Faria
Negotiations Section

Mr. U. Loeser
Investment Co-operative Programme Office

Mr. V. Richardson
Global and Conceptual Studies Section

B-89

80.02.07