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ESTABLISHMENT OF NEW INDUSTRIAL ENTERPRISES IN DEVELOPING COUNTRIES

JOINT INDUSTRIAL VENTURES BETWEEN LOCAL AND FOREIGN PRIVATE INVESTORS IN DEVELOPING COUNTRIES 1/

by

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Private foreign investment in developing countries plays a great role in industrialization. In 1972, a quarter of the total of funds, both public and private, exported by OECD countries to the Third World, were private investments.

Considerable changes in private investments in developing countries have occured in the last twenty years. Before the Second World War, the only investments made in the Third World were either of colonial style or aimed at exploiting raw materials necessary to the industrialized world. No place was given to local partners and local regulation was usually dictated by the investor's country or at least strongly influenced by the industrialized country patterns and needs. The place reserved to local partners, if any, was rarely predominant but rather a guarantee against unexpected internal convulsions or changes in the local regulation (mainly taxes, custom duties, exchange regulation).

A local partner, in brief, was generally a sleeping partner, excepted in really independant Third World nations. Technology was not really transfered but kept by the foreign investor , local capital was generally nothing more than a token. Local management was largely theoritical and limited to subaltern tasks.

Legal, fiscal and exchange problems were self resolving under case by case agreements with local governments and financing was the problem of the foreign investor, solved in his own country as an internal development financing.

Decision making process was unilateral-center of decision remaining out of the country. Marketing was provided by the foreign group. Export markets were in the hands of the foreign investor who remained free to fix the prices of exports so as to make his profit where he liked ; Structure of the local market was not so complicated as to implicate sophisticated plans : an agreement with a local trader was often sufficient to cover it).

These largely foreign dominated patterns have been replaced, since the beginning of the sixties, by completly different situations that all of you, Gentlemen, are aware of and that is not necessary to develop here.

I will only summarize the main changes :

- emergence of a feeling of frustration in the Third World countries ;

- consequently an effort to control inflow of foreign investment, promote local industry and increase local control of economy ;

- Thirdly an effort to reequilibrate the balance of payments, mainly for the so-called Fourth World countries (Third World lacking of abondant natural resources) by slowing down the outflow of profits ;

- lastly to try to get as much technology as possible, as cheaply as possible to enhance local ability and so increase the degree of industrial and organizational knowledge of the nation.

Conquences of these have been the restrictive legislations we know in most Third World countries -not to mention the nations which have chosen the socialist patterns of development :

- rules of national majority in private joint-ventures ;

- restriction of royalties and technical assistance payments abroad ;

- restriction on profit repatriation ;

- and -last but not least- re-exportation obligations which Mr FAZAL illustrated yesterday in the case of India.

The best for many Third World countries might therefore be to get rid of foreign investments and to try to develop completly autonomous industries. Unfortunately, it is now clear that rapid industrial development necessitates inflow of foreign capital goods, foreign technology and foreign training of technical and managerial staffs, and above all, money under the form of capital inflow, export or balance of payment credits.

The restrictions to foreign investments have discouraged many potential private foreign investors which now tend to concentrate in stable Third World countries, preferably entering the era of take-off, with a large internal market and a relatively liberal legislation.

I will try to illustrate the behaviour of a private foreign investor of a developed country -France, in a rapidly developing country-Brazil which nationalistic approach to industrialization is hidden behind a widely publicized so-called liberal policy.

We have lived that case from the very beginning to the present situation by being the promotor of the whole operation -our normal vocation : we are a French semi-public international development consultancy which activity is to promote industrial French investments abroad.

I could have taken examples of our achievements in countries like Indonesia, Iran, Mexico or Ivory Coast,but I think this case is a good sum up of all the problems to be solved presently by a foreign private investor in a developing country.

The sector is moped production and the original idea was to create in Brazil a market for 50 cc - light and cheap motorcycles, a deadly needed individual means of transportation in a country where collective urban transport systems are still to be organized and where towns tend to become megalopolises.

France has the chance to be one of the rare countries to have several industrial groups specialized in the conception and mass production of that sort of machines with an experience of technological transfers and investments in developing countries.

With the idea in head, we had to assess the chances of success of a new product on a rapidly evolutive market, then to convince one of the French firms to explore more in depth the existing opportunities.

I remind you that this first step had to be done in a country where statistics are often erratics, where money melts, where national behaviour is a mix of flamboyant pride and poor organization, and above all, where laws are constantly changing and subject to high level civil servants personal appreciations. The other side of the picture is that decision making in Brazil is rapid and based on the criteria of rapid profitability -quick money- even if the evaluation of the future profit is based on fragile hypothesis.

We had the chance to get the authorization to import half a dozen machines. Needless to say that Brazilian import regulation almost forbid the importation of assembled motorcycles and that the only way to be on the market was to produce locally.

The test we made was such a success that we were in a good position to convince one of this French firms to enter the complex path leading to an investment in Brazil.

The second step of our task was to make a verification of what we thought to be a good opportunity : a market survey of a non-existing product in a developing country is not an easy matter. You have to rely on opinions, impressions, a bit of intelligence information and pass your time in cross-checking unreliable figures and statistics. Finally, our feelings were confirmed and we came to the conclusion that mass-production of mopeds had to be taken up rapidly, the first on the market having the best chances to remain alone during a number of years. This is a general observation which usually encourages private investors to go ahead when the interests of the developing country and the foreign investor converge.

Anyone who knows Brazilian way of doing business can confirm that, although legislation does not formally make compulsory an association with a local partner, the rules of the game are different. Long and medium term credits, provided by the BNDE are only available to companies controled by national investors. Bureaucratic procedures are facilated to local industrialists and made more complex and time consuming for foreign controled firms. Licences to import capital goods not available locally are given more easily to Brazilian controled firms and I could draw a long list of facts which demonstrates that, if the law is liberal, the implementation of the law is restrictive and submitted to the good will of civil servants.

So we began to look for a potential partner. Our consultants having drawn with the French firm the profile of the future partner, began a systematic screening of several industrial sectors then quickly concentrated on four different industrial firms who had reasonable production ability, enough room in their plants to begin to produce rapidly and a commercial network which might easily be adapted to moped sales and after-sales. Needless to say that we carefully checked the reputation, soundness and credit rates of these groups.

After having reported to our principals in France, we decided for particular reasons to eliminate one of the companies and a joint mission was set up to begin the talks with the three remaining groups.

The strategy was to begin with an assembly line, then, after one year of market test, to progressively integrate the production up to a level acceptable by the local Ministry of Industry but we found out that integration meant finding suppliers of parts : motors, brakes, specialized cycle parts, which either were not yet produced locally or when produced, with low quality standards.

It turned out that all the companies visited by the joint-team were interested by the idea and quickly convinced by our previous studies, which we made available to them, that there was a profitable operation to be done in that field. Then we had all their help to explore from the inside the technical, commercial, financial and managerial ability of these firms to become our partners.

At the same time, we began to discuss with the regional and federal governments to get an acceptation of our investment plan and to explore the ability of potential sub-contractors to enter into our integration scheme.

Incidentally, this survey convinced our principal that they needed to have one of their French sub-contratorsto transfer its technology to Brazil to be sure to get a particularly important part with the quality standards required. Finally, this French firm decided to also invest in Brazil.

At the end of this step we made our choice and picked out the partner we found the best one very respect and which seemed the more decided to make the necessary efforts to create the new market we aimed at.

We decided to work out together with the Brazilian company on a 4 steps cooperation agreement :

1. Set up a provisional assembly line in the Manaus free trade area, where the Brazilian company had some land and buildings.

2. Instead of creating a new company, to take an equity participation in the Brazilian company by raising capital so as to provide the

necessary finance ressources to make the necessary industrial and commercial investments.

3. To associate in the capital scheme a specialized subsidiary of the BNDE which was a guarantee for the French side to get an official support to the operation and to the Brazilian side to keep the majority of capital in Brazil.

4. Once the capitalist structure reorganization finalized, to begin to transfer the production line in the center of consumption, which was the Sao Paulo State in order to get closer to our spare-parts suppliers. This transfer could not be made before fresh capital enters the Brazilian company, important investments being necessary to meet the government requirements of integration percentages.

Needless to say that during that time, all necessary clearances had to be obtained both in Brazil and France, where investment in foreign countries is carefully watched on and controlled.

The processus began in October 1973 when the owner of the Brazilian firm first came to Paris to visit the French firm facilities and ended on December 1975 when production began in Sao Paulo.

During that time, the following formalities were completed :

- acceptance of our programm by the Sao Paulo State and the Brazilian Administration ;
- clearances to get the rights to import assembled mopeds from Manaus to Brazil ;
- starting of the assembly line in Manaus at a cadency of 100 machines a day - raised to 200 a day after six months (June 1974 - June 1975) ;

- entrance of BNDE group in the capital of the Brazilian company in such a way that after five years time BNDE group shares will be repassed to the Brazilian group at a pre-determined price. In fact, they took around 25 % ;

- evaluation of the effective asset value of the Brazilian firm to fix the financial conditions of the capital increase. Our firm made this evaluation and we were confronted with the difficulty of evaluating assets in a developing country where inflation is at its highest, land speculation at its peak, double accounting at its worse and tax fraud at its best. Negociations were hard but finally we reached an agreement and capital was raised so that participation of the French concern is of 20 % ;

- negociation of financing of the French investment through a long term soft loan from a specialized French financing institution ;

- agreement of the Brazilian exchange control on a royalty based on turn-over which was traded against re-exportation commitments of spare parts ;

- negociation of a long term loan granted by BNDE to permit extension of Sao Paulo facilities.

y, the French group invested 3 million US$ in the Brazilian ny. It is obviously too early to draw a conclusion of the ll operation but we can say to-day that all parties find their dvantages :

- Brazilian government who saw 3 million US$ capital inflow and commitments of re-exportation of a total of 10 million US$ spare-parts for the next five years.

- French government who has already gained an increase of exportation to Brazil of CKD Mopeds for an amount of 3 million US$.

- The Brazilian company who totalizes to-day an increase of turn-over of more than 6 million US$, who has registred an inflow of capital of 5 million US$ (BNDE + French investment) and last but not least controls a new rapidly developing market.

- The French company who is now exporting to Brazil and buy parts at a lower cost.

But I have to make a point that all this operation would have never been materialized if a third party -ourselves- had not carefully, sytematically and patiently help industrialists to overcome a number of difficulties which are typical of any private investment in a Third World country.

To come to the conclusion, I would try to point out the main difficulties which have to be dealt with in a case like this :

Mutual understanding

To realize the cultural gap between industralists of developed and developing countries is a first step into solving it.

Concept of profitability

For a local investor, to set up a joint-venture is above all to find a way of making money more rapidly than by locally available opportunities. Concepts of profitability are usually different in developing and developed countries -which leads the way to misunderstandings.

Selection of projects

The selection of projects is usually done according to non-technical criterias -sometimes irrational. Besides that, feasibility surveys often lack of realistic conclusions, based as they are on unreliable statistics, theoritical market trends and irrealistic market prices.

This is why a general suspiscion presently wrapped feasibility surveys. They are still taken for granted by the public bodies but less and less by the private investors.

In fact, the most urgent need for developing country being the promotion of medium size industries, the project selection has to be done with a new approach, by taking into account that potential investors have often a small knowledge of industry and are only down-to-earth entreprenors.

Legal problems

Developing countries have a normal tendency to protect themselves against inflow of foreign capital. The legislations adopted are more and more restrictive, discouraging foreign industrialists to bring new technologies and fresh capital into countries lacking of both. The result might be a gradual reconcentration of developed regions foreign investment into their own zone, which could be frustrating for the developing countries.

Financing

As a consequence of the hereabove considerations, financing is usually the more difficult problem to solve. A contradiction exists between legal restrictions of foreign participations in joint-ventures and the capital locally available. This is a source of illegal agreements which are damaging for the industry and image of developing countries.

Management

The management gap between developing and developed countries is obvious. Joint-venture agreements often include management obligations for the foreign counterpart. Such an obligation could lead to a defacto control of the means of production by foreign capital, which is in contradiction with local industrial policy. Also profitability depends strongly upon efficiency of the top management.

Decision making process

This is related to the last point : who makes the decisions and who prepares them ? Problem of the situation of the decision center is often felt as a political issue.

Marketing

Joint-venture partners are generally more sensitive to the organization of production than to marketing implementation. The reason might be found in the fact that once a consumption gap is filled with new production capacity, the partners are convinced that marketing will be a self-resolving question. Unfortunately, it is not always the case for finished goods (both production and consumer goods). Reason might be either cost or quality achievements. Even temporary increase of custom duties could be unsufficient to stop foreign competition.

Re-exportation

Exportation development being one of the main conditions of industrialization, more and more joint-venture projects are subordinated to commitments of re-exportation. This is generally felt as a chore by the foreign party who foresees a potential competitor.

How to integrate these obligations in a viable industrial project is an important condition of the future success of a joint-venture agreement.

Third World nations need actions, more than surveys.

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