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CID/IPE/D.7
Survey of Country Experience

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11 - 29 October 1965

SELECTED HARVARD BUSINESS SCHOOL CASE STUDIES

(Nos. F985, F986, F987, F988,
F989, F990, F991, ICR 261)

65-40643

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RETNA, S. A.

One morning in September 1962, Sr. Jorge Tapia, a recently appointed director of Industrialization and Development Corporation (IDC), received a visit from his long-time friend, IDC's president, Dr. Emilio Tavares.

> "Jorge, I just received a report from our Industrial Services Department on Retna. I haven't been able to spend too much time on this, but from what I can gather, Retna must have been furnishing us with misleading financial statements for some time. I know that you're not too familiar with this particular situation, but I wish you would take a look at it. I think it relates directly to your comments last week about the need for closer financial control over our clients. I have to leave for New York in a few hours, but I would like to go over this with you when I return."

Sr. Tapia agreed to study the report and to give Dr. Tavares his comments.

Sr. Tapia was moderately familiar with Retna's history. The company, a manufacturer of low-priced household items, had been founded in the early 1940's and had enjoyed a long period of virtually continuous profitability. During recent years, however, Retna had encountered some financial difficulties. During the early and middle 1950's, the government had carried on an extensive road-building program in the country's interior. In view of this situation, Retna established subsidiaries to manufacture various types of earth-moving equipment, and furnished these subsidiaries with funds. In 1958, however, the road-building program was drastically curtailed by a newly-elected government. As a result, a good deal of Retna's working capital was frozen in temporarily valueless inventory. Moreover, a new product line, the "King" line, had been introduced in 1959 with the proceeds of two IDC loans totaling slightly under P2,700,000.* Unfortunately, this line encountered

*In 1959, the peso had a value of U.S. $.10.

This case was prepared by Joseph L. Casey, Research Assistant in Business Administration, under the supervision of Charles M. Williams, Edmund Cogswell Converse Professor of Banking and Finance, as the basis for discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

sharp competition, and volume expectations were not fulfilled. As Sr. Tapia went through the report, he noted that Retna had not been able to make even nominal repayments on the 1960 loans. Indeed, IDC had been forced to advance the company an additional P1,300,000 in short-term loans. By September 1962, Retna owed IDC slightly over P4,500,000 (see Exhibit 1).

As he studied the report, Sr. Tapia realized the apparent hopelessness of attempting to revitalize the company. The report had been written by a group of experienced IDC analysts under the direction of Dr. Luis Lopez, a man of especial ability and insight. On the basis of their calculations, IDC's analysts estimated that Retna's accumulated deficit was P12,500,000 as compared to the company's capitalization of P5,400,000 (see Exhibit 2). Sr. Prato, Retna's president and principal stockholder, reluctantly confirmed these figures. IDC's analysts went on to point out that Retna was operating at a steadily declining fraction of its capacity. For example, actual 1962 production of the company's traditional "Mark" line was estimated at slightly less than 5% of possible production (see Exhibit 3). The report contained such passages as:

> "The location of the various departments and the arrangement of the production lines is not at all conducive to efficient production. . . . In general, the maintenance of the machinery has been deficient and major repairs will soon be necessary."

and

> "1. The majority of the Mark models are obsolete and do not satisfy consumer tastes.
> 2. Consumer tastes are moving away from the items produced by Retna and toward less expensive substitutes.
> 3. Whereas Retna once had the field to itself, the company must now compete with large, well-organized firms, some of which are branches of internationally-known foreign organizations."

As he examined the financial statements which had been supplied to IDC, Sr. Tapia understood why Dr. Tavares was so disturbed by the Retna situation. From 1957 to 1959, for example, Retna had reported consistent profits on a sales volume which was never greater than P5,500,000 per year (see Exhibit 4). It was not until late 1961 when he requested a P5,400,000 loan that Retna's president, Sr. Prato, admitted that the company was encountering severe financial difficulties. Even then, Sr. Tapia knew, IDC had been unable to determine the exact extent of the losses. Accordingly, the analysts headed by Dr. Lopez had been assigned to conduct a searching investigation of the company's condition. According to these analysts:

> "If we consider that the breakeven sales volume of this enterprise is P5,950,000 per year, then we can conclude that

the 1963 loss will exceed P3,600,000, assuming a sales volume of P2,240,000. . . .

"These calculations are based on the fact that the yearly fixed costs incurred by the enterprise are approximately P3,600,000 per year. . . ."

Sr. Tapia saw in the Retna situation another indication of the value to IDC of requiring that financial statements be audited by reputable, independent accountants. Actually, IDC's loan agreements normally contained a covenant requiring audited financial statements. For a variety of reasons, however, compliance with this covenant was sporadic, at best. For example, many of the businesses assisted by IDC, particularly the smaller concerns, were operated by successful but relatively unsophisticated men who considered a record of cash inflows and outflows perfectly adequate for their needs. In certain other instances, owners of businesses were reluctant to give "outsiders" a view into the details of their financial affairs.

Since his recent appointment to IDC's board, Sr. Tapia had discussed this general problem area several times with Dr. Tavares. As yet, neither man had been able to come up with a satisfactory solution. Dr. Tavares pointed out:

"Just what can we do if these companies do not provide us with the required information? Even though the loan is in default, we can't just foreclose as some other types of financial institutions might. Why, in many cases, no good record-keeping system exists. The installation and maintenance of a good system might well seem to be an intolerably costly burden for a smaller company."

Although he recognized the validity of Dr. Tavares' comments, Sr. Tapia insisted that IDC must do more than it was currently doing to protect its interests.

"As things stand now, often we do not have any direct knowledge of a company's problems until it is too late. We must somehow maintain a closer control. Perhaps we can do something to educate our clients to the potential benefits of a good accounting system and to their responsibility for providing us with adequate information so that we can give them advice when things appear to go wrong. Perhaps a different type of control would be more useful. What about having our men act as directors of the companies to whom we lend money? Perhaps we should change our policy of not permitting any of our personnel to serve on boards and even insist on representation in the cases of our larger credits."

Exhibit 1

RETNA, S. A.

Retna Loan Position as of September, 1962

Date and amount granted		Type	Principal Outstanding	Interest Due	Total Amount Due
3/6/59	P 875,000	5 years	P 875,000	P153,000	P1,028,000
8/30/59	1,800,000	5 years	1,800,000	322,000	2,122,000
9/2/59	450,000	short term	288,000	72,000	360,000
6/16/60	135,000	short term	86,500	20,300	106,800
10/6/61	540,000	short term	540,000	26,900	566,900
5/19/62	180,000	short term	180,000	4,800	184,800
	P3,982,000		P3,771,500	P599,000	P4,570,500

Note: All figures rounded.

Exhibit 2

RETNA, S. A.

Summary Balance Sheet, September 1, 1963

ASSETS		
Cash		P 9,000
Accounts receivable	P1,900,000	
less: Bad debt provision	1,260,000	640,000
Inventories		1,405,000
Total current assets		P2,054,000
Fixed assets		1,120,000
Investments in subsidiaries	9,000,000	
less: Provision for losses	8,200,000	800,000
Intangible assets		360,000
TOTAL ASSETS		P4,334,000
LIABILITIES		
Due to banks		P4,269,000
Other payables and accruals		1,600,000
Due to IDC:		
Capital	P2,700,000	
Interest	575,000	3,275,000
Total current liabilities		P9,144,000
Long term debt:		
IDC	1,080,000	
Others	1,210,000	2,290,000
Capital	P5,400,000	
less: Accumulated deficit	12,500,000	(7,100,000)
TOTAL LIABILITIES AND CAPITAL		P4,334,000

Notes:

1. All figures rounded to nearest thousand.
2. Balance sheet prepared by IDC analysts, not by Retna, S. A.

Exhibit 3

RETNA, S. A.

Capacity Utilization Analysis

	"Mark" Line		"King" Line	
Year	Production (units)	Percentage of capacity	Production (pairs)	Percentage of capacity
1957	480,000	30%		
1958	516,000	32		
1959	490,000	31		
1960	241,000	15	213,000	32%
1961	179,000	11	270,000	40
1962 (est)	71,800	5	144,000	22

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Exhibit 4

RETNA, S. A.

Summary Income Statements

(Peso figures in thousands)

	1956-1957		1957-1958		1958-1959		1959-1960	
Sales		P4,800		P4,740		P5,500		P4,740
less: Cost of goods sold		2,430		2,360		2,560		2,220
Gross profit		2,370		2,380		2,940		2,520
less:								
Selling & admin.	P 925		P1,030		P1,480		P1,370	
Depreciation	236		154		150		99	
Interest	344		425		385		338	
Other expenses	589		532		677		979	
		2,094		2,141		2,692		2,786
Net profit		P 276		P 239		P 248		P (266)

Notes:
1. All figures rounded to nearest thousand.
2. Income statements prepared by Retna, S. A., not by IDC analysts.

Despite the widespread publicity and the general expectations, the volume of serious inquiries to BNF had been moderate, and the number of actual applications to date had been somewhat disappointing. Four applications had been approved, two more were awaiting board action, and twelve more applications were currently taking form or under analysis.

Background

A particularly striking aspect of the Equipos case was the extent of enthusiasm and support for the project from Otturo, the largest city in the Orientale District, where the plant would be located. Two delegations of leading citizens, headed by the mayor and by provincial leaders of the two major political parties, had made formal calls on the president of BNF to point out that industrialization in that district had lagged behind that of other areas. The citizens' groups saw Equipos as being far more important to the area than simply through the 130 persons who would be employed initially. They were impressed with the expansion potential of the company as revealed by its president, a prominent local figure, and by the likelihood that other new industries would follow the lead of Equipos in locating in Otturo. As one supporter put it, "While the government has helped other cities grow rapidly, we haven't had a new industry in ten years. Equipos could start a real industrial expansion in the east What we need is a pace-setter." The files showed that another had insisted, "If you people don't support this enterprise, I just don't know what you're looking for. These are good people with a product our people need and will buy. Production here will save millions in dollars. And the benefits to the district will be tremendous."

At the time of its loan application, Equipos, which had been organized on March 8, 1960, was not yet actively engaged in manufacturing operations. Initially, the company's product line was to be limited to kerosene stoves. Equipos' founders were most optimistic about the prospects for expansion, and in a letter to BNF, they stressed that they expected ultimately to manufacture such products as:

- kerosene, gas & electric ranges in all types and models;
- water heaters of gas, kerosene, and electric types;
- kerosene garbage incinerators,
- dishwashers;
- bathtubs;
- faucets in all types and colors.
- kitchen pots of all types, models and sizes;
- locks;
- shovels for field and construction;
- roasters;
- hinges;
- latches;

EQUIPOS, S. A.

On the morning of June 6, 1960, Sr. Francisco Ortiz began an intensive review of the material which he had gathered on Equipos, S. A. On the following morning, Sr. Ortiz and the other four directors of Banco Nacional de Fomento (BNF) were to vote on Equipos' request for a P 2,400,000* long-term loan. Sr. Ortiz, a prominent lawyer and a director of his family's mining firm, had been appointed to BNF's board two weeks previously, following the untimely death of a regular director. The forthcoming board meeting represented his first opportunity to participate in a BNF loan decision.

Actually, BNF as an organization was relatively new in industrial lending, although it had been active in other sectors. A major program of industrial development had been inaugurated by the governmental authorities late in 1959. As an important part of the total program, BNF was authorized to extend longer-term loans to new or growing privately-owned industrial firms. Funding was sufficient to permit a large program. The basic enabling legislation left a wide area of discretion to BNF in passing on requests for credit from industry.

The industrial development program was launched with considerable publicity and enthusiasm. Its sponsors and supporters emphasized the vital tie between industrialization and a more rapidly rising standard of living for the nation. The direct contribution of industrialization to employment (unemployment was widespread and underemployment chronic in many areas of the country), and to an easing of the persistent balance of payments problems of the country were stressed. Support from legislators in the agricultural north and east was encouraged by assurances of especial efforts to develop industry in these areas.

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*In 1960, the peso had a value of U.S. $.10.

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door knobs;
metal structures;
license plates;
name plates;
traffic signs, all sorts of products of cast iron, aluminum, copper and bronze.

Equipos' founders and chief executive officers were Sr. Rafael Camargo, president, and Sr. Perez Rodriguez, a Colombian, vice president. In their initial letter to BNF, these men wrote of their complete familiarity with this type of operation:

> "Sr. Perez Rodriguez, a partner of the firm, is an industrial engineer with thirty years' experience. He was the main partner of the company, Equipos, C. A., in Colombia. Until the tenth of March of this year, that firm manufactured the same items that we are going to produce here, and a showing of all these items was made to all representative sectors of commerce and banking, and all of them were extremely pleased with that demonstration of the quality, appearance, and efficiency of the products. Sr. Rafael Camargo, the other shareholder, during his residence in Colombia for four consecutive years was exclusive representative of these products for the east and west of Colombia."

Further investigation by BNF disclosed that the founders planned to employ a local mechanical engineer; a Yugoslav metallurgical engineer; a local engineer; two draftsmen; 19 technicians and administrators from the Colombian firm formerly headed by Sr. Rodriguez; and 130 local workers. The founders of the firm anticipated that it would be necessary to train most of the workers for their new jobs, but with the pool of intelligent, if inexperienced, workers in the area, training was not expected to present major difficulties for the experienced foremen who would be brought in from Colombia. In time it was expected that local workers could be trained to assume the supervisory jobs.

Sr. Camargo, inquiries by BNF revealed, was well and favorably known in Orientale Province. Outgoing, vigorous and enthusiastic, he had many friends in both business and governmental circles. He had experience in several commercial enterprises working primarily in sales. He was regarded as a man of moderate financial resources.

Product Demand

After receiving Equipos' loan request, BNF assigned an economist to investigate the market potential for kerosene and gas stoves. As one BNF department head explained to Sr. Ortiz:

". . . We do not always have to go to the trouble of making this kind of a study ourselves. . . . From time to time, however, this is the only way we can obtain the information we need in order to make a sound decision. . . ."

Sr. Ortiz was pleased to note that the economist's report contained several encouraging items. In particular, the total amount spent in 1960 for imported stoves, most of which were manufactured by large United States corporations, such as Westinghouse, Hotpoint or Perfection, was slightly over P 40,000,000, indicating the existence of a very substantial market. Not only was this market substantial, but it was also a rapidly growing one, since this amount represented a 68% increase over 1956 expenditures (see Exhibit 1). The report pointed out that, in addition to a rising disposable income and a growing population:

"The consumer behavior largely determines the character of the demand, that is, the consumer's desires to obtain greater convenience and economy have given rise to abandonment of impractical methods and kitchen utensils, to a shift to utensils of greater convenience and economy, such as the gas and kerosene ranges. . . ."

Sr. Ortiz noted that the economist's report contained a warning that:

"In regard to prices we cannot give a definite opinion since domestic products are almost always produced at a greater cost than the imported ones, but we believe that this problem can be overcome by the other favorable factors, quality, performance and appearance."

In view of this statement, he was pleased to see that the initial letter from Equipos' founders included the pledge:

"We can proudly state that the products we are going to manufacture are of excellent quality, magnificent appearance and great efficiency, and therefore we are sure that there is nothing to be feared from the foreign competition in all these respects. As far as prices are concerned, they will be equal or perhaps a little lower than the prices of imported products. Furthermore, we are in a position to offer excellent service in our national territory to anyone."

The promoters also had spoken of the potential value of protective tariffs on imported stoves. The government was committed to a policy of protection for domestic industries when these suppliers were fully prepared to meet the needs of the national market. In the case of other products, however, procedures for enactment of protective tariff legislation had proved involved and time-consuming. In the meantime, the prospect of higher tariffs and higher domestic prices had served as an unintended stimulant to increased imports. In some cases, the inflow of goods had represented many months' consumption and had disrupted the market for the domestic products.

Equipment Needs and Financing Plan

The files contained a description in some detail of the production process for kerosene stoves. The main raw material would be imported steel sheets. Equipos would buy large shears for cutting these sheets into appropriate sizes and big presses for shaping the steel. A number of electric arc welding units would be needed to join the components. Assembled units would go to porcelain sprays, and then into an electric furnace where the porcelain finish would be baked onto the metal.

As of the date of the loan application, 50% of Equipos' P 2,400,000 capitalization had been paid in (see Exhibit 2). Short-term advances from the founders, Srs. Camargo and Rodriguez, had allowed the company to acquire some machinery and to begin construction of a plant (see Exhibit 3). The proposed P 2,400,000 loan from BNF was to be used to complete these programs, with funds being divided between machinery and buildings in the following manner:

Machinery and equipment	P 1,112,000	(46.4%)
Plant	1,288,000	(53.6%)
Total	P 2,400,000	(100.0%)

The equipment, all of which was to be purchased new from United States, Italian, and German manufacturers through a well-known importer, was to consist mainly of general-purpose presses and spot-welders. Representative items are shown in Exhibit 4. Invoices were to be furnished to BNF as evidence that the investment program was actually being carried out. The plant was to consist of 15 interconnected buildings.

As security for the loan, Equipos offered the following collateral:

Land, 717,800 $m/^2$ valued at P 3.00/$m/^2$*	P 2,012,000
Construction and improvements	460,000
Machinery and equipment	258,000
Vehicles	66,000
Furniture	10,000
	P 2,806,000
Investment Program	2,400,000
Total	P 5,206,000

Sr. Ortiz was pleased to see that the total value of the collateral was slightly more than twice the value of the proposed loan. It was a tentative policy of

*Value based on cost of land plus improvements, such as landscaping and the construction of access roads.

BNF to consider a loan application only if the "Guarantee Index" were at least 2. As an associate had explained:

> "We believe this policy is a reasonable one. By having a 2:1 ratio, we are usually protected for quite some time if the company loses money, as can often be expected during the start-up period. Moreover, and perhaps even more important, this ratio ensures that the promoters risk their own capital in the project. By its very nature, BNF is willing to take on risks that other institutions would avoid. But we must ensure that the promoters are also willing to take risks."

The Equipos loan proposal called for repayment in 19 semiannual installments of approximately P 126,000 each. The interest rate would be BNF's normal 6%, well below the general market rates of 9% or more.

Opinion of Other BNF Directors

Since the Equipos situation represented his first participation in a BNF loan decision, Sr. Ortiz had been especially interested in a highly informal luncheon discussion of the directors relative to the Equipos case. Although no overall judgments were expressed, a number of observations were made. One director was impressed by the savings in foreign exchange Equipos promised.

> "This project is not one which makes use of local materials, since, at least for the present, Equipos will have to import about 95% of the necessary raw material. However, raw material will probably account for less than 50% of the total cost of the stoves. The remaining 50% represents a clear savings of dollars. And if we are talking about P 40,000,000 worth of imported stoves last year alone, then we are talking about significant savings."

Another director commented about the strong support from Orientale Province for the credit. "I know we have to learn to live with pressures in this job where we've money to hand out. But if we turn down this one, we surely had better know why--and how to explain why we said no."

"It's been more than three months since we first started talking to these people, and we've accumulated a bulging file on this case," commented another director. "But I'm not sure we've collected the right data. I know you think of me as a conservative, but I can't get enthusiastic about this one. Perhaps I just don't know enough about this promotion, but I am far from convinced it will succeed. It will be interesting to see what Eduardo (Dr. Eduardo Garcia, president of BNF) recommends on this one.

Exhibit 1

EQUIPOS, S. A.

Imports of Stoves for Period 1956-1960

Year	Units	Index	Value (000's)	Index
		Gas and Kerosene Stoves		
1960	220,100	126	P41,186	168
1959	205,800	117	35,908	146
1958	147,000	84	28,066	114
1957	173,100	99	27,392	111
1956	175,000	100	24,498	100
		Kerosene Stoves Only		
1960	174,100	115	P19,968	140
1959	159,050	105	15,164	106
1958	118,400	78	13,238	93
1957	149,200	99	16,428	115
1956	150,800	100	14,216	100
		Gas Stoves Only		
1960	46,000	190	P21,220	206
1959	46,750	189	20,744	201
1958	28,600	118	14,826	144
1957	23,900	100	10,964	106
1956	24,200	100	10,284	100

Source: Statistics of the exporting countries.

Exhibit 2

EQUIPOS, S. A.

Equipos Capitalization as of May 30, 1960

Distribution of Ownership

	No. of Shares	Value (000's)	Payments to Date (000's)	Payments to Date (%)
Sr. Camargo	14,000	P1,400	P 700	50%
Sr. Rodriguez	10,000	1,000	500	50
	24,000	P2,400	P1,200	50%

Method of Payment
(000's)

	Land*	Patents	Registration	Other	Total
Sr. Camargo	P 500	P 124	P 26	P 40	P 700
Sr. Rodriguez	500	---	---	---	500
	P1,000	P 124	P 26	P 40	P1,200

*Land owned jointly by the two founders.

Exhibit 3

EQUIPOS, S. A.

Balance Sheet as of May 30, 1960

ASSETS		
Current Assets:		
Cash on hand		P 165,338
Fixed Assets:		
Construction in process	P 414,110	
Land	1,077,526	
Buildings	6,900	
Machinery and equipment	261,150	
Vehicles	60,800	
Other	19,118	1,839,604
Total Current Assets		2,004,942
Other assets		161,862
Intangible Assets:		
Patents, etc.		160,000
TOTAL ASSETS		P2,326,804
LIABILITIES		
Current liabilities		P 172,272
Due shareholders		954,532
Capital:		
Authorized capital	2,400,000	
less: Amount due	1,200,000	1,200,000
TOTAL LIABILITIES AND CAPITAL		P2,326,804

Exhibit 4

EQUIPOS , S. A.

Representative Proposed Equipment Purchases

1	Electric soldering machine, 300 amp	P 10,800
1	Electric arc soldering machinery, 150 amp	3,600
1	Hydraulic press, 100 ton capacity	171,400
3	Hydraulic presses, 150 ton capacity @ P116,400 ea.	349, 000

BARTEX

Shortly before the January 25, 1963 meeting of the board of directors of Banco Nacional de Fomento (BNF), Dr. Eduardo Garcia, BNF's president, sent a memorandum to his fellow-directors which read in part:

". . . As you know, our experience with Bartex has been very disappointing. Indeed, the situation has deteriorated so much that BNF is now the largest single supplier of the company's capital:

	(millions)	(%)
Long-term debt		
BNF	P 5.8	43%
Others	3.2	23
	9.0	66%
Equity (after deduction of losses)	4.8	34
Total	P13.8*	100%

"Now, the company, which is losing money at the rate of P18,000 per month, is asking for an additional P2,400,000 loan. Half of this sum is to be used for working capital to allow the company to increase its sales volume.

"I would like to devote most of our next meeting to a discussion of this situation and to the broader issue of technical assistance to our client borrowers. Could we have prevented this deterioration through technical assistance to management? Can we still do something along these lines here? Is there anything in this situation which should cause us to revise our thinking about our existing technical assistance program?"

---

*In early 1963, the peso had a value of about U.S. $.10.

This case was prepared by Joseph L. Casey, Research Assistant in Business Administration, under the direction of Charles M. Williams, Edmund Cogswell Converse Professor of Banking and Finance, as the basis for discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

Background

The object of Dr. Garcia's concern, Bartex, produced such textile products as: cotton cloth for tapestries and bedspreads; silk, tweed and cotton bedspreads; curtains; and similar related items. For many years prior to 1956, the company's president, Sr. Bars, had sold such products as these, imported from foreign countries, in the eastern part of the country. Sr. Bars's career had been a spectacularly successful one; starting from a humble situation, he had accumulated substantial personal wealth. In late 1956, he decided to expand his operations into manufacturing and founded Bartex. Initially, the company's paid-in capital was P1,200,000.

Initial Loan

BNF's relationship with Bartex began on March 31, 1958 with the receipt of a letter requesting a P2,600,000 loan. In his letter, Sr. Bars explained that he planned to use the proposed loan for:

Acquisition of machinery	P1,738,816
Freight costs for machinery	260,822
Construction of building for machinery	200,000
Working capital	400,000
	P2,599,638

Sr. Bars went on to point out:

"The following important advantages will result from our project:

1. We will more than triple our productive capacity. As a result, we will be able to produce goods of a higher quality at a lower cost than at present.

2. The number of our workers will increase from the present 120 to 150.

3. Our consumption of national cotton will increase to a level of 90,000 to 100,000 kgs per month from the present level of 15,000 to 20,000 kgs per month."

Sr. Bars concluded by pointing out that the loan would be well secured by:

Existing machinery	P2,031,060
Machinery to be acquired	2,599,592
Total collateral	P4,630,652

In assessing the loan application, BNF's analysts noted that the country's textile industry had suffered severely in recent years from the competition of lower-priced imports. As an example, in the period 1951 to 1956, imported cotton goods rose from 4.1% to 51.8% of total consumption (see Exhibit 1). The report noted that:

> "Consequently, the national industry suffered a crisis. Sales of national finished cotton goods were contracted sharply, affecting the well-being of our textile economy in the following ways:
>
> 1. Stocks of finished goods were built up.
> 2. The number of people working in the industry was reduced.
> 3. The industry was forced to operate at less than 50% of its capacity, in contrast to its normal operating level of 70% to 80% of capacity."

As a result of this situation, the government announced new tariff regulations for textile imports on March 15, 1958. The new regulations incorporated suggestions made by leaders of the national textile industry and promised to alleviate the existing situation. The analyst's report concluded with the observation that:

> ". . . Bartex was founded at the end of 1956. Consequently, it was not affected, as were older firms, by the pressures to restrict production and to accumulate inventories. . . . Bartex was able to maintain its production volume in accordance with its sales volume. . . ."

After further analysis and negotiations with Sr. Bars, BNF's board voted on June 6, 1958 to grant Bartex a P2,400,000 loan, to be repaid over a ten-year period in 19 semiannual installments of P126,316 each. The loan was secured by:

Existing machinery equipment	P1,355,756*	
less: Depreciation	101,716	
Net		P1,254,040
Machinery to be acquired		1,738,816
Total		P2,992,856
Land & buildings owned by Sr. Bars	4,436,000	
less: First mortgage	1,980,000	
Net collateral value		2,456,000
Total Security		P5,448,856

Subsequent Loans

Within a year after the initial loan was made, the financial situation of Bartex began to deteriorate alarmingly. During the period July 1, 1958 to

*Value estimated by BNF's analysts.

June 30, 1959, the company had recorded a profit of P324,000. In contrast, during the period July 1, 1959 to June 30, 1960, Bartex reported a P1,056,000 loss (see Exhibit 2). On March 17, 1960, Sr. Bars wrote to BNF asking for an additional P3,000,000 loan, pointing out that:

> "The situation of our enterprise is very difficult because of a continued imbalance between the capital we have invested in installations and equipment and our working capital. . . . While our fixed assets are more than adequate, a shortage of working capital prevents us from attaining a profitable level of operations. Our raw material suppliers have restricted their shipments to us. . . . This difficult situation has forced us to let go a good part of our skilled personnel, which effectively represents a loss of tangible capital for our firm."

The loan was to be used for:

Cancellation of first two payments on original loan	P 256,000
Repayment of first mortgage*	1,000,000
Working capital	1,744,000
	P3,000,000

Of the total loan, P550,000 was to be used specifically for the purchase of raw material.

On September 15, 1960, BNF's board of directors voted to grant the additional loan. The total amount then outstanding, slightly over P4,720,000, was to be repaid over a ten-year period starting September 15, 1961.

Despite this infusion of additional capital, Bartex's problems continued. Because of continuing losses and an everpresent shortage of cash, the company was unable to adhere to the revised BNF loan repayment schedule. In September of 1962, BNF loaned Bartex an additional P400,000, to be repaid over a two-year period. By the end of 1962, Bartex's total obligations to BNF, including overdue interest and principal, amounted to almost P5,800,000. The company's reported loss for fiscal 1962 amounted to P542,482 on sales of P5,232,834, resulting in a total accumulated deficit of P1,827,394 (see Exhibit 3).

In early January 1963, Sr. Bars requested still another loan from BNF, this time in the amount of P2,400,000. In his letter, Sr. Bars

*This item resulted from previous conversations between Sr. Bars and BNF. BNF desired to repay a bank loan, so as to have a first mortgage position on a piece of property pledged as security.

explained that, at the present time, it was possible to operate only 37 of the company's 74 looms, a situation which resulted in a monthly loss of P17,972 (see Exhibit 4). He went on to point out, however, that:

> ". . . Despite a general sluggishness of textile sales, we have never been able to keep up with the demand for our products. . . . Our products are well accepted by consumers.
>
> "In all sincerity, the actual situation of our enterprise is truly critical, despite very promising possibilities. The additional loan which we are seeking is the only way of saving the enterprise. . . . This loan will replace the working capital which has been consumed by our losses and will thereby restore our commercial credit. . . ."

According to Sr. Bars's calculations, a monthly profit of P90,000 could be achieved if all of the company's 74 looms could be operated (see Exhibit 5). However, he explained, this could be accomplished only if he could acquire sufficient raw material. According to his estimates, at least P1,560,000 worth of raw material would be necessary (see Exhibits 6 and 7). In view of these calculations, Sr. Bars hoped that BNF would respond favorably to his request for an additional loan.

Technical Assistance

For some time Dr. Garcia had been considering the wisdom of expanding and reorienting the bank's technical assistance program. Currently the bank's technical assistance group consisted of eight professional degree holders and a small supporting staff. The professionals included a textile engineer, a civil engineer, two industrial engineers, three economists and two accountants. All were regarded as men of considerable intellectual ability, but most were relatively young. Only two had long experience in industry.

Much of the working time of this group had been utilized in the evaluation of loan proposals. In effect, they were called in as experts by the group charged with the analysis of loan requests.

In only a few cases, had these men gone out into client companies for extended periods of intensive, on-the-spot study of the firm's technical or management problems. In each such instance, the experts were assigned only after the company was in rather serious financial difficulty. Moreover, their assignment typically had called for a recommendation of action to the president of BNF rather than to the management of the client company.

In discussing the technical assistance programs with key associates a few days before the Bartex situation had come to a head, Dr. Garcia had observed, "It seems to me that many of our borrowing clients need better management more than they need more pesos. Shouldn't we be equipped to provide management and technical expertise--and perspective as well--to our clients on a routine basis. Instead of waiting until a client is in real distress, shouldn't our technical assistance people be going into companies at the first signs of trouble? Or better yet, shouldn't we be working with managements to prevent the difficulty from arising in the first place?

"If we had a management consulting industry here like they have in the U.S., perhaps we wouldn't need to worry about developing a similar capability in BNF. But, except for the management services departments of a couple of the big American accounting firms, we haven't got a real management consulting industry here. Yet our managements may need such help as much or more than the Americans. Please give this some thought and let me have your reactions."

Reactions to date defied precise summary but generally reflected support for the idea of expanded and reoriented technical assistance but concern for practical difficulties in making this concept effectively operative. Sr. Modoro, for example, pointed out the difficulties of staffing such an operation.

> "We now have hundreds of borrowing clients; many of them could use consultants to advantage. To meet these needs, we would have to expand our technical assistance staff greatly. Where will we find qualified people? You can't send recent graduates out to advise company presidents. As you know, we've had trouble keeping the T. A. group manned as it is.
>
> "It seems as if every time we get a man well trained, he leaves to go directly to some industrial company where the pay is much better. That has happened four times that I know of in the past few years. In fact, two of the people who left were our textile men, one right after another. What can we do? We can't raise salaries in this one department without upsetting the wage scale of the entire corporation. We can't pay more than P80,000 or P90,000 per year; yet a good man can get a lot more than that in industry. And if we have our good men out in the companies more, then more of them will get picked off by industry."

Questions about the expense involved were also raised.

> "If we don't watch, we'll build T. A. into a big bureaucracy that will really be expensive. Will our borrowing clients be willing to compensate us for the costs of preventive assistance? I seriously doubt if many will, especially if they don't think they are in trouble. Yet if we provide this service free, I'm not sure whether they will pay much attention to our advice."

Still another officer saw more basic problems.

"If we force advice on a client, what happens if it proves to be poor advice and the client's troubles are intensified? Can we sue him for collection then? Giving advice is a very ticklish business. It could get us into areas that are management's responsibilities and confuse our relationship. We are lenders not managers."

Despite these criticisms, Dr. Garcia remained convinced of the necessity for and feasibility of an expanded technical assistance program by BNF. He believed that the Bartex situation illustrated the danger involved in failing to provide preventive technical assistance.

"Here is a man, this Sr. Bars, who has invested a great deal of his personal wealth in his company.* He is an excellent salesman. His past career proves that. However, it now appears that he is a singularly poor industrialist. Furthermore, I think that it was our duty to recognize Sr. Bars's failings and to assist him before the situation became as serious as it is now."

---

*See Exhibit 8.

Exhibit 1

BARTEX

Imported Cotton Goods as a Percentage of Total National Consumption, 1951-1958

Year	Total Consumption (tons)	Imports (tons)	Per Cent
1956	7,040	3,640	51.8
1955	---	---	---
1954	7,450	694	9.3
1953	5,350	415	7.7
1952	4,800	319	6.6
1951	5,200	212	4.1

Exhibit 2

BARTEX

Summary Income Statements

(Peso figures in thousands)

	7/1/58 to 6/30/59	7/1/59 to 6/30/60	7/1/60 to 12/31/61	1/1/62 to 12/31/62
Gross sales	P7,788	P6,956	P9,720**	P5,974
less: Returns & allowances	512	912	1,114	742
Net sales	7,276	6,044	8,606	5,232
Cost of goods sold*	5,554	5,104	6,828	4,360
Gross profit	1,722	940	1,778	872
Administrative costs	586	606	828	484
Selling costs	520	986	1,112	634
Operating profit (loss)	616	(650)	(62)	(244)
Other income	10	54	86	12
Other expense	302	460	880	540
Net profit (loss)	324	(1,056)	(856)	(772)
Extraordinary income	-0-	-0-	240	230
Extraordinary expenses	-0-	-0-	46	-0-
Net profit(loss) for period	P 324	P(1,056)	P (662)	P (542)
*Including raw material cost of:	P3,520	P2,754	P3,888	P2,372

**Sales for year 1/1/61 to 12/31/61 = P 4,868,000. Income statement for same period not available.

Exhibit 3

BARTEX

Summary Balance Sheet, December 31, 1962

ASSETS		
Cash	P 132,588	
Accounts and notes receivable	1,991,774	
Inventories	3,121,214	
Total current assets		P5,245,576
Fixed assets (net)		7,676,240
Intangible assets		362,086
Other assets		467,072
TOTAL ASSETS		P13,750,974
LIABILITIES		
Accounts and notes payable	P2,659,046	
Other current liabilities	505,912	
Total current liabilities		3,164,958
Long term debt (incl. BNF)		5,797,362
Capital:		
Authorized	6,600,000	
Legal reserve	16,048	
Total	6,616,048	
less: Accumulated deficit	1,827,394	
Net capital		4,788,654
TOTAL LIABILITIES AND CAPITAL		P13,750,974

Exhibit 4

BARTEX

Summary of Actual Situation Operating 37 Looms
One Shift per Day

Production 34,580 meters		Sale:	P579,818
Raw material 17,980 kgs	P333,120		
Labor and manufacturing costs	101,744		
Other production costs		P434,864	
Selling & administrative expense		112,874	
Shipping & freight costs			547,738
Profit from sales			31,080
Interest costs			49,052
Net Profit (Loss)			(17,972)

Exhibit 5

BARTEX

Summary of Situation Operating 74 Looms
One Shift per Day

Production 59,525 meters		Sales:	P937,126
Raw material 27,802 kgs	P524,858		
Labor & manufacturing costs	131,130		
Other production costs		P655,988	
Selling & administrative expense		141,246	
Shipping & freight costs			797,234
Profit from sales			139,892
Interest costs			49,052
Net Profit (Loss)			P 90,840

Summary of Situation Operating 74 Looms
Two Shifts per Day

Production 115,120 meters		Sales:	P1,637,416
Raw material 53,706 kgs	P1,011,866		
Labor & manufacturing costs	207,460		
Other production costs		P1,219,326	
Selling & administrative expense		171,366	
Shipping & freight costs			1,390,692
Profit from sales			246,724
Interest costs			49,052
Net Profit (Loss)			P 197,672

Exhibit 6

BARTEX

Summary of Investments Required to Reach Higher Operating Levels
October 15, 1962

Plan 1: Operation of 74 Looms One Shift per Day

Raw material:		
Raw material in the process of fabrication for one month of work 27,802 kgs	P 524,858	
Raw material in reserve for the following month 27,802 kgs	524,858	
Material in inspection and ready to be shipped 27,802 kgs	524,858	P1,574,574
Labor and Manufacturing Costs:		
Costs of processing one month's raw material	P 131,130	
Other production costs	131,130	262,260
Selling and Administrative Costs		282,494
Total		P2,119,328

Plan 2: Operation of 74 Looms Two Shifts per Day

Raw material:		
Raw material in the process of fabrication for one month of work 53,706 kgs	P1,011,866	
Raw material in reserve for the following month 53,706 kgs	1,011,866	
Material in inspection and ready to be shipped	1,011,866	P3,035,598
Labor and Manufacturing Costs:		
Costs of processing one month's raw material	P 207,460	
Other production costs	207,460	414,920
Selling and Administrative Costs		342,734
Total		P3,793,252

Exhibit 7

BARTEX

Inventory for Prior Periods

(Peso figures in thousands)

	7/1/58 to 6/30/59	7/1/59 to 6/30/60	7/1/60 to 12/31/61	1/1/62 to 12/31/62
Raw material	P 342	P 708	P 710	P 879
Work in process	664	760	956	836
Finished goods	516	716	550	912
Accessories & supplies	134	378	378	494
Total Inventory	P1,656	P2,562	P2,594	P3,121
Net Sales	P7,276	P6,044	P9,720	P5,974

Exhibit 8

BARTEX

Capital Accounts

Initial capital	12/15/56	P1,200,000
Additional capital		
	6/26/58	1,400,000
	9/26/60	2,000,000
	4/10/61	2,000,000
Total as of 12/31/62		6,600,000
less: Losses		1,827,394
Net Capital		P4,788,654

JUAN GARCIA & CIA.

In the year 1913, Juan Garcia, an itinerant merchant, decided to establish a wholesale food business. Despite a modest initial capitalization of P5,000, the company prospered. By 1924, when Francisco Garcia, the founder's son, joined the firm, Juan Garcia & Cia.'s capital had grown to P150,000. The company continued to expand in the wholesale food distribution field and began to purchase directly from farmers and from the country's larger importers. Credit was extended to the company by several local banks. By 1935, the company's capital amounted to P500,000.

During the world-wide depression of 1937, Juan Garcia & Cia. suffered extremely heavy losses as a result of declining commodity prices, heavy inventories, and poor collection of accounts receivable. The company's creditors reluctantly accepted Francisco Garcia's offer of a 20% settlement, and the firm continued operations on a moderate scale with a capitalization of P100,000. With the general improvement of economic conditions, the firm began once again to progress. Gradually operations came to include the export of coffee and cocoa. By 1946, the company's capital totaled P2,000,000 and its credit standing had been fully restored.

In 1946, a vigorous expansion program was initiated. Through subsidiaries, the company began to engage in the distribution of automobiles and heavy agricultural and road-building machinery. During the sellers' market which prevailed during the postwar period, Juan Garcia & Cia. prospered. By 1956, the company's balance sheet revealed the following financial condition:*

Year ending December 31, 1955

Cash	P 10,000	Bank loans	P3,000,000
Accounts receivable	3,000,000	Other liabilities	2,000,000
Inventory	4,490,000		
Fixed assets	1,000,000	Capital	5,000,000
Investments	2,500,000	Surplus	1,000,000
Total assets	P11,000,000	Total liabilities	P11,000,000

Sales	P12,000,000
Net profit	1,000,000

*Numbers rounded to the nearest thousand.

This case was prepared by Joseph L. Casey, Research Assistant in Business Administration, under the direction of Charles M. Williams, Edmund Cogswell Converse Professor of Banking and Finance, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

As was customary, this statement was signed by the company's president and principal stockholder, Francisco Garcia, and was presented to the local bankers as a part of the company's request for an extension of credit. Juan Garcia & Cia. had a good reputation in the financial community and in the trade. Bills were paid in a rather prompt fashion, and were never allowed to become past due in excess of 45 days.

As the general level of the country's economic activity rose, the demand for the company's various products grew commensurately. As it came under competitive pressure to extend credit to its customers, Juan Garcia & Cia. became an increasingly active user of bank and trade credit. In view of its apparently strong financial position, the company encountered no difficulty in obtaining credit. At the end of 1958, the company's balance sheet showed:

Year ending December 31, 1958

Cash	P 15,000	Bank loans	P6,500,000
Accounts receivable	7,600,000	Other liabilities	2,815,000
Inventory	4,600,000		
Fixed assets	1,000,000	Capital	7,000,000
Investments	4,500,000	Surplus	1,400,000
Total assets	P17,715,000	Total liabilities	P17,715,000

Sales	P19,000,000
Net profit	1,600,000

In January 1959, violent changes took place within the country. As the result of a revolution, a new government came to power. Immediately thereafter, economic activity began a rapid decline. In general, the business community experienced declining sales and a pronounced slowing up of collections. For a time, Juan Garcia & Cia. was able to obtain additional bank credit and to delay its payments to suppliers. By the end of 1959, however, both of these sources of funds were exhausted. Accordingly, Francisco Garcia decided to make an arrangement with the company's creditors similar to that of 1937. At a December 1, 1959 creditors' meeting, he presented the following balance sheet:

Period ending November 30, 1959

Cash	P 5,000	Bank loans	P9,000,000
Accounts receivable	6,000,000	Other liabilities	4,705,000
Other notes receivable	7,000,000		
Inventory	4,000,000		
Fixed assets	1,000,000	Capital	7,000,000
Investments	4,500,000	Surplus	1,800,000
Total assets	P22,505,000	Total liabilities	P22,505,000

Sales (10 months)	P11,000,000
Net profit	400,000

After examining this balance sheet, the company's bankers expressed concern over the sudden appearance of the new account, "Other notes receivable." In response to their queries Sr. Garcia pointed out that financial statements he had submitted in routine to the banks had not consolidated the automotive and heavy equipment sales subsidiaries. Since it was common practice to sell such expensive equipment on installment credit terms, the banks certainly must have understood that the automotive and heavy equipment subsidiaries had active arrangements for sale of the installment receivables they had acquired in making sales to their customers. For some time these subsidiaries had "sold" these notes to finance companies. At the outset of their business with the finance companies the subsidiaries had agreed to take back any of the notes on which a repayment was more than sixty days past due, and at the insistence of the finance companies, the parent company, Juan Garcia & Cia., had agreed to guarantee the performance of the subsidiaries in this regard. For some time, defaults were very minor in number and amount. But as a direct result of the rapid economic decline, a high percentage of the customers had halted payment. The subsidiaries were in no position to meet the demands of the finance companies, which had totaled P 7,000,000. As a matter of good faith, as well as legal obligation, the parent company had satisfied these liabilities. In return, the parent received notes from the subsidiaries. After considerable investigation, the bankers learned that an additional P 10,000,000 in guarantees of this type was still outstanding. When criticized for the handling of these accounts, Sr. Garcia was appalled. He explained that the present accounting system had been used since the company's establishment. Repeatedly, he stated his conviction that the company's present problems were caused not by accounting and financial reporting but by political and economic conditions beyond his control.

CORPORATION FOR ECONOMIC DEVELOPMENT

"Our hearty thanks to you, Sr. Barreto, and your associates for your highly constructive report and proposal. Thanks also to you gentlemen of our board and of our staff for your thoughtful questions and comments. This lease-purchase proposal could be of great significance to the economic development of our country. But if we go into it, we want to do it right. This discussion today has been most helpful. Now top management will have to give this proposal and your discussion the most careful consideration. Thank you all."

With these comments Sr. Roberto Dante, president of the Corporation for Economic Development (CED), terminated a meeting of board members and senior executives of the corporation. The group had assembled to hear an oral presentation of the report of a special committee which Sr. Dante had commissioned to inquire into the advisability of CED's expanding its activities to include a program for the leasing of plant and equipment to new or expanding industrial enterprises.

For many months Sr. Dante had followed with keen interest news of the progress of private leasing plans in the United States and Europe, and of the special leasing programs that had been instituted by certain particularly aggressive development organizations in other countries. His organization, CED, had as a principal objective the development of industrial enterprise in his country. Basically his country shared many of the characteristics of a developing nation, and despite some measure of success, Sr. Dante was not wholly satisfied with the pace of industrialization in the country or convinced that CED had arrived at its full potential as a stimulant to further industrial progress. Sr. Dante was particularly attracted to the idea of leasing because he saw in it a possible vehicle for expanding the base of entrepreneurship in the country. Capital, besides being scarce, was concentrated in the hands of a very small percentage of the total population of the country. Moreover, members of this small group also possessed the education and the experience in administration important to direction of business enterprises. Consequently, in the past active entrepreneurship had been the almost exclusive prerogative of this relatively small and tightly-knit group. A group of less than 100 businessmen were identified with a high percentage of the new enterprises

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This case was prepared by Charles M. Williams, Edmund Cogswell Converse Professor of Banking and Finance, as the basis for discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

which CED had helped finance. It seemed to Sr. Dante highly important to the social stability and progress of the country, as well as to maximum industrial development, that aspiring industrial managers of less favored backgrounds and limited financial resources but with administrative potential and entrepreneurial spirit have more opportunity to participate in industrialization. He anticipated that leasing might make it easier for people of this sort to start or expand business enterprises.

Leasing also appeared to Sr. Dante to be especially promising in the case of small and medium-sized industries since it might be possible through leasing to minimize some of the organizational procedures and general "red tape" that appeared inevitably associated with the administration of the long-term loans against fixed assets as security.

As a first step toward the investigation of leasing as an aid to industrial development, Sr. Dante asked Sr. Luis Barreto, with the assistance of two staff men, to visit a country where the local development agency had operated an aggressive leasing program. Sr. Barreto had reacted most enthusiastically to the leasing program in this country. The development corporation of this country had built industrial buildings or financed the purchase for lease of machinery and equipment for several hundred companies. Overall, its experience was regarded as highly favorable; and currently less than 1% of the lessees were more than 90 days behind in any lease payments. However, Sr. Barreto pointed out that there were many special circumstances in the case of this country that had made its experience only a very general guide for possible programs of leasing by CED.

Shortly after receiving Sr. Barreto's report, Sr. Dante decided to push the investigation forward and for this purpose appointed Sr. Barreto head of a committee to investigate fully the considerations relative to a leasing program and to recommend action on the matter. If its conclusions were favorable to leasing, the committee was instructed to propose the main features of a leasing plan for CED. Sr. Dante also named to the committee two prominent local businessmen, one a vice president of a commercial bank and the other a leading industrialist. This committee had acted vigorously and expeditiously in concluding that CED should indeed undertake a leasing program. Although its formal report was still in the process of reproduction, Sr. Dante had asked the special committee to describe to a key group composed of directors and senior executives of CED the major provisions of the leasing program they were recommending to CED. In opening the meeting he had stressed the desirability of a frank and complete discussion of the merits of the proposal. To that end he urged his fellow-executives and directors to raise constructive criticism and questions about the program.

Sr. Barreto had taken the first part of the conference to outline what he considered the key characteristics of the proposed leasing program.

1. Coverage of the plan. CED should be prepared to lease land and buildings, and machinery and equipment, for any kind of industrial enterprise that furthered the economic development of the country, whatever its nature. Although office equipment and hand tools were to be somewhat arbitrarily excluded from consideration, it should not necessarily discriminate against either large or small items of equipment. Essentially, a prospective CED lessee could avoid any significant investment in fixed assets.

2. Leasing charges. The committee proposed that separate schedules of charges and amortization be established for land and buildings and for machinery and other items of equipment. It proposed that the monthly lease charges for land and buildings be calculated on a basis to amortize the investment by CED on a 15-year basis and to return 7 5/8% on the outstanding investment--that is, the amount not yet amortized. The 7 5/8% figure was designed to cover immediate administrative costs, property taxes (extremely low on industrial properties in that country), and a 6% "interest" return for the money tied up by the corporation in the fixed assets. The charges calculated on this basis would equal P 8.5 per month, or P 102 per year, on each thousand pesos of initial investment by CED. The fixed monthly lease payment would in the early months consist primarily of "interest". As time went on and interest declined as the outstanding investment was reduced by amortization, the fixed monthly payment would provide more amortization and reduce the outstanding amount more rapidly.

The committee recommended that a uniform approach be made to determination of charges for machinery and other types of equipment. They proposed that the charges be set to amortize the investment in machinery in approximately 66 months and to return 6% interest to CED. Charges at these rates would mean monthly payments equal to P17.9 per $1,000 of initial investment in machinery and equipment.

3. Duration of leases. It was proposed that all leases for land and buildings be written for a term of 10 years with renewal options available to the lessee. Leases for the machinery would have a term of 66 months. As protection for the corporation, the committee recommended that the lessees be required to obtain a guarantee by responsible organizations equal to at least six months' lease payments. The liability of the lessee for damages if he attempted to cancel the lease would not be limited to this six months' guarantee amount, however.

4. Purchase options. Each lessee would receive the right to purchase the assets leased by him at any time during the life of the lease. The purchase amount price would be simply the unamortized balance of CED's investment in the assets. Since the assets were expected to have value over a longer period than that covered by the lease, presumably any leasing clients would find it to their interest to purchase the assets at or near the expiration of the lease when the outstanding investment would be reduced to a negligible figure. It was hoped that many of the lessees would decide to purchase the

assets well in advance of the expiration date.

5. Upkeep and maintenance. All maintenance would be at the expense of the client-lessee, who would agree to keep the assets in good condition.

6. Casualty insurance. The leasing client would be obligated to maintain fire and other casualty insurance against physical damage to the property.

7. Other requirements for qualification as lessee. The leasing program would not be available to just any applicant. The committee stressed the desirability of a careful investigation of the proposed ventures for which assets would be provided. The prospective industrialists would be required to present a carefully conceived, practical program for the new enterprise and to be able to convince CED that they possessed the necessary management capacity for the success of the venture. Furthermore, they would be required to provide the necessary working capital for the enterprise, since CED would finance only the fixed asset portion of their financial requirements.

Reactions of the CED executives to the leasing proposal had been active and diverse. Initial questions centered in the ability of CED to insure that lessees followed proper maintenance policies. As one officer commented:

> "We have a hard enough time getting our regular borrowing clients to maintain properly the equipment that they own outright. If our leasing clients think of the machinery as belonging to a big government corporation, are they going to take the same kind of care of the equipment they would if they owned it themselves? If they get into difficulties, won't there be a tendency to work our machinery especially hard and to avoid the downtime on the machinery necessary for proper repair and maintenance? On the portable items, can we be sure that these won't be left outside in the weather? On items like compressors or air-hammers or welding units, which have a broad market through the country, how can we prevent these from being stolen? Can we be sure that our clients won't loan these items out to friends, relatives or associated companies and then lose track of them? It's easy to alter identifying marks such as serial numbers."

Sr. Barreto replied, in effect:

> "This question of maintenance and control, of course, is an important one. We have given it considerable thought. When you see our report, please pay particular attention to the paragraphs devoted to this subject. In summary, we propose that

detailed maintenance schedules be prepared by CED for all important pieces of equipment. This sounds like a lot of work, but actually we can work from the manufacturer's recommended schedule on most items. CED would specify minimum basic maintenance and repair routines, as well as the kind of maintenance records that our leasing clients should maintain. We will have to organize a special group here from our technically trained personnel who will be charged specifically with monitoring the maintenance practices of the clients. They will have to go out to the clients' facilities and inspect the equipment and make spot checks on the smaller items to make sure they are all on the premises. We will have to be very tough about our rule that the equipment is not to be removed from the premises without specific permission of CED. We will have to prosecute the first client who sells or diverts equipment or doesn't do what he has to do to keep it from being stolen.

"We do have one major protection. I refer to the purchase option and the likelihood that each of our clients will actually look forward to buying the equipment as soon as his financial position permits. In these cases, the client will, we believe, tend to think of the equipment as his own and to take the same kind of care of it that he would if it were his own. In other words, the purchase option is an extremely important part of this whole proposal."

After further inconclusive discussion of the problems of insuring proper control of maintenance of equipment, another CED official gave the discussion a new tack.

"I am wondering if the committee really is serious in proposing that we in CED be willing to buy any sort of equipment or machinery, however specialized. If we were to think in terms of relatively standard items of equipment, such as general-purpose machine tools--lathes and drill presses, for example--we can anticipate a fairly broad market in this country. If CED should have to take back the equipment from a defaulting lessee, we might well find other clients who would be happy to lease this kind of equipment from us. If not, there would be some sort of decent market for the equipment in the country. But, as the committee has made its proposal, CED would stand ready to buy and bring into the country all sorts of highly specialized equipment. For example, take those people who were in here recently for a loan to help them buy equipment for a plywood factory deep in the interior. The equipment they wanted to buy was very expensive and highly specialized and it would cost a lot to get it transported into the interior location and installed properly. As you know, we turned them down because they didn't have enough financial resources. Suppose they come back to us and say, 'You buy and then we will lease it from you.' Under the proposed program presumably we would buy it and set them up in business. Now, suppose they ran into trouble and couldn't meet their payments. We would be stuck with huge, highly specialized equipment for turning logs and making veneer and big expensive presses for making plywood. There are only two or three other plywood manufacturers in the country and they are far away. If they knew we had specialized equipment for sale, they certainly would be in a strong bargaining position. They might not want the equipment at all, since their own might be perfectly satisfactory. Even if they did want the equipment, wouldn't they pretend they really didn't want it very much and try to drive a very hard bargain with us? Suppose they would offer us 10¢ on the dollar? Would we have any alternative but to sell it to them at their price?"

Another official took a similar but somewhat different line.

"Actually, the problem area really isn't restricted to the specialized equipment. Many of the costs associated with modern pieces of equipment, particularly of the heavier types, are related to getting them into place and properly installed. Any piece of new equipment loses a lot of its value once it is put into use and becomes used equipment. Overnight it will tend to lose, oh, as much as one-third of its value as new equipment. Now, if you have a rental schedule which calls for an equal monthly rental figure over the entire life of the lease, in the early years of the lease the amount going to amortization will be very small. As Sr. Barreto suggested, we will be recovering our investment at a very slow rate in the early years. Yet this is precisely the period when the risk of failure will be greatest for relatively new companies and when the equipment loses value at the most rapid rate. It looks to me as if very little of our equipment would actually have a resale value equal to the net investment of CED in the equipment in the early years of its life.

"One further point. Sr. Barreto, you referred at one point to the many very successful leasing operations now undertaken by manufacturers of expensive machinery in the United States. You pointed out that many of these have operated with limited losses. There is a big difference, however, in the operation of a leasing business by a sales affiliate of a manufacturing company or even by a dealer in equipment and by an organization like CED. Take the case of a company manufacturing bulldozers. Its leasing affiliate will have a great deal of familiarity with the markets for bulldozers. Furthermore, it will have its own repair and rehabilitation facilities or access to such facilities. If a leasing client can't make the payments, they will have the equipment to go out and get the bulldozer, to get it into the shop and rehabilitated, and then they will know its likely resale value and where it can likely be sold. In contrast, consider the problem that would face CED if we had to recover some equipment. We are not properly equipped to recover it, rehabilitate it, and find customers for it. What we would probably have to do is advertise the equipment and hope that somebody would be interested enough to go out and look at it and buy it in place."

Sr. Barreto replied:

"You are certainly right that problems are involved when we get into the more specialized kind of facilities. But perspective is required. If we are to make an important contribution to industrialization with this lease purchase plan, we will have to extend our coverage far beyond the standard tools or equipment. After all, CED is here to promote new industries. By definition, these will include companies requiring specialized facilities. Of course, there is a chance that we will have some losses; we have them in our regular lending program. We are willing to make mortgage loans against specialized equipment. Is this really very different?"

Another official interjected:

"Yes, but there is a very important difference between our loan program and this leasing proposal. As we all know so very well, it has long been our policy to insist on a substantial margin between the appraised value of fixed assets offered to us as security and the amount of the mortgage loan we are willing to extend. And in a number of cases when we had to move to foreclose on the security, our usual standard of 100% coverage has proved insufficient. What we are talking about in this leasing proposal is 100% financing of fixed assets and no margin of security at all, even at the outset. Isn't this kind of financing going to encourage a lot of people to go into business on a shoestring? Our generous financing will make them highly vulnerable to any kind of difficulty that comes along. In other words, not only will we be badly exposed on our investment, but we will encourage people to get into business who don't have enough behind them to help them weather the problems every business runs into."

Sr. Barreto replied:

"Once again, you are touching on a highly important area. Let me emphasize again that we will have to have rigorous standards in measuring the qualifications of applicants. Applicants will have to know what they are doing and present a real good business plan. They'll have to show us experience or other qualifications that make it likely that they will succeed. Equally important, our plan proposes that we lend only to enterprises where the management can demonstrate that they can provide the required working capital for the enterprise. As you know, many of our borrowing clients have underestimated the money they need for working capital. We propose, and the details are spelled out in our report, that CED review leasing applications extremely carefully and have a form in which the applicant is required to estimate how much inventory he would need for a. say, three-month period, what his probable sales and receivables will be under his proposed pattern of operation and, in addition, what a reasonable cash balance for routine operation will be. Unless he can show us that he has the means of providing this working capital, we cannot consider providing him with the fixed assets. This may seem harsh, but it is an important part of our program."

Considerable discussion followed on these points.

Late in the conference a quite new issue was raised. In the words of the speaker:

"I fear that we will encourage our clients to 'overequipment policies.' As you know, our loan clients sometimes seem disposed toward wanting the very latest and most complete equipment available anywhere in the world, even though simpler or used equipment would do the job. Also, they tend to get equipped for operation at maximum capacity operations rather than trying to get along on a minimum amount of equipment and perhaps working double or triple shifts. This tendency we have all seen despite the fact that our clients are buying their own equipment under our regular loan program. Under the leasing proposal, where the monthly rentals don't seem very formidable, isn't there a strong temptation for our clients to abandon any restraint in their self-indulgence as to the latest and best of equipment. We may end up financing automated monuments costing several times as much as equipment that could do the job. Moreover, if we encourage heavy investment in complicated and advanced machinery, we will not be encouraging employment of local labor so much as we would if less advanced, less expensive machinery were used."

In reply, Sr. Barreto's industrialist associate on the committee commented as follows:

"As I understand your present procedures, when CED makes a mortgage loan, you don't really try to determine whether or not the client really has or is going to buy the equipment that he really needs. We propose that CED's technical experts review in detail proposals for acquisition of machinery--and, of course, for the basic plant also. It would be up to these experts to keep the applicant from getting too exotic in his statement of requirements. It would be up to them to suggest cheaper replacements for the proposed items. In effect, CED would have a great deal more control over the machinery purchases under the leasing program than it now has under its loan program. So, under our proposal there would be a better mechanism for rationalizing equipment procurement than CED has now."

One further area was discussed. An official commented:

"Most of the discussion here has been along the lines that CED would be much too generous in advancing funds under the leasing program. Actually, it seems to me that the amortization schedules proposed are in fact extremely conservative. The machinery plan specifically calls for full recovery of the investment in equipment in 66 months. Actually, a lot of heave equipment will have a useful life very much longer than 66 months. Take a hydraulic press for stamping out metals, for example. I have seen presses in U.S. plants that were considered well equipped that had been in use for 20 years or more and still were working fine. Much the same criticism, of course, could be applied to the 15-year schedule for plant and land. In this country good industrial land is going to increase in value, not decrease. Moreover, the way modern plants are constructed, they ought to be good for 30, 40, or 50 years."

The reply from the committee centered on the question of the heavy equipment.

"Actually, the leasing program as we see it is not designed primarily for the large corporation which is likely to have the need for very massive pieces of equipment. It would not, for instance, be designed for a steel mill or a cement factory where the scale of operation is such that it probably should be financed in a more conventional program. This program is aimed especially at the smaller and medium-sized enterprise where the need is more likely to be in light or medium equipment. This kind of equipment may well last more than 66 months, but for the reasons that many of you have stressed earlier, we feel that it is better to be on the conservative side of the estimated life. Hence we have set our recovery schedules to return the corporation's investment in 66 months or less. There is a good case for having different schedules for different kinds of equipment based on varying estimates of the useful life of the equipment. However, this would get very complicated, and we would probably be drawn into a lot of argument as to just what the depreciation schedule should be on this and that piece of machinery. With a single rate we may be recovering the investment too fast on some items and not fast enough on others, but it seems to me that the administrative advantages of a single schedule for machinery outweigh the risks we assume."

As the meeting drew to a close, Sr. Barreto summarized his position on the program.

"Naturally, this program involves some risks. My colleagues and I think that the risks are not very great. Remember, as Sr. Dante has so often pointed out, it is imperative that the country's entrepreneurial base be expanded. To accomplish this, some risks must be taken. We cannot continue to hope that this problem will be solved with traditional tools."

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Suggested Questions for Analysis and Discussion

EQUIPOS, S. A.

1. Is the tentative BNF policy of insisting on a 2-1 security coverage of its loans a wise one? How much protection does the security offered by Equipos afford BNF?
2. In the analysis of loan requests from new ventures, such as Equipos, what are the most important questions a development bank should raise and answer?
3. In this case, are the more important unanswered questions likely to be resolved by further inquiry or analysis by BNF, or are uncertainties inherent in new enterprises such as Equipos?
4. In the light of BNF's objectives, are the inherent risks balanced by the potential benefits from a loan to Equipos? What action would you as a director of BNF recommend on the Equipos loan request?

BARTEX

1. What action should BNF take on the Bartex situation?
2. In earlier periods what might have been done by BNF to prevent the deterioration of Bartex?
3. Should BNF take steps to increase substantially its capacities to render "preventive assistance"? How should BNF move to overcome the problems inherent in a greater effort (finding and keeping qualified personnel, etc.)?
4. Is the observation, "Many of our firms need management more than they need more money," pertinent and applicable in your country? What is your bank's policy and practice regarding technical assistance?

RETNA and JUAN GARCIA & CIA.

1. What should be learned from the BNF experience with Retna?
2. How important are reliable figures from clients to effective loan extension and supervision by BNF? By development banks generally?
3. To what extent would insistence on audits by reputable public accounting firms assure the completeness and reliability of the financial statements from borrowing clients?
4. Should BNF insist that it be supplied with audited financial statements on at least an annual basis by all of its clients?
5. In the Juan Garcia case, would the use of outsider auditors have exposed the fact of its guaranty of the obligations of nonconsolidated subsidiaries?
6. What sort of a program of loan supervision should development banks undertake?

CORPORATION FOR ECONOMIC DEVELOPMENT

1. What action would you recommend to Senor Dante, President of CED, on the leasing proposal of Senor Barreto and his committee?
2. On what assessment does your recommendation rest?

P. D. C. P.

"You have asked about our experience in development banking and what we could produce in the way of tentatively useful generalizations about how best to establish and operate a successful development financing company. Perhaps my comments would be most meaningful if I first outlined some general policies of our corporation that guide our association with development financing companies. Then we can look together at key features of the newest private development Corporation of the Philippines (PDCP). Its president, Mr. Ortigas, has approved our talking with you about our association with his company. I will give you some background on the key features of the PDCP, and you and your associates can assess for yourselves our policies as reflected in our association with PDCP."

With these words Mr. Hans Tucher,* a member of middle management of the International Finance Corporation (IFC), began a discussion with a case writer from the Harvard Business School.

"As you know, the World Bank has for years been keenly interested in development finance companies. Since its participation in the financing of the Industrial Development Bank of Turkey in 1950, the World Bank and its affiliates have committed more than $250 million to 14 different development finance institutions. Helping to organize and strengthen such companies has become a major activity of the IFC in recent years. In several recent instances, the IFC and the World Bank have played complementary roles in the financing of new development finance concerns, IFC taking an equity position, while the Bank has extended loans--with the guarantee of the government of the country involved. In many respects the Philippine case follows a general pattern that has been developed in the case of banks in Turkey, India, Pakistan, Austria, Iran, Morocco, Malaya, and Finland. The emerging policies shaping our participation in the financing of new industrial development concerns center in five key areas:

(1) the environment in which the development corporation will operate,
(2) the pattern of ownership and control of the corporation;
(3) the capital structure or sources of financing for the corporation,
(4) the quality of the management associated with the enterprise; and
(5) the basic policies under which the corporation plans to operate."

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*Disguised name.

This case was prepared by Charles M. Williams, Converse Professor of Banking and Finance, as the basis for discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

Assessing the Environment

"Before we can consider investing in a development financing corporation, we must satisfy ourselves that the environment or climate in which it will operate is one favorable to its success. First, the country must be one in which there is a strong, vibrant, and expanding private sector. For reasons that I shall develop shortly, we are interested in financing only privately-controlled development finance concerns. Clearly, a private development bank can have a fertile field in which to work only if there is a strong private sector. Moreover, government attitudes must be ones that do not seriously threaten the future of the private sector.

"Second, the country should be one in which there is a significant and increasingly active demand for capital for industrial and other productive enterprise. We should be able to anticipate the emergence of a number of promising projects needing intermediate and long-term capital and offering attractive prospects to investors. Obviously, there is a much greater likelihood of the emergence of promising projects in the case of countries where there is already a nucleus of entrepreneurial and managerial talent, a reasonably broad market for industrial products, adequate natural resources and basic services, an adequate supply of trained or trainable labor, and a reasonably good investment climate.

"Moreover, there must be promise of active demand for capital in the form which a development bank can expect to provide. In most countries long-term and medium-term capital sources are currently inadequate, so that if there is a demand for capital, there is almost certainly a need for a development bank.

"The environment for a development finance corporation in the Philippines seemed to us to readily meet our requirements. Indeed, the World Bank had assumed an initiative in 1961 when Mr. George Woods, now president of the World Bank and IFC, agreed to act as a special consultant to the Bank and IFC in investigating the need and desirability of such a financing corporation in the Philippines, and if these suggested such a course, to assist in its creation."

Policies Toward Ownership and Control

"It is our experience in the IFC and the World Bank that development finance companies will be most successful if the ownership of these corporations is predominantly in private hands, and the control definitely private. We believe that private ownership and basic control of the corporation is the best way of assuring continuity of sound investment policies and experienced management. Moreover, it will help assure that operations will be conducted upon sound business lines and be guided by economic rather than political criteria. Supporting our views is the experience of a number of publicly-controlled development banks which have failed in their purpose because their investment decisions were dictated primarily by political considerations.

"For a variety of basic reasons, the development institution should be regarded as a genuine national concern. Hence it is important, in our view, that the majority of the common stock of the corporation be owned within the country. In some cases, only an IFC participation makes it possible to avoid a foreign majority--if the country concerned is prepared to consider IFC not as a foreign but as a domestic institution. In such cases we have agreed to sell our stock--when we ultimately do sell--only to local nationals. Furthermore, ownership of the financing company should be as broadly based as is possible. We do not want the potential benefits of successful operation to be limited to a favored few. If the public has the opportunity to subscribe to the public shares, there can be less grounds for subsequent criticism of government policies favoring the corporation if and when the corporation proves financially successful and the rewards of ownership are attractive. On the other hand, we feel that it is important that potential investors be such that they can afford to carry their investment for a period of years with limited immediate gain. Investors who buy the shares with other than a long-term point of view are likely to be disappointed.

"In view of our earlier emphasis on the importance of a genuine national character in the ownership-control of the corporation, an additional policy may at first appear contradictory. We do encourage the development corporation to solicit equity participation by selected foreign investors. Typically only fairly substantial private investors abroad who have some particular interest in the development of the country will be particularly interested prospects for equity investment. Such investors, usually commercial bank affiliate concerns or investment companies, very frequently are in a position to contribute valuable experience and useful contacts in the industrialized countries. Share ownership by such foreign investors is highly conducive to their continued active interest and support of the company. For example, we in IFC have alerted local development corporations to investment opportunities in their countries that have come to our attention.

"Now, against this background of our general policies, let us look at the pattern of ownership in the PDCP. The authorized capital stock of PDCP consisted of 2,500,000 shares of 10 peso par value each and divided into two classes. Authorized were 1,750,000 Class A shares. The charter of PDCP required that Class A shares be held either by the citizens of the Philippines or by the IFC. The charter also authorized 750,000 Class B shares, which could be owned by anyone, regardless of nationality. The composition of the board reflected this division of ownership. Eight directors of the corporation were to be citizens of the Philippines and were to be elected solely by holders of the Class A shares. The remaining three directors were to be elected solely by holders of the Class B shares. Except for their voting rights, the Class B shares were identical to the Class A shares.

"In addition to its commitment to purchase 80,000 Class A shares, the IFC also agreed to subscribe to unsold Class A shares up to an additional 420,000 shares. An underwriting commission was payable to IFC for its underwriting commitment. In the actual case the 1,670,000 shares offered Filipinos were completely subscribed, leaving IFC with only the 80,000 allocated it. PDCP was also successful in selling the 750,000 Class B shares, which were taken up principally by 18 leading private institutions outside the Philippines. These include 14 American investment banking institutions, 2 British banks, a German bank, and a Japanese bank.

"We here in IFC were particularly pleased with the support of the Philippine venture by these outside investors. First, of course, these investors do supply capital and foreign exchange. More important in the long run, in our view, is the value to PDCP of the continued interest in the company and in the country on the part of these foreign investors. It would be hard to find a more sophisticated and knowledgeable group of investors than these. They represent important potential sources of additional funds for the future. Moreover, and more importantly, these firms are in a good position to give advice, counsel, and assistance to PDCP on contacting firms all over the world. In effect, the association with PDCP of these firms gives PDCP a global outreach. We anticipate that these outside investors will prove highly valuable partners in the enterprise over the long run."

Capital Structure and Sources of Financing

"As we have earlier suggested, it is hardly in the nature of things for the development financing institution to promise large, near-term return for the common shareholders. Consequently, much of the potential interest in stock subscriptions necessarily will center in institutions or individuals who are particularly anxious to have the developing organization in being as a stimulant to economic development. However, this is not enough. Investors must have reasonable grounds for anticipating a reasonable return on their investment and a degree of safety consistent with the expectation of such a return. In our experience several requisites must be met if satisfactory earnings results are to be achieved. First, the new development financing corporation must anticipate sizable costs of operation. The nature of the job demands a high quality of management and staff. Operating costs and management and staff needs are especially formidable for those development banks that will especially promote and support new enterprises. Second, the development financing organization must employ a high degree of financial leverage. That is, it must utilize its equity base and organizational expertise to raise the great bulk of its capital on a fixed-return, debt basis. Third, even with a high degree of leverage, it is difficult to cover expenses and to allow for adequate bad debt reserves and for income taxes, and still achieve a satisfactory return for the equity shareholders. The operating spread between what the development organization charges for its advances to clients and what it has to pay for its own borrowings from conventional sources is typically too narrow to be satisfactory. Moreover, heavy use of conventional debt sources sharply increases the risk to the equity shareholders. An inherently risky capital structure can encourage management to follow such a conservative investment policy as to limit the contribution of the organization to the development of the country. As a partial solution to these inherent difficulties we have strongly urged our development finance company clients to seek special governmental assistance in the form of what we would call 'quasi-equity', that is, a long-term loan interest-free, or at a very low rate of interest, which is subordinated in bankruptcy not only to other borrowing but also to the share capital of the company.

"In the case of PDCP, the active support of the Philippine Government was invaluable. First, by agreeing to guarantee the repayment of World Bank loans to PDCP, the government made possible PDCP's negotiation of a $15 million credit line with the World Bank for use by PDCP. The actual loan from the World Bank would be to the Philippine National Bank which would relend to PDCP as the funds were needed. The loans would have a maturity of 15 years.

"The Philippine Government directly made no commitments to invest on the 'quasi-equity' basis which I have argued is so important to the economic success of a new development finance corporation. On the other hand, its active support was essential to the negotiation of a successful loan agreement with the Agency for International Development (AID), an agency of the U.S. Government. AID agreed to lend PDCP 27,500,000 pesos from funds generated out of purchases of U.S. commodities under Section 402 of the Mutual Security Act of 1954 (counterpart funds). Repayments would not begin for 15 years and then were spread over 30 semiannual installments. Interest on the outstanding balance of the loan was at the rate of 1/2 of 1% per year. AID reserved the right to disapprove individual commitments and investments made with funds supplied by it. Moreover, AID agreed to subordinate to the equity any installments of principal or interest not yet due and payable in the event of liquidation, receivership or bankruptcy of PDCP. In the event of especial prosperity of the PDCP, certain prepayments were provided for. In summary, the PDCP was able to begin business with the following basic sources of funds available to it:

15-year credits from Philippine National Bank with funds supplied by World Bank	$15 million
Class A common stock	Ps 17,500,000
Class B common stock	Ps 7,500,000
Long-term loan from AID, subordinated to equity	Ps 27,500,000

The Management Associated with the New Development Finance Corporation

"One of the most important requirements for the successful operation of a development finance company is that it have experienced management from the start. Directors and top management should be men of outstanding character and stature who have the respect both of business leaders and of the government officials. Management from top to bottom should have an investment rather than a commercial banking outlook. By this we mean that its investment decisions should take as much account of the economic and business prospects of the enterprises being helped as of the purely credit or security aspects. Moreover, the management of development finance companies should have the capacity to contribute far more than money to the firms they assist. Through its management the development finance corporation should help meet the generalized shortage in developing countries of the experience needed to spot and to seize an industrial opportunity and to plan, execute and operate an industrial enterprise. They can play a part in the search for investment opportunities. They have a special opportunity and duty, through the standards they apply in dealing with their clients, to further that process which converts a varied and inadequate proposition into a well planned, well constructed, well managed enterprise that contributes to the national progress and yields an adequate reward for all investors involved.

"Since the quality of management of the development financing corporation is so crucial to its success, we were especially gratified by the caliber of the local individuals who were willing to help get PDCP organized (see Exhibit 1). Some of these men became members of the board of directors. Agreeing to serve as president of the corporation as he had of the steering committee which brought the corporation into existence, was Mr. Francisco Ortigas, Jr., a well-known lawyer and businessman identified with a number of civic and business organizations. Other directors included the president of the Mining Association of the Philippines, the president of the Bankers Association, and a former secretary of finance in the national cabinet and also chairman of several corporations. Our contacts with these men in the process of developing plans for the new organization led to a high degree of respect around here for their qualifications and capacities. Since the directors and the president were busy men with a variety of responsibilities apart from PDCP, both they and our executives were especially concerned with the selection of the executive vice president who would be charged with the day-to-day operation of the enterprise. After considerable efforts, Mr. J.K. Paulding was engaged as executive vice president. Mr. Paulding is an American with many years of industrial consulting and investment banking experience in Brazil and before that in the United States and Europe."

General Policies of the Development Finance Corporation

"We place great weight on reaching a reasonably clear understanding with the sponsors of the local development bank regarding the general orientation of their policies. Naturally, before promoting or dealing with a local company, we want to be quite sure that the objectives of the sponsors are consistent with the objectives of IFC. For example, it is vital that the sponsors give their corporation a developmental orientation. Basically, we want the people closely associated with the project to think through alternative policies and patterns of operation and to arrive at conclusions on such questions as: the maximum level of debt which will incurred by the corporation; the degree of conservatism of the reserves which will be established; the maximum financing to any one client; and the development of the vital staffs for project appraisal and project supervision. In connection with these policy statements, reference to things which the corporation will not do are, perhaps, equally as important as reference to major areas of effort. In all cases, therefore, we ask sponsors to prepare a written statement outlining in some detail the policies which are to be followed.

"In the case of PDCP, the founders not only prepared a statement which was satisfactory to us but also prepared for public distribution a brief summary of their policies. Key excerpts are shown in Exhibit 2."

Exhibit 1

P. D. C. P.

Original P. D. C. P. Organizers

Francisco Ortigas, Jr. Manila	Lawyer and civic leader; Chairman: Trans-Philippines Investment Corporation, Binalbagan-Isabela Sugar Co., Inc., Delta Manufacturing Corporation; Director: Firestone Tire & Rubber Co. of the Philippines, Philippine Banking Corp.; President: Ortigas & Co., Ltd. Partnership; Partner: Ramirez & Ortigas Law Office.
Jesus S. Cabarrus Makati, Rizal	President: J. Cabarrus & Company, Marinduque Iron Mines Agents, Inc., Acoje Mining Co., Inc., Acoje Oil Exploration & Drilling Co., Inc., Mining Federation of the Philippines, Dingalan Forest Products, Inc.; Chairman: Philippine Petroleum Association; Director: Trans-Philippines Investment Corporation, Binalbagan-Isabela Sugar Co., Inc., Manila Banking Corporation, Travellers' Life Assurance of the Philippines, Inc.
Manuel J. Marquez San Juan, Rizal	Chairman & President: Commercial Bank & Trust Co.; President: Bankers Association of the Philippines; Vice-Chairman: Philippine Air Lines; Director: Republic Cement Corporation, Filoil Refinery Corporation
Aurelio Montinola, Sr. Makati, Rizal	Chairman: Amon Trading Corporation, Eternit Corporation, Far East Bank & Trust Company; President: Tabacalera Industrial Development Corp. of the Philippines, Republic Cement Corporation, Central Azucarera de Bais, Compania Celulosa de Filipinas, Philippine Prestressed Concrete Co., Inc.
Antonio C. Delgado New Manila, Quezon City	President: Delgado Brothers, Inc., A. C. Delgado, Inc. (Caltex Floating Sta.), Delgado Brokerage Corporation, United Services Corporation, Wood-Mosaic (Philippines) Inc., Delgado Stevedoring Co., Inc.; Director: Republic Cement Corporation, Manila Electric Company, Philippine Bank of Commerce; Vice-President: Philippine Chamber of Industries
Vicente R. Jayme Paraneque, Rizal	Vice-President: Philippine National Bank; Deputy Director-General: Program Implementation Agency
Rodegelio M. Jalandoni Quezon City	Partner: Jalandoni & Jamir Law Offices; Corporation's Secretary and Legal Counsel

Exhibit 2

P. D. C. P.

Excerpts from Published Statement of General Policies to be Followed by PDCP

GENERAL POLICIES

The Private Development Corporation of the Philippines was created for the purpose of financially assisting private initiative to develop new and expand existing facilities of a productive nature in the Philippines.

PDCP participation in private enterprise may take the form of investment in medium and long term loans, capital stock, preferred stock, loans with profit sharing features or any combination thereof.

PDCP is also prepared to assist in combining domestic investments with those from abroad whenever in its judgment such joint enterprises appear to be advantageous to local development.

PDCP activity will also extend to participation in private offerings, enter into commitments for the subscription or purchase of shares, debentures, bonds or other financial instruments being or to be offered to the public. Direct offerings of shares or other forms of investment will not be made directly to the public. PDCP's policy calls for the use in this conjunction of existing and new financial services offered by banks, brokers and investment companies.

PDCP does not compete with private capital.

Criteria for Investment by PDCP

The project must have a sound capital structure, able management and acceptable profitability.

PDCP expects private investors to put up a substantial part of the capital for the enterprise seeking financial assistance.

Degree of Participation by PDCP

When expansion of a seasoned enterprise is under consideration, PDCP may consider a financial participation of up to fifty (50) percent or more. The financing of new enterprises will be limited to a maximum of fifty (50) percent of physical requirements.

There are no formal upper or lower limits to the amount that PDCP may invest or advance to any single venture. There are, however, practical limitations which on the up side are governed by PDCP's policy of diversification of investment and on the low side by the economics of the aid in relation to the costs of study and administration.

. . . .

Breadth of PDCP Financing

PDCP is prepared to assist in the financing of expansion or development of a wide range of productive activities of a basic nature in industry, mining, agriculture, forest products and in other fields.

PDCP will not engage in operations essentially of a refunding or refinancing nature nor is it prepared to finance directly imports or exports, real estate developments or others of this classification.

PDCP is restricted to financing enterprises privately-owned or controlled to the exclusion of government-owned and operated entities. This does not exclude however private enterprises in which some public funds have been invested provided the enterprise remains essentially private in character.

General Financial Assistance Conditions

PDCP when granting financial assistance will require guaranties varying in accordance with the circumstances, the nature of the assistance and the currency in which it may be granted.

No liens, mortgages, borrowing restrictions or other security measures will be imposed which might hamper the full development of the borrower. These measures will be applied only to the extent that sound business practice requires PDCP to impose them.

PDCP will reserve the right to control loan disbursements.

PDCP reserves the right to examine the books and visit the properties of the borrower periodically so long as there remains any outstanding debt or participation.

Interest

PDCP does not charge any uniform rate of interest as each case is judged in relation to the particular risk involved, the extent of PDCP's participation and the prospective return on the total investment.

Principal

PDCP's practice with regard to amortization of debts shall be established in accordance with the ability of the borrower to meet such payments without imposing hardship. PDCP customarily defers the amortization payments in order to allow time for the project to reach a period of profitability.

Prepayment of loans may be negotiated.

Investment Policy of PDCP

Participations acquired by PDCP may be sold all or in part whenever in their opinion they can do so on satisfactory terms. PDCP would not, however, sell such to any investor with conflicting interest or to which its partners in the enterprise objected for valid business reasons.

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O. R. D.

High on the list of urgent problems of deep concern to Mr. Antonio Barbosa, president-designate of a new development bank in the process of organization, late in 1963, was that of achieving maximum circulation or turnover of the funds of this bank. Unfavorably impressed by the "freezing-up" of the assets of a predecessor development organization, Mr. Barbosa was extremely anxious to take advantage of the experience of development organizations in other countries that appeared to have had some success in achieving turnover. With this in mind, Mr. Barboza has addressed a letter to several organizations. Excerpts from this letter follow:

"You have, of course, some familiarity with our country and its efforts to strengthen all factors favorably affecting socio-economic development. Thus, I am sure of your acquaintance with the predecessor development organization, ORD, which without disparaging its able President Mr. Lupo who labored under severe difficulties, I think it can be said that the development results of ORD's lending program were disappointing.

"ORD began its life in 1957 with resources equal to 50 million U.S. dollars at the then existing exchange rate. This money was voted as a capital grant by the National Legislature with high expectation for quick and dramatic results. Mr. Lupo felt great pressure to lend, and within 18 months the bulk of ORD's capital was committed for approved loans. To keep credit open to other firms, the Legislature in 1959 reluctantly agreed to a further grant of $25 million. By being extremely deliberate and conservative in new credits ORD made this amount last until early this year. However, loan repayments have been very modest.

"The allowance for credit failures and near failures was somewhat underestimated; many projects have taken more time for completion than initially estimated; start-up difficulties have continued beyond normal expectations; a few foreclosures on mortgage collateral have led to sales, but more are bogged down in legal procedures. Moreover, many of the few successful clients have failed to repay on schedule.

"With the change in our national administration it was decided that a new corporation should be organized to assume the development job. We anticipate a sizable capital grant by our government, but we will be

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This case was made possible through the cooperation of a business firm that remains anonymous.

expected to make our capital work hard and accomplish much more with it than did ORD. You can, with this background, appreciate my especial interest in learning about the measures you have developed to maximize the productivity of your capital to invest.

"I should make clear that we are more concerned with results than recognition. Hence, although we are a semi-government body, if we can stimulate the flow of capital in totally private sectors, we shall be pleased. I suspect you know our country well, so I will outline conditions here only very briefly. Many of the characteristics generally attributed to the economies of smaller developing nations apply to our country. Too much of our economy is devoted to a primary product, which is subject to severe price pressures in highly competitive world markets. We have continuing, sometimes severe, balance of payment problems. Compared to highly developed countries, the rate of savings of our people is low, but we do have wealth in this country. Our people, even most of the highly educated, have preferred to invest their savings in bank deposits or real estate. Ownership of real estate seems safer and a better protection against inflation--we have had our share of inflation--than ownership of bonds or other securities of corporations.

"Lack of enthusiasm for investment intangibles seems in part to reflect a certain distrust in the management or controlling shareholders of companies that have sold securities to the public. The lack of enthusiasm is also stimulated by the actions of stock prices on our small Bourse. The market for the two dozen company's shares traded there is thin and prices, though stable for the better shares, are no real incentive to attract prospective investors. The Bourse is active mainly in trading foreign exchange and governmental bonds issued to finance public works and low-income housing projects.

"Bank credit is rather generally available to the stronger firms for short term purposes. Many loans on normally short term actually are for continuing needs. Sources of medium or long term credit open to industry are almost nonexistent, except perhaps for some firms with strong foreign connections. Share capital is, as I have indicated, not really very available and at low price-earning ratios. Furthermore, the owners of many growing concerns who need more capital are highly reluctant to sell any of the ordinary shares or to disclose financial information to outsiders.

"Quite obviously, we would be much pleased if we could, in the course of solving our capital turnover problems, help to improve the capital market of the country."

Mr. Barboza received several letters in reply. Excerpts from these letters follow.

Dear Mr. Barboza:

Upon receiving your letter I drew up a reply which now seems to me to be much too abstract and general. Instead, I should like to describe a very recent project which will illustrate, I believe, some of the techniques we employ to achieve greater turnover of our own capital.

The project in question involves the production of light steel alloys, an activity which, as you may know, was given very high priority in our country's most recent Socio-Economic Achievement Program because of the increasing foreign exchange cost of importing our rapidly-growing requirements. To produce these alloys, a new company, ROTAN, was established in mid-1963 by a local company, Robinos, Ltd., and a European firm, Tandor A. G. Established in the early 1940's, Robinos manufactures a variety of products including jeeps, trailers, diesel engines and agricultural tractors. The company is also one of our country's important steel importers and distributors and, during the past few years, has handled about 15% of our total steel imports. Robinos' management has a reputation for being competent and progressive and ROTAN will be able to draw heavily on the company for management skills.

Tandor AG, which is participating in the project with equity money and with technical assistance, is one of Europe's leading electro-metallurgical firms. The net worth of the Tandor group, which employs over 15,000 people, amounts to approximately $120 million. ROTAN represents Tandor's first venture in a developing country outside Europe. By mutual agreement, Tandor will provide technical assistance during the planning period, will furnish personnel for the initial operation of the plant, and will train ROTAN's personnel in Europe. Tandor will continue to provide technical assistance for 15 years.

The plant location is considered extremely favorable. As is often the case with capital-intensive operations, ROTAN, up to a point, could achieve certain economies of scale by increasing its capacity. Accordingly, the plant layout was designed to permit a doubling of output with a minimum investment. The project's initial cost, estimated at Ms 78 million, is to be financed as follows:

Equity	(In Millions of Mylars)		Percentages
Common stock:			
Robinos, Ltd.	Ms 5.0		
Tandor A. G.	5.0		
Robinos' stockholders	2.4		
BDC	4.8		
Public*	12.8	30.0	38.4%
Preferred stock*		6.0	7.7
Total Equity		Ms 36.0	46.1%

*Includes local financial institutions

Debt	(In Millions of Mylars)		Percentages
BDC	Ms 18.0		
IDC	7.8		
International sources	13.2		
Suppliers	3.0		
Total Debt		Ms 42.0	53.9%
Total Financing		Ms 78.0	100.0%

Robinos and Tandor have agreed to invest additional equity funds in the event that the cost of the project exceeds the financing plan.

The Ms 12.8 million public equity issue will be underwritten. The Industrial Development Corporation (IDC) and our own Business Development Corporation (BDC) have agreed to underwrite Ms 1.2 million each, with the balance being covered by various life insurance companies, commercial banks and brokerage firms. The recent unsettling of our capital markets makes it most unlikely that an issue of this magnitude can be fully absorbed. Undoubtedly, all of the underwriters, including ourselves, will have to retain a portion of this particular issue. Our Ms 18 million loan, which carries an interest rate of 8% less 1/2% rebate for punctual repayment, is repayable in 24 equal semiannual installments beginning no later than 1969.

Admittedly, this description is a fairly scanty one. However, I believe that it will serve to illustrate the following comments.

First, we try to insist on some sort of foreign participation in major projects we help finance. Aside from the obvious value of technical assistance, particularly in cases involving fairly complex technology, we have found that foreign participations tend to have definite financial advantages. Very often, for instance, it is possible to reduce the scale of the initial investment. As you can imagine, we are constantly cautioning our clients against overbuilding, a fault all too common among our naturally optimistic entrepreneurs. Without a very extensive and expensive technical services department, however, we are not always in a position to enforce our views. A foreign partner can supply additional knowledge and a forceful viewpoint. Robinos' management, for instance, is extremely competent, but Tandor's management is intimately familiar with the advantages and disadvantages of the variety of methods of achieving a given productive capacity. Consequently, in this particular case, it was possible to hold down the initial ROTAN investment.

Moreover, a foreign company normally has access to a variety of financial sources. Assuming that a given project is indeed a viable one, the local operation probably will not be completely dependent upon our organisation and our thinly-developed domestic capital market should unexpected needs for funds develop. You will note that in the ROTAN case, for example, the problem of construction cost overrun appears to have been reasonably well resolved. Therefore, we will be able to devote capital which might normally be kept in reserve to some other deserving project.

Secondly, we devote a great deal of time and effort to drawing up the loan repayment schedule. We do not necessarily aim for rapid repayment. Rather, we try to create a schedule which is as realistic as possible in view of the operation's projected cash flows. Very often we defer amortization for a number of years in order to give the company an opportunity to build up sufficient cash reserves to weather unforeseen temporary difficulties. ROTAN's repayments, for example, will not begin for a number of years yet.

Once a realistic schedule has been drawn up, however, we insist upon strict adherence to it. We maintain close contact on our outstanding loans and we police overdue accounts vigorously. On the positive side, we offer an incentive for punctual repayment in the form of our negotiated interest rate rebate. ROTAN's 1/2% rebate, for instance, will amount to Ms 90,000 per year during the early amortization period if punctual repayment is actually made.

We also rely on the cost of the capital which we supply to help us achieve a satisfactory capital turnover rate. Our interest rate, for example, is approximately equal to the country's "market rate" for medium and long-term debt. As far as we are concerned, subsidizing marginal projects through a low interest rate would result only in a dissipation of our resources and would be wasteful for the country. Of greater importance, we want to be able to sell portions of our portfolio to other investors. Consequently, we want our holdings to be attractive financial investments, so as to facilitate such sales.

Finally, and of greatest importance from our point of view, we try constantly to act as a financial catalyst. Rather than serving merely as the sole supplier of capital, we seek out and bring together, as in the ROTAN situation, funds from a variety of sources, both domestic and foreign. In line with this role, we normally insist upon an equity participation as a condition for furnishing debt capital. Admittedly, some equity participations can become illiquid, thereby aggravating our capital turnover problem. It has been our experience, however, that the risk of illiquidity is more than offset by the fact that our many successful and profitable equity participations can later be sold to private investors. In contrast, the sale of our successful debt participations has proved much more difficult.

Admittedly, our socio-economic position is not strictly comparable to yours. However, many basic similarities do seem to exist. Also, I am sure that you will find, as we have, that many compromises must be made in order to satisfy the requirements of specific situations. Nevertheless, I hope that my comments are of some value to you as you begin to formulate your own policies.

Dear Mr. Barboza:

In addressing our firm, which is engaged in investment banking in the United States, you recognized, I am sure, that we are in the business of obtaining U.S. dollar loan and equity capital for domestic and foreign issuers through the mechanism of the securities markets, primarily in the United States. Like most United States investment banking firms, which by law cannot perform commercial banking functions, we do not ourselves normally provide capital for investment. Consequently, we do not experience directly the kind of problems you pose. We do, however, work frequently with financial institutions in this and other countries on similar problems.

We are strongly of the belief that a financial development institution in a country such as yours should be designed to have a continuing long-term existence. It should avoid the impression of constituting merely a "shot in the arm" to the economy as well as the appearance of a partisan political tool. In order to have a constructive effect over an extended period of time, its total available funds should be sufficient to create a revolving operation, that is, they should be adequate to provide for its operations until the flow of funds from repayment of investments is sufficient to constitute a continuing source of capital for further investments. In addition to making use of its equity capital, it is entirely appropriate for such an institution to borrow additional funds to be reloaned or invested. Prior to the achievement of "investment status", it will be necessary for its borrowings to carry the Government's guarantee. We believe, however, that your local market should be able to absorb bonds of your institution if they are so guaranteed. They would, in fact, be similar to those governmental bonds presently traded on your Bourse.

To the extent that the basic goals of your institution look toward the improvement of exports and substitution of local production for imports, with resultant effect on the balance of your country's foreign payments, it would be appropriate for your bank to make some portion of its borrowings in foreign capital markets, repayable in such currencies as your country may be expected to be able to obtain for payment. Generally speaking, this action is only possible when the credit of your Government has been, or can be, established in the leading capital markets. When this appears premature, the International Bank for Reconstruction and Development (World Bank) may turn out to be the best source of foreign borrowing in the first instance. Frequently, the World Bank can also be helpful to you in creating a market for your securities among those private banks and other investing institutions in the major capital markets of the World which have from time to time taken portions of its loans, either at the time a loan was made or through subsequent resale by the World Bank of its investment.

It can be presumed that the demand for development funds will continue to grow and no amount of funds made available solely through your bank will be adequate to meet all such demands. We recognize, of course, that, as the result of the demonstrated success of the bank's lending operations, new sources of funds will be opened to the bank. However, as your economy developes it is quite likely that a shortage of money will continue to be a rather permanent situation.

It is under these very circumstances that a development bank can make its most effective contribution. While it may not be able to provide sufficient funds from its own resources to meet the demand, it can and should act as a "catalyst" in attracting other funds or savings not directly available to the bank to join it in making productive investments. In this manner, it can effectively marshall financial resources far in excess of its own capital funds and direct their usage toward the sound development of your country's economy.

There are a number of ways in which your bank can act as such a catalyst. However, no such function can be performed by your bank until other potential investors acquire full confidence in the soundness of your lending program. This depends upon careful study of the bank's broad lending policies with relation to the various sectors of the economy having relatively high priority capital needs. It will also entail careful and deliberate appraisal on the part of the bank of each and every project which the bank has under consideration for possible investment. Keeping itself free to the maximum extent possible from outside pressures--political or otherwise--the bank must make a thorough and exhaustive analysis of each loan application and tailor the terms of such an investment to meet the requirements of the bank, the lender and the nation. The need for this was amply demonstrated by ORD's recent experience. Even in the case of its "successful" clients, experience showed that long-term capital needs cannot be financed by short-term loans. In all cases, the repayment schedule must be geared to the borrowers' prospective ability to repay.

In addition to searching investment analysis and careful design of terms and conditions, each investment must remain subject to continued and careful supervision. The importance of a thorough appraisal, careful design of terms and a conscientious follow-up cannot be overemphasized. Bad investments not only stem the return flow of funds required by the bank to meet its obligations and for subsequent relending; much more seriously, they create an undesirable impression among other financial institutions which cannot fail to diminish the bank's effectiveness as a catalyst.

This need for careful investment appraisal--not only from a financial viewpoint but from technical and economic considerations as well--will place heavy demands on the staff of your bank. It is quite possible that a lack of qualified personnel may initially place greater restrictions on the bank's lending operations than will a shortage of capital funds. In such a situation, the bank will have to engage in a careful program of training selected personnel which, in itself, will represent a substantial contribution to the economic well being of the country.

Once its reputation is established, a development bank can act as a catalyst in many different ways. Initially, it can offer to other holders of liquid funds portions of its loan portfolio for sale and participations in its investments. Subsequently, it can try to interest other investors in joint financing ventures. In all events, it should maintain close liaison with and cooperate to the fullest possible extent with the country's banks and other financial institutions, exchanging useful information and making joint use of resources and facilities wherever possible. Inasmuch as the banks of your country are the primary depository of the savings of the people, they are important direct and indirect sources of capital for the projects you wish to assist. We believe it is likely, however, that they will be most useful to you in the early years as a market for the resale of certain of your investments in enterprises which may achieve public recognition. To make such purchases more attractive to the banks, you may find it useful to sell groups of securities in various enterprises to banks in blocks so that they can obtain a spread of their investment and reduce their risk. In any event, close association with you should lead the banks to making joint investments with you in certain projects.

In time you may be able to put together similar blocks of securities from your portfolio, set up in the form of an investment trust or mutual fund, for public sale through the mechanism of the Bourse. Again, the spread of investments plus the prestige of association with your institution will assist you in stimulating the necessary public enthusiasm. In this connection, it would greatly facilitate sales of your investments if the terms and conditions of any loan or investment made by your bank conformed to the fullest practical extent with normal, sound commercial practice.

Broadening and increasing the role played by your Bourse will be an important means of stimulating the development of direct investment by the public and overcoming the present fears of lack of liquidity. As a means of strengthening the Bourse it is important, in your initial public sales, to emphasize in your offer the prospective quotations on the Bourse and to give as much publicity as possible to the public nature of the offer.

Your bank may wish in time to engage in underwriting ventures so as to minimize the amount of funds which you yourself provide and to attract smaller investors into making productive use of their accumulated savings.

We have indicated that in the early years of your operations it is extremely important that you choose your investments with care so that your investments will reflect the greatest credit on the bank consistent with its basic development purposes. To this end we would suggest that you consider including in your initial portfolio securities of some companies which may have available to them alternative sources of capital because of their standing. While perhaps not in accordance with generally accepted development bank practices, you may even wish to consider joining local capital in making investments in local subsidiaries of strong foreign enterprises. These can be useful to you both in the sale of your own securities and in the later sale on the public market of groups of securities from your portfolio.

Public disclosure of your operations is important to the stimulation of the public capital markets. We would recommend that you publish your portfolio and your income results frequently.

We trust you will find these comments helpful in considering the role your bank can play in the development of your country and its capital markets.

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Dear Mr. Barboza:

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The situation outlined in your letter is one with which we have become familiar in the course of our /investment banking/ firm's contacts with less developed countries. . . . It has been our experience that the development of capital markets in developing countries is frequently a discouragingly slow process, but one that requires a clear realization on the part of the government concerned that the first order of priority is the establishment of the government's own credit on the international capital markets. The establishment of the government's international credit in its turn involves a series of preparatory steps which have implications for the growth of an internal capital mechanism as well.

We have advised the governments of less developed countries that an initial entry into the international capital market must coincide with a favorable economic trend, and an atmosphere, over a reasonable period, of political calm and stability. Since establishment of a country's credit is dependent more on the successful absorption and satisfactory market performance of the government's securities after offering than on the size of an issue, we have consistently urged that the country's first issue should be modest in size. Previous World Bank lending to the government or its agencies, or such lending concurrent with a public issue, provides a helpful market atmosphere, and should be considered a most desirable development. Finally, a prerequisite to any financing program would be the government's establishment of some sort of centralized control over the widespread practice of government agencies in most developing countries of financing their own needs by issuing short and medium-term paper to pay contractors for public works and for equipment purchased abroad. The flooding of the market with this paper, sold at large discounts, represents a major obstacle to the establishment of a government's credit in the capital market in an orderly manner and at an appropriate cost.

Once the government's own credit is established internationally, and a number of transactions have demonstrated the availability to the country in question of adequate amounts of long-term funds, the government will be in a position to extend medium or long-term credits to industry, through the mechanism of a development bank or otherwise. Lengthening the term of the government's own obligations should also alleviate the balance of payments difficulties which are common in less developed countries. The centralised borrowing discipline implicit in the government's financing program as outlined above should have as a beneficial side-effect the strengthening of the Ministry of Finance in dealing with the budgetary and other difficulties caused by lack of coordination between government agencies. Moreover, as industry begins to benefit from infusions of longer-term capital, issues of equities on an attractive basis will become more feasible. The local investment public will slowly take note of these changes, and a satisfactory development of the local securities market may then be envisaged.

Steps the country's development bank should take, concurrent with the government's efforts to establish its own long-term financing sources, should include the review of its loan portfolio and the initiation of procedures to ensure that long-term loans are eliminated to the fullest extent possible, perhaps by placing with local investment institutions participations in these loans. A shortening of maturities on loans henceforth to be granted would result in considerably greater turnover on the bank's capital. Moreover, the maturities on loans granted should be spread out so as to result in a more even distribution of loan repayments and an increased flexibility in meeting development needs. Another important measure which would not only conserve the development bank's funds but also contribute to the expansion of the local capital market would be the institution of a policy of having local banks or other institutions participate in development loans through some matching formula. In addition, the development bank should urge local industries to make equity issues concurrently with or in addition to borrowing as a means of attracting from abroad bank deposits of the country's residents. As the securities market develops attractive investment opportunities, these overseas deposits will tend to return in any case. It is of course axiomatic that the development bank should make every effort to attract experienced loan officers for its staff and should demand adequate collateral for all its loans. Improved administration should be of considerable help in conserving and expanding the bank's resources.

Ultimately, however, it is the establishment of the government's own credit standing which would enable a less developed country to maximise the circulation of capital in its economy, and avoid the type of situation described in your case study where a development bank must severely curtail or actually cease its activities for lack of adequate resources. . . .

Dear Mr. Barboza:

It was with great interest that we read your letter of date X, in which you request the opinion of this Institution, based on our experience, concerning some policy considerations for the new Bank that you will manage, in view of the background and experience of the ORD managed by Mr. Silvestre Lupo.

We wish to assure you of the interest with which this Institution has examined your aforementioned letter, as well as of our desire to place at your disposal the results of our experience in our organization. . . .

I. The first comment which occurs to us concerning the description you make of the experiences of the ORD is the following: You tell us that in the first eighteen months of operations the ORD engaged the majority of its available funds, which was equivalent to $50,000,000.00 dollars. Although we are unaware of the nature of the plans which were financed, our impression, a priori, is that the period of eighteen months is a very short time for the ORD to have been able to have duly studied the excellence and viability of all the financed plans and projects, since even if such plans were few in number and of great magnitude, our experience tells us that in such cases it is necessary to study a series of fundamental aspects which require several months before the authorities of the Bank can make a decision. In the case of industrial plans or projects, the fundamental points that must be analyzed could be, among others, the following:

a) The justification of the plant capacity for installation readaptation or expansion, as the case may be, in relation to the national market and the possibilities for export; b) studies on the industrial process selected, in relation to the advantages or disadvantages of other alternative processes, in the face of the competition of other similar articles of national or foreign producers; c) forecast and analysis of estimated costs, taking into account also possible variations in the price of raw materials and wages during the period of the granting of credit, and the financial structure that was deemed most appropriate for the concern to be financed; e) studies of the sources of raw materials and their prices in the following years; f) pro- rma financial statements and cash flow during the period of the grant of credit (that is, while the credit is being paid off), on which the term and other conditions of the operation will have to be based; g) estimate of the possible profits of the firm and their effect on the market for the shares of the firm; h) negotiation, with those requesting credit, on the adequate financial structure, in order to determine if all the financial assistance should be given in the form of long term credit (which could also take the form of purchase of mortgage obligations of the firm) or if this type only in part, the rest through the purchase of shares, common or preferred, or obligations convertible into shares; i) negotiation of the contract or respective contracts of credit; j) forecast of possible future expansion of plant capacity, according to market trends; k) study by the Bank authorities of the hierarchy or priority of each project within the general economic interests of the country, taking into account its effects and impact on other national producers of possibly competitive articles; l) possible sales prices, in relation to foreign competitive articles, to determine if the project will require tariff protection or protection of some other type on the part of the national authorities, if they are dealing with an industry deemed to be in the national interest in general terms; m) the nature and total of the guarantees of the operation; n) judgment on the experience of the administrators of the firm, on the administrative organization of the firm, including production controls and sales policy, etc.

If, on the contrary, the operations performed or contracted for, which engaged most of the funds of the ORD, were of the nature of smaller industrial projects, and therefore more numerous, inasmuch as in every case the same type of aforementioned analysis should be made, our first impression would be that the ORD did not duly study the projects, due to the pressures of a different nature to which it was subjected to make its determinations in a very short time.

In the case of agricultural projects or the cultivation of crops and the raising of livestock, the period necessary to study the fundamental aspects, both technical and financial, can be even longer than for an industrial project. Furthermore, the margins for error in the estimates can turn out to be greater, without taking into account risks caused by the hazards of nature (against which we do not know if there will be in your country a system of insurance to cover them). This is one additional motive for the authorities of the Bank to sufficiently meditate on and evaluate all the aspects of the project, with the time that is required.

The foregoing comments are based on the supposition that the majority of such operations were directed toward financing fixed assets of the firms or, to the greatest degree, fixed assets, and in a supplementary manner part of the working capital of said firms; or agricultural credit, in its case. In any case, we assume that said financing did not exceed in any industrial project 50% of the total investment in fixed assets and machinery. We also assume that in the industrial projects the greatest part of the working capital was contributed by the promoters of each project.

If these last two assumptions are correct, the failure on the part of the financed firms to fulfill their obligations to pay on time their periodic reductions of the principal plus interest, could be imputed to a deficiency in the study or analysis of the market; of the industrial process; of the foreseeable situation--both financial and relating to cash flow of the firm; to an administrative deficiency, or a combination of some or all of these factors.

We believe it appropriate to add four comments of a general nature on this point: first, upon making a loan to industry, it is as important to be sure that the source of payment is ample, in relation to the obligations that the debtor contracts for, as it is to be sure of the aspect of the adequacy of the security or guarantees of the same debtor; second, it is fundamental to the credit policy of the bank, to program the different types of credit it grants, so that a minimum constant and sufficient ingress is assured as a result of its prior operations, since it is absolutely necessary to foresee through annual operation programs, the funds available for new credit and those that should build up assets for future operations; third, the laws of our country authorize the creditor banking firms who grant long term loans to industry to designate an "intervenor" (generally not a member of the personnel of the creditor-institution), who is familiar with the type of business to be financed and whose fees will be rendered to the creditor. This intervenor has the obligation of submitting monthly reports (without prejudice to extraordinary reports, in case in his judgment they are required) to the creditor institution regarding the diverse aspects of the use of the loan for fixed assets and machinery, and subsequently on the operations of the firm; reports that refer as much to the technical aspect of production as to the commercial aspects and the financial situation in general and the cash picture of the firm. We fear that in your country the law on the operation of credit does not provide for this supervision, but we believe it is advisable to put it into practice in your new institution, through agreements with the debtors and as a prerequisite for the granting of credit; fourth, although from the last few paragraphs of your letter we assume that most of the operations that the ORD carried out (and which the new institution you are to head up intends to carry out) are of an industrial nature, we are not sure that operations of another type have not been financed. In this regard, we should tell you that in our judgment and according to our experience, a financing bank dedicated exclusively to industrial problems already carried with it a wide series of problems of a different type, but if such bank in addition adopts other fields such as the cultivation of crops and raising of livestock, the complexities are multiplied despite much greater personnel with specialties in diverse fields. Therefore we are hopeful that the new bank you will head up will limit itself to the benefit of its efficiency only to the field of industry and that the financing of other fields of activity, especially the field of cultivation of crops and raising of livestock, will be carried on by other specialized institutions.

Furthermore, we believe that within the industrial field, the new bank should limit itself fundamentally to the financing of fixed assets and machinery and, only in a supplementary way, working capital for those firms that already have received loans of the prior type. We believe that loans for supplies and working capital for those industrial firms that have not been financed by you should be taken care of by the commercial bank. In this regard, the monetary authorities and the services of banking inspection should adopt policies and measures that are necessary for a sufficient channeling of short term credit to industry. Finally, our experience also tells us to suggest to you that the bank act in a suppletory capacity, so that if the banking or private financing system is disposed to grant a loan presented to the Bank, the latter should induce those requesting the loan to turn to the private banking system.

II. A second comment on the problem of the best utilization of the funds of the new Bank would consist of suggesting that the Bank be able to guarantee, as third parties, credit granted to an industrial firm that desires to expand its capacity. On granting a guarantee, it would have to make as exhaustive a study as that suggested in the preceding paragraphs on the debtor firm and its capacity for payment. Furthermore, be warned that the very assets of the bank would be restricted upon the creation of a contingent liability to its account. Nevertheless if from the studies made it is apparent that the risk of having to pay sums in cash on the guarantee is very small, it is worth while for the Bank to take these risks. This policy could be useful especially in the case of suppliers' loans on machinery and equipment for the industry it is dealing with, as long as the terms and other conditions of credit were satisfactory from the point of view of the economy and financial situation of the debtor firm. We should warn you, nevertheless, that this type of operation only seems justified as an instrument for permitting the financing of fixed assets.

III. One last comment on the problem of the available funds of the Bank should here be mentioned. In the financial support of national industry, the Bank will frequently find it indispensable to turn to the industrial experience of foreign firms. This will be especially true in the case of projects that carry with them new industrial activities in the country. Furthermore, given the small industrial development of your country, many of the plans for new industries or for the expansion of capacity or the modernization of the processes or technology of firms now in existence, will require foreign machinery. Our experience tells us in this regard that with appropriate technical assessment, the Bank will be in an advantageous position to obtain more favorable financing terms than the private promoters of the project could obtain. Due to all these considerations we believe it fitting to suggest to you that you explain to the competent authorities in your government the necessity of the Bank's being authorized to acquire or guarantee loans from abroad as methods of channeling these funds to private industry, although in some cases the Government itself, in perhaps a more systematic fashion, will wish to utilize the foreign financial contacts that the Bank has been able to establish, in order to obtain loans of a medium or long term nature. In these cases, it would be of great importance for the future that the Bank be designated by the government as the only financial agent for the negotiation, on behalf of the government itself, of the acquisition of medium or long-term loans, that is, to carry out operations for longer than a one year term of payment. The effort of the Bank to obtain such attributes and powers on behalf of the State will be amply justified by the advantage that it will represent for the State itself, in that the demand for foreign credit, in the name of its government, will be made exclusively through a single channel, which in turn will permit, to the very benefit of the foreign public credit of the country, an ordered and uniform handling of tactics and policy before the international money market. Upon the success of these proposals, the Bank you head up will have open an additional source of funds to channel into private industry in your country. Nevertheless, it seems apparent that in utilizing this new source of funds, the Bank should be in constant contact with the financial authorities and the Central Bank of the country, to determine the basis on which the possible foreign funds should be distributed between the necessities of the public sector and those of the private sector. It also is unnecessary to mention that this type of activity will result in greater national and international prestige for the Development Bank.

IV. You mention in your letter the fact that a few of the debtor firms have been utterly destroyed upon the foreclosure of the loans or mortgages and the sale of the business, and that in other cases the slow judicial proceedings have the collection processes at a standstill. In this regard, we should remember that the ORD, as well as the institution over which you will preside in the future, have as a fundamental function the fostering of the economic development of the country. The economy of your country is characterized by cultivation of a single crop as the principal source of economic activity. Evidently one of the fundamental objectives of the Bank will be to attempt to diversify production, trying to obtain a structure that will permit greater balance in the generation of profit, in the face of fluctuations in the international markets of the prices of that crop fundamental to your economy. Under such conditions, we allow ourselves to suggest to you the advantage in having the debtor firms and the slow-paying firms financed previously by the ORD, whose activity is considered of interest by the Government and by the Bank, become the object of an exhaustive study with the purpose of the possibility of rehabilitating them under guidance, and if it is necessary, under a special administration appointed by the Bank itself. If the Bank decides to adopt this policy, it should not be afraid to come in, if it is necessary, as a majority shareholder of the debtor firm, such decision being based, of course, on the possible viability advisable as a result of the respective financial and technical studies. This position as a shareholder of the debtor firm would be of a transitory character, until the firm found itself in financial conditions which would permit the Bank to proceed to sell its shares in the firm as it deemed advisable. The help and assistance which the Bank would thus be rendering firms in difficulty, guided always by national interests but without neglecting the purpose of profit, would contribute gradually to the Bank's acquiring solid prestige in the eyes of the businessmen of the country and consequently being able to exercise continually greater influence in fulfilling the objectives entrusted to it.

V. You also request our comments regarding our experience in "increasing to the maximum degree possible the productivity of invested capital." We believe that the preceding comments, especially those contained in Part I are an answer, in brief terms, to this problem. Nevertheless, assuming that it makes the basic, exhaustive studies of the problems presented by any industrial promotion, the Bank should establish certain general criteria regarding the sectors of the economy where the assistance of public funds is most important for new plans of development. At the same time the Bank should, in our judgment, study the creation of a department of industrial programming, which would, within a short time, become the basis of the policy of selection of those industries which the Bank should accord a special and preeminent hierarchy of importance.

VI. Regarding the immediate problem alluded to in the above paragraph, and still with the purpose of contributing to the solution of the long term problems of balance of payments which you mention in your letter, we suggest as one of the fields of immediate action for the Bank, the field of those industries whose objective is the production of articles or products preferably destined for export, as well as meat packing firms, and other agricultural and livestock product packers, and packers of fish, shellfish, shrimp, etc. In any case, the policy of the Bank directed at contributing to the solution of the problems of balance of payments, in its aspect of active operations, will be very modest initially but with very promising perspectives for the long term. This will require intimate contact, in the planning of policy for financing the export industry, with the monetary and financial authorities of the country. On the other hand, the Bank could be, within a few years, a great help to those authorities, if, once designated sole financial agent for the medium and long term operations of the Government, it were preparing the bases for systematic action in acquiring long term funds from foreign governments or international institutions, funds that the monetary authorities would utilize to try to solve the fluctuations of balance of payments.

VII. The tendency of the investor, which you describe, to keep his savings in bank deposits or in real property, is a clear sign of lack of confidence in the stability of the currency. This is a problem outside the orbit of action of the Bank, which will have to be faced by the monetary and financial authorities of the country. Nevertheless, if they adopt in depth a policy of stabilization, your Development Bank will be able to contribute, albeit in modest or secondary fashion, to the efficiency of that policy as we indicate below.

For example, as we have said before, the Bank in the future could be the instrument for obtaining medium and long term funds from international institutions, funds which would help the monetary authorities to stabilize temporarily any imbalance in the balance of payments.

Furthermore, the Bank could collaborate in maintaining a certain degree of price stability for some basic articles produced by firms it finances, through minority participation in the capital of said firms for the purpose of financing. We have had satisfactory experience in this field of action through the years. Our policy is based on the principle that in a relatively small market, such as our national markets, the establishment of a single firm with modern methods of production, not only could amply cover market demand, but would require the entire market to be able to work under conditions of attractive profitability. Under those conditions, searching for or permitting the establishment of one or more firms with the sole purpose of there being competition, generally represents an unnecessary over-investment of funds; aside from which, if the market is small and there are initially no possibilities for export, if there are two or more producers they will probably agree to share the market and raise prices in an unjustified fashion.

Thus, if under the described conditions it is necessary to establish firms which for at least several years would have to function as monopolies, the intervention of the Bank would consist of avoiding the harmful consequences of monopoly as much as possible. Based on this reasoning, our Institution has followed the policy of participating in the capitalization of firms which function under these conditions, as one of the methods of supporting financially their creation and development. The participation in the capitalization should be on a minority basis, but sufficient to assure the appointment of at least one representative of the institution to the Administrative Council of the financed firm. This representative, speaking on behalf of the creditor institution, can, through moral persuasion, influence the price policy of the debtor industrial firm; a policy that should be guided by a reasonable return for the firm, but which attempts to maintain to the degree possible price stability for its products. Incidentally this policy will gradually permit the Bank to form a diversified portfolio of stocks in industrial firms, enabling it to ultimately influence the regulation and development of a market for industrial securities.

Another aspect of the policy of the Bank's collaboration with the monetary authorities in developing a policy of stability, could consist of guiding its policy on operations to avoid loans of an inflationary character in accordance with criteria established by the monetary authorities. On this point, it is always very convenient, as in the case of our Institution, to have on the Board of Directors of the Development Bank a representative of the Central Bank.

VIII. As we assume from the final paragraphs of your letter that the Bank has among its functions the attempt to regulate and develop the capital market, and considering that the common stocks of prosperous industrial firms can compensate, in many cases, over the long term, for variations in the value of the national currency (a circumstance which the Bank could utilize to promote investment in such stocks, when there is a lack of confidence in the currency) we suggest as a possible long range policy of the Bank, the gradual accumulation (for motives different from those mentioned in the preceding paragraph) of a portfolio both of long term industrial obligations guaranteed by industrial mortgages as well as of common stocks or convertible preferred, or obligations convertible into stocks, to be able to influence subsequently the regulation of the market for stocks both of fixed and variable yield. To attain this end you can establish as the basis of your policy the authorization of financial support for industry to finance fixed assets and machinery being done in part through loans documented by industrial obligations secured by mortgages on the industrial plant itself, and in part through obligations of the same type convertible into stock or through common stock itself. Incidentally, this policy can be utilized to gradually force the small groups who control most of the industry in your country to permit the entrance of other small stockholders as partners, since the purpose and justification of this loan policy for industry on behalf of the Bank consists precisely of subsequently placing these common stocks and convertible obligations on the market. By the way, regarding this policy, perhaps the Bank could influence the firms seeking credit, upon the granting of the loan, to agree to follow a policy of annual declaration of dividends to a degree which would not weaken the financial position of the firm, but which would not discourage the small stockholder and would keep his interest in the stocks he possessed. This policy will be able to be carried out since, as you indicate, there is not in reality any long term credit for industry. At the same time, the banking authorities and the office of bank inspection should be more strict in avoiding medium and long term financing through renewals of short term loans, which give a false picture of the supposed position of liquidity of the commercial bank.

IX. One of the purposes in the activity of the Development Bank will be to seek to absorb savings from the national market, through the sale of long term securities, to complement its capital funds. As it is well known, in times of price stability and confidence in general, that this situation will prevail for some years, there will be a greater preference for fixed yield securities. On the other hand, when a situation of lack of confidence in the currency prevails, it is natural for the investor to wish to protect the original value of his savings to the greatest degree possible. Since your country today depends on a single crop, it is probable that the latter situation prevails more frequently. Under these conditions it will be very difficult for the Bank to float bonds or fixed yield obligations, since what the market seems to demand is a type of security which at least in part will compensate for the effects of an intermittent, national price rise. Therefore in the task of encouraging the development of a capital market, although the Bank will have to proceed as circumstances dictate, the decisions that it makes should be based on certain general criteria of long term policy. For the purpose of being able to offer on the market the type of securities that the market requires, the Bank could gradually but systematically create a portfolio as wide and diversified as possible, both of fixed yield securities and common stocks--a portfolio that could be used to effect market sales in accordance with opportunity and market trends, as a form of absorbing private savings and at the same time gradually enriching the expanse of the shares available for exchange transactions. In this regard and with a view toward avoiding the Bank's being the object of criticism for transactions which signify the sale of important blocks of industrial stocks to a determined financial group, it would be advisable for the Bank to limit itself to making small offerings of stock through brokers. It will be difficult nevertheless to cause this type of operation to come to the attention of the small investor, who is not accustomed generally to the operations of variable yield stocks, and who will scarcely have the opportunity to become so accustomed, since adequate publicity is lacking regarding the financial statements of the firm issuing the stock, this being a task which requires a long process of conviction in all the factors which intervene in the market. Furthermore, it would hardly be prudent to induce the small investor to make one investment in one single risk, since no matter how prosperous an industrial firm may be, there can be periods in which, through unforeseeable factors, dividends are not declared for one or two years. To try to overcome these obstacles, it seems that the Bank, once it has succeeded in forming a widely diversified portfolio, both of secured industrial obligations and of common stocks or convertible obligations, could utilize the mechanism known as the "investment trust." In other words, form a diversified group of such securities as a specific guarantee or coverture is composed of and upon the end of the term the holder of the certificate could be left with the option of being paid in cash for the nominal value of the certificate or of having handed over to him the aliquot part of the securities that compose the coverture. For this type of operation there exists, in any event, a series of solutions or techniques, of a practical nature, which derive as much from the banking law and the articles of the Bank, as from the mercantile and exchange practice and custom in your country.

The composition of the coverture would depend on market trends, but it could be thought of initially as being made up of 50% secured obligations, that is, of fixed yield, and 50% common stocks. Among the advantages of this type of issue we could mention the following: a) the book value of the common stocks in prosperous industrial firms would tend to increase over the long term, which would compensate in part for any currency risk; b) on the other hand, the fixed yield securities in the coverture would guarantee a minimum annual yield to the purchaser of the certificates; c) the risk for the investor who acquires the certificates would be spread between various types of risks; d) with this mechanism the Bank would achieve the purpose of disseminating the securities of prosperous firms among a large number of small investors; e) the Bank would be in the position to offer the market the type of securities it is looking for, thus acquiring additional funds for carrying out its objectives; f) this mechanism would allow for the gradual education of the small investor who would become accustomed to handling fixed and variable yield securities, etc.

X. As you must have realized, the suggestions we are making in this communication constitute criteria to form a basis for long term policy. They are inspired as much by our experience as by the general information in your letter which we are answering, but we believe that to the degree the Bank finds in them some merit, they should be sifted through the circumstances of all types which prevail in your country in the moment of attempting to put them into practice. We have the impression that the suggestions made form a body of coherent elements, but we foresee the possibility that through use or custom, through institutional reasons or through other causes, some of them may not be advisable or capable of being put into practice at a given moment.

In any event, we wish to reiterate our initial offer of placing at your disposal some of our officials with experience in those subjects mentioned, as well as our willingness to continue our correspondence in writing.

Hoping that the ideas herein contained may be of some benefit, and awaiting news from you, we repeat that we are

Very truly yours,

/s/

President

N. B. Letter written by president of a large, well-known development bank writing as an interested private individual.

(Comments re ORD from an Investment Firm with Interests in Developing Countries)

From the facts given with respect to the history of ORD, it appears almost obvious that this predecessor development bank moved too fast at the start. This is understandable because its managers must have been under great pressure to obtain the "quick and dramatic results" expected by the National Legislature. Also, being a semi-governmental agency it may have operated under handicaps not encountered by a private agency.

Reflection on these facts would seem to indicate that the new development bank should not attempt to do too much too quickly and should also endeavor to set itself up in as nearly an autonomous basis as possible.

Accordingly, Sr. Barboza should ask for a moderate amount of capital initially from the National Legislature and should state that he intends to operate with care and deliberation. Also, he should set up a board of directors experienced in industry and financing, and the board should be as autonomous as politically practical.

He should further state that from time to time he would return to the National Legislature with requests for additional capital on the basis of a record of sound achievement.

Such an approach would immediately galvanize the substantial and conservative elements of the country behind his program and considerably enhance the "climate for investment."

It must be recognized that this "climate" is of great importance. Investment capital is an exceedingly sensitive commodity and must not merely be attracted, it must be courted. Sr. Barboza in talks to businessmen should indicate his appreciation of this fact.

It would seem that this approach is particularly necessary in a rapidly developing country, where general ownership of securities does not exist and organized markets for transactions in bonds and stock are very thin, yet where the need for capital funds is urgent and continuous.

Of course, a good investment climate alone is not sufficient to create such general ownership and good markets. Rather, tangible steps should be taken in a good investment climate to achieve the desired results. Sr. Barboza might well work with substantial members of the financial community towards this end. Fast results should not be expected; rather, the program should be considered as long range.

It might well be argued, both substantially and politically, that the approach outlined above would achieve results too little and too late.

Accordingly, to accomplish appreciable results within a few years Sr. Barboza should operate through the already existing banks of his country. Such banks already have the facilities and trained personnel and industry contacts to make loans with dispatch, but heretofore have operated only on a restricted short-term basis. If they were able to rediscount loans with a development bank, or obtain insurance on them, they could make substantially more loans and on a medium-term basis. The terms on which loans could be rediscounted or insured should, of course, be such that the banks would have some appropriate continuing liability so that they would use normal caution and prudence in making the loans.

The creation of a competent staff of engineers, economists and analysts for Sr. Barboza's development bank is essential. Very probably ORD was not able to create such a staff in its short period, and this probably contributed to its lack of success. But to create a competent staff Sr. Barboza would need several years. By operating through existing banks he could make almost immediate progress towards his objectives and still have time to create a competent staff.

In a rapidly developing country the existing financial institutions are likely to be not fully adequate for present needs of the country and almost surely not adequate for future needs. If they could be employed in conjunction with the development bank, it would strengthen them and aid in their growth to be adequate for the future; also, it would help in the creation of a favorable investment climate.

Further, it would be desirable for the development bank in making loans to have them set up in such a way that they would be most salable to private investors at some future date if sufficient investment demand should develop in the country; thus, the development bank could be achieving turnover of its capital. The development bank should set up appropriate standards towards this objective and by working through existing banks it would probably be able to set standards as to terms and conditions of loans that would be desired by potential private investors.

PACIFIC VEGETABLE OIL CORPORATION

On May 25, 1963, the Pacific Vegetable Oil Corporation of San Francisco, California, signed a revised tentative financial and technical cooperation agreement with the government of Indonesia. The agreement called for the building and operating of a copra oil mill by the parties in Northern Sulawesi (Celebes), and was based on the principles of "Production Sharing" enunciated by President Sukarno in the previous year. The signing of the agreement was preceded by negotiations and surveys conducted by officials of the company during the preceding eighteen months. Mr. B. T. Rocca Jr., the president of the company, who had negotiated the revised agreement, was not sure whether the company should go ahead with the project, on the basis of the assurances given to it in the agreement alone. He felt that it might be wiser to defer further action until the Indonesian government demonstrated its ability to carry out its obligations under the agreement, and until satisfactory arrangements regarding the insurance of the company's investments could be made.

The company and its international operations

Established in 1924 as an oil mill operator, Pacific Vegetable Oil Corporation (PVO) soon developed into a major vegetable oil trader and crusher on the Pacific Coast of the United States. Following the war years during which its activities were severely restricted, the company expanded vigorously, enlarging its manufacturing facilities, developing new oil seeds and new uses for vegetable oils, broadening its trading activities, and branching out into new lines of business. In a major program of plant expansion commenced in the late 1940's, the company constructed a new mill and refinery at Richmond, California. In 1955, PVO acquired a 50% ownership of a safflower mill at Sidney, Nebraska, and in following year constructed a new safflower mill in Culbertson, Montana. Pacific Oilseeds, Inc. (67% owned) was formed in 1952 to provide field service to PVO's growers and to conduct agricultural research. The latter had a South African affiliate which was engaged in field research in the North Transvaal region of South Africa.

By 1963, the company's business was divided into three major branches (1) the importing, exporting and foreign and domestic trading of a large number of commodities (2) the manufacture of edible and industrial vegetable oils and of cattle and poultry feed concentrates (3) the marketing and distribution of its own brand SAFFOLA salad oil, salad dressing, mayonnaise and margarine. Outside the oil business, the company's 85% owned subsidiary, Pacific International Rice Mills, owned and operated a large San Francisco rice mill. Stockton Elevators, another subsidiary, which was 91% owned, operated a grain and seed elevator with a capacity of 4 1/2 million bushels at the port area of Stockton, California.

The company's shares were publicly held, and were traded on the over-the-counter market. Control was largely in the hands of the Rocca family, whose senior member, B. T. Rocca Sr. the founder of the company, served as the chairman of the board. B. T. Rocca Jr., his son, was president and director of PVO, and another son, C. M. Rocca, was a director and president of Pacific International Rice Mills and Stockton Elevators. Other senior members of the management team were: Mr. D. F. Miller, vice president, treasurer and director, J. R. Smith, vice president and secretary who was in charge of manufacturing operations, and Mr. E. A. Hill, special assistant to the president who was responsible for new facilities development for the company.

PVO's international operations consisted of both trading and manufacturing activities. The company traded in numerous vegetable and animal oils, seeds, and meals including coconut, soyabean castor, cotton and others. Trade was conducted by four departments: meal, bulk oils, foreign oilseeds, and the export, all located at the company's head office in San Francisco. Those commodities which were neither sold nor bought in the U.S. were handled by a fully owned subsidiary, Paveocor A.G. which was formed and registered in 1960 in Switzerland, and had its head office in Rotterdam, Holland, where a large share of the European shipments were handled. The company's affiliates in Japan and in the Philippines handled its Far Eastern trade.

Paveocor held a 50% interest in two Latin American affiliates. Aceites Grasas y Derivados S. A. (Agysda), a Mexican firm located in Guadalajara, processed oils and meals from local cottonseed, linseed, sesame and safflower. La Fabril, de Aceites, another 50% owned affiliate located in San Salvador, the capital of El Salvador, processed cotton seed oil and meal. PVO's fully owned subsidiary in the Philippines, Pacific Costa Packing Company, was a major local processor of copra and copra products. Exhibit 1 shows PVO's sales, net income and dividends during the period 1957-1962. Exhibit 2 gives the company's balance sheet for the years 1961-1962. Exhibit 3 describes the pattern of commodity trade in which PVO was engaged in 1963.

PVO in Indonesia

PVO's interests in Indonesia centered around copra which was one of the country's major export commodities. The company decided to enter the Indonesian market in 1961 in order to take advantage of the lower prices prevailing there, and to diversify further its sources of supply which had originated previously in the Philippines, several South Sea Islands and Mexico. Company officials remarked that doing business in Indonesia was an exceedingly difficult and sometimes an exasperating job, due to the complexity of the regulations and procedures covering foreign trade, and to the difficulties in obtaining supplies.

The first step in securing a shipment, consisted of negotiating an export license with the Ministry of Foreign Trade. The license which was received upon the recommendation of a State trading firm dealing in copra, covered the quantities to be shipped and their C & F price.[1] It was issued after the receipt of a letter of credit denominated in U.S. dollars from PVO's bank in the U.S. which was opened in favor of the Bank of Indonesia, Jakarta. The company's representative, Mr. Yosengbo, who lived in Jakarta, would then proceed to Sulawesi and obtain supplies there through the local copra cooperatives whom he had to pay in cash. Supplies were not easily obtainable, since the growers were reluctant to sell the product to the official trading cooperatives at official prices, reflecting the nominal exchange rate which put very little purchasing power into their hands. In order to secure adequate supplies, a much higher price had to be paid.

Since no single producing area grew enough copra to fill the holds of a ship, Mr. Yosengbo was obliged to travel across the island, buying a few hundred tons in one place, and additional supplies in another. A freighter chartered on time basis would then travel between the stations and load the copra. Frequently, delays would occur in the arrival of the shipments and the freighter would lie idle for weeks on end, collecting demurrage fees of about $1,200 per day. Under the terms of the purchase contract, such fees were payable by the Indonesian State trading firms which were selling the copra, hence little loss was suffered by PVO in connection with the delays. Late arrival of the copra at the port of destination, however, caused the company embarrassment and inconvenienced its clients.

Upon completion of a shipment, and presentation of the bill of lading by Mr. Yosengbo, PVO's bank would pay the Bank of Indonesia in dollars, and the latter would pay Mr. Yosengbo in rupiahs. These

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[1] C & F: cost and freight.

payments were based on the quantity and prices negotiated in connection with the export license, and could either exceed or be short of Mr. Yosengbo's actual outlays. In accordance with the new regulations which were introduced in 1962, 85% of the export value was payable in rupiah's valued at the official rate of exchange (45 rupiahs to U.S. $1.00) and the remainder, in SIVA certificates which would be sold on the free market (800 to 1,200 rupiahs per U.S. $1.00). PVO's copra purchases in Indonesia amounted to 30,000 tons in 1961, 30,00 tons in 1962 and 12,000 during the first six months of 1963.

The company intended to stay in Indonesia despite the difficulties involved. Potentially, Indonesia could become the major source of supply in the world for copra, and PVO's position as an important trader in this commodity would be strengthened by having a working relationship with the country. Besides, Indonesian copra cost $15 to $20 less per ton than Philippine supplies, and a sizeable profit could be made on the difference. The company considered that this margin justified the extra investment in time and effort needed to secure the supplies, and hoped that as time passes, conditions in the country would improve, and transactions would take place in a more businesslike fashion.

The oil mill project

Early in 1962, PVO was approached by the U.S. embassy in Jakarta with the request that it consider extending technical aid to the Indonesian government in connection with the construction and operation of a coconut oil mill in Sulawesi. The island which had just emerged from a ruinous civil war, was in dire need of employment opportunities to provide additional income to its sparsely settled population. Being a net exporter of raw copra, it could well benefit from the value added which would accrue to it from the establishment of an oil processing industry. PVO's officials, who had visited Indonesia from time to time, had been aware of the potential benefits from such a project. Noting, however, the government's negative attitude towards foreign private investments, they had refrained from pushing the idea.

The company responded affirmatively to the embassy's request and engaged in an exchange of ideas with several government officials. In these discussions it was represented by a prominent Indonesian businessman, Mr. Probokeso. A suitable framework within which such cooperation could take place, was found in the government's new policy on foreign investments based on the principle of "Production Sharing," which was announced by President Sukarno on August 3, 1962. Under the terms of this policy, foreign companies would be invited to provide the foreign exchange components: machinery, equipment, technical services etc., required for the execution of industrial projects in the export sector of the economy. The Indonesian government and/or private nationals would provide the local components consisting of labor, raw materials, building materials, working capital etc. The enterprise would be owned and managed by Indonesian nationals who would receive technical assistance and know-how from the foreign investor. The latter would undertake to train local people to assume over-all management functions within a specified time.

The first contract

Negotiations between the government and PVO led to the signing of a tentative contract on August 22, 1962. Its major provisions were as follows:

The Project. PVO was to invest approximately U.S. $1,500,000 in machinery, equipment and services required for the establishment and operation of a coconut oil and cake plant, having the capacity of 200,000 kilos per 24 hours in North Sulawesi. Payment. Payment was to be effected in the form of cake production, 70% of which would be allocated to PVO's account, calculated at market price. PVO would recoup its total investment within 36 months of starting operations. Fifty per cent of the oil produced would be added to the cake, if by the end of 36 months full payment were not effected. Shipping documents would be sent to the Bank of America, San Francisco which would act as trustee. The obligation of the Indonesian government to deliver cake to PVO would cease after all payments were completed to the satisfaction of the Bank of Indonesia and the Bank of America. The company would have the first refusal for purchasing the cake for a period of the five succeeding years. Raw Materials. The government undertook to supply the necessary quantity of copra, and it agreed that if it should fail to obtain the required amounts, PVO would be entitled to purchase the short fall, and charge it to the government's account.

Operations. PVO would assume responsibility for the erection of the plant, its operation and training of the staff and laborers. All foreign exchange expenditures made in connection with the above, would be paid by PVO which would be reimbursed on the same terms as for the rest of the investment. The services of PVO's managers and technicians would be terminated as soon as possible and not later than upon the completion of the contract.

Miscellaneous. Legal ownership of imported equipment would be retained by PVO until the expiration of the contract.

Disputes between PVO and its Indonesian partners would be settled by a panel of three arbitrators. PVO and the government would each select one arbitrator. These arbitrators would in turn select a third, neutral member. The president of the International Chamber of Commerce in Paris would be requested to appoint the third member, if the two parties were to fail to agree on his appointment.

Subsequent negotiations

Both the company and the government recognized that several important issues concerning the project, interest payments, pricing of the equipment, division of responsibilities between PVO and Indonesia officials, the legal setup of the firm, sales commissions and profits, etc. would have to be clarified and settled before the project could be implemented. The tentative agreement, however, provided a basis upon which preliminary work could begin.

On the Indonesian side, a joint decree by the Ministers of Trade and of Cottage Industries issued on October 25, 1962, established a working team made up of twelve civil servants, representing several government ministries and official trading organizations. The task of the team was to carry out studies and make concrete recommendations for the implementation of the agreement.

PVO dispatched Mr. E. Hill, special assistant to the president, to Indonesia in December in order to meet with the team, choose a site, draw up specifications for plant and equipment, and investigate other technical aspects on the spot. Several other company officials, including the president Mr. B. T. Rocca Jr., visited Indonesia during the next six months to discuss technical and financial details, and to clarify other issues which remained in doubt.

Certain potential difficulties presented themselves during this period. First amongst them was the problem of obtaining supplies for the plant. PVO's experience as a copra buyer, demonstrated the difficulties encountered in this area. Although the government assumed the responsibility for securing the required quantities, PVO's representatives entertained serious doubts as to its ability to fulfill its obligations under the prevailing conditions in Sulawesi. Mr. Curt Rocca, president of Pacific International Rice Mills, who visited Indonesia early in 1963 in order to discuss rice sales to the country, conceived the idea that PVO should be allowed, when the government so requested, to import rice and to barter it against copra, thus offering the Sulawesi farmers an acceptable reward for their product.

Another difficulty arose in connection with the title to the equipment. A review of the contract revealed that the paragraph dealing with this question was in contrast with Sukarno's decree of August 1962 which stipulated that all titles be vested with Indonesian nationals or the government.

Realizing that formal ownership of the equipment would afford it little protection in case of seizure by the government, the company decided to give way on this point. The government, on its part, agreed that PVO or its bank should be allowed to retain security interest in form of a mortgage or a similar legal instrument, so as to enable PVO to secure financing for the equipment. These provisions were incorporated into the revised tentative contract which was negotiated by Mr. B. T. Rocca during his trip to Indonesia in May 1953.

The revised contract

The new contract was modeled largely on its predecessor, but it contained several new provisions as well as modifications of the old ones. The text of the agreement appears below:

REVISED TENTATIVE CONTRACT
for the
FINANCIAL AND TECHNICAL COOPERATION AGREEMENT

between the REPUBLIC OF INDONESIA, or a governmental agency designated by the REPUBLIC OF INDONESIA, hereinafter referred to as RI; and PACIFIC VEGETABLE OIL CORPORATION, hereinafter referred to as PVO.

1. PVO undertakes to deliver at the conditions of the present contract the complete buildings, machinery and equipment, as specified more fully in Exhibits A, B, and C[1] to the contract for the production of crude and refined deodorized coconut oil, soap, and copra cake meal and/or pellets in North Sulawesi.

Average capacity of plant:	200,000 kilos of copra (basis 7% moisture) per 24 hours.
Maximum capacity of plant:	250,000 kilos of copra (basis 7% moisture) per 24 hours.
Refinery capacity:	42,000 kilos of refined oil (undeodorized) per 24 hours.
Location of plant:	Bitung, on approximately five (5) hectars of land, provided by RI, adjacent to and West of the Port Facilities.

2. PVO undertakes to furnish, besides the special machinery for the copra plant, drawings, working instructions, as well as other necessary documentation, and building materials, viz construction iron, etc. not available in Indonesia.

[1]Exhibits A, B and C were omitted for brevity sake.

3. The total price of construction, deliveries and services of the contract amounts to approximately U.S. $2,500,000. This price includes the cost of all imported materials (including trade goods when so requested by RI), machinery[1], salaries and wages for foreign engineers and technicians, transportation and living expenses of Indonesian trainees when abroad, and any other costs payable in dollars. It does not include the cost of the land, supplies available locally, local labor required for the construction of the plant, or any other costs payable in rupiahs, all of which are to be paid by RI.

4. Payment for the plant will be effected in the form of delivery of Fifty Per Cent (50%) of the copra cake and/or coconut oil produced in the plant. These products will be shipped on instructions of PVO and all shipping documents will be sent to the Bank of America, San Francisco, as Trustee. Payment for trade goods may be effected from the proceed of export sales of either copra or products of the plant.

4. A) Title: Title to the plant and equipment shall be vested in RI upon delivery to the plant site at Menado. However, PVO or PVO's bank shall retain a security interest in all equipment, supplies or trade goods supplied by PVO until fully paid for by RI. Such security interest will be in the form of a mortgage or such other instrument of security as shall be appropriate under Indonesian law.

5. RI will authorize the exportation of Fifty Per Cent (50%) or more of total production of the oil mill or the copra equivalent and guarantees export licenses to cover such exports. PVO will have priority for purchase of these products or copra and from the proceeds of sale will retain quarterly payments equal to Five Per Cent (5%) of the total cost of the project, thusly total payment will be effected in sixty (60) months. Payment will be guaranteed by the Bank of Indonesia,[2] and should full quarterly payment not be effected in any period for any reason, the difference will be paid by the Bank of Indonesia to the Bank of America in dollars within ten (10) days after the end of the quarter.

6. PVO commits itself to buy not less than the quantity of the export products or copra at check prices established by RI as shall be required to pay for the plant. Such purchases

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[1] PVO was going to supply the machinery from one of its U.S. plants which had excess capacity.

[2] Indonesia's national bank.

shall be not above world market prices, less freight, insurance, and commissions payable, for such products. Should bags for cake exports and/or drums for coconut oil exports be supplied by PVO, their value will be deducted from the price of the cake and/or the oil.

7. At RI's discretion, RI may tender PVO additional quantities of products or copra in order to set up a credit against which PVO will deliver to RI specified trade goods and/or supplies for sale by the RI in the neighborhood of the mill and in the copra collection areas as "inducement goods" to coconut farmers.

8. RI will organize a company of Indonesians, including Copra Cooperatives, the government of North Central Sulawesi and private enterprises, to conduct operations under this agreement. These operations will include the purchase of copra and the distribution of consumer goods to the producers of copra as an inducement to producers to deliver copra to the mill, or for export if desired. Since an adequate supply of copra is essential for the operation of the plant, the Indonesian Company shall demonstrate, prior to the commencement of construction, of the plant, its ability to regularly obtain a minimum of 4,000 tons of copra a month. This copra will be offered for export to PVO until the plant is ready to operate.
To assist the Indonesian Company, PVO will, prior to the operations of the plant, supply rice or other trade goods accepting payment as provided in clause 4. In addition PVO will open letters of credit to cover the balance of the purchase price of such copra to facilitate the internal financing of the Indonesian Company.

9. A detailed list and specifications for tanks, transportation equipment, pumps, etc. will be compiled in Exhibit C. RI will arrange automatic approval of import permits during the full contract period for spare parts and any other equipment that both parties agree would improve the operation. The delivered cost of such spare parts will be reimbursed to PVO each quarter in addition to the regular quarterly payments.

10. Interest charges of six per cent (6%) per annum as computed on the outstanding balance will be added to the total cost of the plant in the final contract.

11. Price Escalator Clause

Should there be any increase in prices of equipment, buildings, etc. from the date of submission of the contract to the date of final approval, the increase in costs will be added to the price of the contract. Our final contract will specify time options on equipment.

12. Time of Delivery

The delivery to Bitung of materials for construction of buildings can be completed within six (6) months after signing of the final contract and import permits have been issued. Shipments of machinery and equipment will be scheduled to arrive when the buildings are completed to house such machinery and equipment.

13. Construction

A) Construction will be authorized to commence as soon as:

1. The Indonesian Company has demonstrated for a period of 3 months its ability to obtain an adequate supply of copra;

2. The necessary guarantees have been obtained by RI from the Bank of Indonesia and by PVO from the appropriate American governmental agency (A.I.D. or Export-Import Bank).

3. The plant design and company organization have been completed and approved by RI and PVO.

B) As soon as possible RI will furnish PVO, or authorize PVO to obtain at RI's expense, a topographical elevation survey of the parcel of land selected at Bitung. This is needed before a proper plant design can be completed and before final construction costs can be developed. The construction of buildings, installation of equipment, etc. will be the responsibility of PVO; however, PVO reserves the right to subcontract any PHASE of the project to others.

C) PVO, or its subcontractors, will supply the necessary experts, technicians, skilled craftsmen and staff required for the supervision and construction of the project. RI will furnish necessary visas and work permits for such personnel.

14. All import and export duties and other taxes involved will be paid by RI. This is to apply to all materials and machinery for construction as well as operating supplies, i.e. spare parts, cake bags, etc. This also refers to any taxes which might be levied on PVO, its subcontractors, and their personnel.

15. Operation

PVO is now investigating a small container plant to manufacture either tin or plastic containers for consumer sales of refined coconut oil. This plant will have a capacity for producing containers of two (2) kilo size to package ten and a half (10 1/2) metric tons per five (5) day week, which is twenty-five per cent (25%) of the refinery capacity of forty-two (42) metric tons per five (5) day week. If it is jointly determined to construct such a plant, this contract shall be broadened to cover the agreed upon cost of the plant. The terms of payment and all other conditions of this contract shall apply to the container plant as well as to the oil mill and refinery.

A) The Indonesian Company shall select a qualified individual as managing director to make decisions and carry out obligations of the RI under this agreement. RI will consult with PVO prior to the selection of this individual and he must be acceptable to PVO.
The Managing Director shall be an Indonesian, who will direct general policy of the operation to conform to Indonesian laws, regulations and established local management practice.

B) PVO will train, at its cost, an adequate number of qualified Indonesians for the operation of this plant. It is agreed that the cost of this training will be included on the total price of the contract. These costs will be based upon the number of Indonesians to be trained and the number of months each will need to complete his training. It is expected that a minimum of ten (10) technicians will need training, as follows:

1. Proposed Managing Director
2. Proposed Superintendent (Engineering training)
3. Chemist
4. Electrical Engineer
5. Maintenance Electrician
6. Two (2) Maintenance Mechanics-Welders
7. Three (3) Foreman Operators

It is proposed that these technicians will go to PVO Plant in the Philippines for preliminary training and, if it is felt necessary, two or more to these could be further trained at PVO Plants in the United States. This training should be completed at least four (4) months before completion of the Plant so they could learn more about the equipment by actually participating in the installation. PVO will retain a sufficient number of American technicians from the construction project to further train the Indonesian staff in the operation of the plant. It is estimated that the American technicians can turn over operations to the Indonesian staff within three (3) months after the plant is operating properly, with the exception of the Technical Manager and Superintendent. The Superintendent will turn over supervision of the plant to the local Superintendent within six (6) months after the local Superintendent shall have demonstrated his ability to properly run the plant, as jointly certified by the Managing Director and the Technical Manager. The Technical Manager will be selected by PVO and approved by RI and will direct, supervise and be responsible for the proper operation of the plant. He, or his successor, will retain this position until completion of this contract.

16. Force Majeure

In the event that conditions beyond the control of either party should frustrate or otherwise prevent the execution of this contract as contemplated, RI shall reimburse PVO within three (3) months after the occurrence of such condition for the purchase price of this contract, less any payments against the contract price previously made by RI, and less the salvage value of any equipment, spare parts, or supplies included in the contract price but not yet delivered to Indonesia. Such repayment shall be guaranteed by the Bank of Indonesia.

17. Arbitration

In case of any differences arising from this contract which cannot be settled by the contracting parties, each contracting party is entitled to submit the case to the International Chamber of Commerce in Zurich for arbitration. Both contracting parties agree to submit to the final ruling of the International Chamber of Commerce.

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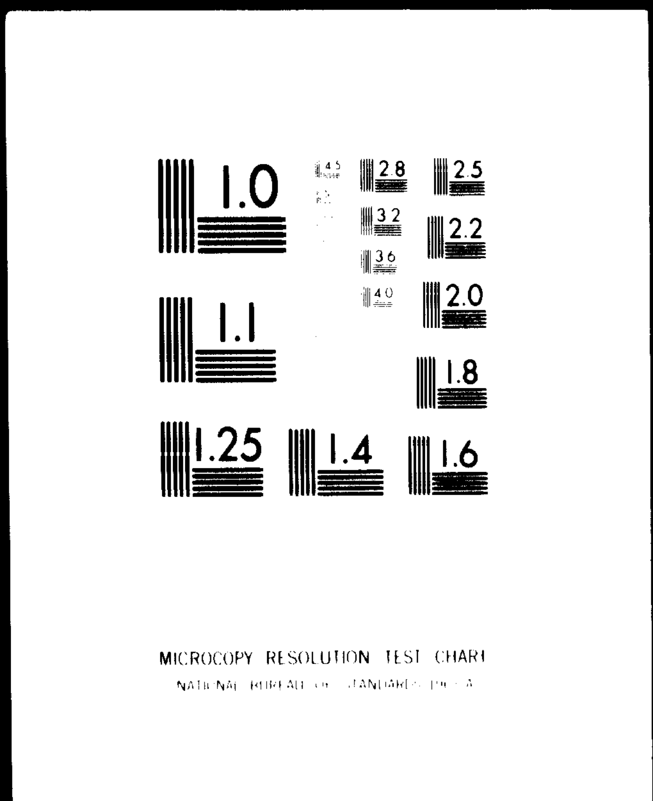

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18. All enclosures and/or exhibits mentioned in this contract, i.e.

A.
B.
C.
etc.

form an integral part of this contract. The same refers to supplements to this contract which may be added.

Dated and signed this 25 day of May, 1963.

On Behalf of PACIFIC VEGETABLE OIL CORPORATION	On Behalf of THE MINISTER OF TRADE
PACIFIC VEGETABLE OIL CORPORATION	DEPARTMENT OF PEOPLE'S INDUSTRY REPUBLIC OF INDONESIA

Finance and Insurance

While these developments took place in Indonesia, PVO initiated discussions with the Export-Import Bank in Washington concerning the financing of the project. The company's management considered the Eximbank to be the most suitable financial institution to turn to, since it was especially equipped to deal with such projects as PVO had in mind. The bank provided medium and long-term financing for U.S. exports in those cases where the exporter was not likely to find a private source of financing. It was obvious to PVO that a private bank would not consider financing a transaction of the kind it had envisaged.

Early in November 1962, Mr. B. T. Rocca Jr. made a formal application to the bank in which he outlined the project and its possible benefits to Indonesia and the U.S., asking for a loan which would cover about two thirds of PVO's expected outlays. The letter was preceded and followed by a series of meetings with the bank's officials in both San Francisco and in Washington. While the bank's officials conceded that PVO's project was just of the kind which their institution was designed to handle, they pointed out that Indonesia was in the midst of a serious financial crisis at the time, and that negotiations were going on between the U.S. and Indonesia about how the crisis could be alleviated. Pending the satisfactory outcome of these talks, the officials felt reluctant to make a definite commitment to PVO.

At the suggestion of the U.S. embassy in Jakarta, PVO also contacted the Agency for International Development (AID), seeking assurances that its project would be eligible for insurance under the Agency's guaranty program. Under the terms of this program U.S. investors abroad could purchase an insurance policy which would cover them against noncommercial risks involving expropriation, currency inconvertibility, government refusal to grant export licenses etc. AID's policy was to issue such a guaranty only after concluding a bilateral agreement with the government of the country in question in which the letter undertook to refrain from expropriating U.S. property without offering its owners fair and adequate compensation. By the end of 1962, Indonesia had not signed such an agreement with the U.S., although the subject was under continuous discussion between the two governments.

The U.S. embassy in Jakarta was urging upon AID the desirability of extending guarantees to U.S. investors in Indonesia. The Agency however, felt that a change in its policy was not warranted under the circumstances, although it recognized that Indonesia's "production sharing" plan did offer promising opportunities to U.S. investors.

The situation in June 1963

Aside from the signing of the revised contract in May, little progress had been made as regards the implementation of the project by the middle of the year. Indonesia had concluded a foreign aid agreement with the U.S. under which it received U.S. $17 million dollars worth of aid used mainly to finance imports of urgently needed goods. PVO's management felt that there was no point to approach the Eximbank again despite these developments, as long as a guaranty was not obtainable from AID.

The company's apprehensions about the ability of the Indonesian government to supply the required raw materials were not allayed despite the provisions of the new contract. In an attempt to determine the government's ability to fulfill its obligations, PVO insisted on inserting into the contract a paragraph which stated that: . . . "The Indonesian company shall demonstrate prior to the commencement of the construction of the plant, its ability to regularly obtain a minimum of 4,000 tons of copra a month. This copra will be offered for export to PVO until the plant is ready to operate." No shipments were so far made under the terms of the above provisions, and there were no indications that the Indonesian government was preparing to implement them in the immediate future.

While considering its next move, PVO management became aware of the fact that several other companies, European and Japanese as well as American, were planning to establish enterprises in Indonesia. Another California based company which was engaged in fishing and in canning, had been operating for some time in the country. Its management stated to PVO that it was satisfied that the Indonesian government would honor its pledges since the arrangement was so obviously beneficial to both sides. Moreover, since title to the imported equipment was in any case vested with the Indonesians, they could gain very little by expropriating it.

Several of the other prospective investors in Indonesia were, like PVO, in the vegetable oil business, and one of them, an American firm based in New York, was a direct competitor. This company had reportedly signed a contract with the Indonesian government which was closely modeled on the PVO's, calling for the erection and operation of a copra oil plant in Sulawesi.

Mr. B.T. Rocca was mindful of the fact that the first foreign company to actively engage in vegetable oil production, would be likely to gain competitive advantages in the country and could expect to get sympathetic consideration regarding the establishment of other manufacturing and trading ventures. He had to decide whether to recommend to the company's board of directors to go ahead with the implementation of the plan immediately, or whether a satisfactory conclusion of the AID guaranty and the supply question should be insisted upon first.

Exhibit 1

PACIFIC VEGETABLE OIL CORPORATION

Selected Consolidated Financial Data
(000's omitted except for per-share figures)

Sales, Earnings and Dividends 1957 - 1962

Year Ended June 30		Net Sales	Net Income	Per Capital Share Earnings***	Per Capital Share Cash Dividends Paid	
1962		$101,013	$964#	$1.66	$0.80	on 580,493 shares##
1961	(pro forma)	$103,500	$915#	$1.58	$0.75	on 538,958 shares
1961*	(6 months)	$ 48,522*	$327*#	$0.57*	$0.40*	on 538,958 shares
1960**		$109,397	$870#	$1.52	$0.70	on 477,174 shares
1959**		$119,043	$947#	$1.66	$0.53###	on 470,746 shares
1958**		$ 83,679	$413	$0.72	$1.00	on 214,120 shares
1957**		$104,672	$500	$0.87	$1.00	on 194,670 shares

*6 months to June 30, 1961 (new fiscal year ends June 30).
**Former fiscal years ended December 31.
***On the 580,493 $5 par shares outstanding June 30, 1962.
#After income taxes and minority interest, including equity in income of affiliated companies.
##Shares outstanding at end of period.
###25¢ per share was paid on 214,120 shares in each of the first two quarters; 25¢ per share was paid on 235,532 shares in the third quarter, and 17 1/2¢ per share was paid on 470,746 shares in the final quarter.

Exhibit 2

PACIFIC VEGETABLE OIL CORPORATION

Consolidated Balance Sheets

June 30, 1961, 1962

ASSETS

	1961	1962
CURRENT ASSETS:		
Cash	$ 846,396	$ 1,441,655
Receivables, less allowance for doubtful accounts	6,960,510	9,555,444
Due from affiliated companies	670,686	480,652
Commodity inventories--		
Priced at the lower of average cost or market	5,099,359	5,766,310
Priced at cost determined on last-in, first-out basis	3,533,501	1,507,792
Advances for joint accounts	1,068,168	384,170
Prepaid expenses and operating supplies	390,050	536,861
Total current assets	$18,568,670	$19,672,884
INVESTMENTS AND OTHER ASSETS:		
Investments in--		
Foreign affiliated companies	$ 1,224,406	$ 1,313,192
Domestic affiliated companies	367,783	503,672
Noncurrent receivables and other assets, less reserves	1,057,171	924,742
	$ 2,649,360	$ 2,741,606
PROPERTY, PLANT AND EQUIPMENT, at cost:		
Land	$ 376,786	$ 376,786
Buildings and improvements	4,823,874	5,126,747
Machinery and equipment	5,195,343	5,381,074
Furniture, automobiles, etc.	316,470	336,218
	$10,712,473	$11,220,825
Less--Accumulated depreciation and amortization	3,466,130	4,167,503
	$ 7,246,343	$ 7,053,322
	$28,464,373	$29,467,812

Exhibit 2 (continued)

LIABILITIES

CURRENT LIABILITIES:		
Notes payable to banks, partially secured by pledge of inventories and receivables	$ 8,428,049	$ 7,791,324
Current portion of long-term liabilities (Note 2)	298,892	406,246
Accounts payable	3,266,452	4,533,596
Due to affiliated companies	151,169	25,364
Accrued United States and foreign income taxes	437,427	754,168
Other accrued liabilities	607,005	806,178
Total current liabilities	$13,188,994	$14,316,876
LONG-TERM LIABILITIES:		
Notes payable to banks and others, excluding current portion shown above (Note 2)	$ 4,563,558	$ 3,799,102
6% convertible subordinated debentures (Note 3)	1,418,000	698,000
Deferred United States and foreign income taxes	263,000	353,400
	$ 6,244,558	$ 4,850,502
COMMITMENTS AND CONTINGENT LIABILITIES (Note 4)		
MINORITY INTEREST IN CONSOLIDATED SUBSIDIARIES	$ 171,510	$ 227,242
STOCKHOLDERS' INVESTMENT:		
Capital stock, par value $5 per share (Notes 3 and 5)- Authorized--1,000,000 shares Outstanding--580,493 shares in 1962 and 538,958 shares in 1961	$ 2,694,790	$ 2,902,465
Capital surplus	1,667,380	2,161,725
Earned surplus (Note 3)	4,327,554	4,728,916
Equity in undistributed earnings of affiliated companies	169,587	280,086
	$ 8,859,311	$10,073,192
	$28,464,373	$29,467,812

Exhibit 3

PACIFIC VEGETABLE OIL CORPORATION

Principal Commodities of International Trade

Commodity	Major Source(s) of Supply	Principal Market(s)
ALFALFA PELLETS	United States	Japan
CASTOR BEANS	South Africa, Ecuador, United States	United States, Western Europe
CASTOR OIL	Brazil, India, United States	United States
COCONUT MEAL	Philippine Islands	Scandinavian Countries, United States, Western Europe
COCONUT OIL	Philippine Islands	United States, Western Europe, South Africa
COPRA	Philippine Islands, Indonesia, South Seas	Europe, Japan, South America, United States
COTTONSEED	Central America	Japan, Germany
COTTONSEED MEAL	Central America, Mexico, United States	Scandinavian Countries, United States, Western Europe
COTTONSEED OIL	United States	Worldwide
FISH OIL	United States	Western Europe
FLAXSEED	Canada, United States	Japan, Mediterranean Area, Scandinavian Countries, Western Europe
LARD	United States	Germany, United Kingdom, Japan
LINSEED OIL	United States	Australia, Philippine Islands, United States, Western Europe
PALM KERNELS	Africa	United States, Western Europe
PALM KERNEL OIL	Africa	United States, Western Europe
RAPESEED	Canada	Japan, Mediterranean Area, Western Europe
SAFFLOWER SEED	United States	Japan, France, Finland
SAFFLOWER OIL	United States	Australia, New Zealand, United States, Western Europe
SOYBEAN MEAL	United States	Japan, Philippine Islands, United States, Western Europe
SOYBEAN OIL	United States	Worldwide
TALLOW	United States	Worldwide
WOOD (TUNG) OIL	South America, United States	Australia, United States, Western Europe, Japan Philippine Islands

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