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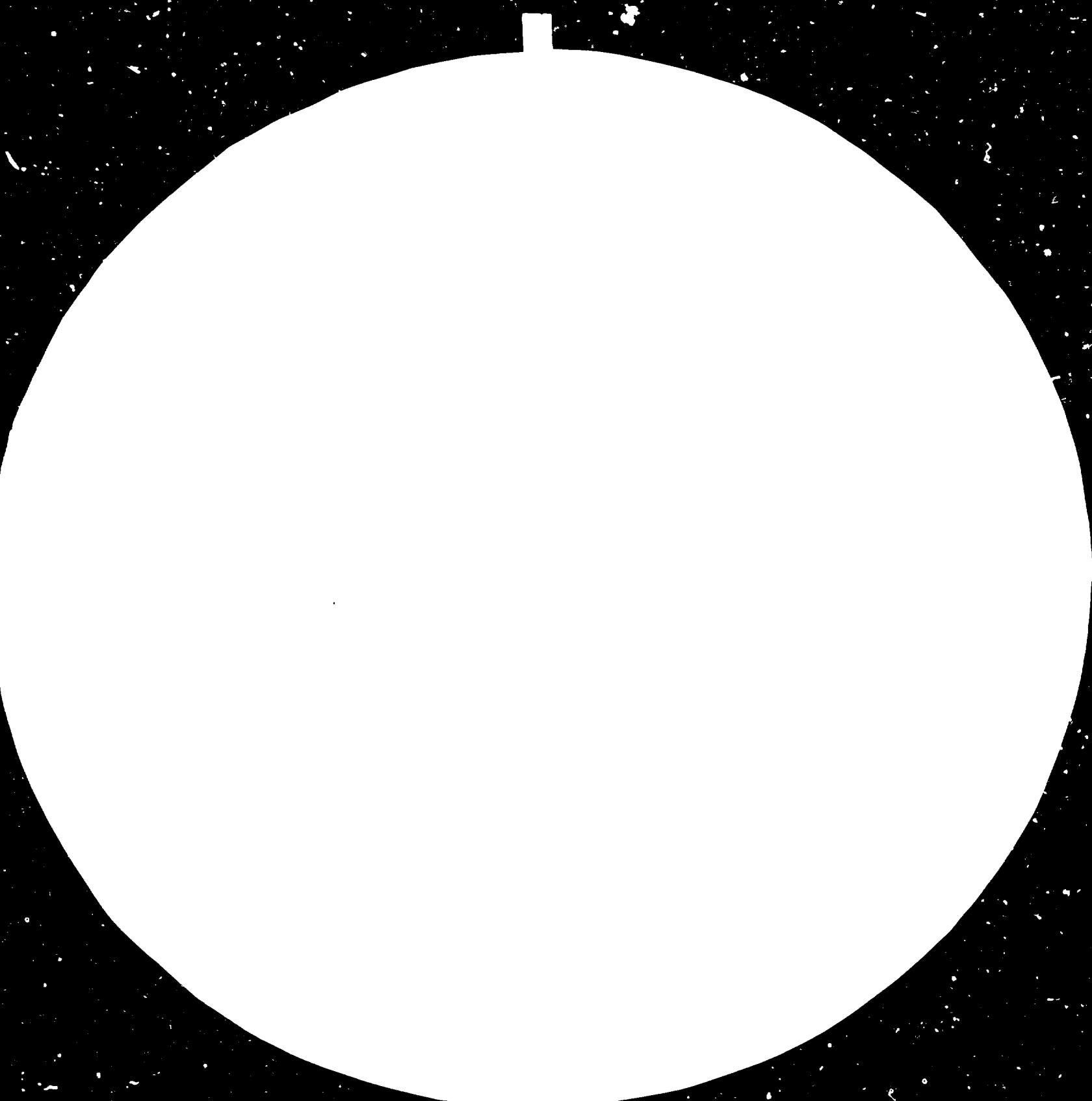
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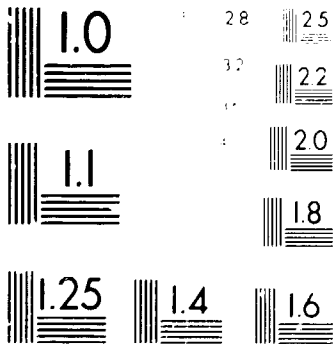
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Distr.
LIMITED

ID/WG.411/2
28 December 1983

United Nations Industrial Development Organization

ENGLISH

Third Consultation on the Leather and
Leather Products Industry

Innsbruck, Austria, 16-20 April 1984

CHECKLIST FOR CONTRACTUAL AGREEMENTS
IN THE TANNING SECTOR
BETWEEN ENTERPRISES FROM
DEVELOPED AND DEVELOPING COUNTRIES *

Background paper for issue no.1

prepared by

the UNIDO secretariat

13227

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V.83-65734

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I. INTRODUCTION

1. The Second Consultation on the Leather and Leather Products Industry, held in Cologne, Federal Republic of Germany, 23-26 June 1980, concluded that "...there is ambiguity as to what should be part of a contractual agreement between parties interested in international development in the (leather and leather products) sectors", and recommended that "the UNIDO secretariat and its Leather Panel should undertake the research necessary to establish a checklist of clauses, conditions and variations thereof that could be included in contractual agreements".^{1/} The Consultation indicated the various types of enterprises from developed and developing countries who could form partners in international co-operation, and identified their respective objectives which should be taken into consideration in formulating the checklist.
2. In undertaking the work for the checklist, the UNIDO secretariat found it expeditious to develop separate checklists for the different subsectors of the industry, i.e. the tanning and footwear industries, since each subsector poses unique problems in international co-operation. The checklist for the footwear sector was developed and submitted for approval to the Fifth Session of the UNIDO Leather and Leather Products Industry Panel, where the document was approved for general circulation to the industry. The present checklist was submitted to the Sixth Session of the Leather and Leather Products Industry Panel (Vienna, 29 November-1 December 1982) and similarly approved.
3. For the present checklist, the UNIDO secretariat kept in mind the work done on the footwear sector ^{2/} and has tried to minimize the areas of potential overlap between the two documents. Thus, for example, the present document does not cover the area of joint ventures with equity participation, since the checklist on this topic, for the footwear sector, was considered sufficiently comprehensive to be applicable with respect to the tanning industry. Further, the secretariat narrowed down the major problems confronting international co-operation in the tanning industry as being the transfer of management know-how and that of specification and acquisition of the technological process most suited to a given raw material supply in a developing country.

1/ See ID/255 - Report of the Second Consultation on the Leather and Leather Products Industry, Cologne, FRG, 23-26 June 1980, para. 7, pp. 9-11.

2/ See ID/WG.411/1 - Checklist for Contractual Agreements in the Footwear Sector between Enterprises from Developed and Developing Countries, 21 December 1983

4. The present checklists cover four methods of international co-operations, i.e.
 - (a) Management contracts;
 - (b) Turnkey projects;
 - (c) Reverse marketing arrangements;
 - (d) Plant leasing by the foreign partner.

5. The checklist, along with the companion document on the footwear industry, is being submitted to the Third Consultation on the Leather and Leather Products Industry as a background paper to issue no. 1.

II. BASIC CONSIDERATIONS RELATING TO INTERNATIONAL CO-OPERATION IN THE TANNING INDUSTRY

The need to ensure maximum utilization of the finite raw material

6. The demand for real leather has continually grown, due both to global population growth and the enhancement of living standards. However, due to the finite nature of the raw material, with minimal growth in availability, production can only slowly expand and it is incumbent on the industry to maximize the utilization of the available raw material with respect to both volume of output and technical enhancement of the end product.
7. During the last decade there has been a migration of the tanning sector from developed to developing countries, partly due to the logical desire for "on-the-spot" processing and also due to ecological factors which have made the tanning industry less and less attractive in the developed countries.
8. The relocation of the production base of the sector from the developed countries, where technological expertise was long established, to developing countries, where such expertise is recently being imbibed, indicates the need for increased international co-operation at the enterprise level between developed and developing countries and among developing countries, to ensure maximum utilization of this limited global resource.

The nature of resources required by the Leather Sector

9. The major resources required may be summarized as being:
 - Raw materials, i.e. hides and skins, which despite their general availability vary greatly in quality from area to area, with equally large variations of characteristics for the possible end product;
 - Plant and machinery, which in this sector do not have to be unduly sophisticated in order to yield optimum technological results;
 - Chemicals and auxiliary inputs, which are of prime importance, and should generally be obtained from internationally reputable sources (with the benefit of proven international research and development built into the product);
 - Technology ^{3/} is of paramount importance in this industrial sector. Tanning is an industrial art, and it is necessary to control the

^{3/} "The science of industrial arts", O.E.D.

interaction of raw material, plant and chemicals in order to optimize the economic and technical potential of the heterogeneous raw material. In this respect, the leather sector differs from most other industries, where the technology is usually dependent on the plant and machinery/equipment installed;

- Labour, although essential in this sector, does not require great pre-existing skills, only the willingness to accept somewhat arduous working conditions;
- Management, as with all industries, is an essential component. It may be stressed that due to heterogeneity of product, the wide range of possible product grades and qualities which are assessable only on the basis of personal value judgements, a high level of entrepreneurial skill, flexibility and experience are demanded. Such entrepreneurial skills must rapidly assimilate market intelligence and adjust the product-mix to conform to market demands and obtain the best market prices.

The Characteristics of the Leather Industry

General

10. The leather industry has long been a truly international industry with few countries exhibiting self-sufficiency at all stages within the industry. In the past, raw materials were exported from the developing to the developed countries, where it was processed to ensure maximum attainment of the materials' potential and compliance with the quality levels demanded by consumer. With the increase of the production base of the sector in the developing countries, the nature of international co-operation has changed with the developed countries supplying much of the plant, machinery, equipment and chemical inputs, in addition to large markets for end products, both finished and semi-finished leather.

11. Leather production in the industrialized sector can economically be installed in a wide range of tanning capacities, e.g. from 200 to 2000 hides a day. Although the basic technology varies little, the larger units reap some benefits of economies of scale and can possibly afford more modern machinery which allows more regular product quality. Larger units may practise more formal quality control procedures, employing both laboratory facilities and technological supervision. However, smaller units may offset these apparent advantages by specialising in certain end products (yielding higher return) and with lesser

throughput. The entrepreneur may exercise his personal skills to ensure the product-mix optimises the potential of the plants' capabilities and the raw material available to it. At whatever scale tanning is effected, there is a need and scope for co-operative assistance ventures.

12. Although the tanning sector globally adopts similar basic technology, the quality of leather from a given raw material, produced in different tanneries need not to be the same. Indeed, with noticeable exceptions, it has been seen that for a variety of reasons, the end product from many of the new tannery projects in developing countries is not of such high standard or as uniform as could be expected from the same raw material processed in older tanneries of some developed countries. Thus, in certain cases the same raw material when processed in developed countries could yield a substantially higher return than if processed in a developing country with lower technological skills.

13. Amongst the reasons for lower quality output from a similar basic technology may be:

- (i) Non-availability of most suitable chemicals/agents;
- (ii) Less experienced management at all levels (technologists - selectors - operators);
- (iii) Lower awareness of the need for uniformity;
- (iv) Unlike most developed countries, the industry in developing countries has not raised leather to "luxury" item. As a utilitarian item, the consumer has not been prepared to pay sufficient premium for high quality products;
- (v) Lower quality standards accepted in local finished products has a rub-off effect on products for export.

14. In addition to producing lower quality leather, there may be some degree of capacity underutilization in developing countries. Traditionally, a tannery's incoming raw stock is selected piece by piece to ensure that it is utilized for the highest value-added leather to which it is suited. In some developing countries, with no internal demand for the higher value products, all hides and skins sometimes processed for low value products, with a concomitant loss of potential revenue.

Quality Concepts

15. The craft content of the technology and trade within the leather sector is reflected in the difficulty in resolving problems encountered in quality control, standardisation and grading. These problems may be broadly separated

into two classes, i.e. quantifiable and unquantifiable factors. It is often not appreciated by those outside this industrial sector that the quality/value of any leather is determined by visual/manual assessment (value judgements). A leather may meet certain analytical or chemical standards, and fall within acceptable physical test parameters, yet still not be acceptable to the purchaser, due to insufficient visual appeal.

- Quantifiable Areas

16. Official standards exist relating to the measurement of both chemical and physical quality, but only a small volume of world leather production and trade is based exclusively on these standards.

17. Most governmental purchase contracts usually refer to such standards, however, the majority of global leather produced is traded in conformity with one or more of the following:

(a) In house standards: Major leather products manufacturers purchase to their own specifications often involving chemical analysis and physical testing, varying in emphasis according to end-use requirements. Thus, chrome, fat and salts content coupled with lastometer readings may be utilized in crust leather transactions, with pigment film testing being included for finished leather.

(b) End use suitability: The majority of transactions in the leather sector are based on an assessment of end-use suitability for a given type of leather. The purchaser orders his upper, gloving or lining leathers on the assumption that the tanner will supply leather with suitable characteristics. Such apparently loose trading is however based on mutual trust built up over an extended period of time and requires much "give and take". The resolution of differences between producer/user is normally straight-forward. For example, either a leather stands up to the normal process of shoe production, or it fails (grain cracks on lasting-cracks and spews on direct moulding etc.). Failures could be due to the fact that the technology of shoe production had been altered, requiring differing technical parameters for the leather or that the leather does not conform to the parameters required by a given shoe production technique.

- Non-quantifiable Areas

18. However, even if the leather apparently satisfies in house standards or end use suitability criteria, it may still not be acceptable to the purchaser for a variety of reasons, most of which are based on visual/manual assessment (human value judgements).

The problem areas are so wide that here only some major aspects can be outlined:

(a) Quality Control

19. Due to the natural heterogeneous nature of raw material, and the batch and individual production techniques, there may be significant non uniformity between and within individual leathers, yielding a less standard final product or lower (area or weight) yields.

20. The aesthetic appeal of leathers is also non quantifiable, and perhaps overrides all other parameters with regard to quality and acceptability for a given end use. This valuable characteristic is only assessable after much experience in visual and manual assessment, by the tanner.

(b) Grading

21. Although internationally agreed grading standards exist for raw hides and skins, they have little relevance to grading of semi-processed and finished leathers. Grading, a personal, skin by skin assessment, attempts to recognize and evaluate the value of each piece giving due allowance to a host of variables, some of which are:

- Holes and poor shape due to premortem or flaying and curing defects;
- Defects due to the leather conversion process;
- Variation within the piece of leather with regard to technological quality;
- Suitability for end product;
- Aesthetic appeal;
- Potential cutting yield.

22. To obtain consistent grading standards with such variables requires both great experience and high levels of mutual understanding between tanner and purchaser. In this respect, it may be noted that it is not unusual for each customer of a tannery to have his own grades established, incorporating his particular norms.

23. In some respects, grading is more difficult in semi-processed leather (pickled, wet blue and crust), as many defects are difficult to observe in the early stages of transformation, and only experience can determine whether visible defects can be removed or hidden by later processing. It may be relevant to note that many developing countries are now producing and marketing leather in these semi-processed states, and they sometimes experience difficulty

in establishing grading patterns consistent with the requirements of specific individual international purchasers.

(c) Pricing

24. In general, it is apparent that there can be no predetermined "international price structure" for leather, given the wide quality variation caused by one or more of the following factors:

- Variations in technical quality or cutting value;
- The possibility of producing nominally similar material which has different technical characteristics;
- Variations in the quality of raw material;
- Diversities in end product value of different leathers;
- Influences of current market demand.

25. Possibly the USA and Argentina may be excepted from this generalisation, as their raw material is of more homogeneous nature and is well categorized, and its potential is widely recognized.

26. Accepting this general characteristic of the industry it can be concluded that pricing of outputs is the result of a balance of inputs, technological efficiency and entrepreneurial skills.

III. CONSIDERATIONS IN SELECTING THE MOST SUITABLE TYPE OF AGREEMENT FOR CO-OPERATION

Objectives

27. A wide variety of alternate forms of international co-operation are possible, and these are individually outlined in the next chapter. It should be appreciated that these forms of co-operation are flexible, and will need tailoring to suit individual circumstances, it may also be seen that such agreements are not mutually exclusive, and several types may be packaged into a single agreement. The form of agreement should be based on a clear mutual appreciation of the short and long-term objections of both potential partners.

28. The developing country partner may seek to achieve one or more of the following objectives, through international co-operation:

- The establishment of new and/or the expansion of existing production capacity;
- Financial assistance/investment;
- Improvement in quality standards and product optimisation;
- Advancement to a higher stage of processing (pickled → wet blue crust → finished);
- Improved management and technological ability;
- Expand markets (particularly for export) and marketing skills;
- Improve financial return on existing/expanded investment.

29. The objectives of the developed country partner may be conditioned by the proposed end product, i.e.:

(a) Pickled/wet blue/crust projects

Foreign partners for such projects may ideally be finished leather tanners who wish to expand their capacity. Alternately, partners may be found amongst those developed countries' tanners who, due to poor trading conditions over the last few years, have closed their production units and wish to capitalize on their unemployed plant, machinery and know-how. In either case, the objectives of such developed country partners could be:

- Selling plant and machinery (new and used);
- Selling management and marketing skills;
- Selling technological service;
- Securing a long term supply of semi-processed leathers prepared to their own specification and under their own technical control;
- Expansion of their offshore production capacity.

(b) Finished leathers

Partners for such end products could be tanners wishing to market the developing country's product, employing their existing marketing arrangements. More likely they would be international traders in this field, who wish to expand the volume of their trade. In such circumstances, in addition to the above objectives the developed country partner may be interested in expanding his market and profit base by creating offshore production capacity in conformity with his market demand, and increasing the utilization of his existing marketing capability.

Compatibility of objectives

30. It is self-evident that in any partnership the aims of the partners must in the long-term be mutually compatible. It is essential that the real objectives of both parties be clearly specified and agreed during the pre-negotiation phase.
31. Such specification of objectives is best appreciated when viewed against a fully documented project proposal or feasibility study. For the purposes of this checklist it is suggested that such a detailed study should include:
- Full plant and machinery layout;
 - Services detail;
 - Capacity;
 - Cost (value);
 - Production costs etc. of existing plant;
 - Proposed new plant and equipment;
 - Raw material and chemical inputs;
 - Production mix;
 - Technical product specification;
 - Past and projected future profitability of project.

32. During the preagreement negotiations, prefeasibility studies and loose technical agreements may have been the basis for ascertaining the mutual compatibility of objectives, but recent experience has shown that, except where only joint marketing is involved, there is a need to prepare detailed project proposals/feasibility studies. Such a final study must be acceptable to both parties, and ideally it should be prepared by an independent party(ies). The final projections and recommendations should be seen to be mutually acceptable and attainable by both partners. In the majority of cases, however, the study is prepared by the foreign partner due to his apparent possession of "know-how" and market intelligence. In such circumstances, it is incumbent on the domestic partner to fully evaluate the study to ensure that it will yield mutual benefit. Should the domestic partner have limited experience in this respect, an independent evaluation of the project/study would yield significant benefits in clarifying the potential gains and problems involved in the collaboration. The feasibility study should address the fundamental questions pertaining to the investment decision:

- (i) Given available raw materials, technological and managerial skills and finance, are the scale, proposed product-mix and technology the most suitable to the circumstances?
- (ii) Could the same production be achievable with lesser capital inputs,
 - could lower cost buildings be employed?
 - lesser machines utilized more rationally?
 - less sophisticated machines be employed?
- (iii) Should the whole project be implemented initially or is there scope for a step by step approach to be adopted? If the project aims to produce finished leather could one expect finished leather sales of a sufficient volume which would allow reasonable capacity utilization, or would it be preferable to initially install only wet blue or crust plant with a small finishing unit, which could be expanded in further phases as technology and market acceptance are proven?

Availability of partners

33. Recent UNIDO studies and papers have attempted to document the migration of the leather production centres towards the developing countries. One major result of this restructuring has been, the closure of a large number of tanneries in developed countries, resulting in the under utilization or non utilization of

large quantities of plant and machinery, skilled labour, management, technical and marketing know-how. Thus the inputs for co-operation are easily available, with potential partners in developed countries seeking to obtain maximum returns on either a long-term or short-term basis.

Finance

34. In recent years, with the expansion of Industrial Development Banks and other development oriented institutions, finance has been easily obtained for purposes of covering fixed assets for new or expanding tanneries. However, for a typical tannery in a developing country, it may be that working capital - to include up to 2-3 months raw and finished stocks - may far exceed fixed capital. Such working capital is not easily obtainable from development institutions, and recourse to somewhat conservative commercial banking sources does not always provide the necessary finance. This may well be an area where international co-operation could be effective, and marketing or other contractual agreement could result in the foreign partner lessening stock levels and accepting some of the financial burden at an early stage (in return for reward), thereby reducing the tanneries' financial burden to more acceptable levels.

IV. CHECKLIST OF AGREEMENTS

Management Contract

General

35. Management contracts vary widely in content and have recently established themselves as suitable for certain situations in the leather industry. Such management contracts, at their broadest, may cover all aspects relating to the operation of a tannery, i.e. complete financial, managerial and technical control, coupled with marketing responsibility. At their narrowest, such management contracts may cover only minimal managerial and/or technical advisory, with or without marketing responsibility.

36. Management contracts may be suitable for existing tanneries in developing countries who wish to:

- (i) expand their production,
- (ii) raise quality levels,
- (iii) proceed to higher value-added products,
- (iv) have improved market access,
- (v) improve profitability of the operation.

37. New projects may also avail themselves of co-operation via a management contract, but for the purposes of this checklist the actual supply of plant and machinery is considered outside the scope of a management contract (where a co-operative management agreement includes the supply of plant and machinery, it may be considered a "turnkey supply" contract coupled with a management contract).

38. The scope of a management contract will be dependent on an evaluation of the domestic enterprise's level of development with regard to potential product-mix, production capacity, management, technological and entrepreneurial skills. This evaluation should enable the nature and scope of the collaboration to be determined and indicate the type of foreign collaborator required to achieve the aims and objectives of the enterprise.

Checklist for Management Contract

39. Preamble

Definition of terms and expressions

Detailed justification and scope of agreement

Recognition of objectives of both parties
Status and qualification of both parties
Contributions of both parties
Responsibilities of partners in execution of the agreement
Duration and territorial delineation of agreement

40. Production Programme

Raw material availability/quality
Product-mix - related to plant/machinery, capacity/market
Production volume - related to plant/machinery, capacity/market
Production build-up - related to plant/machinery, capacity/market
Quality and grades - related to market intelligence
Responsibility for production decisions
Guarantees of output volumes

41. Machinery, Equipment

Existing building, plant and machinery plans and layout (to be annexed)
New plant and machinery (plans, layout, cost, capacity) contained in feasibility and project study (to be annexed)
Suggested deviation, alteration and expansion of above. Justification of amendment or alteration of plant on grounds of costs/benefits or improvement of productivity
Responsibility for negotiations for future plant, machinery and equipment
Responsibility for installation of new equipment
Responsibility for start-up
Responsibility for plant and machinery maintenance
Responsibility for spare parts procurement

42. Technology

Technological processes to be employed
Control and purchase of raw material
Control, specification, selection and purchase of chemicals and auxiliary inputs, procedure for purchasing these items
Responsibility for deviation from proposed processes
Quality control, chemical analysis, physical test parameters of product
Responsibility for technological control
Technical guarantees (see marketing)

43. Management

Structure

Division of overall authority between the domestic and foreign partner

44. Training

Training of management

Training of technical staff

Total number of personnel required

Anticipated breakdown of costs and responsibility for training

Expatriate experts - qualifications, number and the time period for which they are required

45. Marketing

Responsibility (link with know-how)

Guarantees of volume/price/quality (tie with know-how - technical control)

Agency (sole?)

Commission/terms

Market intelligence

46. Finance

Capital structure - production unit

Capital structure - stock/distribution/marketing

Guarantees - local party investment/foreign party management

Guarantees - foreign party investment/supply contract

47. Remuneration

Agreed sum basis - initial payment on signature and/or schedule of regular payments,

- cost plus a percentage of costs

Incentive - share of improved profits or percentage of increased turnover

- separate market contract with commission based on sales volume or profit

48. Arbitration

Comments on aspects relating to management contracts

General

49. The existence of a management contract results from an assumption that one party in the co-operative venture has superior expertise in one or more of the facets involved in the manufacturing, marketing and financing of leather production. Accepting one party's superiority it would appear essential to offer advice to the weaker party to ensure equitable execution and share of all benefit accruing from the management contract.

Performance Assessment

50. Management contracts have been made wherein the supplier of expertise agreed to inject technical/managerial inputs in return for cash, for a given duration of time. However, unless the supplier is of known character such simple purchase of expertise may not be efficiently implemented. Ideally a management contract should have some built-in element of incentive for the supplier in order to urge him to maximize the efficiency of his input.

51. Such incentive should be based on performance assessment. This assessment of the degree of efficiency achieved during implementation of the contract, based on the original contractual offer, should concern itself with the following aspects:

- Volume of production;
- Quality of production;
- Cost of production;
- Profitability.

52. Although performance assessment in these areas is dependent upon subjective analysis, and external factors may override the input of the contracts' successful implementation, it would appear imperative that consideration be given to incorporation such performance assessment, with incentive payments, within the contract.

53. Due to the heterogeneous non quantifiable nature of the raw material and leather it is not easy to assess the efficiency or otherwise of an ongoing management contract. In the final analysis, the success or failure of executing a management contract would depend on the degree of mutual trust established between the co-operating parties. Even in the case of the indications suggested above, certain limitations should be kept in mind:

(a) Volume of production

54. Offers by supplier to attain certain volume of output may be irrelevant or counter productive, as quality may suffer yielding lower net financial return.

(b) Quality of product

55. Written offers to raise quality standards may also prove ineffective despite the attainment of analytical standards. As mentioned previously quality is also assessed by grading and this is dependent on who makes the value judgements involved, i.e. whether it is done by the supplier of services or the recipient. This assessment is not easily seen to be impartial.

(c) Market changes

56. It must be stressed that offers to produce "leathers of internationally acceptable quality levels" or similar offers have minimal value, as virtually all leathers are exportable, albeit at varying prices. Attempts to index price of product incorporating fluctuation in the prices of raw material/chemicals etc., have not been successful. Fluctuations in market demand affect the value of the end product and the volume of demand and can override the apparent result of a management contract.

(d) "Arms Length" transactions

(i) Machinery: If technical and managerial control is given to the party supplying machinery, it will be necessary to ensure that all purchase transactions are carried out by him at "arms length". The supplier offering machines must be prepared to show that they are both suitable and competitive, and that he is not in receipt of hidden commission. Open offers to tender should go to 3 or 4 reputable machinery manufacturers to allow a basis of comparison for suppliers' offers.

(ii) Chemicals: If either partner has control of selection and purchase of chemicals and auxiliaries, a similar problem exists. Most basic chemicals within the sector are of known composition and quality and competitive quotes should be obtained. For example, many dyestuffs are listed in the colour index and alternate trade names are given, allowing competitive quotes to ensure fair purchase at "arms length". However, the exact composition/effectiveness of many tannery inputs is not easily determined (fat liquors, syntans, binders, etc.) and the selection must be left to the technical management - in such cases only mutual trust can overcome the fear that the suppliers is receiving monetary reward in the purchase of specific products.

(iii) Raw materials: In many co-operative ventures, the local entrepreneur retains the responsibility to purchase the raw material due to his better appreciation of local customs, language etc. Raw material purchases may sometimes be done via another company, with which the local partner has some association. In such circumstances the foreign partner, if his remuneration were governed by the ventures' profitability, may fear that unfair transfer prices were employed to his detriment.

(iv) Leather Sales: Similar fears of unfair transfer pricing may exist when one partner is marketing the product to companies with which he may have some open or hidden connection.

57. From the above it may be seen that in many areas it is difficult to contractually safeguard both parties, at all stages, in any co-operative agreement. This underlines the necessity of selecting a partner of high repute who can engender mutual trust, who has serious long-term objectives and is unlikely to be motivated by considerations of short-term profitability.

Performance guarantees

58. As mentioned earlier, it is often recognised that such guarantees have little effect in the leather sector.

(a) Machines under normal given circumstances can easily yield quoted specific outputs. However, such output and the quality of output is governed by the operator and the servicing and setting of the machine as well as the condition of the material being processed. The quality aspect can seldom be covered by performance guarantees due to the influence of the machine operator, and even the supplier of management/know-how could not guarantee continued quality of output by each machine without unduly high levels of supervisory staff, and control over production.

(b) Know-how/quality. It is questionable whether a serious supplier of know-how would be willing to unconditionally offer guarantees of the results of know-how supplied. It can be argued that there are too many elements which are beyond the control of the know-how supplier, such as, for example materials not arriving in time, labour absenteeism, electricity supply problems, etc. It would be difficult to specify all such circumstances. Generally speaking, the provider of know-how would probably be willing only to accept an obligation to make his best efforts to achieve a pre-specified performance.

Arbitration

59. Although many co-operative agreements include clauses for selection of arbitrator when reconciliation between parties is found impossible, this has only been sought as a last resort when mutual trust has collapsed. Some more recent co-operative agreements have nominated one or more arbitrators initially - known and accepted by both parties - and slightly more informal arbitration has been relied upon at an early stage of disputes, when reconciliation could be obtained without loss of mutual trust.

Turnkey Projects

60. In essence, a turnkey contract requires that an individual supplier takes full responsibility for preparation of site, erection of building, supply and installation of plant, machinery, equipment and services. The supplier ultimately hands over to the recipient, a tannery which is ready to commence production.

Checklist for Turnkey Projects

61. Preamble

Parties to the agreement
Definition of terms and expressions
Legal code applicable

62. Supply Offer

Package cost/currency/fluctuation/escalation
Production parameters and technological basis for plant
Location - selection and preparation of site
Design, specification and construction of buildings
Machinery specification, detail and layout
Infrastructure and services specification, detail and layout
Equipment specification
Origin
Time span/penalties/escape clauses/force majeure
Supply guarantees - specification of buildings plant, machinery and capacity
Payment guarantees
Consulting engineers

63. Implementation Assessment/Acceptance

Procedure for assessing conformity to supply offer
Bi-party, item by item, acceptance
Commissioning procedures, individual units, departments, complete tannery

64. Remuneration

Possible pattern is:

Percentage payment at signature of contract

Percentage payment at foundation laid

Percentage payment as buildings roofed

Percentage payment when 50 % plant and machinery shipped

Percentage payment when all plant and machinery shipped

Percentage payment when majority plant at site

Percentage payment when machinery, plant and equipment installed and commissioned

Final payment one year after plant commissioned

65. In some cases the number of payments may be reduced, to be effected at major points in the project's completion. Turnkey projects are often financed by long term supplier credits, but this does not invalidate the basic payment structure outlined above.

Comments on aspects relating to turnkey projects

Basic concept

66. The major advantage of a turnkey project is that the supplier undertakes to co-ordinate all the inputs necessary to erect and outfit a tannery ready to the stage when it is ready to commence production. Thus, the recipient does not have to liaise with a variety of suppliers of equipment and services and conflicts between various subcontractors are removed from his shoulders. In short, the responsibility of managing the construction of the plant, and of its commissioning is removed from the shoulders of the recipient of the equipment.

Suitability

67. Where domestic entrepreneurial and technical skills are available, the potential entrepreneur may draw his own outline project plan (or have it prepared by specialists). Then he may seek competitive quotes for the basic turnkey installation of the tannery. When construction is complete the entrepreneur takes over and operates the plant.

68. In situations where entrepreneurial and technical skills are not fully available, problems may be encountered in the following areas:

(a) If the recipient is not familiar with the industry he may not be able to prepare the initial project outline plan. He may avail himself of independent assistance in this task or he may ask the potential supplier, it may be influenced by the supplier's desire to maximize plant and machinery sales. Thus, again the need for independent project analysis should be apparent.

(b) In the absence of entrepreneurial and technical skills, it would be essential to also have complementary co-operation contracts covering the areas of

- training,
- know-how,
- management,
- marketing.

69. Such complementary contracts must be associated with the original turnkey contract to ensure that the production capacity guaranteed within the turnkey contract is reflected ultimately in the marketing contract.

70. The majority of potential suppliers of turnkey assistance will readily undertake training responsibility and are usually prepared to arrange know-how and technical assistance often for one year with a full expatriate team being progressively phased out over a 3-5 year period as national operatives are trained.

71. In some areas, where existing skills are minimal, such period has not always proved sufficient, and the recipient must be assured that he has the power to control the phasing out of technical control.

72. Generally "turnkey" suppliers have not been willing to directly link the turnkey operation with a complete and binding marketing contract, which ensures viability of the overall project. There may be willingness to market 100 % of production (often employing an associate company) but this has not yet been linked with a guaranteed economically viable sales price structure.

"Reverse" Marketing Arrangement

73. A "reverse" marketing agreement could emerge from a situation that the developing country partner would buy equity in a foreign marketing enterprise in order to establish a long-term basis for marketing (as opposed to selling) the output his production unit in one or more export markets.

Checklist for the "Reverse" Marketing Agreement

74. Preamble

Description of partners

Qualifications of each partners

Structure of joint ownership in the marketing enterprise

75. Marketing Enterprises' Obligations

Assessment of volume of business that could be transacted

Specification of types of leather to be marketed

Provision of market intelligence and sales prospects to developing country enterprise

Provision of pricing information and prospects

Provision of sales contacts and best efforts to achieve target sales volumes

Provision of related marketing services, as necessary, advertising sales promotion, etc.

76. Producing Enterprises' Obligations

Provision of necessary samples of output, in conformity with market intelligence

Guarantees of volume/price and quality of output

77. Decision Making

Should be dependent on equity structure and operating relationship between the marketing and producing enterprises

78. Remuneration

Agree on prorata basis of equity held by the two partners in the enterprise

Comments on aspects of "reverse" marketing arrangements

79. The concept of a developing country enterprise acquiring shares in a foreign marketing company, to operate within an export market area, should prima facie remove the apprehensions of the developing country partner, since by such a mechanism, the production unit should be able to ensure that maximum sales values are achieved, with profits from the joint marketing operation being equitably shared between the marketing organization and the production unit.

80. However, on analysis, it may be seen that "reverse" marketing arrangements may be suitable in only limited situations and do not automatically overcome some major problems.

81. It is pertinent to reflect on what the basic objectives of the "reverse" marketing arrangement company, which could be:

(i) A marketing service which is provided at agreed terms, i.e. it markets the output of the tannery on a cost plus basis, or on the basis of a commission. In such a case, what is the potential advantage of the "reverse" marketing arrangement over a simple agency arrangement, and are the advantages sufficient to justify the foreign currency expenditures by the equity participants?

(ii) A trading operation. In such circumstances control of transfer price and ultimate profitability of the marketing company vis-à-vis the tannery becomes crucial.

82. A "reverse" marketing arrangement could be a mutually satisfactory arrangement if it is associated with projects of a joint venture nature, where the partners have similar shares in each arm of the operation, i.e. production and marketing. In such circumstances the total profit of the whole operation could be equitably distributed, proportionate to the equity holding of either parties in the whole enterprise.

83. A "reverse" marketing arrangement could also be mutually beneficial, if associated with a production unit covered by management contract which has inbuilt performance guarantees reinforced by incentive payment schemes.

84. A "reverse" marketing arrangement which is associated with a joint venture project, or projects covered by a management contract, the advantage to the developing country equity holder would be that he would have access to market contacts and intelligence, and could ultimately take complete control of

marketing. However, the cost of such exercise may be prohibitive, to all but the largest developing country enterprises.

85. In the event that a "reverse" marketing arrangement is established as the mechanism to sell the output of a tannery, independently of any other co-operative agreements, one major area of contention could arise if the "reverse" marketing arrangement established a trading operation as opposed to acting only as a commissioned agent. In the case of a trading operation, the transfer price would become the key issue. The pricing of output would be dominated by the objectives of whichever partner is controlling the "reverse" marketing arrangement. The developed country partner, if in control, would wish to establish a low transfer price in order to maximize the profit in the territory of the export market. The developing country partner, if in control, should attempt to obtain a high transfer price, in order to maximize domestic profits and returns for this domestic economy. This would result in a concomitant low return for the foreign partner's marketing expertise, and provide him with a poor incentive in the marketing arrangement.

86. It may be possible to reconcile these two positions, by relating the profit levels achievable in the marketing operation, to the profit achieved in the tannery, but it is unlikely that any serious developed country partner, with no control over the operational efficiency of the tanning unit, would accept such a constraint.

87. Possibly the greatest hindrance would come from within the developing countries themselves where in most instances treasury officials may:

(i) Question the need for foreign currency to be invested in a marketing operation;

(ii) Question the basic concept of the "reverse" marketing arrangement which by its very nature would allow manipulation of transfer prices and would open wide breaches in normal foreign exchange control procedures.

International Leasing

88. The previous forms of agreement cover the conventional forms of international collaboration which have been used in the Leather and Leather Products Industry. There are three specific problems encountered in the sector which pose obstacles to the development of international co-operation along these conventional forms:

- (i) The adverse terms of commercial financing experienced in recent years have made it very unattractive for the industry to rely on this source for maintaining or expanding its operations;
- (ii) The internal cash flow from most tanning units in both developed and developing countries is too small to provide an adequate accumulation of funds for investment in international collaboration ventures;
- (iii) Even if a developed country firm is able to summon the financial resources, the risks posed by investment in overseas ventures in developing countries is an inhibiting factor for long-term investments.

89. The effects of these factors may be alleviated by the utilization of the mechanism of international leasing. This concept is already employed in the hotel industry, for example, and it could be possible to explore its extension to other industrial sectors. The underlying concept of international leasing is that the developing country undertakes the risk investment in plant, equipment and machinery, and leases the enterprise to a foreign partner to manage and operate the facility, for a specified period of time. This is particularly contemplatable when the developing country partner is a public sector enterprise, which can use its government's credentials to obtain risk capital from multilateral sources, at less than commercial terms. Under this arrangements the following benefits seen apparent:

90. From the developed country partner's point of view, the assumption of risk capital investment by the developing country alleviates the threat of exposure to nationalization of his investment, and requires him to provide only the working capital for the unit, which could be derived from its internal cash flow. From the developing country's point of view, the benefit from such an investment could be in obtaining technology without the well recognised limitations of having it packaged with direct foreign investments. In addition, from the financial point of view, the lessee's payments to the developing country would ensure a flow of a steady stream of returns on investment which would be somewhat predictable, and insulated from the effects of fluctuations in trading conditions. Finally, it may be likely that the tendency to over-specification of plant may be checked, in the case

that the lessor's payments to the developing country are established in relation to the value of the plant and equipment installed.

Checklist for a Leasing Agreement

91. Preamble

Parties to the agreement

- developing country enterprise
- developed country enterprise
- financing body

Status and qualification of each party

Contributions of each party to the agreement

Duration and territorial delineation of agreement

92. Obligations of local partner (lessor)

Procurement of risk capital investment

Procurement of machinery and equipment

Erection and installation of plant, machinery and equipment

93. Obligations of foreign partner (lessee)

Advisory on technology to be employed, plant layout and specification of machinery and equipment, during the construction phase

Management of plant with reflect to technical and marketing functions (see the Management Contract, above for detailed scope)

94. Remuneration

Payment of fee by the lessor, to the lessee, on one of the following bases:

- Periodic fee, established prorata to the capital invested in the fixed assets of the project;
- Periodic fee plus a percentage of operating profits of the enterprise
- Periodic fee plus a fixed amount per unit of leather produced

95. Conditions of Termination/Renewal

96. Arbitration

Comments on leasing agreements

Objectives

97. The objectives of the developing country could be to find a satisfactory way of establishing tanneries and leather product units by motivating internationally renowned tanners and leather product enterprises to co-operate in the development of this sector.

98. The motivation of the foreign partner would lie in the exploitation of a viable built up infrastructure without investing risk capital in the developing country.

99. The steps that should be followed are as under:

- (a) Identification of the developing country;
- (b) Assessment of availability of raw hides and skins;
- (c) Assessment of the need to upgrade the production and collection of raw hides and skins;
- (d) Economic viability and feasibility study based on available raw material of the type of tanning unit to be established e.g. a tannery solely to produce bovine hides or skins a universal tannery to produce a mixture of both;
- (e) The viability studies should be conducted by expert consultants. The consultancy could best be provided by identified potential partners who may be interested in the leasing operation itself and who are already established in international markets. In their own interest they would not over specify the plant and machinery, since they would be keeping the investment figure low and would gain by paying a lower value for the lease. Monitoring by third partners could be a suitable safeguard;
- (f) On the basis of the feasibility study, the Government of the developing country should approach international development banks or any other international financial institutions for establishing a mechanized unit as specified by the consultants;
- (g) Conclusion of construction and implementation of the lease agreement.

Conclusions

100. It must be stressed that the concept of a leasing agreement has been proposed in order to meet a specific set of obstacles posed in the international flow of risk capital. The lease contract is contemplated as a management contract, with the critical financial implication that the developing country assumes the risk capital investment and the developed country partner assumes management control in the return for the payment of a fee to the developing for this right. Unlike a conventional management contract, the developed country partner is harnessed to the project by ensuring its commercial profitability, since any net operating

returns after paying his lease obligations accrue to him as profits. Upon termination of the lease agreement, the developed country partner should be permitted the option to invest in the plant's equity or to withdraw/renew the agreement, depending on the two parties' assessment of their collaborative experience.

