Proposal for a Joint Venture between a Multinational Company and a Local Tobacco Factory in an Economy in Transition

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ABSTRACT

This case uses an actual investment proposal brought to an EDI seminar on private sector development in transition economies. The case highlights some of the main decisions that should be made among the key parties to such an arrangement: the government, the local tobacco company management, and the management of the multinational company. In order to facilitate the use of the case, two teacher's notes have been prepared.

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PROPOSAL FOR A JOINT VENTURE BETWEEN A MULTINATIONAL COMPANY AND A LOCAL TOBACCO FACTORY IN AN ECONOMY IN TRANSITION

Introduction

Peter was glad that he was selected to participate in the second module of the EDI seven-part training program on Enterprise Management for Restructuring and Privatization. The selection was exacting, but his hard work before and during the first module paid off. From 64 participants in the first module, only 30 were selected to continue the program. During the month-long program, he did not get much sleep, but he learned a lot. Accounting and corporate finance became his favorite topics. The only problem he had to resolve immediately was how to prepare a business plan with his colleagues from the training program, which was a requirement for participation in the second module. One of his colleagues was an enterprise manager who was very interested in developing a business plan for his company.

Peter went to his boss to ask for flexible working hours while he worked on the business plan. “Out of the question,” was the short answer of his boss. “You have already spent too much time this month on your training — in total, over two weeks. We have work to do here. The representatives of the Multinational Company are coming in three months to discuss their proposal for a joint venture with the local tobacco company. The formal proposal was received yesterday, and we have to work on it.”

Peter was deeply disappointed, but he was not in a position to argue. Only recently, immediately after graduation, had he joined the Ministry of External Economic Relations. He was a member of the group for foreign investment. Although his country had abolished the central planning system and had gone through democratic elections several years ago, not many foreign investors expressed significant interest in his country. A number of small and not very promising investors had spoken to the Ministry, but no substantial agreements had been signed. Peter thought that maybe one of the reasons for this lack of interest was that privatization was being implemented slowly. He thought another reason might be that most of the enterprise managers were not capable of preparing feasible business plans. Their lack of enterprise management skills in an emerging market has been very evident.

This void motivated Peter to apply for the EDI training program. At first his boss had serious reservations about the idea. “You work in a ministry, not in an enterprise. You don’t need that type of training.” Peter managed to convince him that this type of knowledge is extremely relevant for them. “How can we be involved in policy decisions and implementation if we don’t understand what managing an enterprise in a market economy is about?” was his main argument.

Now he was in the training program, but he was not sure whether he would be allowed to continue, since he had no opportunity to work on a business plan. The fact that the second module would not take place for another three months made him feel more comfortable. He knew that he would find a way. For now, he was supposed to focus on the proposal of the Multinational Company. Everyone in the Ministry was excited about the proposal. Finally, it had something that easily could be the turning point for foreign investment in the country. Suddenly it occurred to Peter that this proposal could serve as a basis for preparing the requisite business plan. He immediately took a copy of the proposal and started to study it very carefully.

Participation in the first module was very useful to him. He was able to review the financial part of the proposal without difficulty, or so it seemed to him. His only regret was that, because of his attendance at the second module of the training program, he might miss the opportunity to participate in historical negotiations with the Multinational Company. “But will there be any substantial negotiations?” Peter asked himself. “The proposal looks so good, so beneficial for my country.”

With the proposal from Multinational Company in mind, he went to the second module of training on enterprise management. The first three weeks passed quickly. On average he slept no more than five hours per night. His studies were intensive. At the end of each day, he tried to apply the knowledge he had acquired that day to an analysis of the proposal. After three weeks, he had some doubts about the proposal’s validity. He knew that representatives of Multinational Company had already arrived in his country. Should he send a fax to his boss and share some of his doubts about the proposal?

Multinational Company Investment Proposal for a Local Tobacco Factory

Overall Approach

Internationally known Multinational Company (MC) is interested in jointly collaborating with Local Tobacco Factory (LTF), which is situated in a country whose economy is in transition. This is to be the first MC investment project in this country. MC and its sister company are committed to developing diverse businesses in this region and are interested in other potential projects.

The government of the country is interested in proceeding rapidly with the privatization of selected industries and in encouraging an influx of foreign, private sector capital investment to help revitalize the country's economy.

In order to guarantee the long-term success of LTF and to enable it to compete with imported products, it should develop the capability to produce international quality cigarettes as well as traditional products. Growth in and development of the existing business of LTF will benefit the country, the factory's region, and the employees and management of LTF through larger revenues to the government, substitution of local products for imports, enhanced prosperity for the community and LTF personnel, transfer of technical and management expertise to the country's agro-processing industries, and an increased supply of cigarettes for domestic consumption and export.

MC proposes to link its major investment program for LTF with the simultaneous privatization of LTF, thus creating a model for similar privatization programs in the country. This approach can be negotiated and implemented rapidly. This program is expected to act as a magnet that will attract other international investors to the country.

This investment proposal is preliminary and is intended to assist in discussions and negotiations. This proposal is supported by the management of LTF; it is based on guidance from specialist advisors to the government and industry of the country and on MC's extensive worldwide experience in the cigarette and agricultural industries.

MC has approached LTF for several reasons:

- The country provides a stable political environment that seems to promise a smooth transition to a market economy.
- Current MC manufacturing facilities in Europe and the former Soviet Union are close to full capacity, and MC needs additional capacity in the region.
- The LTF management team has the skills, qualities, and strengths with which MC can work successfully as partners.

- LTF is one of the few manufacturing enterprises in the economies in transition with a strong enough potential for modernization to meet MC's standards for international quality products.
- Regional government officials have been extremely receptive and supportive of MC-LTF project discussions.

Cooperation with MC will provide tremendous advantages to LTF upon its integration into the MC network of affiliated businesses. As a large worldwide tobacco company, MC can provide LTF with significant advantages in acquiring quality tobacco and materials at low cost, technical assistance in processing and production, and strength in product development, management, marketing, and distribution.

Benefits of the Investment Program

MC proposes to bring these key benefits to LTF, the region, and the country:

- Rapid negotiation and implementation of a visible and substantial investment project will attract other foreign investments to the country.
- Excise and income taxes and greater economic activity caused by MC's presence and investments in LTF and the regional community will increase contributions to the state budget.
- Imports of cigarettes and tobacco will be reduced through LTF's increased production capacity and quality and an estimated reduction of tobacco waste equal to at least 10 percent of the total tobacco throughput.
- Employment levels will substantially increase because of increased production capacity.
- Cigarette production output will nearly double, over 27 billion units, by the third year of the project.
- Development of a Tobacco Agronomy Program will increase agricultural productivity in the country.
- Improved processing and packaging technologies will be introduced and transferred to the agro-processing industries of the country.
- Financial reliance of LTF on state assistance for imported materials will be reduced as MC's network takes on this responsibility.
- An influx of Western management and technical training will enhance the quality of the regional work force and will set an example for regional industry.
- MC will sponsor community education programs.

Benefits of MC as Partner

MC is a world leader in the manufacture and marketing of consumer packaged goods and is one of the largest consumer companies in the world, producing several famous cigarette brands. These brands are enjoyed all over the world and have a growing consumption in the country.

MC is the strongest possible ally for LTF and will enable it to face the challenges of the restructured regional tobacco industry successfully. In the last several years MC has established a range of joint ventures in some countries in transition. MC proposes to use this experience to lead LTF into the 21st century as a consumer-oriented company producing unsurpassed quality products at affordable prices.

- *Wealth creation* — MC's strengths as outlined earlier will ensure the development and future profitability of LTF in an extremely competitive environment. Through the combined efforts of planned activities in and around LTF the employees of LTF can be assured of maximum professional development and premium compensation. The local economy will benefit as LTF expands its business activity and investment.
- *MC's commitment to the community* — MC has a reputation as a model corporate citizen in the communities around the world in which it has activities and understands the value of contributing to community educational and cultural organizations. Traditionally MC presents a gift of welcome to the community in which new ventures are established. MC would like to contribute to the development of young civic and business leaders in the country and will work with local authorities to find an appropriate venue for this work.
- *Emerging market economies* — MC already has several investments in countries with economies in transition.
- *Commitment to compete globally* — MC is active in more than 150 countries and competes successfully with other international cigarette companies.
- *Commitment to local management and employees* — MC recognizes the talent and quality of the existing LTF management and employees and will provide additional resources to enable the organization to grow significantly in the future. MC will maintain and work with local management and employees to achieve the strategic objectives set out in its business plan, an approach that is unique to MC and that is implemented in all of its operations worldwide. For instance, in the first joint venture (JV) in a country with an economy in transition, MC increased employment by over 25 percent in the first year of partnership operations.
- *Strong worldwide brand portfolio* — MC has several international brands that have substantial market share in many countries around the world, including those with economies in transition. A selection of MC's brands are planned for production at LTF by the second year of the project.
- *Experience in diverse markets* — With its global presence, MC has experience in working with diverse cultures and markets. MC's operations in each of these countries are staffed and managed with local personnel.

Each site is supported by a tight network of MC international business and management contacts.

- *Technology leader* — With its significant R&D operations and facilities, as well as its substantial investment in financial and human resources, MC is one of the world leaders in all areas of tobacco technology.

MC is the best international partner for LTF. MC is large enough to have achieved global market penetration, an unmatched level of technological expertise, and extensive experience in diverse markets, but not so extensive as to maintain LTF's identity in its own country by generating most of its products specifically for the country's market.

LTF and MC need each other. The joint venture will provide LTF with expertise, international products, and investment capital to meet the challenges of the new environment and will give MC additional manufacturing capacity to provide products for its growing markets.

Other Potential Benefits

The geographical positioning of the country and the city in which LTF is situated, as well as the vast markets of the economies in transition and the stability of the country with its highly educated work force, make the region highly attractive to commercial development. Following the start-up of the MC-LTF project, several related investment and development projects have been identified in which MC would be interested:

- Development of modern business hotel accommodations at an existing hotel in the city in which LTF is located;
- Development of a secure bonded warehouse facility in the city for storage and distribution of imported products and materials for the country and neighboring markets; and
- Investigation of potential development projects in sectors related to MC activities such as the production of packaging materials used in the consumer goods industry and the processing of materials used in the packaged foods industry. Some projects could be developed in the area of food production.

Joint Venture Investment Proposal

Introduction

LTF and MC propose to establish a tobacco joint venture (JV) in the country with an economy in transition with the principal objective of expanding LTF's existing cigarette manufacturing business. The proposal calls for the simultaneous privatization of LTF with the JV and petitions the government of the country to pursue this project rapidly as a precedent-setting case for the privatization of the country's industries.

In order to modernize LTF's production facilities to increase output and improve operating efficiencies, a major capital investment program is required. LTF has no ability to fund such an undertaking because of the high commercial risk created by the transformation of the country's economy.

MC is both capable and willing to invest in the redevelopment of LTF's facilities but requires a degree of management control and a reasonable financial return from the profits of the enterprise. MC believes its expertise in the tobacco industry worldwide will provide some degree of assurance that it can generate a financial return sufficient to cover the cost of the investment.

The financial projection shown later in the financial forecast has been developed on the basis of an optimistic business outlook and assumes a rapid solution to the problems inherent in the country's economy today. As these problems are very real and serious, it is possible that these financial returns will be somewhat diminished. For this reason, MC believes that the proposed management control and sharing of profits is favorable for LTF and the country.

The JV contemplates full operations on a local currency basis with a major portion of annual profits to be re-invested in the business during the initial years to build a strong working capital base, necessary to enhance profitable operations and growth.

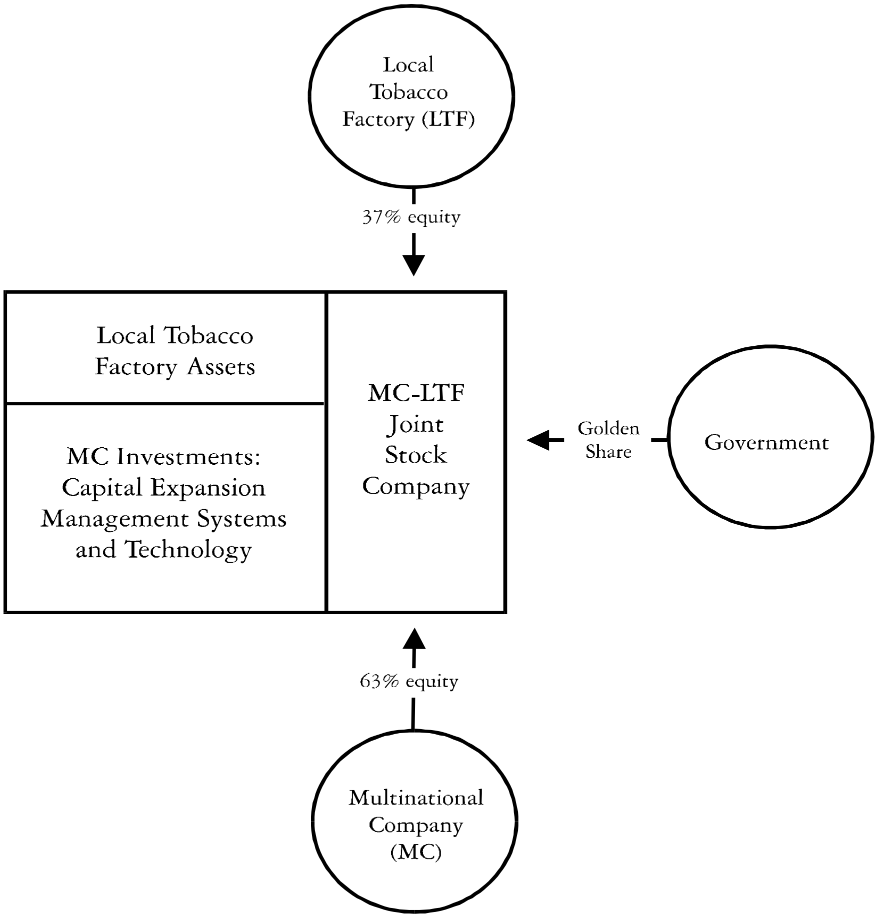
Investment Philosophy

There are two possibilities: to have a pilot privatization or a traditional joint venture.

Pilot Privatization Option

The project postulates the formation of a JV by LTF and MC with the immediate privatization of the state-owned assets of LTF. This approach is preferred by both MC and LTF management and has considerable benefit for the government of the country in creating a model investment and privatization project to serve as a magnet for further investment and privatization in the country (see Diagram 1).

DIAGRAM 1 — PILOT PRIVATIZATION OPTION



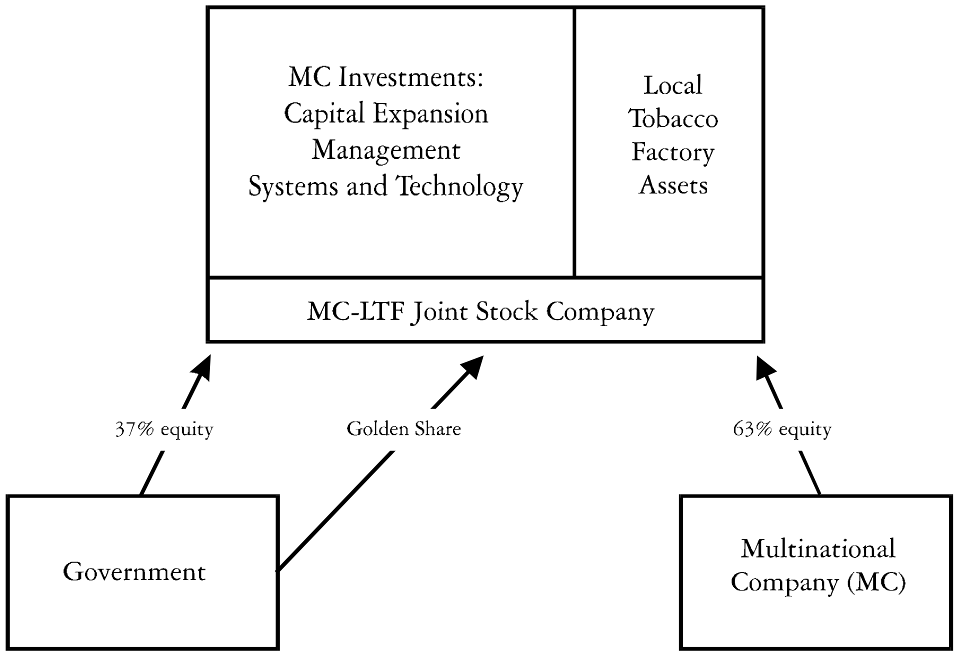
JOINT STOCK COMPANY. The JV will be implemented through a newly created, closed joint stock company (MC-LTF JSC); 37 percent of the stock will be held by the management and workers collective of the state-owned LTF, and 63 percent will be held by MC.

GOLDEN SHARE. In order to assure the government of the country that commercial management of the JV does not conflict with the general interests of the state, a golden share of the JV can be held by the government with certain negotiated controls.

Traditional Joint Venture Option

If this pilot privatization option is consistent with government policy regarding LTF and the tobacco industry, MC would agree to a more traditional joint venture option where the government would maintain a stronger active interest in the business. The project concept would be similar to that discussed in the following sections, except that the government's golden share would include 37 percent of the joint stock company created by the JV, as in Diagram 2.

DIAGRAM 2 — JOINT VENTURE OPTION



Paid-in Capital

MC shall make the following contributions, which will constitute paid-in capital for its 63 percent equity stake of the MC-LTF JSC:

- Additional production equipment to improve and expand LTF's current cigarette manufacturing capacity
- Capital for upgrading or replacing designated tobacco primary processing equipment
- Filter-making equipment
- Spare parts
- Cigarette manufacturing materials
- Working capital support
- Improvements in factory buildings and necessary ancillary equipment (generators, boilers, etc.)
- Technical expertise
- Marketing and management know-how
- Specific industrial property rights
- Training programs for specific manufacturing and administrative personnel

LTF will make the following contributions, which will constitute paid-in capital for its 37 percent equity stake in the MC-LTF JSC:

- Present production, administration, and warehousing facilities
- Machinery, equipment, inventories, and stocks
- Land-use rights
- Inventories and stock
- Work force
- Any and all other assets under the control and use of the factory (such as kindergartens, clubs houses, dachas, and employee apartments)

Management Structure

MC-LTF JSC will be managed by a five-member Board of Directors. The Board of Directors will be appointed by the shareholders, with the country partners appointing two members and MC appointing three members.

MC envisions temporarily assigning expatriate managers to work with local managers, particularly in finance, marketing and sales, and production management. These expatriate managers will be expected to train local managers in Western (MC) management skills and systems within the first few years following start-up so that expatriate managers will no longer be required (see Management and Employee Programs).

Preliminary Assessment of Investments

The total volume of MC investments will be made during four years and is equal to US$88.8 million. For detailed information about MC's projected investments in the MC-LTF JSC, see Exhibit 1.

Project and Investment Implementation Schedule

The implementation schedule for MC-LTF JSC covers four phases (see Table 1: Investment Implementation):

Phase I.

Finalization and signature of agreements and the charter (January-February of the project's first year)

- Agreement and signature of investment program TEO
- Negotiations of founding agreement and JSC, including charter fund contribution annex and other annexes
- Signature of foundation agreement and JSC charter conditional on: (a) board approval and (b) approval by the government of the country

Phase II

Registration of JV and MC-LTF JSC (March)

- Founding meeting and election of Board of Directors
- Registration of JSC
- Contribution to paid-in capital in accordance with the founding agreement

Phase III

- Conversion of LTF from a state enterprise to a private enterprise owned by the newly formed JSC (April-May)
- Conversion of LTF into a private enterprise via the pilot privatization

Phase IV

MC-LTF start-up and development program implementation (April-May)

- MC-LTF start-up
- Immediate active program to provide critical raw materials and spare parts
- Refinement and implementation of production strategy
- Implementation of equipment refurbishment and investment program

TABLE 1: INVESTMENT IMPLEMENTATION[1]:

	Year 1	Year 2	Year 3	Year 4
Building Improvements	I, II, III, IV	II, III		
General, Computers, Utilities	II, III, IV	I, II, III	I, II, III, IV	
Primary Processing	III, IV	I, II		
Spare Parts	II, III	I, II		
Making and Packing Overhaul	III, IV	I, II, III		
Add Making and Packing Lines	III, IV	I, II, III		
Equipment Replacement Program		III, IV	III, IV	III, IV
Filter-Makers Addition	III			

(I-IV indicate year quarters)

Production Volume Forecast

[1] The above timing is indicative of MC's planned expansion of LTF. This timing depends on the equipment suppliers' ability to provide and deliver equipment within the target deadlines. It is anticipated that minor deviations could occur to this schedule on a year-to-year basis.

Full production capacity, including the installation of additional lines of 27.1 billion units, will be reached by Year 3. See Exhibit 8.

Financial Results Forecast

See Exhibit 7.

Local Partner Development Program

Local partner development program consists of several elements, discussed below.

General Strategy for Development

The overall strategy of the development program has the following major objectives:

Manufacturing Operations

- To improve the technical capability of LTF quickly
- To upgrade the LTF manufacturing plant so that it can produce superior quality local cigarettes with vastly improved efficiencies of production
- To more than double the current production capacity of the factory and develop the capability of producing international quality cigarettes over the next two to three years

Tobacco and Material Supply

- To implement barter trading operations quickly to assure the supply of all required raw materials at levels to assure the production of consistent, high-quality products
- To integrate the MC-LTF supply system into MC's regional supply network to take advantage of the volume buying power of MC in purchasing high-quality materials at the best possible prices
- To work with the country's suppliers of materials, if required, to improve the quality and efficiency of their operations, thus minimizing the need to import materials

Management and Employee Development

- To install computerized financial, accounting, and production management systems and train the appropriate personnel in their use so that senior management has access to management information required for the fast changing commercial environment
- To implement training in and systems of modern material management and production flow for efficient operations
- To implement a revised compensation program to reward the most productive workers and motivate the entire work force

Marketing, Sales, and Distribution

- To refine a business strategy focusing on current production brands with long-term potential for growth in the region
- To implement quality improvement initiatives for gradually improving the product line in terms of taste, smoking characteristics, and brand image
- To implement a sales and distribution system capable of assuring that MC-LTF products are delivered to all appropriate retail locations across the country as well as to neighboring export markets
- To develop a new international quality country's brand with international market potential.

Production of local brands will be expanded to the maximum levels attainable on existing equipment in order to meet the strong market demand for inexpensive papirossi and plain and filter cigarettes. Additional capacity and improved production will be achieved through the installation of modern high-efficiency plant equipment.

Manufacturing Operations

Manufacturing operations consists of several elements, discussed below.

Objectives and Programs

KEY OBJECTIVES. The key objectives of the new MC-LTF manufacturing operations will be:

- To maximize manufacture of traditional product lines (papirossi and oval non-filters) for the country's market and for export barter to finance imports of raw materials;
- To improve quality significantly and install additional throughput for tobacco primary processing to provide capacity for 27 billion units per annum on a two-shift basis and to allow for international blend production;
- To revitalize existing Western making and packing equipment; and

- To move aggressively to install additional high-speed modern make and pack capacity.

KEY PROGRAMS (YEAR 1 - YEAR 4). The key programs for the first four years of operations include:

- Installation of computerized financial, accounting, and production management systems and training of required personnel
- Immediate purchase and use of necessary spare parts to achieve planned production levels on all Western equipment lines
- Overhaul and refurbishment of all existing make and pack production lines
- Installation of additional modern high-speed filter cigarette make and pack equipment lines with an output of 9.4 billion units
- Gradual replacement of existing cigarette make and pack equipment as necessary
- Replacement of existing one-ton capacity tobacco primary processing lines with a new high-capacity unit to achieve higher output of high-quality cut tobacco filters and to produce international type tobacco blends
- Installation of additional cut filter silos
- Build up of spare parts inventory to ensure continuous operation of equipment
- Installation of modern filter makers with sufficient capacity for 10.8 billion units of filter cigarettes per annum

Primary Processing

EXISTING EQUIPMENT. The existing tobacco primary processing system will be improved considerably by:

- Installing an on-site steam plant with input water treatment;
- Refurbishing steam supply lines to and controls for existing vacuum chambers, conditioning drums, and re-drying cylinders; and
- Modifying equipment to incorporate tobacco by-products into cut-filter blends.

These improvements will be made on an urgent basis following the JV start-up in order to maximize the quality, filling-power, and throughput of the five existing 0.85 ton per hour primary lines.

ADDITIONAL CAPACITY. Additional primary processing capacity is required to fulfill the projected production volumes anticipated by Year 2 and to replace the existing capacity with higher efficiency modern processing. This high-capacity primary line will be installed in re-constructed space in the warehousing facility near the existing primary processing workshop. Additional cut-filter storage silos will be installed to provide maximum flexibility of manufacturing planning. The following activities will be undertaken:

- Reconstruction and site preparation of the new primary processing workshop
- Installation of a modern high-efficiency primary line with complete flow and process controls and international blend capability
- Installation of additional cut-filter storage silos

Cigarette Making and Packaging

The make and pack equipment is in moderate running condition; however, the old machinery for the unfiltered cigarettes continues to run at acceptable efficiency levels. Efficiency of the equipment producing filtered cigarettes (about 23 percent of total production) is low (around 62 percent), and an extensive overhaul and equipment refurbishment program is required to improve efficiency and product quality levels. The program will include:

- Overhaul of all existing equipment of Western origin used for the manufacture of filtered cigarettes
- Overhaul of existing Western-type packers
- Build-up of spare parts inventory to cover one year of full operations, and
- Implementation of a modern manufacturing planning and reporting system, which will allow plant operation at maximum possible efficiency.

Incremental Capacity. The existing production building has sufficient space for the planned additional make and pack lines. The additional lines will increase the capacity for filtered cigarettes by 9.4 billion units per year. Incremental capacity includes:

- Installation of cigarette makers and packers in international king-size configuration, and
- Installation of the first line, anticipated for the fourth quarter of Year 1 with 9.4 billion units of additional capacity available by mid-Year 3. The package configuration will depend on commercial factors.

Replacement Capacity. Gradual replacement of existing make and pack capacity will be implemented as market forces shift demand from traditional oval unfiltered cigarettes to filtered cigarettes. The investment budget allows for the replacement of about 3.6 billion units of making and packing capacity between Year 2 and Year 4.

Filter Making

In order to reduce the hard currency requirement for imported acetate tow filters, filter rod assembly equipment will be installed to meet the factories' demand for filters. For details of projected filter production, see Exhibit 10. The balance of required filters (Years 3-5) is anticipated for light cigarettes, requiring special filters to be supplied externally.

Quality Control

A modern quality-assurance laboratory and all necessary production floor quality control equipment will be installed. MC specialists will work with LTF management to develop and implement procedures, specifications, and tolerances for quality control of raw materials, production, and finished products. Furthermore, technical and management assistance will be provided to the local materials suppliers to assure improvements in quality material supply.

General Improvements

This includes site improvements and improvements in buildings and utilities.

SITE IMPROVEMENTS. In order to improve site utilization, the following steps will be taken:

- Redefine areas of greenery, access roads, parking, and material handling access (including loading and unloading facilities)
- Implement a complete site security system including fencing, electronic safety device, and admission procedures (check in/out of vehicles and personnel). This refers to both the factory site in town and the warehouse facilities in the outskirts.
- Completion of paved area
- Installation of a sheltered area for loading and unloading
- Completion of loading and unloading equipment, such as lift trucks and truck dock levers

BUILDINGS AND UTILITIES. The following areas will be upgraded:

- Flooring
- Windows and doors
- Furnishing
- New fire and security system

The urban steam supply will continue to be used to heat the buildings. To improve tobacco processing, a new on-site steam plant, including water treatment, will be installed to provide food and tobacco industry-quality steam.

In order to ensure the required power supply at any time, an on-site power generator will be installed. Furthermore, the total power consumption will be reduced through appropriate building and process energy management.

A functional overhaul of ventilation, air conditioning, and dust extraction equipment will be necessary, accompanied by the replacement of existing duct work where necessary.

It appears that vacuum chambers do not operate up to expectations because of insufficient vacuum capacity. The complete replacement of existing vacuum pumps is a contingency.

The existing compressors do not appear to have acceptable capabilities for the food and tobacco industry. The replacement of these units with new machinery may be necessary.

Tobacco and Material Supply

Tobacco and material supply elements are described below.

Tobacco Supply Strategy and Usage Requirements

The factory purchases its tobacco on a contract basis with deliveries being fulfilled effectively only for convertible currency payments or the equivalent in barter trade.

MC will work with LTF to procure tobacco from traditional suppliers as well as MC worldwide suppliers. All tobacco supplied can be procured through barter in exchange for the export of MC tobacco products and other exportable goods produced in the country.

MC has begun to cooperate with tobacco growers and fermentation plants in other countries with economies in transition to maximize the acquisition of tobacco from the traditional trading areas of these countries.

Exhibit 9 represents projected tobacco use by the JV.

Tobacco Agronomy Development

To reduce the need for importing tobacco and to assist in the economic development of the agricultural sector of the country, MC will work with the growers of tobacco and similar crops to develop the full potential of tobacco growing in the country.

MC will integrate agronomy programs operating in other regions to provide development assistance to farms in the country suited for commercial development of tobacco growing. In spite of climatic limitations on the commercial viability of tobacco agronomy due to the length of the growing season, certain tobacco species are adaptable to large volume production with the appropriate support.

Experimentation Farms. MC will develop pilot growing schemes to select and develop varieties of tobacco most suited for commercial development in the country. MC will work with the selected farm to develop proper planting, curing, and processing facilities to produce high-quality tobaccos for international blend cigarettes.

Pilot Program. MC will commit to establishing the first such development program within six months of the JV's start-up. This program will include the following features:

- Farm and acreage selection for initial pilot crops
- Seed bed preparation and selection of tobacco varieties
- Implementation of initial crop planting with advisory assistance to participating farmers and crop technicians
- Development of curing facilities as required for initial crops
- Continued training and assistance to expanded groups of farmers
- Expansion of the program with more farmers
- Ongoing assistance

Other Raw Materials

Cigarette paper, tipping, and wrapping materials are purchased when possible from domestic suppliers. Acetate filter rods are being procured from abroad.

MC will work with the country's suppliers to improve their capability of producing quality components and will obtain imported components through barter trade from other countries in economic transition.

Management and Employee Programs

MC will support the management of LTF through the participation of MC expatriate managers assigned to LTF, MC representation on the Board of Directors, and initially with an on-site integration team. The integration team will consist of a group of ten to fifteen highly qualified MC experts from all business areas and from all over the world. They include primary processing specialists, making and packing specialists, quality assurance specialists, inventory specialists, finance and management specialists, and computer and systems specialists. In this respect, experience accumulated while working in other economies in transition will be used.

Training and Development Programs

The JSC will be managed by a board comprising three MC nominees and two LTF (Workers' Collective) nominees. This board will nominate a general director who will oversee the management of MC-LTF operations. The principal priorities of the management team will be:

- Rapid implementation of an appropriate management structure capable of developing modern and efficient controls and procedures for accounting, production, material procurement, inventory control, and personnel management. This new structure will be supported by the appropriate automation and systems.
- Development of a broad-based training program calling for Western business training for administrative staff and quality training for machine operators and key production personnel.

These training programs will be conducted both on-site and at selected MC facilities worldwide. The overall objective of the management program is to strengthen the MC-LTF JSC qualitatively to ensure that it becomes a notable example of a successfully restructured market-oriented competitive organization serving as a model for both regional and national industry.

MANAGEMENT AND STAFF. Training will be given to staff as follows:

- **General Director** — Two months' training in business administration; one month of intensive English training per year for three years plus periodic ongoing training; MC internal management development program; other designated training programs
- **Management** — At MC facilities or elsewhere, training provided over the first three years of the JV; on-site training to finance staff and production staff
- **Sales and marketing staff** — Training for technical staff on an as-needed basis
- **Employees** — On-site training for production operators as required, as well as at selected MC facilities worldwide

Employee Compensation and Work Force Levels

MC will work with LTF management to review current salary levels. MC anticipates that salaries will be adjusted considerably within the first three months of the JV. MC-LTF intends to implement new systems of compensation including bonus payments and incentives to reward productivity.

Given the increased activity anticipated for LTF, the number of employees is expected to rise.

Social Facilities

MC has no current wish to dispose of any social assets belonging to LTF or to change traditional practices of LTF in providing social services that are consistent with similar former state enterprises in the region. As these traditions change with the economic situation, MC will assist in implementing sound realistic solutions that protect the interests of LTF and its productive employees.

Employee Safety

MC has extremely high standards for safety in its production facilities around the world. Primary safety concerns in a cigarette manufacturing operation are fire, industrial equipment accidents, and respiratory problems caused by dust levels. A safety audit will be conducted by an MC safety specialist to assure proper systems and operating procedures regarding fire and industrial accidents. The proposed investment plan includes improving the air conditioning and ventilation system for the production areas, which will lower the dust levels considerably.

Marketing, Sales and Distribution

Marketing, sales and distribution consist of the following elements:

Current Market Analysis

The market for cigarettes in the country of project implementation is estimated to be 21 billion to 22 billion units per year. The total projected output of LTF for Year 0 is estimated at 13.2 billion units.

The current cigarette deficit is estimated to be between 8 billion and 9 billion units. As a result, the JV's objective is to increase capacity. The planned product mix is presented in Exhibit 11.

As part of the domestic market demand for cigarettes is expected to continue to be met by imported products, a substantial portion of MC-LTF's production will be available for export to generate hard-currency financing for raw materials.

Product Quality and Strategy

All efforts will be made to ensure that the best quality products, produced within the cost limitations set by each product segment, can be commercialized successfully.

With the addition of improved tobacco processing equipment, the refurbishment of cigarette-making equipment, and improved operating and maintenance procedures, product quality and uniformity will be increased dramatically while product costs are reduced because of efficiencies gained in material usage. Better tobacco conditioning, flow control for feeding to tobacco cutters, and application of tobacco casings are expected to:

- Reduce tobacco usage and loss by over 10 percent of the total tobacco throughput, significantly reducing the current LTF estimated waste rate of at least 144 to 24 percent, and
- Assure quality products with fresh tobacco filler and with good burning and taste characteristics.

It is anticipated that the cigarette market will move gradually towards the quality level set by Western premium imported cigarettes as the average income increases for the country and the region.

LTF management, working with MC marketing and product development specialists, will refine the product strategy with the following objectives:

- Rationalization of the current production brands, focusing on those brands with identifiable long-term market potential
- Development, introduction, and marketing support for a new filtered cigarette brand with a strong country brand identity using high-quality consumer packaging and professionally proven brand imagery and advertising themes
- Introduction of international MC brands during the second year of the JV through imports.

MC will work with LTF management to determine the best approach to promoting local brands and introducing selected MC internationally renowned brands.

Initial efforts will focus on maximizing production of low-priced local brands in order to meet the demand of the local consumer market. MC will extend its brand development efforts in progress in other joint ventures in economies in transition (production of international blend products) to the LTF venture.

Production and development of filtered cigarette brands will increase during the three-year investment plan with the installation of the additional make and pack lines and appropriate filter equipment, which will increase the production capacity of filtered cigarettes to 13.9 billion units.

Distribution

Initial efforts for the development of MC-LTF distribution will focus on:

- Increased delivery to the state distribution network;
- Development of sales to emerging private distribution channels;
- Direct relationships with large commercial enterprises in the country and in other economies in transition;
- Participation in retail merchandising and sales, where feasible, with development and training of a LTF sales force, further expanding employment; and
- Distribution and sales offices will be opened in the capital and other key cities of the country. Liaison offices will be established in key export markets in the countries with economies in transition.

Marketing and Advertising

Marketing and advertising campaigns will be developed quickly for key local brands with registerable trademarks that can be defended under emerging trademark laws. This campaign will be concentrated initially on promoting the image of MC-LTF as a producer of high-quality affordable cigarettes with the additional promotion of specific local brands. Marketing and advertising will be promoted aggressively to build current brands with identifiable long-term potential.

Pro Forma Financials

The following financial projections have been developed for indicative purposes only, on the basis of approximate costs and prices anticipated for the first and second years, depending on domestic inflation and changes in currency exchange rates. The estimated profit generation is optimistic in the short term but considerable over the long term.

See Exhibits 1 through 7.

Proposal for a Joint Venture between a Multinational Company and a Local Tobacco Factory in an Economy in Transition

Teaching Notes
Case B

Djordjija Petkoski

Nemat Talaat Shafik

This case can be used for a standard classroom discussion or as a basis for a negotiation exercise. This document contains two teaching notes: *Teaching Note A* by Djordjija Petkoski guides the trainer through a traditional discussion of the issues raised in the case; *Teaching Note B* by Nemat Talaat Shafik guides the trainer through a negotiation exercise and a role playing exercise. Also included here is *Case B* which provides new information on the Tobacco Company (not included in the main case) for further discussion.

Regulatory Reform and Private Enterprise Division
Economic Development Institute
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CONTENTS

TEACHING NOTE I

Djordjija Petkoski

Summary

The case represents an investment proposal prepared by a big diversified multinational company (MC) and submitted to the government of one of the former socialist countries (the country). Multinational Company wants to collaborate jointly with a local tobacco factory (LTF) in the country.[1]

The investment proposal was prepared for the local government, as at the time the privatization program for the country was still being prepared and LTF was not privatized.

For MC, the investment proposal was intended to involve the company in cigarette production in the area and to initiate diverse business development in the region, based on the potential for other projects in agribusiness. MC was also trying to convince the government that this investment would support the country's privatization program and encourage an influx of private sector capital investments to help revitalize the country's economy.

The case begins with Peter's dilemma as to whether he should send a fax to his boss at the Ministry of External Economic Relations to share some of his doubts about the investment proposal made by MC.

After listing the benefits of the investment proposal to LTF and the country as well as MC, the proposal offers two options: privatization of LTF with a joint venture or a joint venture with the government, which will keep a portion of the MC-LTF shares. Giving a preference to the first option, the proposal then details (a) MC's paid-in capital of 63 percent equity share, (b) the joint venture's management structure, (c) preliminary assessment of the investment, (d) project and investment implementation schedule, (e) production volume forecast, and (f) the projected financial returns.

The proposal section, titled *Local Partner Development Program*, addresses several important issues, including (a) strategy of company development, (b) manufacturing operations, (c) tobacco and material supply, (d) management and employee programs, (e) marketing, sales, and distribution, and (f) several pro forma financials.

Although the proposal mentions that "the country provides a stable political environment which seems to promise a smooth transition to a market economy," it is not clear whether the country liberalized its investment regulations and proclaimed its openness to foreign direct

[1] In preparing the case study, all the names were changed and the information that could lead to identifying the multinational company and country was omitted. Furthermore, all the financial data were changed by the same factor. The original financial data was presented as a mixture of US dollars and local currency, making the comparison very difficult. Mr. Alexander Gurianov, a participant at one of the EDI training programs, prepared them in US dollars. No other substantial changes were made.

investment and the position of the citizens is regarding giving control of part of the economy to foreign investors.

The case ends with Peter's decision as to whether he should share some of his doubts about the investment proposal with his boss at the Ministry of External Economic Relations.

Teaching Assignment

Read *Proposal for a Joint Venture Between a Multinational Company and a Local Tobacco Factory in an Economy in Transition*.

Study Questions

1. How attractive is the joint venture proposal from the perspective of the (a) government, (b) LTF, and (c) MC?
2. Is the privatization scheme suggested in the investment proposal a good privatization pilot project, an example that will hasten privatization in the Country?
3. Review the pro forma financials. Are the assumptions and predictions reasonable?
4. What would you advise the Ministry of External Economic Relations to do?

Learning Objectives

The case can be used to highlight several related issues. It can be used to:

- Help students to better understand the complexity of foreign direct investment in economies in transition;
- Define the role of the foreign investor, local enterprises, and the government in this process;
- Enhance skills needed for establishing productive communication among interested parties;
- Assess the possible relationships among foreign investment, privatization, and restructuring;
- Establish a basis for a negotiation exercise (a separate teaching note was prepared for this purpose); and
- Show how critical macroeconomic and political variables can be in attracting foreign direct investment (FDI) .

This case has been used in different types of training programs and seminars: training of trainers, short-term seminars on business planning for enterprise and bank managers and government officials in economies in transition, and in Western business schools.

Teaching Plan

There are different ways to approach this case, depending on the number of class sessions and how much the instructor wants to emphasis certain aspects.

Introduction

One way to introduce the case is to set it in the broader context of FDI and its role in supporting the privatization and restructuring process in economies in transition. In this context, the discussion should first focus on the information that is available in the case about the Country and MC. One presentation of this information is given in Exhibits 1 and 2.

Attractiveness of the investment proposal

Then, the students could discuss the government's interest in attracting FDI. They could be easily guided to a list similar to the following. (For a more detailed list, see Exhibit 3.)

- Capital
- Technology
- Management skills
- Access to new markets
- Access to other capital markets
- New product development
- Empowerment
- Speeding up the privatization process
- More efficient restructuring
- Increased revenues for the government

The discussion could continue by identifying the interests of LTF and MC (see Exhibits 4 and 5). Possible answers to the question "Why does MC want to invest in the country?" include:

- Low acquisition costs
- Low wage cost
- Low input cost
- Access to growing economies in transition markets
- Opportunities for other investments

The first impression from the submitted investment proposal is that MC is offering something that any government in economic transition will accept:

- MC is ready to invest capital, technology, and bring new management practices.
- MC will retain the present level of employment and may increase the number of workers in the future. The benefits inherent in FDI will accrue to a larger segment of the society.

At this point someone can mention the political aspect of FDI, referring to the possibility that domestic groups might protest what they perceive as the "selling out" of their own country to foreigners. Obviously, MC is ready for an up-front public relations campaign to convince the community of the advantages of the joint venture. The instructor could ask a student to identify MC's commitment to the community.

The case contains some information regarding MC's intention to establish good public relations with the community:

- Contributing to educational and cultural organizations
- Welcoming gifts to the community
- Supporting the development of young civic and business leaders

If there is time, students may also be asked to identify other potential benefits of this particular joint venture, such as:

- New hotels
- Warehouse facilities (not only related to tobacco processing)
- Potential new projects in the production of packaging materials for the consumer goods industry

The case can also be used to consider the impact of macroeconomic policies from the perspective of an enterprise. It gives the students an example of how critical macroeconomic and political variables can be in attracting strategic investors.

At this point, the instructor can push students to discuss some general issues and concerns faced by foreign direct investors, although not explicitly mentioned in the case (see Exhibit 6).

- Macroeconomic stability
- Inflation
- Currency devaluation
- Taxation
- Profit and dividend repatriation
- Property rights (in particular, land ownership)
- Political stability
- Threat of nationalization/expropriation
- Worker compensation and participation

This can help students to better understand the dramatic changes underway in economies in transition.

The interesting point is that these issues are not directly addressed by the case, and therefore it is not clear whether they were completely resolved or clarified by MC's management before making the proposal.

Some students might argue that, in the case of economies in transition, these issues cannot be resolved to the extent that is customary in Western countries and that this is a part of the risk an investor must deal with in such economies.

In concluding this part of the discussion, the students usually point out that this is a good example of a foreign company buying an enterprise with obsolete equipment and no marketing skills and revitalizing it with capital, technology, and Western-style management. They might also claim that this joint venture will accelerate the privatization process and attract other foreign investors.

Students could discuss another controversial issue: whether the government should award preferential tax treatment to MC. If MC is given such treatment, does it follow that a similar policy will apply to other FDI? Would this policy put the local strategic investors in a disadvantageous position relative to foreign investors?

Another important issue to review is whether in addition to being relieved of taxes, MC is also trying to build a monopolistic position in the country. With the proposed investment project, MC expects to play a key role in the import of tobacco through its international network and to use barter trade agreements for export and import. With potential new investments in the production of food and other consumer goods, the question of competition and the implication of the country's anti-monopoly laws on these activities will require careful consideration.

Is the proposal a good pilot model for privatization?

This is a moment to focus more on the privatization process. Provocative questions on this subject include the following:

- Who are the main beneficiaries under the proposed privatization scheme?
- Are the management and employees getting their 37 percent of shares free of charge?
- Who were the owners of the assets before the privatization, and what are they getting out of it?
- Should other segments of the society benefit from the privatization and how?
- What is the rationale for introducing a golden share?
- What does *golden share* mean in this case?
- What are the advantages, if any, from creating a closed-type joint stock company?
- Is the closed-type joint stock company going to contribute to capital market development in the country?
- How important is it to start developing a capital market in parallel with privatization?
- Is this investment proposal going to be a magnet for further investment and privatization?
- Could it further broaden the complex issues of privatization in economies in transition?

First, students should specify the two options offered in the investment proposal: pilot privatization and traditional joint venture.

Pilot privatization:

- Immediate privatization of LTF
- LTF — 37 percent of the shares
- MC — 63 percent of the shares
- Government keeps *golden share*

Traditional joint venture:

- Government — 37 percent of the shares and *golden share*
- MC — 63 percent of the shares

Some of the most promising topics for discussion are how did MC assess the value of LTF, why it proposed ownership of 63 percent of the shares for itself and 37 percent for LTF, and what MC and LTF each are contributing to the joint venture. The instructor could summarize the discussion similar to Exhibit 7.

There will be considerable disagreement among the students about: (a) whether MC is contributing its 63 percent in cash or primarily in equipment, and (b) is the equipment new or old, shipped from some of the Western countries with decreasing demand for cigarettes?

The instructor can then push the analysis a bit further by asking the students how much this investment is worth to MC and how much MC should be willing to "pay" for it.

Although their immediate reaction could be that there is not enough information to value the company, the instructor could remind them that the cash flow projection could be used as a first step in assessing the value of LTF. In this context the instructor should remind the students that property rights is a subtly complex issue. For example, from the case, it is not clear what land-use rights means legally and how to value them in the context of LTF's contribution to the joint venture.

Although the case contains no information about the city in which LTF is located, it could be expected, on the basis of the traditional structure of a central planning economy, that the social assets of the enterprise represent an important part of the city's infrastructure. By owning 63 percent of the MC-LTF shares, MC could also have full control of these assets.

The critical issues of how to deal with social assets is left unresolved. Although in the investment proposal it is indicated that the social assets will stay with the JV for the time being, it is not clear how this important problem is going to be resolved in the future.

Review of the pro forma financials

In analyzing the pro forma financials in the case, students should be pushed to examine Exhibits 1 through 7 and Figures 1 through 3. The financial calculations submitted make an impression that economically the deal seems to make great sense. MC would gain a low-cost base for its continuing expansion in economies in transition, making LTF a logical target for the company's international expansion.

Even before a detailed analysis, some students might argue whether the amounts of NPV and IRR are enough to compensate for the risk associated with the investment. Immediately, two controversial issues could arise:

1. Why does MC use 5 percent for the cost of equity and then use 12 percent as a discount rate for calculating the NPV?
2. Why is the residual value of $102,129,000 after five years high enough (almost equal to the total investment, see case Exhibit 4) to make financial analysis look good?

Furthermore, looking at Figure 3, someone might also argue that: (a) all the projections are manipulated to show a large financial benefit for the government, the key player in the country; (b) it is not explicitly mentioned that the main revenues for the government come from sales taxes; and (c) MC is submitting an investment proposal on which MC is going to lose money for at least five years, the reason for which is unexplained. Other concerns might include the high cost of buildings and site improvement ($2,484,000), which most likely will be done by the local work force, and the high cost of training and technical assistance ($3,312,000) (see case Exhibit 1). Furthermore, training and development is not considered an expense in case Exhibits 1 and 2.

Depending on how much time instructors are ready to spend on these and similar topics, students can discuss a whole range of issues related to financial projections and the decision to accept the investment proposal or not.

Although not mentioned in the investment proposal, it is clear that MC assessed different macroeconomic variables (such as inflation, interest rates, exchange rates, tax rates and tax holidays, social insurance benefits, and so forth) that are highly uncertain and subject to political decisions. From the case exhibits, it is not clear how the MC team made these assumptions and how they were integrated into the financial calculations.

From the case exhibits with financial information, it is obvious that quantitatively it is difficult to derive hard answers. However, although the intention is not to run a complete set of numbers, it is useful to press students to discuss the possible assumptions underlying the proposal's calculations.

As there is no single correct estimate, the real focus should be on identifying those variables that are most important and how certain they can be. The students should discuss some of these "big" assumptions, such as interest and devaluation rate, cost of capital, and production and sale projections.

No analysis is made in the case to clarify the harm the fluctuation in exchange rates can have, i.e., local currency devaluation, on MC's dollar profits, nor the "cost" of inflation (including the possible loss incurred by holding devalued inventories and receivables).

In this context, students should discuss some of the following issues:

- Why is MC presenting only one version of the pro forma financials?
- Why is this version the optimistic one?
- Why is no rationale behind the selection of particular values for the critical variables presented?

Once again, students should be reminded that it is obvious that MC is making this investment decision under tremendous uncertainties. Not only are many critical issues unresolved, but it is also unclear whether the government has the power to resolve them. Students should be reminded that, although not explicitly mentioned in the case, probably different institutions and political entities are in charge of these issues and there could be serious coordination difficulties.

Decision to accept the investment proposal

At this point, the students should be asked to decide:

- Whether they will accept the investment proposal.
- What additional clarifications they need from MC in order to make a decision.

The discussion should in some way summarize the broader issues of investment in economies in transition as well as refer to the relevance of quantitative financial analysis. The instructor could take this opportunity to guide students to identify those elements in the investment proposal that require additional clarification. Exhibit 8 summarizes some of them.

It is clear that the most precise calculations should be based on different unknowns, such as the real potential for in-country sales and exports, imports of the same product, cost of raw materials, and labor costs. Furthermore, any estimate is subject to possible changes in foreign investment laws, repatriation laws, political shifts, laws related to the environment and public health, and so forth.

In any case, just based on a formal financial analysis, it would be very difficult to decide whether to accept the investment proposal. However, there is enough information for a deeper analysis and assessment of the substance of a number of assumptions made by MC, and MC should be asked to provide explanations about them. Then the decision should be made based on whether the fundamentals of the deal look sound. The fundamentals include things like whether MC will really bring new technology, sound managerial practices, and new products and materials, etc. to the country.[2]

[2] In this context, one possible concern might be that the R&D budget for the joint venture is equal to zero for the first five years. What is going to happen to the R&D facilities and personnel in LTF?

This does not mean that detailed financial calculations should be avoided. Using a structured financial analysis will help the decision-making process systematically, identifying the most important variables to be taken under consideration. The analysis could help identify how many variables are unknown and how many known variables are vulnerable to the threat of political shifts in the country. At the end of the discussion, the students should be asked to decide formally whether to accept the investment proposal.

The key is to give students a chance to defend their analyses and their assumptions. For example, if they insist that there are problems with the pro forma financials, the instructor should ask them what additional explanations they would require from MC. Similarly, if they argue that local currency devaluation will be a problem, they should explain why it will be a problem and why they think it is likely to be a problem in the country.

Board Plans

Exhibit 1. The Country — Why MC Would Like to Invest There

- Political stability
- Smooth transition to market economy
- Good geographical position — MC is already in that part of the world and needs additional production capacity
- Highly educated work force — LTF management team possess some relevant skills, qualities, and strengths
- Low wages
- LTF has potential for modernization
- Local government officials supportive to the joint venture

Exhibit 2. Multinational Company

- Active in more than 150 countries
- Joint ventures in several economies in transition
- Experienced working in diverse cultures and markets
- Relying on local personnel
- World leader in manufacturing and marketing of consumer packaged goods
- Technology leader
- Several famous cigarette brands

Exhibit 3. Benefits to the Country

- Access to capital
- Access to technology
- Management skills
- Access to markets

- Transfer of technical know-how
- Access to other capital markets — magnet to attract other international investors
- New product development
- Employment
- Speeding up privatization process — pilot model for privatization
- More effective restructuring — modernization of tobacco production
- Increased revenues for the government
- Import substitution
- Increased exports
- Increased agricultural production

Exhibit 4. LTF Interest

- Need for investment:
  - Capital
  - Know-how
  - Technology
  - Management skills
- Increased production, efficient production, and increased quality (reduction of tobacco waste)
- Increased employment (the first MC joint venture in one of the economies in transition resulted in a 25 percent increase in employment)
- Increased employee safety
- Benefits from MC's worldwide network
- Sourcing quality tobacco and other material at low cost
- Technical assistance in processing, production, development, management, marketing and distribution, and packaging

Exhibit 5. MC Interest

- First joint venture in the country
- Potential opportunities for other reinvestments
- Need to increase production capacity in that part of the world
- Access to growing economies in transition markets

- Low acquisition cost
- Low input cost

Exhibit 6. Broader Consensus Faced by FDI

- Macroeconomic stability:
  - Inflation
  - Currency devaluation
- Taxation

- Profit and dividends repatriation
- Property rights (in particular, land ownership)
- Political stability
- Threat of nationalization/expropriation
- Workers' compensation and participation

Exhibit 7. Paid-in Capital

1. MC contribution of 63 percent of equity:

- New technology
- Technical expertise
- Market and management know-how
- Training

2. LTF contribution of 37 percent of equity:

- Existing facilities
- Machinery, equipment, and inventories
- Land-use rights
- Work force

Exhibit 8. Elements that Require Additional Explanation

- Justify MC's optimistic assumption of the rapid solution of many problems inherent in the country's economy.
- Basis for equity distribution: 63 percent vs. 37 percent
- How was the value of LTF assets determined, including the leasing rights for land use?
- Were the social assets included in valuing LTF for land use?
- Will MC's investment be in cash or in old equipment from downsizing in other countries?

- What are the transfer prices between the joint venture and MC?
  - Equipment
  - Spare parts
  - Raw materials
- How much of the locally produced tobacco and other raw materials are going to be used?
- What is the future of the current R&D in LTF?
- What is the planned re-investment in the joint venture during its initial years?
- What are the implications of the golden share to the country and to MC?
- What is the possible impact of external factors on the implementation of the investment project?
- The marketing study does not address several key issues:
  - Pricing of products
  - Market segments
  - Possible reaction of competition
- What are the main implementation concerns?
- What is the future of LTF's social assets?
- Environmental concerns
- Impact of the possible changes in health regulations
- More details about the economic analysis of the investment project, including:
  - Impact on related industries in the country
  - Secondary investments (hotels, warehouses, etc.)
  - New jobs in the country
  - Impact on local tobacco growers
- Differences in the prices between imported cigarettes and those produced in the country. How will the exports from this new joint venture be coordinated with the exports from other joint ventures already owned by MC?
- The issue of competition, bearing in mind the proposed privileged position of the joint venture

Background Readings

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6. Parker, Nicholas. 1993. *Investing in Emerging Economies: A Business Guide to Official Development Assistance and Finance*. London: The Economist Intelligence Unit.

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TEACHING NOTE II: NEGOTIATION EXERCISE

Nemat Talaat Shafik

Summary

This case study is based on an investment proposal prepared by a big, diversified multinational company (MC) that was submitted to the government of one of the economies in transition. MC wants to establish a joint venture with a local tobacco factory (LTF) that is not privatized.

For MC, the investment proposal was considered a first step in establishing diverse businesses in the region, based primarily on potential future profits in agribusiness. MC was also trying to convince the government that this investment will support the country's privatization program and will serve as a model for similar privatization activities. MC believes the program will be a magnet for attracting other foreign investors, thus helping to revitalize the country's economy.

After listing the benefits of the investment proposal to LTF, the country, and MC, the case gives two options:

- Privatization combined with joint venture
- Joint venture with the government, which will keep the shares originally meant for LTF

Given MC's preference for the first option, the investment proposal then details: (a) MC's contribution of 63 percent of paid-in capital, (b) the management structure (including the board of directors), (c) a preliminary assessment of the investment, (d) the project and implementation schedule, (e) a production volume forecast, and (f) projected financial returns.

Learning Objectives

The case can be used to highlight several related issues and to help students gain a better understanding of:

- The complexity of foreign direct investment in economies in transition;
- The nature of negotiations among foreign investors, local enterprises, and the government and the skills needed to establish productive communication among interested parties;
- Possible interrelation among foreign investment, privatization, and restructuring in economies in transition; and
- The importance of macroeconomic and political variables to attracting foreign investment.

The case can be used for a standard classroom discussion and as a basis for a negotiation exercise. This teaching note provides guidelines on how the case can be used as a negotiation exercise. A separate teaching note was prepared to help the instructor organize classroom discussion.

Teaching Assignment

Read *Proposal for a Joint Venture Between a Multinational Company and a Local Tobacco Factory in an Economy in Transition.*

Teaching Plan

Each participant should be randomly assigned one of the following roles:

- Management of Local Tobacco Company
- Representative of Multinational Company
- Investment advisor to Multinational Company
- Union leader
- Government official

Participants will not know their assigned roles until the start of the class, so they will have to keep all possible perspectives in mind while reading the case. One member in the group should record the results of the negotiations. Although it is not necessary to close the deal, it is important to summarize the results of the negotiation. Bearing in mind the complex issues addressed by the case, it is to be expected that different groups will emphasize different issues. For this reason, after the negotiation is over, each group should present the result of its discussion to the rest of the class. This exchange of experiences can contribute considerably to the overall learning process.

Appendix I contains the overall negotiation instructions, which should be given to all participants together with the case. Optional special instructions for the government official, union leader, and company manager, provided in Appendix II, can be distributed to some groups to add further variety to the negotiation outcomes. To facilitate the comparison of the negotiation results, Appendix III provides the format in which groups should report the results of their negotiations.

APPENDIX I: NEGOTIATION INSTRUCTIONS

1. The attached proposal for the privatization of a tobacco company presented to a government by a multinational company should be read thoroughly before class. During the class, you will be meeting to review the proposal, make any modifications, and possibly — although not necessarily — come to an agreement.

2. You will be randomly assigned one of the following roles to play in negotiations:

    - The manager of the tobacco company
    - The representative of the potential multinational investor
    - An investment advisor to the multinational investor
    - The head of the trade union at the factory
    - The government official responsible for the privatization

    You will not know the role you will play until the start of the class, so you will have to keep all possible perspectives in mind while reading the case. You must adhere to the facts of the case, and you must act in the interests of the person you represent.

3. Someone in the group must record the results of the negotiations on the attached form. You do not have to make a deal, but whatever is agreed upon must be summarized and a copy submitted to the instructor. You may want to keep a copy for the group to support the class discussion.

Instructions for each participant (participants should only see their instructions, not those of other players):

Manager of Tobacco Company — The manager of the tobacco company has an effective management team that is keen on a divestiture if the team stands to gain from it. S/he has participated in discussions with representatives of the multinational company and is optimistic about the proposed expansion. However, s/he is also worried about being marginalized with the introduction of foreign managers.

Representative of Multinational Company — The multinational corporation considers this cooperation with LTC and the country as an important foothold in the economies in transition, especially since cigarette consumption in the West is declining while markets have high growth potential in transitional economies. Although there are other tobacco companies in neighboring countries that are possible candidates for privatization, their facilities are in worse shape and the local markets are less attractive. You have heard that governments in neighboring countries have not had success in selling their tobacco companies and may be getting desperate. On the other hand, the information you have is uncertain and you would have to devote time and resources to learning more about these alternative investments.

Investment Advisor — The investment advisor to the multinational is paid a variable fee that is in direct proportion to the sale price agreed on the transaction. There is no fixed fee. This is the first major transaction in this region and s/he anticipates considerable further business if this deal is successful.

Union Leader — The union leader was a member of the former communist party and was elected as head of the local union on an anti-privatization, nationalistic platform. S/he is an old style *apparatchik* who harbors considerable skepticism about the motives of foreign investors. S/he is also closely allied with local tobacco farmers, who are worried about their future incomes as a result of the privatization.

Government Official — The government has been criticized by opposition parties for being too eager to attract foreign investors and risking giving the country away. Local tobacco growers have also complained to the government that they will lose market share if the multinational company relies on foreign suppliers of tobacco. Farmers also fear that the price they will receive for tobacco will be lower. But the government official is under considerable pressure from his/her Minister to make this deal a “showcase” privatization. Further pressure is coming from the Minister of Finance to obtain a high price from the sale to raise revenues that will shore up his budget deficit. The government official should chair the meeting.

APPENDIX II: OPTIONAL SPECIAL INSTRUCTIONS

(To be selectively distributed to certain players in some groups to add further variety to the negotiations)

Government Official — The Minister of Health has called your Minister to complain about this privatization because s/he fears that the superior marketing by the multinational will result in higher rates of smoking. She is insisting that the deal be conditional on the imposition of an additional 30 percent tobacco tax, the revenue from which will go to public health programs under her/his Ministry. S/he has threatened to go the Prime Minister and the press.

Union Leader — You have polled the union members in the plant and have promised that you will require the multinational to guarantee that employment levels will not fall for five years at the factory. You have also promised to try to secure worker representation on the Board of Directors.

Company Management — You have gotten wind of public and union opposition to the sale of the firm to a multinational. Meanwhile, some of your management team have proposed a management buyout of the firm. You are very interested since the payoff could be substantial and you would not lose control of the enterprise. However, you do not have the capital to make a credible bid. You would have to persuade the government official to agree to a lower price and an installment plan through which you paid for shares over 10 years. You would also need some assurances that the state-owned banks would be willing to finance the needed investments to improve the plant.

Remaining Groups — No change in instructions.

APPENDIX III: RESULTS OF NEGOTIATIONS

1. Did you agree to the joint venture proposal in the draft business plan (including the $89 million capital contribution by the multinational, the 37 percent local stake, and the proposed management plan)?

2. If not, what modifications were made to:

   - The capital outlays of each party
   - The shareholding structure
   - The business plan
   - Any other aspect of the proposal

3. Were there any additional conditions agreed to?

   - Employment levels
   - Investment commitments
   - Regulations or government actions
   - Other

4. Were there any issues that you could not resolve? Why?

5. What issues were:

   - The hardest to resolve?
   - The easiest to resolve?

PROPOSAL FOR A JOINT VENTURE BETWEEN A MULTINATIONAL COMPANY AND A LOCAL TOBACCO FACTORY IN AN ECONOMY IN TRANSITION

CASE B

Peter sent a fax asking his boss to postpone negotiations with Multinational Company (MC). He pointed out that there were many things in the investment proposal that required additional clarification.

At first, his boss did not know how to react. He doubted that Peter had learned so much in only a few weeks that he could question the work of a group of experts from a company that is a world leader in its industry. After all, he thought, MC, with operations in over 150 countries, has developed cultural sensitivity and must know how to adopt its proposals to local circumstances. But what if Peter is right? This is supposed to be the first big foreign direct investment in this country, a pilot model that is to be followed by other foreign investors, a model that will speed privatization in the country. “Too many things are at stake,” he thought. “I will wait for Peter to come back.”

Immediately after his return from Vienna, Peter discussed his dilemmas with his colleagues in the Ministry. He believed the following was true about MC’s proposal:

- The investment proposal was prepared without any deep understanding and assessment of the situation in the local tobacco factory (LTF).
- MC tried to show a high level of government revenues from the project without paying much attention to such important questions as:
  - Privatization
  - Division of shares in the joint venture
  - Financial calculations and profitability of the project for other parties (except the government)
  - Ecological and social aspects of the proposal
- The financial statements were badly prepared.

The perception that MC prepared an investment proposal that was not “up to international standards” made the Ministry of External Economic Relations reluctant to continue negotiations with MC. As Peter presented several convincing arguments, a decision was made to engage experts from the European Bank for Development and Reconstruction to assess the investment proposal. As a result, the Ministry suggested LTF open discussions with other foreign investors.

Several months later, LTF received a formal proposal from another multinational company interested in establishing a joint venture. LTF found this new proposal less attractive than the first one prepared by the MC.

In the meantime, the financial and technical situation of LTF continued to deteriorate. The factory was using only a quarter of its installed capacity. It had no money for serious technological or organizational changes. LTF was losing domestic market share to imported cigarettes. The main reason was the low quality of its products. LTF believed that with an infusion of $70 million, it could implement a restructuring program that was not prepared in detail and become internationally competitive.

Very recently, the Ministry of Agriculture decided to help LTF resume negotiations with MC. They asked MC to prepare a more detailed investment proposal with particular emphasis on privatization and valuation of LTF assets. When it seemed that the negotiations were going in the right direction, a new obstacle emerged. LTF was put on the list of state enterprises that are considered to be of strategic importance for the country and therefore cannot be privatized. MC insisted that they could only form a joint venture with a privatized company. Although this strategy was approved by LTF and the Ministry of Agriculture, the government still objected to the privatization of LTF.

Meanwhile, Peter was promoted to the position of Department Deputy Chief. He was very proud of being the youngest Department Deputy Chief in the Ministry of External Economic Relations. Even more importantly, he was in a position to influence very important decisions, and through sharing the knowledge he gained within the EDI training program on Enterprise Management for Restructuring and Privatization, he could improve the performance of his department. He also maintained cooperation with EDI. Two months ago he joined a World Bank Operations mission to assist in identifying the training needs of one of the republics of the former Soviet Union and to design a training program on enterprise restructuring and attracting strategic investors for its use.

Although quite satisfied with his professional career, he frequently asked himself:

- Was it a good idea to send the fax from Vienna to the Ministry of External Economic Relations and practically disrupt negotiations between MC and LTF?
- Was it worth the loss of two years and the further deterioration of LTF to allow nearby countries to make joint venture deals for their tobacco companies with multinational companies, or should the Ministry have accepted the investment proposal, even though it had many shortcomings?
- Why was MC not more careful in preparing the investment proposal?
- Did MC underestimate the capacity of the local experts?
- Who are the losers?