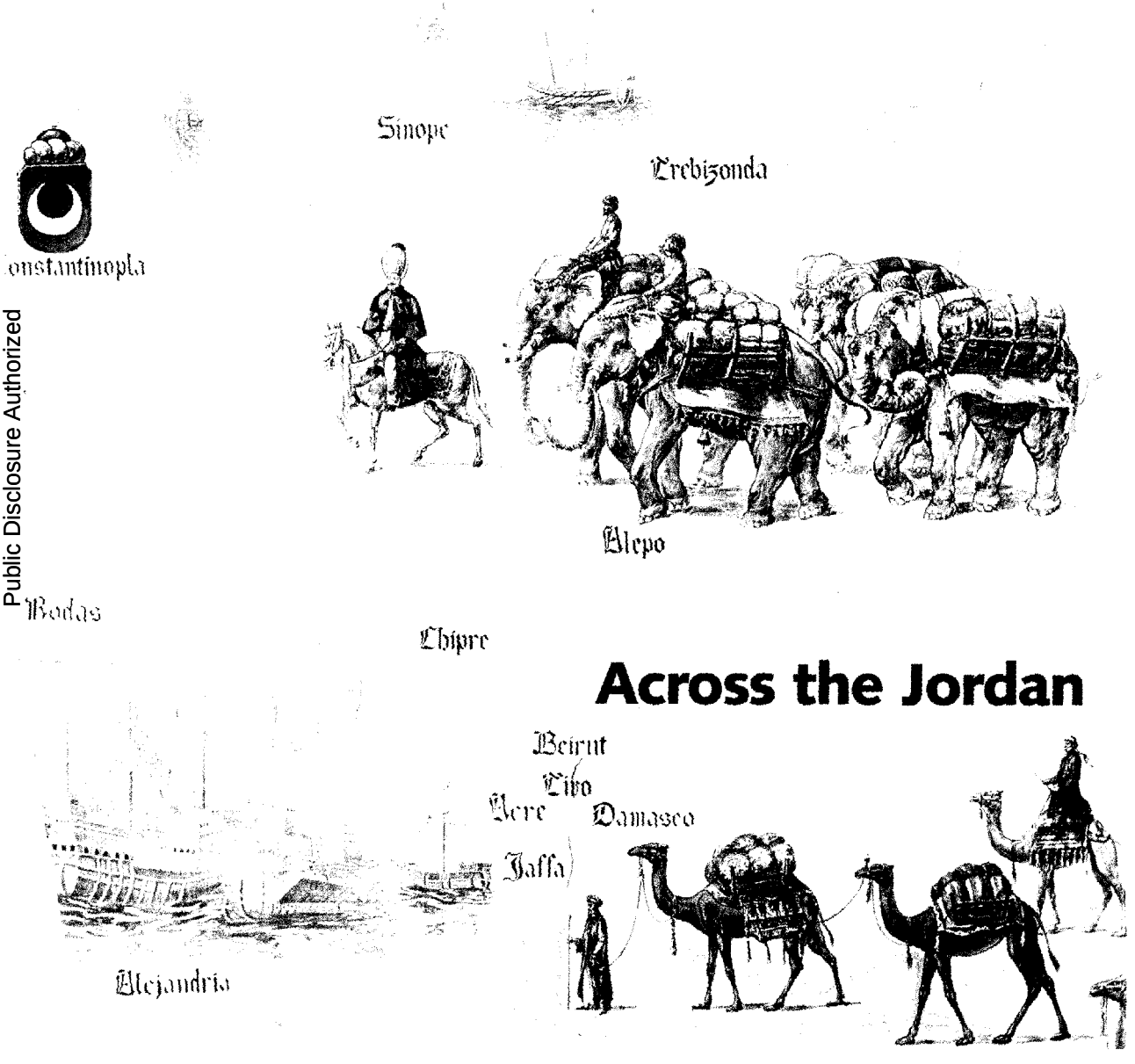
The IFC Review of Private Investment in Dev[redacted]af[redacted]

[redacted] Vol. 2 No. 1



Across the Jordan

IFC

IFC is a member of the World Bank Group supporting private sector development in member countries through investment, advisory services, and technical assistance.

International Finance Corporation
2121 Pennsylvania Avenue, NW
Washington, DC 20433 USA
www.ifc.org

Editor
Rob Wright

Copy Editor
Chitra Alwis

Design
Patricia Hord.Graphik Design

The IFC Review of Private Investment in Developing Countries

IFC Impact

Winter 1998 Vol. 2, No. 1

In this issue

Cover: Map of eastern Europe, the eastern Mediterranean, the Near East, and the Black Sea, 1600. Naval Museum, Barcelona.

All references to dollars are U.S. dollars unless otherwise indicated.

Models from Manila

I was very pleased to receive a copy of *Impact*. The topics are interesting, well chosen, and clearly written.

Being a Filipino and a lifelong customer of the Metropolitan Waterworks and Sewerage System (MWSS), I found the article on the privatization of the Manila water works very interesting and enlightening. It is almost unbelievable, given the Philippines' past experience in privatization, that such a large contract which was hotly contested was awarded with the losing bidders readily accepting the process and decision as fair. Of course, this successful IFC-assisted privatization is also a source of pride for all IFC staff, including myself, a former IFC staff member of some 15 years.

I am also pleased that one of your articles gave recognition to the Philippine Business for Social Progress (PBSP). I was actively involved in PBSP for almost a decade in the 1970's (before I joined IFC), and all the partners in our firm contributed 1% of our gross income every year to PBSP. I hope that your article will help further promote PBSP in the Philippines and will encourage the replication of PBSP in other countries. Indeed, even developed countries would greatly profit from a program such as this.

Ignacio D. Maramba
Manila

Czech Private Power

Thank you for your informative article on the financing of the Kladno power project in the Czech Republic. The Kladno project financing achieves some very worthy objectives: it avoids a government guarantee, it does not automatically pass on fuel cost increases to consumers of power, and — by relying upon 50% local debt — it holds currency risks within reasonable bounds. In short, project risks are not shifted to unsuspecting Czech taxpayers and consumers; they remain primarily where they belong — with project investors and lenders.

While your article correctly points out the favorable conditions in the Czech Republic that were conducive to the success of this transaction, I am not convinced that the prospects for Kladno-like financing projects in weaker emerging market countries are as thoroughly bleak as they first appear. The most formidable barriers to the assumption of project risks by investors and lenders are expectations (usually quite justified) of currency depreciation at unpredictable rates and illiquid (or nonexistent) capital markets that do not permit the mitigation of these currency risks through local currency medium- or long-term funding.

The growing acceptance of two major policy reform measures is cause for optimism that these barriers will be alleviated in some countries more rapidly than one might otherwise have predicted. First, a currency board, which investors and lenders expect to be maintained for most of the life of the project financing, overcomes the currency depreciation problem and, if combined with liberal foreign investment regulations, will contribute to local capital market liquidity. Second, social insurance privatization can provide, in most emerging market countries, the single most important source of capital market liquidity. In turn, a reasonably liquid capital market will serve its classic function of marshaling funds for long-term financing requirements from investors with relatively short-term horizons.

Let's hope that the Kladno model will soon be replicated in a broad range of emerging market countries.

Bruce R. MacQueen
President
Novecon Financial Ltd.,
Washington, D.C.

But Kenya Keep it up?

Please accept my congratulations on launching *Impact*, the new quarterly magazine of the IFC. The magazine is informative and interesting, and I hope it will go a long way in bringing together various players in the development sector. The magazine will certainly play a catalytic role in enhancing private sector involvement in development work with a view to alleviating poverty in developing countries.

Manu Chandaria
Chairman
The Kenya Association of Manufacturers
Nairobi

Once in a While . . .

Congratulations on the new publication *Impact*. The articles present interesting examples of IFC's work, in a refreshing and readable style. As a former IFC staff member, I am pleased to see that the institution continues to be involved in very sophisticated and challenging projects.

There is an obvious tendency to highlight and present projects and deals where IFC's role greatly contributed to the overall success. Maybe, once in a while, you can also publish an article about failures and what we all should learn from them.

Jean Van den Eynde
Russell Reynolds Associates
Brussels

West Bank and Gaza: A New Direction

They were investing in peace.

Meeting in Paris Jan. 20, World Bank Group President James D. Wolfensohn, Palestinian leader Yasser Arafat, and former Israeli Prime Minister Shimon Peres signed an agreement to launch a $100 million investment fund targeting private companies in the West Bank and Gaza. The new Peace Technology Fund (see p.7) will be a joint effort of IFC and leading Palestinian and Israeli investment firms, bringing together capital and expertise from both sides' leading businesses to help boost the Palestinian economy and thus contribute to the peace process.

"Even if there are some troubles on the political front, there is no reason why we shouldn't move ahead economically," said Peres, who will be chairman of the privately managed fund. "I am convinced that the better the economic situation of the Palestinians will become, it will be easier for them and for us to cooperate in making peace a palpable reality."

"Our presence here today to sign the Peace Technology Fund agreement sends a strong and clear message on the extent of our commitment to peace as the strategic option for all of our people," Arafat added.

Political and business leaders agree that rebuilding the Palestinian economy must be a vital underpinning of any lasting peace. It will require creation of the legal infrastructure needed to absorb private investment, create jobs, and provide new opportunities for those who currently live in poverty. Establishing this basis for peace will require not only initiatives such as the Peace Technology Fund, but also strengthening key building blocks of the local economy such as banking systems, the stock exchange, housing markets, financing for small business, and the like. Though far from easy, these efforts will help the Palestinian economy to take full advantage of its highly educated work force, strong entrepreneurial tradition, and other assets when the political climate improves, and then turn the corner as the first significant private investment flows arrive.

The task is daunting. The West Bank and Gaza face a deteriorating standard of living and some of the world's highest unemployment. In an effort to compensate, public investment has increased, but this in itself has done little more than unleash a balooning of the public sector and a potentially disastrous fiscal burden. Until 1993 the lack of self-government had left Palestinians relying on the predominant private sector to keep the economy afloat, but declining incomes, ongoing legislative and regulatory uncertainty, high risk, and limited access to finance have since challenged local firms to the limit. They are hard pressed to create the 30,000 new jobs needed each year in a population that is growing faster (at 5.6% a year) than any other in the world.

Still, there are prospects for hope. Much of it lies with Palestinian entrepreneurs, long known throughout the Middle East for their business acumen and abilities to survive under the most difficult of conditions.

Small businessmen like Bassem Khouri tell the story best. CEO of a leading Palestinian pharmaceutical company called Pharmacare Ltd., he was one of the first to turn international attention to the Palestinian private sector. Given the heavy post-Oslo focus on public investment, he feared the private sector would be overlooked despite its potential to create a viable, well-structured economy. These convictions led him to help found the Palestinian Businessmen's Association and other initiatives aimed at ensuring optimal growth prospects for local companies. Through foresight and determination, he won a French government grant in 1996 that was instrumental in initiating his company's expansion plans. Now he is about to open a new $4.5 million facility that will allow Pharmacare's Ramallah-based plant to add seven products, increase its current $6 million in annual sales, and add 180 new jobs.

Khouri had long been adamant that expanding Pharamacare could make a tangible difference to the local economy, building export markets for a home-grown product and demonstrating to others that financing is available for firms that are sufficiently organized and determined to obtain it. But to make the project a reality he had to turn to those trying to fill the local financial sector's many gaps. In November 1997 he received a loan of $500,000 from the Arab Palestinian Investment Bank (APIB), a local financial institution that IFC had helped establish. Another $450,000 loan directly from IFC sealed the financing for the project. Within a few months the new facility will be fully operational, consolidating Pharmacare's market position and its potential to increase exports in areas where its products have already demonstrated success: Central and Eastern Europe, the former Soviet Union, Yemen, and Oman.

"Without the IFC funding we would not have been able to complete our new plant," Khouri said.

Loans

Banking solely on export activities to kick-start the economy, however, would be folly.

Creating more long-term jobs within the local economy depends largely on improving Palestinian firms' competitiveness and increasing investment. But access to financing remains a major problem, and external parties such as IFC can meet only a small part of the need. Local financial institutions must step up.

Since the post-1993 transfer of authority for banking legislation to the Palestinians, about 20 new local banks have opened, creating 71 new branches throughout the West Bank and Gaza. Yet despite the subsequent fivefold increase in deposits, financing for local firms remains heavily restricted. The high risks and relatively low returns currently associated with local lending so far limit the banks' average loan-to-deposit ratio to only 27%.

To help combat these problems, in 1996 IFC joined forces with an Arab Bank–led group to establish APIB, the West Bank and Gaza's first investment bank. Since then, APIB has built a committed loan portfolio of $8 million that reaches manufacturing, construction, tourism, and other sectors. General Manager Samir Abdullah sees the bank playing an important role in financing viable Palestinian enterprise such as Pharmacare, a firm that operates at international standards and has passed inspection by the U.S. Food and Drug Administration.

West Bank and G
At a Glance

Population:

GDP Per Capita:

GDP Growth:

GDP Per Capita Decline Since 1992: 30%

Current Account Deficit: of GDP

Unemployment:

Poverty: 35% (Gaza)

Refugees: 64% (Gaza)

Annual Population Growth:

Private Sector:

Key Exports: leather goods, fruit

Major Trading Partners: Israel, Jordan

Currencies: jordanian dinar, U.S. dollar

Improving the local regulatory and legislative framework could stimulate far greater amounts of investment, Abdullah argues. Much more needs to be done to create a more comprehensive, credit-prone financial sector. Without stronger legislation and equally convincing enforcement mechanisms, the West Bank and Gaza business climate will continue to suffer.

According to World Bank research, for example, only 30% of land in the West Bank is registered. Improving land titling and clarifying property rights would help borrowers post the collateral they need to reduce risk perceptions and obtain loans. There are also needs to reduce banks' reserve requirements and facilitate longer maturities and effective risk-sharing mechanisms. The Palestinian Authority

has taken up these issues, but local capacity in drafting and ratifying new legislation remains limited.

These banking difficulties are hardly reflected, however, in the growing Palestinian equity market. With considerable drive and determination, local company Palestine Development and Investment Ltd. (PADICO) has succeeded in establishing a modern stock exchange in Nablus. Although its market capitalization is still tiny at $350 million, the Palestine Securities Exchange's information technology is already as advanced as any in the region. Since trading began in February 1997, 25 companies have been listed, and 18 of them are traded. There are now two trading days per week and six brokerages on the PSE. Investor interest has been high for an exchange operating in such difficult conditions.

"There is still ongoing international interest, and it comes particularly from foreign fund managers," confirms Safwan Bataina, general manager of the PSE. But he cautions "with the current mix of political turmoil, Israeli closure policy, and the absence of structural prerequisites, there is no telling how long it will last."

Nevertheless, like many Palestinian returnees committed to rebuilding the country, Bataina is not about to give up. During the worst closures of 1997 in July and August, when Palestinians were not

even allowed to move freely inside the West Bank, the PSE did not miss a single day of business. Through establishing remote electronic trading, investors were guaranteed access to the market, if not to Nablus, creating a "closure-immune" exchange.

Without appropriate national securities legislation, however, the PSE so far has had no choice but to be self-regulating, a fundamental disincentive to both the foreign investors who rely on independent overseers to set the rules of the game and their local counterparts who lack confidence in such a new institution. In response IFC has obtained Canadian grant funds to send experts who are helping the relevant Palestinian ministries draft new securities legislation that could lead to the investor protection needed to increase trading volumes and stimulate demand.

Deviating from its more traditional direct finance mechanisms to provide donor-funded technical assistance in the financial sector is one way IFC is adapting to the unique circumstances of the Palestinian business environment. There really is no other choice in an economy area threatened by a hazy legislative framework and associated high risk.

One example is insurance, where IFC is working with Irish funding to improve the existing mishmash of economic laws accumulated during the West Bank and Gaza's different eras of external rule: British, Egyptian, Jordanian, and Israeli. The goal is to develop a solvency-based, rather than a capital-based, law to bring the Palestinian insurance sector into line with European standards. Another key focus is housing. There is no denying the increasing demand from a rapidly growing population, or investors' strong interest in meeting it. Yet without the necessary legal tools to ensure property rights and housing finance, many of the new dwellings that mark the Palestinian skyline will remain empty, with local residents unable to afford to buy or rent them. IFC has stepped in, working closely with the Palestinian Housing Ministry, among others, to provide the regulatory environment and long-term finance needed to offset the high risk in the market.

Scaling Down

But the mere creation of a more sophisticated and comprehensive financial sector is not, in itself, an all-encompassing solution to the Palestinians' economic or development problems. A way must be found to allow financing to reach those who need it most. Aladean Shawa is director of the Development Resources Center, a Gaza-based Palestinian nongovernmental organization (NGO) working directly with small businesses. He worries about "the institutional gap between the very informal nature of most Palestinian companies, more than 95% of which have fewer than five employees, and the formal nature of the lending institutions." An appropriate allocation of credit, he emphasizes, depends on an effective delivery mechanism. Without it, he fears, many local firms may shy away from the complicated procedures needed for accessing loans, keeping demand low despite the great need for capital.

Echoing his sentiments is the chief economist of the Center for Palestine Studies and Research, Hisham Awartani. In a recent debate held in the West Bank's trade and commercial hub of Nablus, he stressed the lack of basic information about potential financing from local firms, as much the case with current small credit providers as with newcomers such as the "Extending IFC's Reach" initiative. He also added that several seminar participants felt that the "small" nature of the facilities was not small enough and that the $250,000 minimum loan offered by the IFC program far exceeds the needs of average Palestinian companies.

The issue has not gone unnoticed. IFC and the World Bank have jointly launched a $23 million microenterprise project in conjunction with three local banks. It aims to pioneer the concept of microlending to the formal financial sector, with loans not to exceed $30,000 and at least 20% of the total funding allocated to loans of less than $10,000. Any loan to a microenterprise will be divided among the participating local commercial banks, IFC, and the World Bank. In this way, local banks will have enough of their own money involved to ensure their seriousness in administering the loans. Perhaps most important, though, is the way the project will go one step beyond the many existing small credit programs. It will incorporate a Dutch-funded technical assistance component that will help smaller companies identify their financial needs and present them in a formally documented manner, thus improving their chances of success.

Carrie Woodcraft

Dividend Reinvestment

Improving the West Bank and Gaza's investment climate and promoting private sector growth to create jobs, a stable economic base and an element of hope are directly linked to peace. This was reiterated by IFC Executive Vice President Jannik Lindbaek on an October 1997 visit to Gaza, where he signed an agreement with the Palestine Industrial Estates Development and Management Company (PIECO) to finance a Gaza industrial estate. But until an enduring peace comes, creating some of the fundamental institutional prerequisites and reinjecting some confidence into the West Bank and Gaza's investment climate can help reinvigorate optimism.

Local banks would grow more ready to lend, for example, if the legal context of taxation and land titling improved, which would, in turn, make local companies more likely to raise capital on the PSE. Foreign investors, including those of the Palestinian diaspora, would then be more likely to invest. The result: two of the things that are needed most — more jobs and higher incomes. The 50% of the population currently under the age of 15 would gain a brighter future.

IFC has now approved investments of $60.9 million in eight projects in the West Bank and Gaza, seven of them in the last 18 months. As PIECO Director Amin Haddad said during Lindbaek's October visit, IFC activity in the area is "a statement reflecting the trust and confidence in the investment potential of the economy." A demonstration, perhaps, that the peace dividend may well be delayed but is not necessarily lost. ■

J.C. Tordai

Israelis, Palestinians Unite In $100 Million Fund

In a first-of-its kind undertaking, IFC is teaming with leading Palestinian and Israeli asset managers and the Peres Center for Peace to create a new $100 million investment fund for companies in the West Bank and Gaza. World Bank Group President James D. Wolfensohn launched the initiative at a Jan. 20 Paris ceremony alongside 1994 Nobel Peace Prize winners Shimon Peres and Yasser Arafat, calling it "a very positive development on the road to peace and prosperity in the region."

The Peace Technology Fund will have $100 million in committed capital from the private sector, 30% from Palestinian/Arab investors, 30% from Israeli investors, 30% from international investors, and a minimum 10% commitment from IFC. It is the first time Palestinian and Israeli investors have united for such an enterprise and will support the peace process by encouraging joint ventures between Israeli and Palestinian companies, helping investors to establish business ties with Palestinian entrepreneurs, and supporting start-up companies in the West Bank and Gaza. By injecting much-needed capital into the Palestinian economy, the fund will facilitate technology and know-how transfer, create job opportunities, and enhance managerial and production skills.

Peace Technology Fund: *Arafat, Wolfensohn, and Peres at Jan. 20 signing in Paris.*

The fund will be managed by a new company. It links IFC with Capital Investment Management Corporation, a West Bank investment group with $300 million under management and an extensive knowledge of the local business environment, and Tel Aviv-based Evergreen Canada Israel Investments Ltd., which oversees $125 million in long-term venture capital funds and has a sister company affiliated with BancAmerica/Robertson Stephens of the United States.

One of Evergreen's key areas of expertise is the fast-growing Israeli technology sector, which has supplied a steady stream of new listings on New York's NASDAQ exchange in recent years in Internet and related communications hardware, software, and other products. Given the high education levels in West Bank and Gaza, the firm sees great potential for bringing Palestinian firms into cooperation with Israeli technology groups as contractors or joint venture partners. Information technology production and distribution, electronic component assembly, and telecommunications are all considered potential areas for the fund's investment, along with other industries such as agribusiness, tourism, textiles, and general manufacturing. Investments are expected in both unlisted firms and others traded on the growing Palestine Securities Exchange in Nablus.

Cosponsorship comes from the Peres Center, an apolitical, nonprofit organization that backs wide-ranging Arab-Israeli ventures aiming to cement Middle East peace. Each Peres Center project is structured around practical incentives intended to bring growing numbers of Israelis and Arabs to the understanding that there is more to gain from cooperation than from continued conflict.

The project started taking shape at the November 1997 Middle East economic summit in Qatar. IFC's Central Asia, Middle East and North Africa Director André Hovaguimian says the fund is precisely the kind of risk the World Bank Group needs to take, and indeed "something that no one else can" to spark the private sector growth that the West Bank and Gaza so badly needs. He sees the fund's commercial orientation as bringing an important new element into the peace process, business-to-business cooperation.

"What this can do is open up a lot of avenues, and then *que sera sera*," said Hovaguimian. "The Peres Center has a tremendous amount of credibility among both Israeli and Palestinian companies, which is absolutely necessary, and IFC can help by acting as middle man and providing our experience from other parts of the world. Business is business. Once you remove the barriers, the Palestinian economy will be able to take off."

What's New about Globalization?

Jane Fraser and Jeremy Oppenheim
McKinsey & Company

"superconductor" of knowledge and capital is about to reach the right temperature. A $21 trillion market will emerge, with no natural owners. The challenge will be to leverage brands, ideas, and people. Many of the great companies of the twenty-first century will come from outside the industrial world and have yet to be born.

Cynics ask, "What's so important about globalization? It's been under way for decades." In some respects, they are right. The underlying processes have indeed been evident for some time, though without making much more than a modest impact on the world economy. Apart from the relatively small international trade in goods and services and a few industries that globalized early, national economies have remained predominantly local. Gross international trade flows, except in small open economies, typically account for less than 35% of GDP. International capital typically finances less than 10% of investment — even in emerging economies.

But all this is changing. Suddenly, the pace of globalization has quickened. The gradual process that gave companies ample time to adjust has gone for good. In just a couple of decades, the economy will become substantially global. And much of the impetus for that will come from the integration of vibrant, emerging markets into the global economy.

A Fundamental Transformation

The transformation under way in the world economy is unlike anything we have experienced before. The increasing availability of global capital, coupled with advances in computing and communications technology, is accelerating the processes of globalization. Economics are becoming superconductors of vast flows of capital and transplants of production techniques. The barriers to globalization are coming down wherever you look: not just in Western Europe, North America, and Japan, but also in the emerging giants of China, India, Brazil, Russia, and Indonesia.

Underpinning these changes are three mutually reinforcing factors:

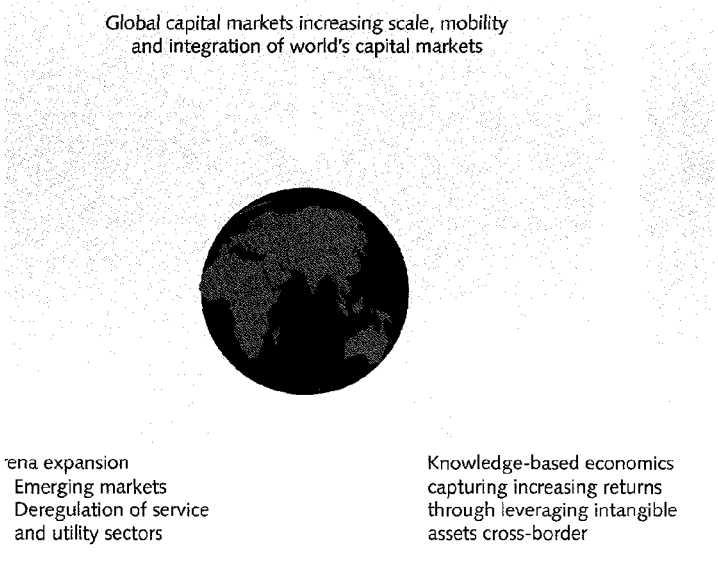
- the growing scale, mobility, and integration of the world's capital markets
- the increasing irrelevance of national borders as regulation is liberalized and other economic barriers fall
- the expanding ability to leverage knowledge and talent worldwide through technology.

Global Capital Markets

The growth and integration of the world's capital markets are the engines of globalization. As foreign exchange and bonds become more integrated, the law of one price begins to apply throughout the world. As equity markets start to integrate in their turn, capital becomes more mobile.

Cross-border capital flows rose from $536 billion in 1991 to $1,258 billion four years later. These totals exclude foreign direct investment, which itself soared from an average of $26.2 billion between 1986 and 1990 to over $250 billion by 1996. The world's stock of liquid financial assets grew from $10.7 trillion in 1980 to $41.5 trillion in 1994 and is expected to exceed $80 trillion by the year 2000. The impact of these capital market developments is striking. First, they are driving a convergence of economic policy across more and more countries. Economies that the capital markets perceive as fiscally responsible and politically committed to market-based policies attract the international capital they need to finance growth and infrastructure development. This is as true for emerging markets as it is for more developed economies. Conversely, governments that pursue economically unsustainable policies — for example, by failing to impose sufficient discipline on domestic capital markets — get swiftly punished and find they can borrow only on discriminatory terms.

Factors Catalysing Globalization of the World Economy



Second, a deepening pool of internationally mobile capital is pursuing profitable investments. No longer the ally of vested interests within a closed national economy, capital is increasingly available to anyone capable of generating high returns, wherever in the world they may be. Companies that used to face capital constraints can now obtain virtually limitless supplies of relatively inexpensive capital to fund their growth. This is also true in many emerging markets, where traditional bank credit is being supplemented (and often out-competed) by an array of new capital markets players: venture capital, principal investment funds, royalty trusts, and specialized leasing companies. These intermediaries are no longer content to focus on larger corporates, an increasing number of which tap international capital markets directly. Rather, they often serve the most innovative, medium-sized companies in emerging markets: the companies that, only 5 to 10 years ago, got squeezed between excessive regulation and insufficient financing.

As capital markets grow and mature, the financial instruments that can be used to unbundle and manage different classes of risk become more sophisticated. Ten years ago, infrastructure projects in emerging markets were almost always financed through public sector resources. Today, despite regulatory and exchange rate risk, more and more of these projects are funded by private sector sponsors. They are able to disaggregate the various components of the risk, allocate them to the players that are in the best position to bear them, and then securitize the project financing, spreading risk efficiently through the capital markets. The world's capital markets now possess both the power and the instruments to globalize the world economy.

A Global Arena

With the greater mobility of capital comes an expansion in the scale of the profit opportunity. We estimate that the value of the world economy that is "globally contestable"— that is, open to global competitors in product, service, or asset ownership markets — will rise from about $4 trillion in 1995 to well over $21 trillion by 2000, boosted by emerging markets and new sectors joining the fray. This trend to economic openness looks set to continue, fueled by communications technology and by the power of the idea that markets create freedom and expand individual choice.

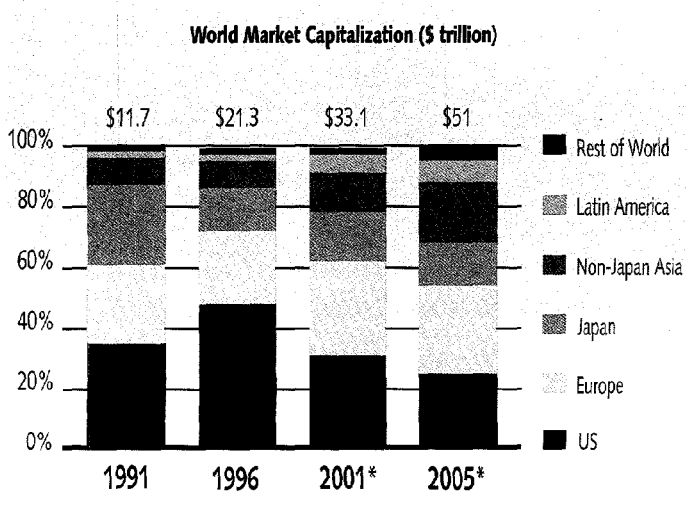
In the past decade, the legitimacy of the state's role in running national economies has come under question: witness the demolition of the Berlin Wall, the wave of economic liberalization across Latin America, and the explosive dynamism of capitalism with a Chinese face. In many cases, the market revolution has been pushed farthest fastest in emerging markets. Consider, for example, the privatization of pension arrangements in Chile, with its long-term savings regime as sophisticated and market-based as anywhere in the world. The result: Chile has attracted some of the world's best fund managers to enter and help develop its pension market, vastly upgrading the competitiveness of domestic players.

As regulation is relaxed and other barriers — such as foreign exchange controls, ownership restrictions, and access to capital, infrastructure, and information — are overcome, opportunities to globalize products and relationships and capture country differences are growing exponentially. In the financial, utility, and transportation sectors, among others, the creed of national interest and natural ownership that has kept international competition at bay is being swept away. The profit opportunities now there for the taking are worth hundreds of billions of dollars. Moreover, unlike most such opportunities in national economies, they have no natural owner. Consider personal financial services, which has an annual pretax profit opportunity worth roughly $300 billion, over 95 percent of it currently captured by nationally based competitors. Within a decade, this opportunity is likely to double in value, quickly becoming accessible to global competitors via transplants of integrated business systems, or through electronic distribution. Today's national players will see their profitability come under threat as they face hundreds if not thousands of new competitors, any one of which could, if it plays the game well, reap extraordinary rewards.

Knowledge Economics

Three decades of constant progress in information and communication technologies have triggered a complex pattern of social and economic change. This technological revolution is shaping the process of globalization by providing new tools and infrastructures with which to capture global opportunities.

Evolving technologies and the worldwide deregulation of the telecommunications industry have lowered the marginal cost of computing and communications almost to zero. The upgrading of the world economy's computing and communications infrastructure is enabling a massive increase in the cross-border information flows that serve to reduce the risks associated with unfamiliarity, speed up the arbitrage of price anomalies, and stimulate consumer demand for world-class products, services, and brands. Soon, services that used to require a local physical presence will be opened up to electronic delivery, amplifying companies' ability to reach consumers across the globe. And valuable business knowhow that a relatively small number of players used to monopolize will be accessible to all, in many cases at close to marginal cost, across the Internet. Across the mature economies, from the oil industry through to retailing, we are seeing a resurgence of small but high-growth entrepreneurial companies taking advantage of the new opportunities opened up by low-cost information technology. There is every reason to expect the same trend in emerging markets, many of which suffer from a deficit of precisely the medium-sized firms needed to disrupt the existing industry hierarchy and usher in the revolution.



*McKinsey & Co., projections

A Quick Guide to Globalization: Definition of Terms

International	• Refers to world economy that is composed of markets w are largely contained within national boundaries
Global	• Refers to a world economy that is composed of markets which largely operate without regard to national bounda
Globalization	• Refers to the process of transforming the world's econor from one that is composed of national and regional marl into markets that operate without regard to national bou
Multinational	* Refers to a company which operates in multiple countries and competes primarily within the national ma
Global company	* Refers to a company which is able to operate across nati boundaries in pursuit of both international and global opportunities

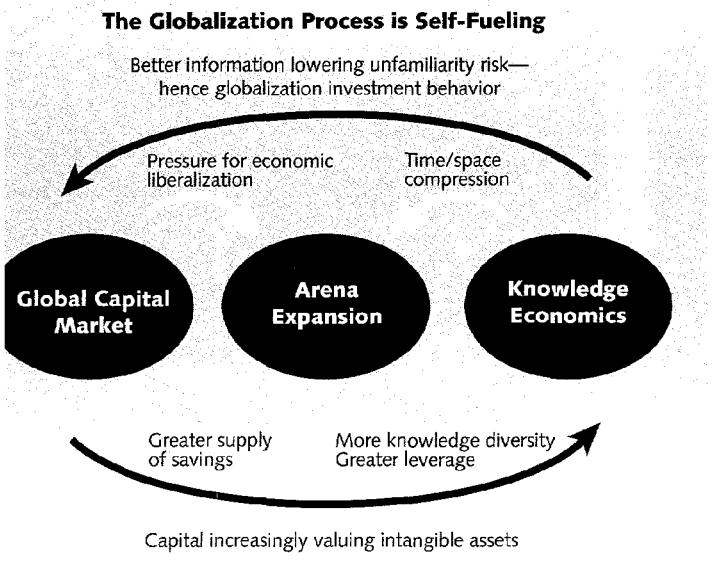
More subtly, technological change is also driving up the relative value of all forms of intangible assets — brands and reputation, intellectual property, software, media content, talent — throughout the world. Many of these assets have huge scale effects when leveraged globally, giving intangible-rich companies strong incentives to shape their industries along global lines. While the likes of Coca-Cola and Microsoft are the masters of this game, the advantages of the intangible model have not been lost on more progressive players from emerging markets. Banc Itau from Brazil has worked out how to use its superior banking skills to carve out a niche in Argentina, profitably delivering basic banking products to that nation's underserved low-income segment. Ranbaxy — an Indian generic pharmaceuticals manufacturer — is building a global reputation for the quality of its products, and yet is also one of the world's low-cost suppliers in a global market that operates on wafer-thin margins. Meanwhile, Proton, the Malaysian auto-assembler, executed its intangible strategy in one leapfrog by acquiring Lotus, the pre-eminent British engineering company, to upgrade its product performance and reputation on a global basis.

Trailblazers

Trailblazing corporations have their foot on the global accelerator. These pioneers realize how large the profits can be for a player that captures arbitrage opportunities between countries or shapes a global industry. They understand the dynamics of globalization: first find a way around national barriers, and then turn them to your advantage. They know how to shape an industry to play to their own strengths.

They recognize that unplanned globalization can destroy value for all of an industry's participants, leading as it does to wars of attrition in which players contest away value in country after country, eventually commoditizing the entire industry. They need look no farther than automobiles, semiconductors (recent favorite investments of the Korean chaebol, or conglomerates), interbank foreign exchange trading, and public telecom switching equipment to see that not all globalization is profitable. Such corporations know how to create opportunities through deep knowledge of local markets married with global reach — opportunities that others are unable to see until they are converted into real profit streams.

Pioneering corporations in search of global profits are driving the globalization of their industries. There is no structural reason why soft drinks should be global while beer and spirits remain much



more local. The only difference is that Coca-Cola has redefined soft drinks as a global industry. Similarly, it was hardly inevitable that trainers should become the only global footwear product. But Nike and Reebok drove their business in a global direction, creating global brands, a global customer segment, a global supply chain, and a set of global imitators.

Much the same is true of fast food, aircraft production, construction equipment, and credit cards, where Citibank, VISA and GE Capital are creating a global sliver. One or two players shape an industry on a global basis, and we all discover with hindsight the global scale and skill effects in R&D, the supply chain, branding, knowledge management, talent development, and risk diversification, to name but a few.

Since about two-thirds of the world's economy and almost all services are still in the early stages of globalizing, it seems likely that most of the great growth firms of the twenty-first century have yet to be born. These companies will start out with a vision of the world as their market; they will share few of the mental constraints that inhibit the incumbents; they will seek to recruit and develop the best talent from all nationalities; and they will aspire to a market capitalization that seems enormous today. Lacking all respect for the status quo and having nothing to gain by preserving it, they will be the architects of discontinuity in their industries. Many will be from outside the United States and Western Europe.

This new era presents a fundamental challenge to all but a very few companies that have already learned how to ride the globalization whirlwind.

Closing Down . . .

With greater freedom and choice come intensifying competition, diminishing control, accelerating product cycles, and deepening uncertainty. In the new global economy, most companies, unable to rely on patronage or position for protection, are permanently vulnerable. The scale of the global opportunities, the complexity of the competitive arena, and the relentless performance discipline imposed by the capital markets will force companies either to specialize and become world class and world scale in their chosen field, or exit. In industry after industry, globalization is raising the stakes and forcing national and regional players to double or quit. The next decade will see shakeouts and consolidation in new and old industries alike — even in such highly fragmented industries as machine tools or electricity transmission and distribution equipment, which until recently had appeared relatively immune from globalization-driven restructuring.

Many companies — in both developed and emerging economies — respond to these challenges by "closing down" the problem. They look at globalization as primarily a threat and seek to hold onto the past by intensifying their lobbying activities or by playing an increasingly complex and opaque game of cross-subsidies. The firms most at risk in this era are paradoxically those that thrived most robustly in the 1970s and 1980s. Their skills, relationships, talent pool, and (in many cases) diversified business portfolio look increasingly misaligned with the new set of opportunities. It will be in their economic interest to get in the way of change, and to paint a dark picture of globalization — as a blind and destructive force, in which the rich get richer at the expense of everyone else.

In our view, nothing could be farther from the truth. This is an era when privileged insiders who have traditionally captured most of the value get progressively outflanked by attackers — new companies with nothing to lose and no respect for the existing order. Expect to see a galaxy of medium-sized Chinese, Mexican, Polish, and Turkish companies forcing their way onto your radar screen over the next decade. These companies will start by mobilizing knowledge and capital from global markets to capture massive arbitrage opportunities in their home markets (created by the price umbrella of highly inefficient "national champions," subsidized for years by their governments). They will then get to meaningful scale by spreading into their immediate regional hinterland through joint ventures and targeted investments. They will orchestrate a web of strategic alliances with industrial country players to improve their access to consumers, talent, and new intangible assets. And they will move onto the world stage within a matter of years rather than decades.

. . . Or Opening Up?

Looking behind the success stories of leading globalizers, you find companies that have learned how to think differently from the herd. They seek out different information, process it in a different way, come to different conclusions, and make different decisions. Where others see threats and complexity, they see opportunity. Where others see a barren landscape, they see a cornucopia of choices: how to define their industry; which customer segments to target; which countries to prioritize; how to manage the risks in uncertain geographies; how best to rationalize the business portfolio; what to own and what to influence; how best to manage a network of external relationships; how to shape their organization's internal architecture; and which levers to pull to overcome the rigidities of their formal structure.

These choices are made easier when companies understand what is new about globalization. With this in mind, they can identify strategies that fit the processes under way, instead of conflicting with them. They can shape opportunities by concentrating on pieces of the business in which they have world-class skills and proprietary intangible assets. They can create open business ecologies that thrive on constant change, translate diversity into strength, attract top talent from all over the world, and leverage third-party capabilities.

Conclusions

We are on the brink of a major long-term transformation of the world economy from a series of local industries locked in closed national economies to a system of integrated global markets contested by global players. This is a world where capital is freely available to those with the necessary assets and skills, where intangible and not physical assets are the source of strategic differentiation, and where a glut of opportunities are up for grabs. Within a global arena that is expanding to four times its former size, standing still means falling behind in the race for position and opportunity. Creating a shared understanding of this reality is the principal leadership task for most corporations. Without a global mindset, companies risk being marginalized; with it, the opportunities they face will seem almost limitless. ■

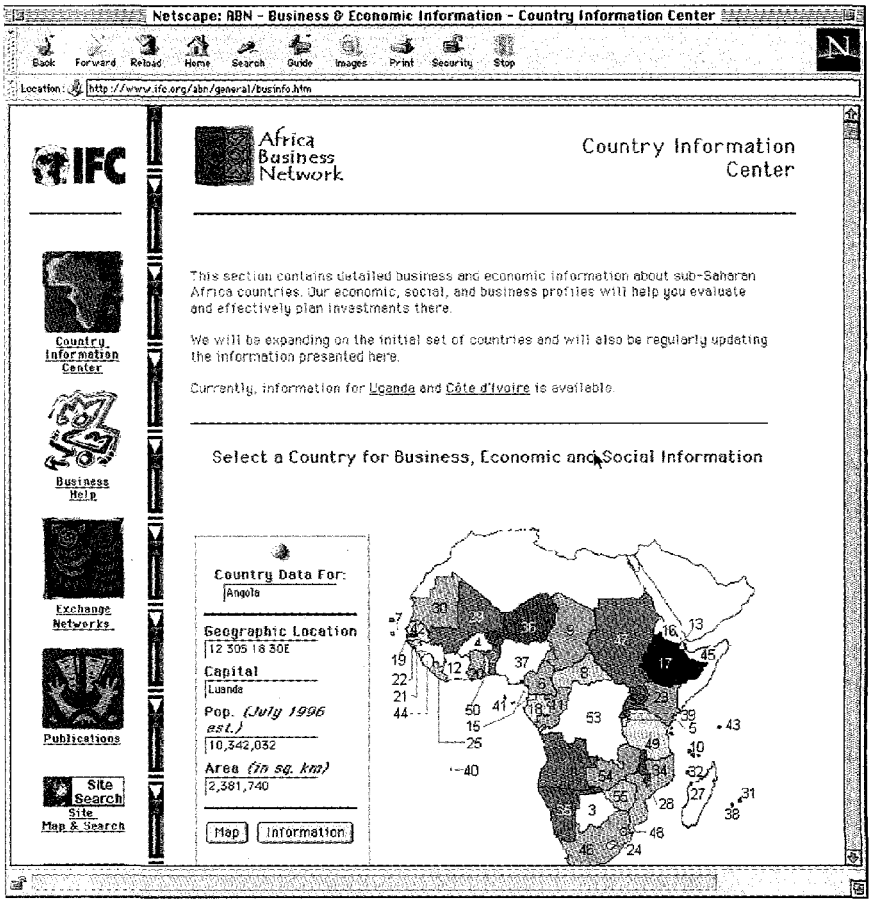
McKinsey and Company is an international management consulting firm with offices in more than 30 countries, offering strategic and organizational advice to the world's leading corporations and governmental entities. Jane Fraser is a consultant in McKinsey's New York office and Jeremy Oppenheim is a consultant in the London office.

The Electronic Opportunity

As the world goes digital, more and more opportunities are opening up to small and medium players in emerging markets. Consider the impact on distribution economics of Asian Sources Media Group (ASM), a publishing company based in Hong Kong. ASM's website serves as a shopfront for more than 7,000 Asian suppliers, mostly small and medium enterprises (SMEs) in China, Korea and elsewhere, selling everything from cheap plastic toys to multimedia technology — and new customers for these suppliers have emerged from South America and Eastern Europe. SMEs that used to face very high fixed costs of finding buyers in developed economies will now be able to do so at a much more modest cost. As a result, they will be able to secure not only the trade financing but also the investment funds needed to grow profitably and create employment.

Just Out!

Africa Business Network: Web Page for the World



For a wealth of information about Africa's private investment environment, visit WWW.IFC.ORG/ABN, home page for the Africa Business Network (ABN). The user-friendly, interactive site that IFC recently launched is one of the most comprehensive information sources about Africa available. It offers the latest World Bank country and regional economic data, local press reports, free electronic mailing lists for the benefit of the African business community, and more.

ABN is tailored to the specific needs of investors in Africa. For small businesses, it provides general business help and "how-to" information in formulating a business plan, starting, financing, and managing a business. It also includes a variety of information for larger businesses.

Entrepreneurs and investors will find the web page an easy way to contact IFC field offices and Washington staff, and to learn more about the activities of the African Project Development Facility, African Enterprise Fund, African Management Services Co., the Enterprise Support Service for Africa, and other facilities. Any African entrepreneur with a project idea can learn from ABN what he or she needs to include in an initial proposal, then send it via e-mail for a quick response. Ditto for foreigners seeking a potential business opportunity in Africa.

Anyone with Internet access can use ABN for free. Once there cyber-investors will also find quick links to African stock exchanges, multilateral and bilateral institutions, and other sites of interest. The number of African countries connected to the Internet now stands at approximately 30, and is expected to grow fast. Come visit — ABN is constantly being refined in order to become as valuable a tool as possible for increasing the quantity and quality of private investment in Africa.

www.ifc.org/abn

The Biggest Bank in the World

There are many ways to measure a bank. But whether by equity ($25.7 billion), market capitalization (about $70 billion), or profitability ($7.6 billion), HSBC Holdings ranks as the largest in the world. Those profits, it should be added, are efficiently accumulated on an asset base of only $401 billion, not enough even to be in the world's top 10.

Founded by a steamship company executive and other international investors in Hong Kong in 1865 as the Hongkong and Shanghai Banking Corp., it has grown into one of the world's few global financial institutions. Yet its largest share of profits still comes from operations in the former British Crown Colony, where it has long been the leading bank. The rapid transformation of the island economy, where per capita incomes have risen from $1,000 to $24,000 in the past 25 years, and flagship unit Hongkong Bank's subsequent growth throughout developing Asia have provided a base for expansion into many lines of retail and wholesale banking throughout the world. A string of acquisitions last spring and summer have made HSBC the largest foreign player by far in Latin America, and the opening of initial offices in Azerbaijan and Kazakhstan gave it a foothold in parts of the world where its familiar hexagon flag had not flown before.

Chief Executive John R.H. Bond is a new member of IFC's Banking Advisory Group, a panel of top international bankers who meet with IFC senior management twice a year. His 36-year career with HSBC has included service throughout the world, including stints in Asia and as chairman of Hongkong Bank of Canada and Marine Midland Bank in Buffalo, New York. Interviewed at HSBC's London headquarters, he shared the following perspectives on international finance that come from his unique position atop the biggest bank in the world — and one for whom the high-growth-potential markets have always been the highest priority:

IFC: Uniquely among major international banks, HSBC has roots that lie in the developing world. How does this make you different from the others?

BOND: Our origins in Hong Kong and China have shaped the character of HSBC. We grew up in a world of limited resources: human and, to start with, financial. And we grew up in an era of imperfect communications, so the character of our group is to manage on as limited a resource base as we can and to be self-reliant. We are used to people who go to countries and are self-starters, who do not have to have somebody looking over their shoulders or talking to them every day on the telephone. This also shows in our strategy for information technology, where we tend to develop all our own systems in-house. We're thrifty as an organization. We watch the pennies. Where we came from has dictated to a large extent the essential character of the HSBC Group today.

IFC: How does it affect the kinds of banking business you do?

BOND: 'Emerging markets' is not a description we particularly favor, but what we look for in our strategy around the world are markets where the demand for financial services is growing. For example, in 1997 we invested in Argentina, where we estimate maybe 20% of the population has a bank account, and in Brazil, where maybe 30% of the population has a bank account. I suspect the comparable number for India is no more than 20% of the population, and we have been there for over 100 years. But in the western markets,

On the record

Name: John R. H. Bond
Title: Group Chief Executive, HSBC Holdings plc, London (becomes chairman in May after retirement of Sir William Purves)

HSBC Holdings plc

Born: July 24, 1941
Key Holdings: Hongkong Bank (top bank in Hong Kong, more than 600 offices in 32 countries and territories in Asia); Hang Seng Bank (Hong Kong); Midland Bank (UK); Marine Midland Bank (US); British Bank of the Middle East; HSBC Investment Banking (global); HSBC James Capel (global equity brokerage); HSBC Equator Bank (sub-Saharan African investment bank)
Employees: 130,000 in 79 countries
Recent Transactions: Invested roughly $2 billion in banking acquisitions in Latin America in 1997: $960 million for 100% of Banco Bamerindus in Brazil; $174 million for 19.9% of Banca Serfin in Mexico; $600 million to increase shareholding from 29.9% to 100% in Banco Roberts of Argentina; $16 million for 10% for Banco del Sur in Peru; and $14.5 million to increase shareholding from 3.9% to 7% in Banco Santiago of Chile
IFC Involvement: Member, IFC Banking Advisory Group; has approximately $50 million in IFC B-loan participations, including financing for private power generation in the Philippines, textile plants in Indonesia, and others.

nearly everybody who's likely to want a bank account already has one. The source of growth in mature markets is likely to be how many customers you can wrest from your competitors and what the increase in the surplus income of individuals and companies will be. So you are going to be really in a market share game, whereas in emerging markets, you participate in the growth of the market itself.

IFC: That said, what has been the key to your profitability?

BOND: We are fortunate to be in markets where the demand for financial services and the demand for funds has been growing. It's axiomatic that no bank can be better than the clients it serves. We've had some very successful clients for very many years. We are very fortunate in that respect, but management would like to claim the credit for managing the expenses tightly and managing the risks of the business well.

IFC: A large portion of your business is done in Southeast Asia. What is your reading of its financial crisis?

BOND: The financial systems vary from country to country. Some of them are in fairly early phases of development; some of them are very sophisticated. Looking at it from that perspective tells you which countries are likely to have a temporary slowdown and which countries are likely to take longer to resolve their particular issues. What strikes me about Southeast Asia is that for 20 years western commentators accorded near-halo status to its economic achievements. It strikes me as slightly odd that they applied the horns within two months of a market correction, albeit a severe one. But I don't want to make light of the situation. There are some serious issues out there.

IFC: Are you optimistic or pessimistic on the region?

BOND: We remain confident. The underlying fundamentals of high savings rates leading to high investment, strong commitment to basic education, primary and secondary education, raising the intellectual capital of the country, a group of very talented entrepreneurs — all of those fundamentals remain in place in most of the countries.

IFC: What drove your recent acquisitions in Latin America?

BOND: This is something that has been at the back of our minds for 20 years. People at the top of this group have said "There's going to come a time when it will be sensible for us to make some investments in Latin America." Why has this not happened until today? A very simple answer: the opportunity wasn't there. It took the reforms in Brazil, Argentina, and Mexico to enable foreign financial institutions to own banks in those countries. So we were unable to make the investments until really recently. The opportunity came and we weren't slow to capitalize on it.

IFC: Spanish banks like Banco Bilbao Vizcaya and Banco Santander got there ahead of you. But it appears that by waiting, you found opportunities to come in at very attractive prices. Were you necessarily waiting for special situations such as these to arise before you entered this market?

BOND: Well, it's in our character to be careful with money. We are very price sensitive in making major investments and yes, we wait for suitable conditions.

IFC: Do you see these moves helping HSBC facilitate a growth in Asian–Latin American trade?

BOND: We believe that will come. If you look, for example, at Argentina's relationship with Malaysia, you will see that just over five years ago they did virtually zero trade with one another. Today, they do a half-billion dollars a year, and Malaysian Airways flies to Buenos Aires, and Varig flies to Hong Kong from São Paulo. These links are going to grow. What a group like ours can do is bring in the attributes of our experience in Asia, which would be productivity, customer orientation, self-reliance, and thrift.

IFC: Your acquisition in Brazil, Bamerindus, is that country's fourth largest private bank and currently lacks the high profile of its larger competitors Bradesco, Unibanco, and Itau. It has been reported that you intend to build it into number one. Is that true?

BOND: We always set ourselves challenging goals, but it will take time. This is a five- to seven-year program for us. Our ambition is to be successful. We've benchmarked ourselves very carefully against the competition and we don't go for size for size's sake. We would like to be what our clients and our shareholders want: the best bank in the region.

IFC: Are you interested in entering any other Latin American countries, say Colombia or Venezuela?

BOND: What we have to do is the art of the possible. You have to make your priorities and not assume that you can be everywhere at once. It is a big management and information technology challenge to support the investments we've made, and we have to make sure those are properly put to bed before we think about anything else.

IFC: Now that HSBC is active in Latin America as well as the Middle East, the former Soviet Union, Africa, and Asia, what would you say the introduction of a major foreign bank means to a developing country's financial sector?

BOND: You have to consider it from the host government's perspective because, after all, they are the people who enable it or disallow it. I would have thought it makes good sense to have foreign capital in your financial system, particularly if it is in need of recapitalization. If you've got strong demand for capital for other projects in your country, you want to release that capital into providing jobs, economic development. So use foreign capital in your financial system, especially if it brings with it some expertise. I will always consider that to be a very sensible strategy. But we need to be quite clear: the sovereign states still write the rules for the financial sector, so they can control the behavior of the banks.

IFC: In addition to your holdings in Hong Kong, HSBC recently opened its eighth branch in China, and has a reputation for knowing that country as well or better than anyone else. How much of an opening do you see in the years ahead for foreign banks in China?

BOND: China has pursued a very sensible strategy in its financial services sector. It is adopting a gradualist approach, which is just what I would advocate. I don't think it wants foreign financial institutions to have substantial market share in China, and we understand and we respect that. It is a sound decision on their part. On the other hand, with a tremendous amount of foreign direct investment comes a need for some financial institutions to help

facilitate that process, and that's exactly what they're doing. There is no doubt in my mind that China is destined to be a major economic power. It wouldn't surprise me at all if it is the largest economy in the world at some point in the next century.

IFC: Do you have a domestic banking license in China?

BOND: No, we have a license to deal in renminbi under specified terms. It started this year. They issued several licenses to foreign banks to do that, and it started just as they've done it previously, in a gradualist way, which I think is right. You learn what works, what doesn't work, and then you fine tune and improve. It's off to a good start.

IFC: IFC is increasingly working to support the financial sector liberalization process in China, whose government is a shareholder. Is there anything you think we should be cautious of?

BOND: It is hard to give a general answer to that question. There's going to be a series of ad hoc issues. The Chinese government is going to say "It would be nice to have a different view on that, or have somebody act as a catalyst for change." IFC will participate, I am sure, in ad hoc solutions to issues of the day.

IFC: The Southeast Asian crisis threatens to give some aspects of financial sector liberalization a bad name. Do recent events tell us how these reforms might be carried out more successfully in the future?

BOND: Several issues should be considered. They include controlling the amount of lending on a sectoral basis; on an individual name basis; making sure there's sound liquidity; making sure there's competent management — it's all the basics of a properly functioning banking system. Out of recent experience, we are likely to see a slowdown in the opening up of the equity markets in that part of the world and perhaps a bias toward direct investment. I would expect that people would press the brakes a little bit on how you develop the futures markets. Nothing says that the financial system in a country with a GNP of $30,000 a head is the right one for a country with a GNP of $1,000 or less a head. The challenge in Asia is to cherry pick the bits that make sense and to put aside those bits that don't. Very often the western mind believes that what's good in the West is good in Asia. That's not necessarily true in my experience.

IFC: Taking a step back from it all, what would you say is the most important contribution IFC can make in the developing world?

BOND: Our view of IFC's role is that it's there to do the things the private sector banks will not do, either for risk reasons or for lack of detailed knowledge of how a particular sector in a particular country works. Over the years, IFC has been very successful at this. HSBC has worked with IFC in various countries around the world. The difficult judgments IFC has to make are when is the private sector is ready to commit fully and when is it time for IFC to fade from the scene — whether a sector in one market, or an entire market. That is always going be a delicate judgment. ■

Estonia: The Electronics Age

Estonia has much in its favor: a government that has successfully carried out sweeping economic reforms, a well-educated, efficient work force, and geographic and linguistic ties to Scandinavia.

IFC can help not only by financing selected enterprise modernizations, but also by setting an example for foreign investors who can provide long-term funding — something that has so far been scarce but is vital to Estonia's continued growth. Nowhere is this more apparent than with Elcoteq Tallinn, A.S., a contract electronic manufacturer specializing in assembly of printed circuit boards. In 1996 it underwent a $40.6 million expansion that was partly financed by a $7.7 million IFC A-loan.

The expansion has doubled the size of Elcoteq, and made its Tallinn operations the base for the current $500 million in revenues. It has established the company as both Estonia's largest exporter and Europe's largest contract manufacturer in electronics.

The expansion has also increased Elcoteq's labor force by up to 1,200, making it the country's largest employer and having a significant effect on joblessness in Tallinn, a city of about 500,000. The factory there has only two expatriates, and the firm's Estonian CEO has emphasized a training program to upgrade the skills of the Estonian management team together with universities in both Finland and Estonia.

Products made at the Tallinn plant will mostly be used in the rapidly expanding cellular telecommunications industry as an outsourcing base by Ericsson and Nokia, and in the power industry by ABB. Spurred on by its success at home, the company now will open a pilot production base in Russia in a few months. St. Petersburg operations are expected to be managed by key personnel from Tallinn. Elcoteq Tallinn's successful expansion has attracted significant interest among other producers and is likely to lead to other similar ventures, improving the environment for Estonia's emerging electronics industry.

In November Elcoteq Tallinn's parent company went public, selling 33% of its shares for approximately $100 million on the Helsinki exchange. Most of the shares were sold to international investors based in London and New York who were attracted by the fact that the company's revenues had grown 64% in the past year because of the Estonian operations ■

— Jyrki Koskelo, IFC Europe Department and
Paul Crystal, IFC Corporate Relations Unit

Sector Attracts Investors

Sally Gelston, *IFC Corporate Relations Unit*

Poor perceptions. The plague of Africa.

Nowhere are they poorer than among private investors, who sent the continent only about 3% of the roughly $265 billion they poured into the developing world last year. The reasons are many, but partly stem from their sense that Africa has missed out on the world privatization parade, with its economies still far too marred by the heavy hand of state intervention.

Until recently the perceptions have been true. While reformist governments in other regions have reaped billions of dollars from private investors eager to purchase and revitalize state assets, Latin America receiving about $90 billion in the 1990s alone, Africa has had few transactions of the kind to report. Whatever the reason — be it too little political will or attractive assets, too many miles of red tape or entrenched old guards, or something else altogether — the deals just weren't getting done.

Lately, though, the reality has begun to change, as IFC has seen in a recent utility privatization assignment in Gabon. Or consider Mozambique. The poorest country the World Bank measures, with per capita GDP of only $80, it has nevertheless carried out what many consider to be Africa's most successful privatization program, continuing the dismantling of its Marxist legacy by selling majority interests in approximately 500 state-owned enterprises. Although almost all of them have been very small, the World Bank has catalogued an impressive list of efficiency gains coming with the change in ownership. It includes a doubling of sales volumes and tripling of productivity, net job creation with higher wage scales, and increased tax collections for the state.

Yet no matter how many small fisheries, grain mills, and cashew processing plants Mozambique may sell, it will always be the larger transactions that attract the world's attention. An increasing number of these are starting to close in Francophone Africa, especially in the critical infrastructure sector.

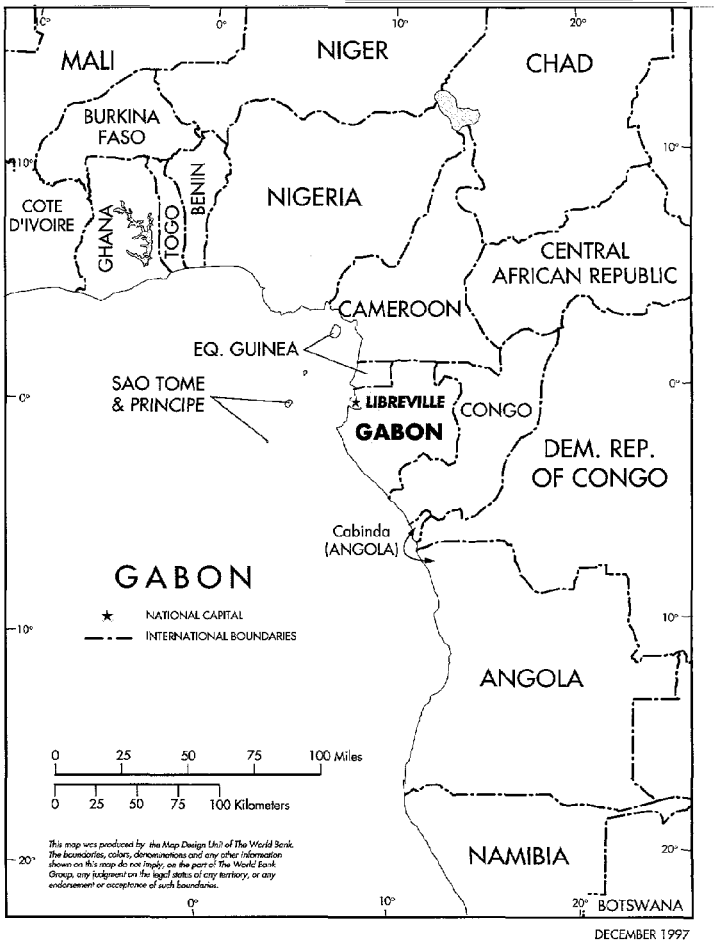
In December, for example, the Senegalese government raised $60 million by selling a 17.6% local currency–denominated stake of national telephone company SONATEL as the debut issue on the new regional stock exchange in Abidjan. This added to the $107.4 million it had raised from France Telecom's purchase of 33% of the same company five months earlier. IFC supported the process by overseeing the creation of the Abidjan exchange over the past three years and structuring and investing in Framlington's $25 million West Africa Growth Fund, an important local institutional buyer of SONATEL shares.

Snapshot: Gabon

Population: 1.1 million
Capital: Libreville (pop. 436,000)
Currency: CFA franc
GDP per Capita: $3,980 (1996)
Current Account Surplus: 3.7% of GDP (est., 1996)
GDP Growth: 4.5% (est., 1997)
Inflation: 2.5% (est., 1997)
Key Exports: Oil, timber
Oil Production: 368,000 barrels/day (third highest in Africa after Nigeria and Angola)
Major Trading Partners: United States, France, Côte d'Ivoire

Sources: World Bank, Economist Intelligence Unit

IBRD 29267



DECEMBER 1997

Be Creative

But who says you need a stock exchange for an initial public offering (IPO)? December also saw the local flotation of a $14 million piece of the Gabonese water and power utility, Société d'Energie et d'Eau du Gabon (SEEG). Enthusiastic retail and institutional investors bought shares through a local bank because Gabon has no bourse, leaving the offer oversubscribed. SEEG's IFC-advised privatization was the first significant one in the country's history, and the first privatization of a water and electricity utility in Africa involving full commitment for future investment by the private operator. Some African water networks had previously undergone various forms of privatization, but SEEG's involved the first real financial commitment for system expansion. New majority owners from France have agreed to invest at least $200 million to upgrade the company during their 20-year concession, and likely will end up spending much more, thus making it one of Africa's largest privatizations.

The bottom line for consumers is better service at lower prices. As a result of the sale:

- Gabon's water and electricity customers have been paying 17.25% lower rates since July 1.
- More Gabonese will gain access to clean water and electricity through a required buildout, which takes place at no cost to the government and thus frees its resources for other needs.
- Service upgrades will improve water quality and reduce brownouts.
- The public, by becoming shareholders in SEEG, has been given its first glimpse at the way capital markets can channel savings into investment.

None of this came easily. Especially not the bid opening for SEEG's privatization, which took place in front of an international audience of 70 journalists, diplomats, and business people at the Hôtel Le Méridien Re-Ndama in Libreville last March. As an edgy crowd looked on, Gabonese ministers opened the envelopes, looked at the bids, then without announcing the numbers called for an "interruption" and inexplicably left the room.

The sudden silence left IFC's Philippe Liétard fearing his team had wasted 16 months of advisory work in Gabon. He had no idea what the Gabonese ministers were doing and "decided not to try to know."

In the end, transparency ruled. Although Gabonese Privatization Committee Secretary Meye Bekourou says to this day he does not know for sure what happened, he speculates that the bid openers — surprised by the results —needed to reach Gabon's President Omar Bongo, who was traveling outside the country at the time. They did not want him to "receive the news over the radio," Bekourou said. After two hours, they returned to the almost-deserted banquet room and awarded the concession to the technically qualified bidder offering the greatest reduction in tariffs, as had been planned. SEEG's long-standing partner, Lyonnaise des Eaux of France, was out of a job, replaced by low-bidders Compagnie Générale des Eaux (CGE) of France in association with Electricity Supply Board International (ESBI) of Ireland.

The winners were outsiders to Gabon, outsiders even to Africa. Many saw it as a victory that they and a third competitor, SAUR International of France, had offered bids at all given that Gabon was, in Liétard's words, "known as being rather secure for the usual investors."

SEEG: *Better service, lower prices after privatization.*

That image has since changed for Gabon. Liétard quickly points out: "This has created a reputation for Gabon that in the end privatization happens there. So the next time they put something on the block, people will say, 'This is serious.' "

Serious indeed, for President Bongo had provided the kind of staunch government support that is essential to seeing a privatization through to completion.

"It's somewhat unfortunate that when we did the privatization of SEEG certain large corporations — some Americans, some from elsewhere — thought the game was being played with a loaded deck. They were later disappointed," said Bekourou, who is now working on selling the national railroad, telecommunications network, and other assets. "The public sector has had its day and is handing the baton to the private sector. Privatization is going on all over the place, not just Gabon, because it is necessary if you want to participate in the global market."

Roots

The bid award culminated a lengthy process in Gabon, whose combination of oil wealth and small population give it Africa's highest per capita income.

Following the 50% devaluation of the common regional currency, the CFA franc, in January 1994, its government began earnest efforts to restructure the economy. This included a broad reform program in the public enterprise sector to improve efficiencies and reduce costs. As part of this effort, Lyonnaise des Eaux was retained on contract for 2.5 years to manage the utility along with HydroQuébec of Canada and Électricité de France.

The International Monetary Fund (IMF) supported Gabon's initial stabilization program with a $56.4 million-equivalent 12-month standby. This was replaced upon completion by a three-year $165 million-equivalent Extended Arrangement in November 1995 under which the IMF called upon IFC to assist the Gabonese government in expediting SEEG's privatization. The World Bank, meanwhile, had been working to strengthen Gabon's mechanisms for regulating utilities and will continue to do so for several years.

To get the company ready for tender, IFC drew upon Japanese grant funds of $389,800 to hire

outside consultants, including French lawyers Klein-Goddard of Paris and Abidjan, industry experts Management Systems Consultants of Paris, and tax/accounting specialist Arthur Andersen of Paris. This team, together with IFC, appraised SEEG and restructured its finances; developed a privatization strategy, financial model, regulatory guidelines, and rate structures; and prepared a concession contract, share purchase agreement, and bidding documents.

IFC structured a deal designed to encourage competition, keeping the water and electricity units together in order to make the asset more attractive to bidders. This prevented duplication of administrative functions such as billing and collections that had been efficiently handled together.

IFC also opted early on to push for an international competitive tender instead of negotiating a concession contract with Lyonnaise and its partners. This choice involved a risk: if no outside companies bid, IFC would have to resort to negotiating a contract with incumbents who knew IFC had nowhere else to turn if it did not like their price.

Mindful of the need for outside interest, the IFC advisers quickly realized that allowing unified bidding by the Lyonnaise-led consortium, with its perceived inside track, could kill fair competition. That option most likely would also drive away any outside interest, especially since SEEG was not an obvious choice to attract international attention. It was small, serving less than 100,000 households, commercial customers, and government offices out of a population of 1.1 million. And it had one other major weakness: its largest shareholder (64%) was the state, whose delinquency in paying its own utility bills left SEEG teetering on the edge of bankruptcy. So to attract the strongest possible field of bidders, IFC advised the government to insist that no two companies experienced in Gabon's water or electricity sector could bid together. IFC team member David Donaldson recalled that the incumbent foreign partners "didn't like it at all. They objected publicly, privately, in all sorts of ways. But finally, the government of Gabon realized this was the only way to generate true competition."

"It's an illustration of how the best way of privatizing is not necessarily by following the rules written in a rule book," added IFC's Bernard Portier. "You have to make your own rules."

The Judgment of Paris

So a fair bidding was held, with three of the premier French infrastructure firms contesting each other to take over the top utility in a small African nation. Once the award was made, attention quickly shifted to the winners' obligation to meet

"The fact that IFC was a participant with real authority was the element that permitted the process to proceed with complete transparency from beginning to end."
— Alain Tronche, Compagnie Générale des Eaux

Milestones in African Privatization

Country	Company	Sector	Date	Price	% of Shares Sold	Purchaser
Zambia	Zambia Consolidated Copper Mines (ZCCM)	Mining/smelting; Power transmission	Initial transaction in ongoing process closed January 1997; final transaction due to close in February 1998	$940 million for nine packages ($260 million cash, $220 million debt, $460 million investment requirements)	Up to 88%, depending on package	Major mining companies, including Anglo-American (South Africa), Cyprus Amax (U.S.), Falconbridge (Canada), and Phelps Dodge (U.S.), and power companies Cinergy/National Grid (U.K.)
Ghana	Ashanti Goldfields	Mining	May 1994	$450 million	30%	International investors
Gabon	SEEG	Water/power	July 1997	At least $200 million (including capital increase and investment requirement)	99.9%	CGE (France) in association with ESBI (Ireland)
Côte d'Ivoire	CI-Telcom	Telecommunications	March 1997	$193 million	51%	France Télécom
Senegal	Sonatel	Telecommunications	July 1997	$167.4 million	33.3%	France Télécom, public shareholders
Kenya	Kenya Airways	Transport	January-June 1996	$70 million	77%	KLM (Netherlands), international investors, employees, Kenyan public and institutions

How They Did It

Name: Société d'Energie et d'Eau du Gabon (SEEG), utility for both public water supply and treatment and power generation, transmission, and distribution.
Service Area: Before privatization SEEG was the exclusive provider of electricity (84,000 connections) and water (43,000 connections) in Gabon. The concession agreement transferred to the private sector exclusive responsibility for serving major population centers and 30 unserved villages across the country.
Pre-Privatization Financial Condition: Nearly breaking even through improved management from 1993 to 1996 by Lyonnaise des Eaux/HydroQuébec/Électricité de France consortium; but with total accumulated losses of CFA 61 billion ($103 million), compared to 1996 revenues of CFA 50 billion ($85 million).
Government's Goals in Privatization: Improve quality of service; provide universal coverage of service at affordable rates; end fiscal burden; free up public sector resources for more efficient use elsewhere.
Length of Concession: 20 years
Selection Criteria: All qualified parties agreed, if chosen, to purchase all of SEEG's shares, minus one, at non-negotiable book value price of 2 billion CFA francs ($3.4 million) and to subscribe to a capital increase of 15 billion CFA francs ($30 million). After prequalification, the draft concession contract and the share purchase agreement were fully discussed, refined, and finalized with all bidders individually. Award was made solely on basis of largest across-the-board tariff reduction.
Financial Restructuring: Complete restructuring of SEEG's balance sheet through absorption of past accumulated losses; transfer to state of all of SEEG's state-guaranteed long-term loans to offset overdue bills.
Winner: Compagnie Générale des Eaux (France) in association with Electricity Supply Board International (Ireland), with rate cut of 17.25%.
Other Bidders: Lyonnaise des Eaux (bid rate cuts of 11.51%) and SAUR International (bid rate cuts of 5.8%), both of France.
Capital Investment Requirement: At least 100 billion CFA francs ($170 million) for system rehabilitation, plus an undefined amount for future expansion based on demand.
Mandated Service Improvements: Must expand water and electric services to reach a growing segment of the population through 2015, as specified by geographic region; heavy fines to be paid to the regulator if coverage targets are not met.
Job Losses through Privatization: None
Government's Adviser: IFC

buildout targets or face penalties. As time goes by, the share of the population that SEEG must serve increases, with individual percentages stipulated for water and electricty in five different areas. In Libreville, water coverage must rise from the 49.3% when last calculated in 1993 to 53% by 2000, then to 60% by 2005, 65% by 2010, and 70% by 2015. The company is obligated to keep up with its targets as the population grows and service about 30 unserved villages before 2015 by installing independent generators and by drilling wells. SEEG is now raising another $30 million through a capital increase to cover some of the initial costs of this system upgrade. Out of this $30 million, $14 million came in December through the first-ever Gabonese public offering, which was structured by IFC and conducted through BICIG, the local Banque Nationale de Paris affiliate. The transaction allocated 5% of the shares to employees, 20% to local institutional investors, and 24% to Gabonese individuals.

As there is no stock exchange in Gabon, a secondary trading mechanism had to be designed where BICIG agreed to become the market-maker for SEEG shares. To prevent any possibility of manipulation in such an illiquid environment, the shares cannot appreciate in the first year beyond the 6.5% interest rate offered by local savings accounts. This arrangement is seen by the Gabonese government as a temporary step, coming before the eventual creation of a formal stock exchange.

In dollar terms the SEEG transaction is not an enormous one for CGE, one of the largest private sector groups in France with 1996 net income of FF1.1 billion ($220 million). But it did further its international presence, which previously included water projects in the U.K., Mexico, Argentina, Malaysia, and other countries. Now that the SEEG-seeking process is over, CGE's Alain Tronche credits IFC's advisory services with shepherding all parties through the process. "The fact that IFC was a participant with real authority was the element that permitted the process to proceed with complete transparency from beginning to end," he said. "There needs to be a political will for transparency, but then there has to be an organization that has the technical and moral capacity to see it through."

In Washington, World Bank Executive Director Ali Bourhane of Comoros has taken the unusual step of reporting in detail on the SEEG privatization. He mailed out 66 copies of his report to top government officials in the 22 Francophone African nations he represents, hoping they will follow Gabon's textbook example. His 13-page analysis, written in French, concludes with a word to the wise: "Do not expect all privatizations to happen as quickly as SEEG's. That would be unrealistic." ■

Hungry for Capital

Rob Wright, *IFC Corporate Relations Unit*

Budapest

The halls of the stock exchange are buzzing. The atmosphere is tense. People spill out into the lobby, jostling each other for a glimpse inside.

All eyes are on the price quotations of the overhead monitors. Rushed conversations are taking place in a half-dozen languages, but attention centers on the screens.

It is a November Friday afternoon: 3:30 p.m. local time, 9:30 a.m. in New York. With the prime minister watching on the trading floor, Hungary has just launched the biggest equity offering to date from Central and Eastern Europe. Trading is immediately active on both sides of the Atlantic, as the global flotation of 26.9% of privatized national telecommunications company Matav raises more than $1 billion, despite the grim emerging market conditions stemming from the Southeast Asian financial crisis. Its initial public offering (IPO) is quickly termed one of the year's most successful, receiving more than three times as many orders as could be filled and seeing its share price rise 27% in the following month.

The Matav deal was big news in the world's financial press, demonstrating the value the market attaches to strategic investors' ability to turn around a former state-owned enterprise. After more than three years and $1.7 billion of investment, majority owners Deutsche Telekom of Germany and Ameritech of the United States had built Matav into one of the transition economies' best private companies, doubling its number of installed lines and increasing earnings by 44% a year. The equity offering's flare under such difficult market conditions made it "the flagship transaction for Hungary as well as for the region," said Pal Szabo, head of the Hungarian privatization body APV. It was another milestone for a country that leads Central and Eastern Europe with approximately $15 billion of foreign direct investment in the 1990s, and, in the recent words of the *Financial Times*, "has the strongest economic fundamentals of any post-communist country in the region."

But it isn't only the big deals that define a country's progress. Sometimes the little ones mean a lot.

To NASDAQ

Eight months earlier another Hungarian technology company, Euronet, had listed with far less fanfare on NASDAQ, the U.S. market for small and mid-sized companies. Euronet sells something just as vital as Matav's phone calls: access to one's own money. It runs the country's first independent network of automatic teller machines (ATMs), allowing Hungarians to withdraw cash around the clock, and not just at bank branches but from "bankomats" conveniently placed in gas stations, shopping districts, cinemas, bus and railway stations, even in small rural villages. The idea has become as big a hit in Hungary as elsewhere, introducing valuable new efficiencies to the local financial system. To cite just one example, Magyars can now pay utility bills at ATMs via bank card rather than wait in long lines to drop them off at the local post office, as had long been the custom.

Euronet's initial public offering raised $83 million, too small to raise eyebrows on Wall Street, but big enough to give the company money to build on its base in Hungary and expand into Poland, the Czech Republic, Croatia, eastern Germany, and elsewhere. It was also a venture capitalist's dream. One of the world's largest private equity managers, Boston-based Advent International, had made a high-risk investment of $3 million in

the company between 1995 and 1996. The day Euronet went public, that stake suddenly was worth $30 million.

Not Bad

"You don't get many deals anywhere in the world that net you ten times cost in a year or two," said Advent Senior Vice President Nicholas Callinan. "That's outstanding by any measure. Even in the United States, any venture capitalist would be very happy with it."

IFC played an important background role in 1997's two big Hungarian IPOs, using different tools to help the country develop its potential as a prime investment target. On one hand it injected $30 million into Matav in 1993 to help strengthen the company's balance sheet and add enough credibility to the privatization prices to attract investors like Deutsche Telekom and Ameritech. One the other IFC worked through some of its investee venture capital funds (see box), which take equity positions in growing Hungarian companies like Euronet unable to attract financing from other sources in their early stages. One of these funds, Euroventures Hungary, put up $300,000 in July 1994, only a month after Euronet had been founded and long before it had any cash flow. The others, Advent and its related private equity funds in Hungary and Poland, finalized a $3 million investment in April 1996, about three months before Euronet began contemplating going public.

In both cases, the equity from IFC and the venture funds' other investors showed how critical foreign venture capital can be in an emerging economy, where domestic sources of long-term financing are often scarce, if available at all. The venture capitalists take the early risks that banks and capital markets won't, knowing they can reap far higher returns if things work out as planned.

On the Beautiful Blue Danube

	MATÁV	Euronet
Business:	Principal telecommunications company in Hungary	Owns and operates independent network of Automatic Teller Machines (ATMs) in Hungary and other Central European countries
History:	State-owned until privatized in December 1993	Founded 1994
Principal Shareholders:	MagyarCom (50/50 joint venture of Deutsche Telekom and Ameritech), 59%; public, 18%; Hungarian and Privatization State Holding Co., (APV) 6%; EBRD 2%, IFC 1%	Public (40%); CEO Michael J. Brown (21.7%), DST Systems, U.S. (8%)
Competitiveness:	Holds monopoly in voice telephony in most of country until 2002; strong leader in domestic markets already open to competition, such as cellular and network and data transmission services	Sole service provider in its market
Employees:	18,850	140
Profit/Loss:	Profits of $93 million on earnings of $616 million for six months ending June 30, 1997	Losses of $7.6 million on revenues of $1.2 million in calendar year 1996; projecting first profits in 1999
IPO:	Raised approximately $1 billion Nov. 14, 1997, in the largest equity offering ever from Central and Eastern Europe, valuing company at more than $4 billion; listed in New York and Budapest	Raised $83 million March 6, 1997, valuing company at approximately $200 million only two years after startup; first NASDAQ listing of a Central European company
IFC Role:	To facilitate Matav's upcoming privatization, IFC invested approximately $30 million in October 1993, when the company needed new equity to improve its financial ratios but could not get it from the government or private sector	IFC invested in four venture capital funds (Euroventures Hungary, Advent Private Equity Fund–Central Europe, Hungarian Private Equity Fund, Poland Investment Fund) that together provided $3.3 million in high-risk pre-IPO equity
Development Impact:	Since privatization Matav has doubled its number of installed lines and turned into one of region's top companies in four years; IPO marked the first time a Central European company had listed on the New York Stock Exchange and did more to increase local participation on the Budapest Stock Exchange than any other issue	Creation of high-skill jobs; precedent for other small business startups, especially in technology sector; demonstration effect for efficient foreign direct investment and technology transfer

Venture Capital in Hungary: Two Funds

Company Name:	Euroventures Hungary	Hungarian Private Equity Fund
Initial Size:	$16 million (denominated in Dutch guilders), of which $10.5 million has been invested	Initial Size: $15 million, of which $6.2 million has been invested
Current Market Value of Invested Portion:	$20 million	$9.1 million
Primary Shareholders:	ABN-AMRO, Netherlands (28.6%); Hungarian Foreign Trade Bank (21.8%); IFC (16.8%); Dresdner Bank, Germany (10.2%); Euroventures BV, Netherlands (9.5%)	Advent Private Equity Fund–Central Europe (43.2%); Abu Dhabi Investment Authority (16.7%); IFC (16.7%); EBRD (16.7%); Creditanstalt, Austria (6.7%)
Founded:	1990	1995
Objective:	Longterm capital appreciation through equity participations of up to 15% in, and management support to, export-oriented private enterprises	Longterm capital appreciation through equity participations of at least 10% in medium-sized private enterprises typically having access to western management
Duration:	10 years	10 years
Local Adviser:	Antra Kft, Budapest	Equinox Investment Management, Budapest
Number of Companies in Portfolio:	10 (food and agribusiness, technology, retailing)	5 (food and agribusiness, technology)
Average Investment per Company:	$1 million	$1.2 million
Projected Annual Returns:	At least 15%	Goal of 25–30%.

Such was the case with Euronet. It is the brainchild of U.S. entrepreneur Michael J. Brown, founder of what became a Silicon Valley financial software company called Informix that had annual revenues of $170 million by the time he left it in 1990. In 1994 Brown sensed there could be a mass market for ATMs in Hungary. Knowing that only 8% of the population had a bank account at the time, but that far more wanted them, he launched Euronet with $1 million of his own and $1 million from DST Systems, a company in his home town of Kansas City, Missouri that packages data for U.S. mutual funds.

Brown specifically wanted to find local partners to supply some of the additional $1 million required in his business plan. But finding no Hungarian companies strong enough to do so at the time, he had little choice but to turn to Hungary's nascent venture capital industry. A lack of prior experience in the country did not stop Brown and partner Daniel Henry. One of their first stops was Euroventures Hungary, a vehicle IFC was supporting to help develop exactly this kind of company. Euronet General Counsel Jeff Newman well remembers the first meeting with Euroventures' man in Budapest, Andras Geszti.

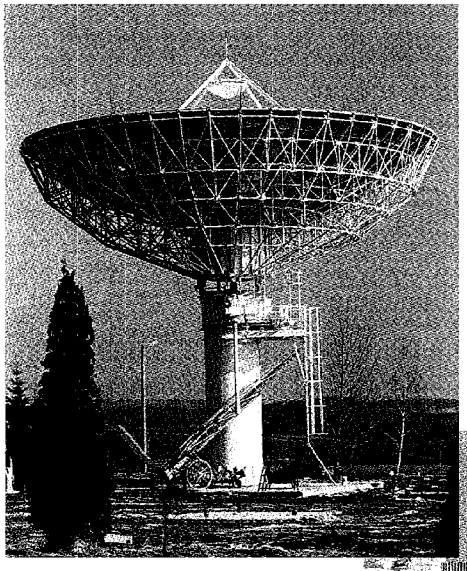
"What he essentially saw were two guys from Kansas City trying to do business exclusively with the five biggest Hungarian banks, which at the time were still government-owned and managed exclusively by Hungarians," Newman recalled. "That was a big risk."

Risky Business

In 1994 few foreign investors thought it worthwhile to make investments of less than $5 million in Central or Eastern Europe, and at the time Euronet had only two employees: Brown and Henry. But Geszti saw potential in the concept, which had two strong selling points: (1) enabling Hungarian banks to avoid the heavy cost of building large ATM networks of their own; and (2) unlocking hidden demand by introducing western marketing savvy and customer service standards rarely seen in the region at that point.
The idea was one of classic outsourcing, or making money by performing a key business process for clients more cheaply than they can do it themselves. Euronet envisioned becoming the region's leading low-cost ATM service provider, charging client banks about $1 per transaction. Knowing that the service could work and that whoever introduced it first would have a huge advantage over competitors, Geszti took the idea to his investment committee, which included an IFC representative. He won approval and put the fund's money at risk, buying 10% of an infant company with little to show beyond a good idea and an untapped market.

By the end of 1994, Euronet was seeking another $6 million in a second round of venture capital financing. Interested this time were the funds IFC had invested in through Advent, which manages a $3 billion global portfolio. Although Euronet's balance sheet still showed nothing but intangibles and projected earnings, Advent's team was equally intrigued with the business plan, which depended on negotiating contracts with local banks to install ATMs in locations that would draw high customer traffic. But good venture capitalists are not easily impressed. They typically turn down 10 deals for every one they accept and put one thing above all else when considering whether to invest: management's track record. Here Euronet fared the best.

"I've been in the venture capital business for 14 years, and I'll put



down Mike Brown as one of the best entrepreneurs I've ever seen," says Callinan of Advent. "He is an all-around, classic American entrepreneur, with all the skills to know where he wants to go and how he wants to get there in terms of when to spend the money, how to attract the right kind of people, and so on. Unfortunately, a lot of entrepreneurs are, to quote Marshall McLuhan, 'driving into the future looking in the rear view mirror' but Mike's overall performance has been outstanding everywhere he's been. Consequently there are opportunities unfolding even he had never envisioned."

In April 1995, Advent and its related Hungary Private Equity Fund and Poland Investment Fund invested $6 million. Euronet then signed up several leading local banks and began spending its money on ATMs imported from the United States at a cost of roughly $30,000 each. At the end of the year, it had 53 of them installed, 113 by the end of 1996. No profit stream yet, but business was looking up.

Branching Out

One of the contracts signed was with the Hungarian branches of ING Bank, whose investment banking arm ING Barings soon sensed that Euronet's basic franchise and earning momentum were strong enough to merit going public. In early 1997, a prestigious new investor came on board in the form of GE Capital, further strengthening the salability even though Euronet was still in a capital-intensive buildout phase and not expecting to make money until sometime in 1999. Offsetting that were other points in the company's favor: it was starting to earn new revenues by taking advertising on ATMs and managing banks' own on-site machines; its only competitors were the banks that, ironically, also were its customers; and it could point to the history of Portugal, where the number of ATMs in use had grown from zero to 4,000 between 1985 and 1995.

Euronet was the dominant player in a good business to be in for a country where demand for efficient financial services was rising fast, and Wall Street's raging bulls were craving new issues of precisely that kind. The underwriters went to market, and the markets took the bait. The IPO was seven times oversubscribed, with demand neatly split between U.S. and European investors.

The ING Barings-led underwriting syndicate was able to sell 40% of Euronet to NASDAQ investors at $13.50 a share, instantly valuing a company that had been worth nothing only three years ago at $200 million. That made it quite a day for Euroventures, which less than three years earlier had gambled $300,000 of its $16 million fund on an unknown company in its highest-risk opening stage. The early bird got the worm: the IPO valued that original $300,000 stake at $4.2 million, or 14 times its cost.

"You don't see many deals like that," says Jeffrey T. Griffin, IFC's representative on the Euroventures investment committee.

Risk and Reward

It was the first time a venture capital-financed Central European company had listed on the international markets, and those that took the risks got the reward. Today Euronet has installed 650 ATMs, just under half of them in Hungary, and is a growing small business with reported 1997 earnings of more than $5 million. Although it is still losing money while aggressively installing its infrastructure around the region, ING Barings estimates that by 2000 Euronet could report annual profits of $39.6 million.

But the story is more than financial. In chancing its money on Euronet through a risk-diversifying venture capital fund before the IPO, IFC has helped build a company that today has 140 different employees in seven different Central European countries, 100 of them local hires, and a high-tech Budapest processing center almost entirely staffed by Hungarians. The jobs that have been created are attractive, demanding English skills and computer literacy and coming with a bright future for the young Hungarian graduates who hold them. But perhaps most important is the model it has set for these employees, the first Hungarian generation in 50 years to grown up in a market economy.

"What this has done is to create a culture where people can understand entrepreneurship," says Euronet's Newman. "They've seen their bosses, who are 32 and 40 years old, grow the company from zero to $200 million in two years, and it's had an incredible effect on them. We now use stock options as part of the compensation package throughout our entire employment structure."

The Matav and Euronet deals showed the value of well-structured foreign direct investment in an emerging economy that had much to gain by partnering its way into competitiveness in the computer age, and the venture capitalists agree there is more to come in Hungary. Euroventures, for example, is high on similar investments in its portfolio in local companies, one testing semiconductor equipment for foreign manufacturers and another designing Internet sports trivia games. For its part Advent is in the markets raising money for a larger second generation fund for Central and Eastern Europe that will invest at least another $15 million in Hungary, much of it in growing technology companies. ■

Planting Bulbs

Dana Younger, *IFC Environment Division*
and Christopher Granda, *IFC Consultant*

In Dec. 11, after 11 grueling days of negotiations in the ancient Japanese city of Kyoto, delegates from 159 countries agreed on what one leading publication called "the most ambitious feat of environmental diplomacy ever attempted." It was the Kyoto Protocol, a legally binding treaty to cut the industrial world's emissions of the key greenhouse gases implicated in human-influenced climate change.

There was no lack of controversy over how the new emissions reduction standards were to be achieved, or to be divided among the 38 nations agreeing to them. But it did appear that a credible first step towards creation of a global climate change mitigation regime had been taken. Many industry observers have noted that these emissions targets will help create market signals for clean, efficient energy products and services, while also spurring technology transfer to developing countries. This presents a multibillion dollar investment opportunity for the private sector, whose active participation will be essential in reaching the targets the world has just set.

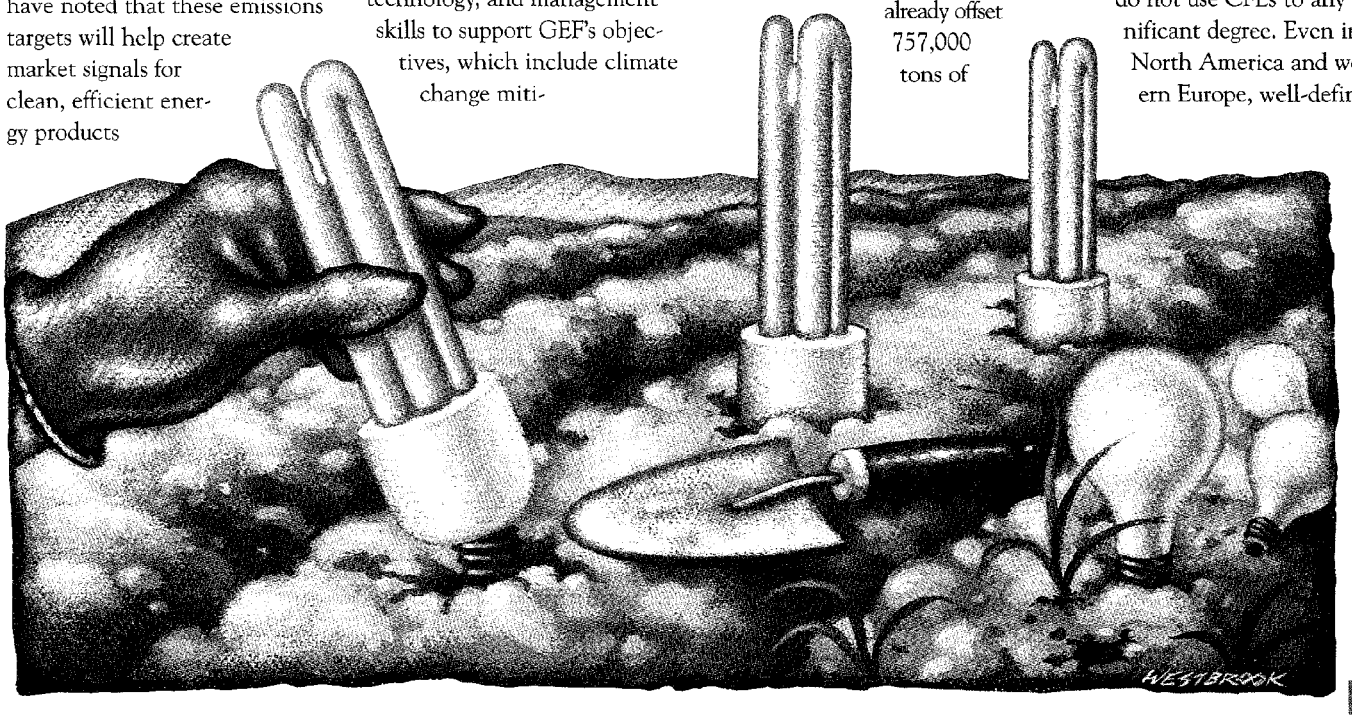
Long before Kyoto, however, it was clear that bottom line business sensibilities and technical capabilities had to be engaged in order to reduce climate change. As part of this effort, IFC has for several years been developing pilot, private sector-oriented, climate change mitigation projects with financing from the Global Environment Facility (GEF), a World Bank-administered entity that provides grant and concessional funding to help eligible economies protect the global environment. IFC's activities seek to mobilize private capital, technology, and management skills to support GEF's objectives, which include climate change mitigation. Through one such effort, IFC has worked with a $5 million GEF grant for the last three years in Poland, a country with serious air pollution problems and substantial greenhouse gas emissions from coal-fired power plants. The Poland Efficient Lighting Project (PELP) uses a package of price subsidies and consumer education designed to build the market for energy-saving light bulbs.

Self-PELP

A two-year program of subsidies has been completed, and all sales targets have not only been achieved but exceeded. The Polish market for energy efficient lighting projects has received a big boost, and by all indications it will continue to expand, as others have done during the last decade in North America, western Europe, and Japan. In the process PELP has already offset 757,000 tons of emissions of the most abundant greenhouse gas, carbon dioxide (CO_2); reduced electricity consumption by 725 GWh; and laid the foundation for even greater reductions in the future.

The effort has targeted compact fluorescent lights (CFLs), a product made by several manufacturers around the world that provides a similar quality of lighting to ordinary incandescent bulbs while consuming only 25% as much electricity and lasting up to 10 times longer. Their high-efficiency design enables them to help fight air pollution by lowering utilities' need to generate electricity, especially when widely used. But there's one big catch: they can cost up to 35 times more than ordinary light bulbs.

This price barrier is so steep that most developing countries do not use CFLs to any significant degree. Even in North America and western Europe, well-defined



programs of manufacturer subsidies, consumer rebates, and other forms of financial incentives combined with consumer education have been essential in building the market for these products.

When IFC began looking at ways to help the developing world overcome such price obstacles in late 1992, Poland seemed an ideal place to begin. Its northern location offered high potential demand for efficient lighting during months of long winter nights. It was also a nation where IFC had made a loan to finance Philips Lighting's modernization of a privatized lighting manufacturer, which by then produced several lines of CFLs sold throughout Europe. Yet while this formerly state-owned plant outside Poznan manufactured 14 million CFLs for export a year, the long-lasting bulbs accounted for less than 0.1% of the total Polish lighting market. It would clearly be more economical for Polish consumers to save electricity while also aiding the environment. But how could they if the price was so high?

To find out, IFC and a U.S. nongovernmental organization (NGO), the International Institute for Energy Conservation, studied the ways industrial country utilities had stimulated demand for CFLs. The most promising model was the one that Southern California Edison had used since 1985 as part of the "demand side management" activities prompted by local public utility regulations. Based on manufacturer administered wholesale price reductions, this program's combination of private sector input and competitive market principles had worked to encourage manufacturers, wholesalers, and retailers to increase CFL availability and sales by significantly lowering retail costs to consumers. After receiving input from the Polish Foundation for Energy Efficiency (FEWE) about ways to adapt the model to local conditions, IFC received a $5 million GEF grant in late 1994 and then competitively selected the private Dutch utility subsidiary Netherlands Energy Co. to manage PELP from Warsaw in close cooperation with Polish utilities, lighting manufacturers, government agencies, and NGOs.

Most of the GEF grant funds were set aside to subsidize prices enough to allow the sale of a total of 1.2 million technically qualified CFLs over the 1995–96 and 1996–97 winter lighting seasons. IFC and PELP encouraged local affiliates of Philips Lighting, GE Lighting, and other smaller Polish manufacturers to compete with each other to apply the GEF subsidies most efficiently. This enabled PELP wholesale subsidies to average $2.14 per light at the retail level, 27% of the consumer cost — quite a low level of subsidy per CFL compared to other lighting efficiency programs in North America and western Europe.

Manufacturers voluntarily provided an additional $1.6 million in further wholesale price reductions and were reimbursed by PELP only after submitting proof that their CFLs had been sold. When combined with forgone retail markups and VAT taxes, the effective average CFL subsidy under the program to consumers thus reached $5.91 per bulb, and the five participating manufacturers also worked with distributors and retailers to enforce the pass-through of price reductions to consumers. But lower prices alone were not enough to build a market. Poles needed to understand the environmental benefits of such purchases and to know that trusted parties were behind the effort. So $570,000 of the GEF funds went to build receptivity through consumer education, including design of an eye-catching PELP logo affixed to the packaging of the promotional campaign's products and incorporation of endorsements from leading Polish organizations such as the National Energy Conservation Agency (KAPE), the Polish Ecological Club (PKE), and the Polish Consumers Federation.

By May 1997 the subsidy funds had been fully used. Sales had exceeded the anticipated 1.2 million CFLs. The share of Polish homes using them had risen by 70%, with 97% of those who have bought them saying they were "very satisfied" and interested in purchasing more of them. The estimated number of total CFLs sold on the Polish market increased by 50% between the 1995–96 and 1996–97 seasons, creating a booming market whose total annual sales may someday reach 4 million units a year, more than three times current levels.

This winter manufacturers are keeping their prices at or below the previously subsidized levels, jockeying with each other to build market share and reap the resulting advantages of economies of scale. Projections show this season's sales will exceed last year's, even without subsidies.

Looking Back

PELP has succeeded in meeting its goal of addressing global environmental issues by reducing national CO_2 emissions in Poland through a modest expenditure of GEF funds. The market growth it has stimulated has had other important benefits at the national and local level as well: consumer electric bills have been cut by an estimated $40 million, and there have been reductions in emissions of other conventional air pollutants (SO_X, NO_X, and TSP) that contribute to Poland's air quality problems.

Much more can still be done through demand side management to save energy, cut Poland's air pollution levels, and contribute to further climate change mitigation. But through PELP a relatively small amount of donor funds has already led to positive change, demonstrated the efficiency that comes with private sector administration, and leveraged additional private financing to supplement GEF resources in a cost-effective way. The receptivity of consumers suggests that the private sector can now largely continue the market-building process on its own in Poland. To carry the message on, IFC has begun to prepare a new $30 million GEF project that will hopefully be able to expand this model to 10 other developing countries in Africa, Asia, Central Europe, and South America beginning later this year. ■

Georgia In Two Minds

Maria C. Thomas, *Special Assistant to the Executive Vice President, IFC*

ere distance measured in terms of spirit, culture, and language, Georgia could not be farther from the former Soviet Union (FSU). A small, proud, predominantly Christian nation nestled between the Black and Caspian seas, it is a land of vineyards, orange trees, and a distinctive language where the word for "mother" sounds like "dada." Its people routinely live past 100 — I've never found anyone who knows why.

Perhaps the answer lies deep within the natural springs of the Borjomi Valley, which produce a unique mineral water widely believed to possess curative powers. Until its output declined after the breakup of the Soviet Union, Borjomi water had long been one of the region's favorite beverages. Helping revitalize this critical brand name has been the subject of IFC's first major investment in Georgia.

The outcome of this effort looks promising today but was far from certain when we started work in May 1996. At the time, I knew only two things about Georgia: it was the location of the ancient kingdom of Colchis, where Euripides' Medea killed her two sons to spite her unfaithful husband; and it was always on the Beatles' *mi-mi-mi-mi-mind*. Armed with this information, I boarded Georgian Airways' 30-year-old Tupolev 154 in Frankfurt for my first journey into the FSU.

Soon I learned that the Borjomi Valley had first supported a popular spa in czarist times, then in the Soviet period grown synonymous with its heavily mineralized sodium hydrocarbonate bottled water that became the "Perrier of the U.S.S.R." Borjomi was commonly known to Russians (as confirmed by my informal polling of IFC Moscow staff) as an excellent cure for hangovers and stomach upsets. As recently as 1986 more than 300 million half-litre bottles of Borjomi mineral water were produced and sold a year. A majority of these sales were in Russia, a centrally planned economy into which Borjomi was sold by then-state-owned enterprises.

Bottlenecks

Georgia's business climate deteriorated shortly after the dissolution of the Soviet Union in 1991, however. The onset of civil war and secessionist challenges in the northern province of Abkhazia pushed it into depression. The country's economic collapse was one of the worst in the FSU, with GDP declining in 1994 to 30% of its 1990 level. The average real monthly wage in the private sector dropped by 90% to about $40, with government workers earning only about $16. Beset by a chronic electricity shortage, the government was forced into rationing, and stranded trolleys lined the streets of the capital city of Tbilisi.

From 1992 to 1995 much of Georgia's industry was idle, including the Borjomi Valley's largest glass bottle factory and the two state-owned Borjomi mineral water bottling plants. Things got so bad that a 65-year-old glass master disassembled critical machinery and hid the parts in his back yard to save them from thieves. Then the darkness led to dawn. After narrowly surviving an assassination attempt in August 1995, President Eduard Shevardnadze began to crack down on thugs who had taken control of

Georgian society. His administration annulled a questionable earlier privatization of the two Borjomi bottling facilities, jailed the erstwhile owners, and reclaimed the plants for the state. By November 1995, President Shevardnadze had ended the civil war and was freely elected to a five-year term.

That same year, a new company called Georgia Glass and Mineral Water (GGMW) acquired one of the valley's glass bottle makers, Khasuri, in one of Georgia's first large privatizations. It also concluded a 50:50 joint venture agreement with the government to operate the two Borjomi bottling plants. This arrangement continued until January 1997 when GGMW won, through a public tender, the exclusive right to manage both bottling plants and to control and license the prized trademark.

Borjomi and IFC became acquainted in April 1996. I was in London to meet the manager of Baring Asset Management's First NIS Regional Fund at one of those "I Ate Too Much for Breakfast" breakfasts. In walked Bob Meijer, a successful Dutch venture capitalist.

Venture capitalists can be colorful people. This one is no exception. Among other things, he is the developer of a major St. Petersburg office and retail project, an antique race car enthusiast, and proprietor of an eclectic Amsterdam art museum devoted solely to cats. He had fallen in love with Georgia upon roaring into the country during a road rally through the former Soviet republics. Following him into the breakfast room was his partner Mamuka Khazaradze, the most successful businessman in Georgia although still only 30 years old. Together, they quickly began to tell the legend of Borjomi: the healing powers of the water . . . the majesty of the valley . . . the bottling plants located near the birthplace of Stalin himself . . . their need to finance a $10 million project to restore Borjomi to its place among the leading mineral water brands in the FSU.

It sounded fascinating. I had to see it.

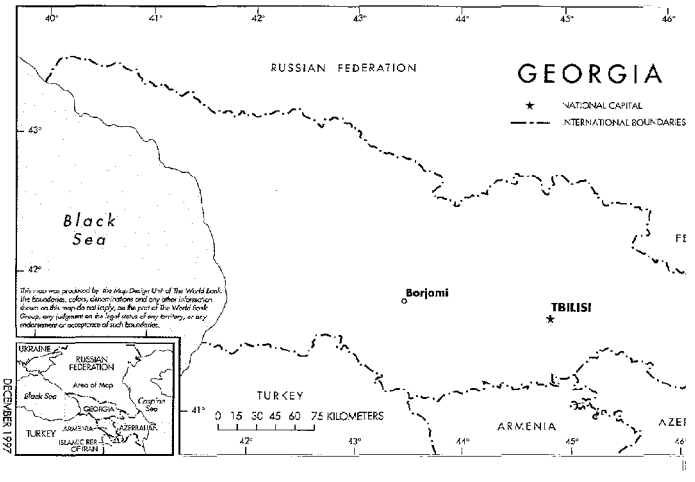
More Hachipuri, Please

On my arrival in Tbilisi late one evening after a 20-hour trip, I was greeted by Mr. Khazaradze and several of his business associates. Sleep was not on the agenda. We drove to a part of the city distinctly lacking in electricity. Toting flashlights, we found our way to a humble local restaurant. Several people in one way or another connected to GGMW crowded into plastic chairs around a table overflowing with plates of cheese, fresh vegetables, and the local staple, hachipuri bread. There, well after midnight, I met the other principal investor in GGMW, Fred Zimmer, a Dutch national who had been president of Perrier before its purchase by Nestlé.

The sponsors' credentials were strong. Mr. Meijer's company, VCI, manages a $500 million investment portfolio. And during his 35-year career, Mr. Zimmer had successfully launched several top mineral water brands: Poland Spring (U.S.), Volvic (France), Buxton (U.K.) and others. Mr. Khazaradze founded and runs Georgia's premier private business conglomerate, the TBC Group, which owns a chain of retail supermarkets, one of Georgia's most important private banks, a television studio in Tbilisi, and an outdoor advertising company.

As the night wore on, our collection of dinner companions grew ever more exotic, and the proclamations of the "tamada," or traditional Georgian toastmaster, increasingly philosophical. Had I acted on first impressions, I would have jumped the next plane to Moscow. The next day we visited the project site. Had I acted on second impressions, I would have jumped the first bus to Istanbul, abandoning the decrepit buildings littered with broken glass that housed outdated bottle-making machines. Then, in the heat of the early Georgian summer, I had my first bottle of Borjomi. The high sulfur content makes it an acquired taste, to say the least. In fact had I acted on taste alone, I would have run for Armenia!

Still, I was struck by the sponsors' passion for restoring Borjomi to its former glory. In a funny way, I couldn't help but think of Atlanta, Georgia, an emerging market a hundred years earlier. Given a similar opportunity, would I have invested in a brand name there called Coca-Cola? Was it possible that this Georgia's unique local product and powerful Borjomi brand name could be resurrected? Was there an economic way to transport it more than 1,000 kilometers to its main markets? Did consumers need to be educated to distinguish between real Borjomi and the plethora of lower-quality imitators that had hit the market between 1992 and 1995?



Diligence Is Due

IFC mounted an extensive effort to explore these questions and assess this opportunity. Over nine months, we studied the viability of the business and the strength of the brand name, drawing on $133,000 in grant funds from the U.K. and Dutch governments to help fund essential market, accounting, legal, and environmental assessments. Zenith International, a U.K.-based consulting firm specializing in mineral water, conducted the technical and market study. Coopers and Lybrand reviewed GGMW's unaudited existing accounts, including many transactions recorded manually in the Georgian language. The international law firm Clifford

Chance conducted legal due diligence on Georgia's nascent legal system and laws and proposed laws protecting the Borjomi trademark. All of this input helped develop the basic framework of the project.

IFC also initiated discussions with senior government officials, including President Shevardnadze, about:

- the critical importance of trademark protection and enforcement
- the need for systematic, transparent authorization of private companies to extract mineral water from Georgia's state-owned natural springs
- the benefits of encouraging exclusive private sector management of state-owned bottling facilities
- the need to develop standards for extracting mineral water on a sustainable basis and to pay royalties to the government of Georgia
- the importance of developing and issuing hygiene and maintenance standards that can be applied uniformly to all mineral water producers in Georgia.

Snapshot: Georgia

Population: 5.5 million
Capital: Tbilisi
Currency: Lari (introduced in 1995)
Per Capita GDP: $440
GDP Growth: 10.5% (1996)
Foreign Direct Investment: $20 million (1996)
Inflation: 15,606% (1994); 163% (1995); 39% (1996)
Poverty: 30% of pop.
Structure of Economy: Services — 41.4%; agriculture — 33.5%; industry — 25.1%
Major Trading Partner: Russia

Source: World Bank

Deal

The valuation of GGMW and negotiation of IFC's equity investment were complicated by the lack of historical financial data as well as pre-existing liabilities that were difficult to enumerate and assign. But after much work, IFC decided to invest. This move was based largely on two equally important factors: (i) the power of the Borjomi brand name and its consumer loyalty; and (ii) the commitment and local reputation of the Georgian partners. In the end IFC invested $2.8 million for 14.9% of GGMW's common shares and 20% of its preferred shares, which encouraged an additional $5.7 million from the Baring First NIS Regional Fund and approximately $2 million more from the project sponsors. Following IFC's decision to invest, the European Bank for Reconstruction and Development (EBRD) agreed to lend GGMW $10 million more. When fully disbursed, EBRD's loan is expected to help GGMW export much more mineral water.

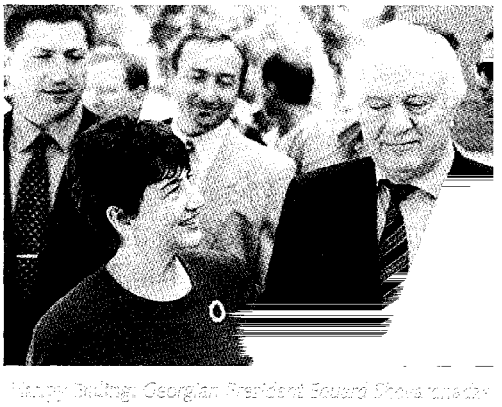
The risks associated with IFC's investment in GGMW are relatively large. There is no well-defined exit strategy or "deep-pocket" strategic investor, although a sale to one may be possible once the company establishes a track record and simplifies its legal and financial structure. However, IFC's management and board acknowledged that one of IFC's central roles is to supply promising companies with equity capital alongside other partners in countries not yet in the investment mainstream.

Thanks to the new manufacturing equipment and technical assistance made possible by the investment, GGMW is now operating relatively smoothly. It sold nearly 28 million half-litre bottles of Borjomi in 1997 and expects 1998 sales of up to $20 million, increasing to about $50 million by 2000. The latter figure assumes sales of 100 million bottles in 2000, which would still represent only a third of Borjomi's 1986 sales volumes. If the market remains as responsive to the product as it was in the past, the future could be bright indeed.

So What?

What about the development impact bottom line? A major player in a key export industry is back in business. GGMW is now the third-largest exporter in the country. IFC investment helped facilitate transfer of technology and know-how having ripple effects throughout the entire economy. For example, IFC has also attracted an additional $400,000 from the Japanese and Dutch governments. These grant moneys will fund an industry-wide program of technical assistance and a full audit of GGMW, the first international audit of a private manufacturing company in Georgia. The Japanese funds ($257,400) will finance an assessment of all mineral water resources in Georgia, train Georgian hydrogeologists and environmental scientists in organic analysis, and establish a laboratory with state-of the-art testing equipment. The Dutch moneys ($125,000) will fund a full audit of GGMW according to international standards and will help the company establish an opening balance sheet. In all, IFC accessed more than a half-million dollars from three donor countries for this project. The country, sponsors, and IFC are all grateful for this endorsement.

In late June 1997, our investment group signed all respective investment agreements at a ceremony in the Borjomi Valley attended by President Shevardnadze and followed by lunch at his eighteenth-century dacha. A few weeks later, I made what became my last trip to Georgia to speak at the country's first major private sector investor conference. A little more than a year after my first trip to Georgia I was, of course, billed as an "expert." With so much to say on the country's economy, its private investment climate, and its most famous export, Borjomi, Georgia would always be on my mind. ■



Happy Smiling: Georgian President Eduard Shevardnadze and the author at signing of the GGMW financing packa

IFC
International Finance Corporation
2121 Pennsylvania Avenue, NW
Washington, DC 20433 USA
www.ifc.org

IFC is a member of the World Bank Group supporting private sector development in member countries through investment, advisory services, and technical assistance.