Financing the Venture

Experience in Mexico: A Medium-Sized Canadian Company – Diachem Inc. (Vancouver, British Columbia)

Diachem is a manufacturer of specialty chemicals used for water purification. One of the major industrial users of the company's products is the pulp and paper industry. In 1991, the company decided that Latin America was likely to be a growth market for its products.

Diachem chose Mexico as its first Latin American venture. By the end of 1991, the company had located a Mexican partner and had established a joint venture to manufacture some of its products for the Mexican market.

Diachem's motivation to establish a joint venture was based on certain conditions prevailing in Mexico. First, the reformed economic environment there made it the logical choice for an initial venture. Second, the Mexican government's strong environmental laws created an immediate and growing market for Diachem products in the pulp and paper sector. Third, good Mexican partners were available with technical ability and access to distribution channels. The Mexican partners also demonstrated the integrity and openness Diachem was looking for.

In the joint venture Diachem negotiated with the Mexican partner, it retained 51 percent of the shares. Diachem remains responsible for introduction of the technology, for which it is paid a royalty by the Mexican partner while the Mexican partner assumes the manufacturing, sales and distribution tasks of the business. Diachem also sells Canadian products in Mexico through its partner's distribution network. Diachem retains ownership of the patents of products manufactured in Mexico.

Diachem assessed both the Mexican market and potential partners thoroughly in advance. During the initial stages, the company worked closely with the Canadian Embassy in Mexico. The company believes the Embassy's help was crucial to the eventual success of the venture.

As a result of its own preparations and Canadian Embassy assistance, Diachem was able to negotiate a deal with its Mexican partners in less than a month. The partnership agreement was put together by Diachem's senior officers. Since then, Diachem has made a continuing effort to ensure that both the Mexican partner and the company's Canadian employees are comfortable with the new arrangement.

Diachem believes the alliance would have benefited from a stronger Canadian presence in Mexico at the outset of operations. Because this was not possible, Diachem has provided for regular visits to Mexico by its senior management and regular visits to Canada by the Mexican partner. Diachem also provides Spanish lessons for its Vancouver employees. And, the company has introduced a training programme on laboratory and sales techniques for the Mexican operation.

The financial arrangements involved in the partnership must be specified in the negotiations leading to an agreement. For example, the method used to finance new investment should be established as part of the deal. The same goes for the timing of establishing a new plant, sending personnel, and inventory; conditions for debtors and creditors; and banking arrangements to be negotiated in new markets. In addition, a plan should be made to deal with foreign currency transactions in existing markets; and new sources of business financing and their costs, including overseas banking. There is also the issue of dividend payouts and reinvestment of profits.

Five factors are important in determining how the alliance should be financed. They cannot be considered in isolation but are an interconnected whole. The decision on the form and amount of financing should be made based on how each factor influences the overall deal.

Structure of the Partnership: The type of partnership being contemplated will influence the nature of the financial commitment by the partners. For instance, a joint venture based on equal shares for the partners will have different financing implications than would a licencing arrangement or a marketing agreement. Joint ventures involve more significant legal and financial obligations than do other forms of cooperation. In fact, co-marketing, cross-manufacturing and cross-licencing alliances may not require a substantial financial commitment at all, since they use resources that can be financed out of existing operations budgets.

Roles of Parties: The amount that a company may be willing to invest in a partnership will depend on its role. It may assume the role of financier, in which case it takes on the responsibility for providing capital for the whole project. If it wants a controlling interest, it will have to make a corresponding financial contribution. Sometimes, an investment is required as evidence of serious commitment to a project. It may also be limited to an initial exploration of future possibilities for cooperation. If the role of one of the parties is to contribute know-how to a project, it may offer patent rights in exchange for shares in the venture.

Capital Sources Available: Much depends on the financing available to each of the partners. In addition to financing available through the commercial banking system, the Canadian partner may also be eligible for financial assistance from various federal programs (see Chapter IX). Financing is also available in Mexico though it currently tends to cost 1.0 to 2.5 percent more than capital in Canada. The specific rate charged, however, will depend on the quality of the borrower and the nature of the investment. Part of the difference in the rate is due to the perceived risk still associated with Mexican ventures. That perception is expected to linger for a while. Part of the additional cost of Mexican capital, however, arises from the large bureaucracies of the Mexican banks themselves. The effects of bank privatization should overcome this problem in the short to medium term. State governments and various incentive programmes established in Mexico may be helpful in providing access to local sources of financing or incentives. Private sector financial specialists may also