"CORPORATE TRADING COMPANIES: "A RESPONSE TO MARKET GLOBALIZATION AND COUNTERTRADE"

SEMINAR PROCEEDINGS

co-sponsored by:

The Department of External Affairs
and
The Canadian Export Association

Ottawa, June 26, 1986

This text was prepared by the Trading House and Countertrade Section
Export Finance, Capital Projects and Trading Houses Division
Department of External Affairs

"CORPORATE TRADING COMPANIES:
"A RESPONSE TO MARKET GLOBALIZATION AND COUNTERTRADE"

SEMINAR PROCEEDINGS

co-sponsored by:

The Department of External Affairs
and
The Canadian Export Association

Ottawa, June 26, 1986

This text was prepared by the Trading House and Countertrade Section
Export Finance, Capital Projects and Trading Houses Division
Department of External Affairs

Foreword

Co-sponsored by the Department of External Affairs and the Canadian Export Association, the objective of the seminar was to provide the participants with a better appreciation of the factors leading to the development of corporate trading companies, what range of functions can be performed by them and how to properly plan for their establishment and ensure their success. This was supplemented by a review of global and Canadian countertrade trends, an examination of how a corporate policy and strategy should be developed for coping with countertrade and a review of several Canadian approaches to corporate trading companies and their functions.

This seminar was targetted specifically at exporters of capital goods and services who face countertrade demands most often of all Canadian exporters and are the parties most likely to establish internal trading companies to cope with countertrade and undertake other related trade functions.

An examination of the pre-registration list showed the following breakdown of participants:

Capital goods and services exporters	60
Trading Companies	23
Consultants	23
Government Officials (federal & provincial)	21
Various Associations	12
Banks	6
Universities	6
Lawyers	2
Retailers	1
Other Individuals	4
TOTAL	158

The presence of others demonstrates the diversity of parties interested in the subject area not only from across Canada - Nova Scotia to British Columbia - but from the United States as well. Final registration figures for the seminar totalled 170 participants.

The enclosed presentations from the seminar were reproduced to provide a departure point for interested parties on the subjects of corporate trading companies and countertrade and as a reference for those in attendance. Indeed, their value may exceed that of other texts in that they not only provide guidance in these two areas but also illustrate numerous experiences which are so valuable for corporate planners and exporters alike.

Where appropriate, transcribed speeches for which original texts were not available have been edited and condensed. Prepared texts of speeches provided by speakers may differ somewhat from the actual presentations.

For further information on corporate trading companies and countertrade, interested readers should contact the

Trading House and Countertrade Section
Export Finance, Capital Projects and Trading Houses Division
Department of External Affairs
125 Sussex Drive
Ottawa, Ontario
K1A 0G2
Tel: (613) 996-1419, 995-7576

or

The Canadian Export Association
Suite 250
99 Bank Street
Ottawa, Ontario
K1P 6B9
Tel: (613) 238-8888

CONTENTS

Presentations:

GLOBAL OVERVIEW OF TRADE AND COUNTERTRADE

SEMINAR
Corporate Trading Companies:
A Response to Market Globalization and Countertrade

co-sponsored by:

The Department of External Affairs
and
The Canadian Export Association

Ottawa, June 26, 1986

Presented by: M.A. MacDonald
Director/Trading Houses and Countertrade
Canadian Export Association

Recent statistics indicate, if we exclude the U.S.A., that foreign major project activity has gone from approximately $50 billion in 1981 to $29 billion in 1985 representing a 42% decrease. This is the result of the present world recession, which affected slow growth in industrial countries and weaker construction spending plans for developing countries. This situation has been further compounded recently by the collapse of world oil prices and its impact on industrial process plant work abroad. As a result international competition for major projects has intensified dramatically to the extent that implementing countries have become not only demanding but very imaginative in their countertrade demands. For those of you who are not familiar with the term "countertrade", it is simply a generic term encompassing all transactions which replace or augment traditional cash or credit for various types of agreements between buyer and seller whereby a sale to an importer is conditional upon a reciprocal purchase or undertaking by the exporter. For those of you who are not familiar with the common forms of countertrade such as barter, counterpurchase, advance purchase, offsets, buy-back, and bilateral agreements, I will attempt to explain them as quickly as possible. To those of you who are old hands on this subject I ask you to please bear with me.

BARTER - A form of trade in which parties undertake a simple exchange of goods without the use of currency. Covered in one contract, delivery of goods or services are usually over a relatively short term. Barter deals are uncommon due to a myriad of problems primarily attributable to the valuation of goods in terms of each other.

COUNTERPURCHASE - (Also called counter delivery, parallel trade or reciprocal trade) is the most frequently practiced form of countertrade. Under a counterpurchase arrangement, an exporter commits himself to buy (or to have third parties buy) products from the party or country he is selling to, equivalent to a certain percentage of his own deliveries. This can range from 5% to in excess of 100% depending on the circumstances. The major feature of counterpurchase is that two separate contracts are signed and linked - one for the sale by the exporter and the other representing the counterpurchase obligation which can be fulfilled over a certain period of time. This period can be negotiated or fixed depending on the circumstances. Unlike barter, each contract should have its own financing arrangements and not involve payment in kind. This overcomes the valuation problems found in barter and enables the exporter to be paid on delivery of his goods.

ADVANCE PURCHASE - The purpose of advance purchase is to secure payment. The hard currency generated by the advance purchase is placed in an escrow account outside the customer's country to ensure access to it. The major problem with this approach is identifying the appropriate products ot use for advanced purchase. In many situations the goods being exported have to be considered incremental to existing trade in order to receive approval from the central authorities in that country.

OFFSET - Offsets are really a form of counterpurchase. However they differ from counterpurchase in the respect that offset activities are normally considered to be directly related to the product or services being purchased. They are normally found in large projects where there is substantial government procurement of military goods. The rationale for such offsets is that there has to be some incremental industrial or economic benefits to be derived from such large expenditures. Offsets normally take the following forms: co-production, licensed production, sub-contractor production, overseas investment and technology transfer.

BUY-BACK - Buy-back is where the seller makes a contractual commitment to purchase or buy-back a certain quantity of products produced from the original sale. Buy-back is most commonly found in the sale or modification of capital plant and equipment. The cumulative value of the buy-back contract can involve either partial or in excess of full payment by means of agreeing to purchase the resulting product. This is a very popular form of countertrade in China since it requires technological transfer and a joint partnership in marketing the products internationally which the Chinese view as being very beneficial to their economy.

BI-LATERAL AGREEMENTS - Bi-lateral arrangements are a systemized form of barter binding all or a certain amount of trade between two countries. This normally arises because of the lack of hard currency. These trade balancing arrangements commonly make use of clearing accounts, which permit trade to take place without the need for foreign exchange and are balanced after a predetermined time. These arrangements are very common among eastern block and lesser developed nations.

SWITCH - From time to time trade under bilateral agreements may become severely imbalanced and difficult to clear. Normally, the bilateral trade arrangement is stalled until, for example, the East European country reduces its surplus by accepting additional goods from the developing country. The East European country with no requirement for these goods sometimes attempts to transfer the amount of the surplus, or a portion of it, to a third party supplier of goods and/or services to the East European country.

SWAP - Takes place when the two parties agree to exchange exporting responsibilities thereby saving on freight. A good example of this is where a Dutch trader sells a shipload of crude oil from the Persian Gulf to Brazil. Mexico had sold a similar shipload to a customer in France. The two parties, Mexico and the Dutch trader, decide to swap shiploads with Mexican crude going to Brazil and Persian Gulf crude going to France.

HISTORICAL PERSPECTIVE - Since many of the countertrade concepts and practices being implemented by LDC's were originally developed by governments in Eastern Europe, it is important to examine the East European experience. In the immediate post World War 11 years, barter characterized most trade with Eastern Europe. In the 1960s, most bilateral trade and clearing agreements were dropped to be replaced by countertrade demands that expanded and contracted in accordance with the economic cycles of the industrialized west. The reason was simple: during boom periods, the East European countries were able to sell many of their products, particularly raw materials and some manufactured goods for hard currency. However, during times of economic recession in the west, it was difficult to find buyers. Therefore, East European authorities responded by urging western suppliers to accept payment in local products against deliveries of Western goods and equipment. Between 1973 and 1980, there had been a rapid development in the practice of countertrade primarily attributable to the ten-fold increase in oil prices which led to the Western banking system's surplus of petro dollars. All through the 1970s, these petro dollars were recycled to East European and developing countries to finance overly-ambitious development plans, with the end result that these countries were soon saddled with huge, external debts which led to difficulties in meeting debt service obligations. This precarious situation was further exacerbated by the dramatic increase in interest rates of the early 1980s, the concurrent global economic recession, and the resultant drop in commodity prices. As a result, not only East European countries, but also a number of under-developed and developing countries began in the 1970s to increasingly use countertrade as a way of generating some or all of their hard currencies for their development requirements. It was also seen as a way to develop new markets for their commodities and products. The estimates on countertrade vary anywhere from 1 to 40% of global trade, or somewhere in the vicinity, of 15 billion to 900 billion U.S. Dollars. The tremendous variations are caused by lack of agreement on what constitutes countertrade, the lack of data on transactions, and the secrecy that surrounds the practice. A conservative estimate of about 10% of world trade ($150 billion) developed by Business International appears to be the most widely accepted figure. The statistics that should really interest the participants here today are those pertaining to East-West which is the countertrade between OECD and Eastern Bloc countries and North-South which is countertrade between the OECD and less developed countries. These represented 20% ($8 billion) and 6% (18 billion) of OECD exports to these regions in 1984.

The Department of External Affairs has estimated that approximately $600 million of Canadian exports in 1984 involved some form of countertrade. This is equivalent to .5% of total Canadian exports.

We find this figure misleading to a certain extent, since it gives one the impression that countertrade is not that serious an issue for Canada. This may be true for exports to the U.S. and food and raw material exporters. However the $600 million pertains to exports of capital equipment and services to the Third World. Therefore if your company is pursuing marketing opportunities of this nature, in this area of the world, you must be prepared to deal with countertrade demands.

That is why in 1984 the Canadian Export Association established a countertrade information centre. We felt that it was vitally important to be well informed on how to deal with the countertrade practices of different countries around the world. In this regard, the CEA has developed countertrade profiles on approximately 50 countries and is prepared to provide advice and guidance on the subject to exporters. In addition, we have sponsored, along with the Department of External Affairs, a series of countertrade seminars across Canada, such as the one that you a are experiencing today.

I sincerely hope that the information you gain from this seminar will help to better arm your company to deal with the intricacies of countertrade.

THE CANADIAN COUNTERTRADE STUDY: A REPORT ON ITS FINDINGS

SEMINAR
Corporate Trading Companies:
A Response to Market Globalization and Countertrade

co-sponsored by:

The Department of External Affairs
and
The Canadian Export Association

Ottawa, June 26, 1986

Presented by: **M.J. Reshitnyk**
Deputy Director
Export Finance, Capital
Projects and Trading
Houses Division

Thank you very much Mr. Chairman.....

A countertrade anecdote comes to mind to me that has much to do with the subject of my talk today I'm sure many of you have heard of the comparison of countertrade to the sex life of the middle age Canadian executive. Lots of talk but little action. Yet to quote the recent issue of Countertrade and Barter Quarterly, "more talk than action - yet the population of the world continues to climb at an alarming rate" - one has to believe that something is going on.

In a word, this anecdote summarizes the findings of our study. Substantial growth in the incidence of countertrade being engaged in by Canadian exporters, tempered by the fact that it is still relatively small in comparison to total Canadian exports. Leaving however, the unanswered question of "Where will this growth level off?"

Before relating to you some of the statistical findings of the study and some of the comments concerning the experiences of Canadian exporters, I'd like to just briefly touch upon what was known about Canadian countertrade experience prior to the study.

For Canadian exporters, countertrade as a global trade phenomena - not just Eastern European, originates in the late 1970's and early 1980's. Indebtedness, lack of foreign exchange, lack of traditional trade finance facilities, recessions and more recently countertrade being used as a tool for economic development, all combine as the basic reasons for its rise. The reaction of Canadian exporters to countertrade at the early seminars on this subject was typically one of , "what is countertrade?" and "how does one cope with it?"

It appeared originally that Canadian exporters grudgingly engaged in it, hoping all the time it was a fad that would soon disappear along with the indebtedness of less developed and newly industrialized countries. History and current developments have demonstrated it to be otherwise and I think Canadian exporters have likewise adapted.

The Canadian countertrade study, designed and conducted by Professor Lawrence Kryzanowski of Concordia University on behalf of the Trading House and Countertrade Division of External Affairs, was an attempt to expand the basic level of knowledge about Canadian countertrade experience, to develop a profile of its growth and to get a feel for how Canadian exporters were coping with it. To stave off the inevitable questions concerning the study's availability, we hope to have the study prepared and ready for release later this summer. All of the participants of this seminar will be forwarded a copy.

I'd like to break down my review of the results of the study into four sections - methodology, statistical findings, qualitative responses and summary. As the study covers much ground, I will focus only on the findings and comments of most interest to you today in order to keep my presentation short and not to put you into a state of relaxation.

Methodology - Briefly, the study's methodology consisted of an extensive questionnaire mailed to 275 major Canadian exporters and 150 trading houses covering all sectors of the Canadian economy.

The questionnaire attempted to elicit responses as to the exporters' general exposure to and involvement in countertrade transactions, his attitude, mechanics of his involvement and perception of future trends. Questionnaires sent to trading houses differed somewhat in that countertrade reported by trading houses also cover that done in support of Canadian exporters. Because of the double counting possibilities, final combined results are presented in a range form. The questionnaire was followed up by interviews with 52 companies who had reported involvement in countertrade activities in the questionnaire or who had been identified elsewhere as being involved in countertrade, in order to improve the response rate and to expand the qualitative portion of the study. These interviews covered 31 exporters, 15 trading houses and 6 other entities including banks and facilitators.

The findings will be reviewed for exporters and trading houses separately and then combined to given an overall picture of Canadian countertrade involvement.

Findings related to Canadian exporters:

Countertrade statistics for Canadian exporters were derived from 169 returned questionnaires and 31 interviews.

1) Exposure to countertrade demands:

Of 115 replies to this question, 62 or 54% responded that they had experienced countertrade demands; 94 of 110 replied they did not try to avoid countries making countertrade demands and 21 of 108 stated that they lost at least one contract because of their inability or unwillingness to engage in countertrade. In addition, 21 of 108 answered they have developed specialized in-house countertrade negotiating expertise and 16 of

108 believed they had in-house expertise for satisfying countertrade obligations. questionned on factors considered important for a successful export sale, countertrade ranked fifth behind competitive price, technological advantage, attractive credit terms and import priority assigned to the product.

Three important benefits from the use of countertrade were identified by Canadian exporters. These included entry into an otherwise closed market, maintenance of exports and market share and development of goodwill with the host government. Problems identified with engaging in countertrade included long and complex negotiations, and risk in handling unfamiliar goods. Willingness to engage in countertrade was considered most important in Eastern Europe, then Asia, Africa and Middle East and Latin America.

Statistical findings - It should be emphasized that 20 of 169 respondents were identified through the questionnaire as having completed an export transaction involving countertrade and that only 11 provided data on their activity. This was supplemented with data from the 31 interviews. Confidentiality and lack of data on corporate countertrade activities were reasons given for not responding. The identities of the respondents are not known to the speaker or mentioned in the study without prior approval.

Based on information provided by these companies, it is evident that total countertrade activity increased dramatically for the five years 1980-1984. Specifically, the number of firms engaged in at least one countertrade transaction per year rose from 2 to 11, the number of annual transactions rose from 2 to 31 and the total value of export transactions involving countertrade rose from \$12.2 million to \$376 million.

Trading house findings

As previously mentioned results for trading houses cover both countertrade transactions done in support of their own exports and on behalf of Canadian clients. The basis for trading house statistics comes from 67 of 150 questionnaires returned and 11 interviews.

1) Exposure to countertrade demands

Of 67 replies to the questionnaire, 17 answered they have dealt with Canadian clients who have experienced countertrade demands, and 44 of 67 did not avoid countries making countertrade demands when exporting.

In addition, 14 of 67 responded they have developed in-house countertrade negotiating expertise.

Trading houses, when queried on factors considered most important for a successfull export sale, considered competitive price first and countertrade last in a ranking of five factors. Similar to exporters, trading houses ranked entry into otherwise closed markets and maintenance of market share as reasons for engaging in countertrade. Problems associated with engaging in countertrade included risk in handling unfamiliar goods, possibly longer time before final payment is received and long and complex countertrade negotiations. For trading houses, a willingness to engage in countertrade was felt most important in Eastern Europe, then Africa and the Middle East, Latin America and the Caribbean and Asia.

Statistical findings

As was the case for the exporters, a number of trading houses were reluctant and/or unable to supply statistical information on their countertrade activities involving Canadian exports. Results are from information provided by 10 respondents to the questionnaire and 11 interviews. Over the five year period from 1980 to 1984, the number of trading houses that engaged in at least one countertrade transaction on behalf of a Canadian client and/or themselves increased from 3 to 10, the number of annual countertrade transactions increased from 11 to 94 and the total annual value of countertrade export transactions increased from $71.5 to $439.5 million.

Combined results

With regard to total Canadian countertrade activity, a combination of the number and volume of countertrade transactions must be bound by an upper limit of combined figures for both exporters and trading houses and a lower limit of trading house figures only. No reliable estimate of the extent of double counting (trading houses operating on behalf of Canadian clients) can be obtained.

Thus, the study found that for the five-year period 1980 to 1984, the total number of Canadian export transactions involving countertrade rose from between 11 to 13 in 1980 to between 94 to 125 in 1984 and the total value of countertrade export transactions rose from between $71.5 to $85.7 million in 1980 to between $439.5 to $815.5 million in 1984. Using these figures and based on total Canadian exports of $131.3 billion in 1984, countertrade affected exports were estimated to consist of between one-third and six-tenths of one percent of total exports. If trade with the U.S. and Japan of $101.8 billion is excluded, this rises to between 1.49 and 2.77 percent of total Canadian exports.

One can summarize the statistical findings by stating that because all Canadian exporters and trading houses did not reply or were not questioned that the ranges given could quite possibly be minimums for the years surveyed.

Qualitative Responses

In addition to statistical information elicited from companies, the study also developed information concerning the actual experiences of Canadian companies involved in countertrade. This covered a range of issues from countries involved, to negotiating techniques used, to fees charged by trading houses. I have chosen several subject areas to review, that are of particular interest and where possible will try to illustrate them with comments from those interviewed.

Countries Involved

Twenty-one countries in which Canadian companies consumated countertrade transactions were identified in the course of the study. These included: Guatemala, Brazil, Yugoslavia, Romania, Hungary, Czechoslovakia, East Germany, Thailand, Indonesia, Malaysia, Phillipines, China, Egypt, Nigeria, Israel, Iran, Denmark, the Netherlands, Spain, Italy and Australia.

Products Involved

Canadian products exported in countertrade transactions consisted primarily of capital goods, turnkey plants and services but also sulphur, potash, potatoes and dairy products. Return goods offered in countertrade transactions included ham, jam, mangoes, fish and fishing rights, sesame seeds, rice, sugar, coconuts, edible oils, canned and frozen foods, spices, foodstuffs, sorgham, wine, beer, cotton, rubber, bauxite, shipping services salt, pulp, wood, furniture, keys, machine tools, electric motors, medical equipment, truck axles, fire fighting and light house equipment, construction and other industrial products.

Contrary to popular public perception of Canada being flooded with Romania strawberries, most of the interviewed companies stated that counterpurchased goods were not sold into Canada. One company stated that "it is a fallacy that countertrade goods will be disposed of in Canadian markets. little will be so disposed due to their pricing, style and quality". We can also add to this list, the small and scattered size of the Canadian market and transportation costs.

Motivation:

The motivation of Canadian exporters engaging in countertrade also provided for some interesting comments:

"Countertrade is a marketing tool or lever which can be used to win contracts"

"Accommodation of offsets and other countertrade demands is a way to gain a competitive edge in certain export markets"

These proactive motives give way to comments concerning reactive motivation:

"Countertrade was imposed by decree and was not negotiable. Although no one really wants to do it, we either had to accept to do it or back away from that opportunity"

"We are increasingly being drawn into it. We have lost a market which we traditionally supplied for the past 14 to 15 years. So have all of our Canadian competitors in that market"

When questioned further on motivations some companies offered the following replies:

"After losing a sizeable project in Central America to a higher-priced Japanese bid which included a countertrade offer, we started to think about proposing countertrade in some bids as a marketing sweetener."

"Our firm is moving away from reactive to proactive countertrade over time. I see a much more proactive philosophy for our firm in the future. If it is going to be required by the end of the negotiations, you might as well start off with it at the beginning."

and a final comment

"We initiated the countertrade proposals. We were the driving force behind the countertrade transactions. We wanted the business."

Countertrade Success Ratio:

Based on responses from interviews, it would appear that no more than 10 percent of countertrade possibilities or offers pass an initial screening. A company provided this comment:

"A detailed evaluation of a countertrade lead is costly both in terms of dollars spent and opportunity costs. Many offers are quickly found to be unrealistic"

Further, no more than 2 or 3 every 10 countertrade proposals passing initial screening resulted in final deals. primary reasons given for this included:

- over-priced countertrade goods
- unavailability of these goods
- soft markets and poor quality of these goods

Use of Third Parties and Trading Houses

Most of the interviewed exporters revealed that they had used one or more third parties to gain information about countertrade and/or to facilitate or fulfill their countertrade obligation. Some of their comments illustrate the varied approaches taken in this area:

"We went to two trading houses to learn about countertrade costs and methods of countertrade operation. It would have been easier to discharge out our countertrade obligation through a trading house if we could have afforded that"

"We had a person from Phillips talk to us in-house"

"Our first reaction when faced with countertrade was to run away from it. We had a briefing on countertrade from MG Services"

"We had an exclusive agreement with one trading house which was a disaster"

"We sought information from the government (External Affairs, etc.) and various third-party exporters that were operating in French-speaking Africa. We had to hire a representative to do some 'back-street negotiating'. We made no approach to a countertrade house"

"A large number of corporate brokers are used by our U.S. parent. Such services have been used by us"

"We phoned the banks. A company from a European country sent us a telex and then followed up twice. Our buyer then put us in touch with an importer who handled his product."

Trading Houses Fees:

Nine trading houses provided full or partial data on the fees they received for fulfillment of countertrade obligations on behalf of their clients. Fees here are defined to cover expenses, subsidy for disposal of goods and profit. Average fees charged ranged from 3 to 25 percent of the obligation. The lowest fees charged range from 1 to 10 percent and highest ever charged from 4 to 38 percent. Most trading houses mentioned they took no retainer or upfront fee. Renumeration was common after performance.

Chosing a Trading House:

Criteria used by the interviewees, in choosing a trading house included: (a) risk-bearing and distribution capacity; (b) ability to assure a high level of performance; (c) level of financial standing; (d) value-for-money rating; (e) specific product, country and market knowledge; (f) network of affiliates; (g) whether they have a physical presence in the buyer's country; (h) whether they have had previous "hands-on" experience in countertrade and/or in the buyer's country, and (i) their relationship with the government of target country. Because the ratings on these criteria can vary significantly across the available trading houses, and can also vary significantly for the same trading house from transaction to transaction, most of the interviewed entities comparison shop for countertrade sercices.

The spokesperson for one of the interviewed entities noted that they had short listed three trading houses for one of their countertrade transactions. Their final choice was influenced by two factors:

1) the client's preference, and

2)"the faith and trust that the country and we had in the people we were dealing with from the trading house."

Other Facilitators:

On other so-called countertrade facilitators or experts some interviewees commented:

"Being a countertrade expert appears to be a high growth phenomenon in the Canadian service sector. These operators read a few books on countertrade and attend a few conferences, and then they begin to market. They promote their extensive countertrade experience and their great connections. In fact, this is becoming one of our fastest growing cottage industries. There may be more people doing this in Canada than are actually involved in pursuing or fulfilling countertrade."

"We were approached by many marginal operators in Canada. Lots of individuals discussed countertrade with us, and wasted our time. There were a lot of middlemen who tried to get a piece of our countertrade action."

Negotiating countertrade with Eastern European FTO's

Comments on common negotiation ploys used by the Eastern European negotiators include:

"A unnamed and probably nonexistent competitor is offering a price which is 40 percent less. If you want to win the contract you will have to match it."

"They change negotiators often. The new negotiators start from the beginning. They try to wear you down over time."

"Since the negotiators are not the decision makers, they will leave the negotiations to check if something is possible. They will invariably come back, apologize, and advise you that their superiors would not agree to it."

The spokespersons of the interviewed entities identified the following strategies as being useful in such negotiations:

"Break off the negotiations abruptly. The FTO's negotiators will have trouble explaining why the negotiations were terminated."

"Provide benefits to the East Bloc participants, such as presents, trips to the West, and so on. The best way is to include such 'benefits' in the bid as being technically necessary for the project's success."

"Since the negotiators have to justify the choice of deal to someone else who has to make the decision, it is important to help the negotiators formulate a good justification."

"The important thing is to determine what their real objective is. Generally, price is secondary since they have volume quotas that need to be fulfilled. Meeting their production goals results in bonuses being paid to them."

In-house countertrade units:

Responses to questions on this subject included the following:

"Too small of an exporter to have such specialization. Management attention is too scarce of a resource to become too involved in such endeavours."

"Lack of depth to be highly proficient or specialized in countertrade pursuit or delivery."

"We would have to have a large volume of countertrade transactions before we set up our own trading unit. It takes a certain structure and size to be effective in handling countertrade in-house."

"We weighted the costs of setting up a trading department and the difficulty in getting new people with countertrade experience. We decided that it was not workable to set up a trading department."

Future Trends:

Both Canadian exporters and trading houses felt that capital projects, followed by high tech and other manufactured goods would subject to increased countertrade demands in the future.

Conclusion: Several key points can be made to summarize Canada's past countertrade experience.

1) The frequency and volume of Canadian countertrade involvement has shown a significant increase since 1980.

2) The primary burden of countertrade demands on Canadian exporters has fallen on companies in the following sectors:

a) transportation and related equipment

b) telecommunications, defence and other high technology products

c) Resource extraction and energy generation equipment

d) Agricultural and forestry equipment

e) Engineering and other consulting services

3) Canadian exporters have been varied in their response to and success with countertrade in the past

4) Canadian exporters are moving from a reactive to proactive use of countertrade.

I think that the prognosis for the future, needs no elaborate discussion. Three simple points can be made here:

1) Countertrade will be an increasingly important factor for Canadian exports of capital goods and services;

2) Without proper knowledge and use of appropriate forms of countertrade, Canadian exporters cannot be expected to win continued export sales;

3) Canadian exporters must devote the appropriate financial and personnel resources to addressing the countertrade demands of the global market place in order to survive.

RECENT TRENDS IN CORPORATE TRADING COMPANIES:
REASONS FOR SUCCESS OR FAILURE

SEMINAR
Corporate Trading Companies:
A Response to Market Globalization and Countertrade

co-sponsored by:

The Department of External Affairs
and
The Canadian Export Association

Ottawa, June 26, 1986

Presented by: **Rod Handeland**
Consultant
San Francisco

Thank you Frank, and also thanks to the Canadian Export Association for including me in today's program. I look forward to meeting many of you who are members as well as others at this seminar during later periods during the program. I appreciate the welcome to Canada, particularly since the last time that I was in Ottawa was at the end of February this year and I can assure you that Ottawa looks very different from an outsiders perspective at the height of summer in June than it does at the end of February. But it is a wonderful country and I am glad to be back.

I had the pleasure of being able to work with Canadian companies and with Mike Reshitnyk over the last couple of years on various trading company and countertrade issues that Canadian corporations have been dealing with. This grew out of some of the work that I had done with US corporations and some of the advice that I had provided US companies looking at countertrade issues over the last 5 or 6 years particularly when I was with Business International.

Mike is very, very correct, countertrade and trading companies, in general, is an area and a topic where there has been a great deal of talk and not quite as much action. More importantly, there has actually been not as much understanding of either what a trading company does or how countertrade is structured, or is likely to evolve, as would be needed to essentially make a business decision or respond to various pressures that companies face. And then finally, there has been some very difficult experiences that companies have gone through over the last 5 years in their attempt to respond to both issues relating to trading companies, per se, and countertrade. I know in the first couple sessions we focused particularly on countertrade but corporations also have not only look at countertrade and countertrade pressures but they also look at trading and trading companies from the opportunistic stand point of, "is this a new business that can generate a fair amount of profit in the buying and selling on a wholesale basis of products and services for our companies?". So, in my comments with respect to the success and failure and I'll try and concentrate on those areas that seem to be very key to the success of corporations, I will deal with both the issues of companies that have looked at trading, forming trading companies as a way to diversify or move into other product lines as well as companies that have looked at more specific narrow aspects of countertrade and the pressures of countertrade to either maintain sales or increase sales of products that they would prefer to sell for hard currency somewhere.

Canada has a very interesting perspective and experience in that, Canada very often pays a great deal more attention to the issues of trade, trading companies and countertrade, than has been my experience with US corporations. Part of the reason and understanding of this is certainly that trade is much more important to Canada as a percentage of its overall economy than for the US and this really has been reflected in the fact that in the US, trading has been looked at has something that is really a little bit less understood because you have the large market of 250 million domestic consumers and most companies look at that as their major market. So Canada really has paid a great deal more attention to trade and I would contend that Canadian corporations are doing a bit more to understand the aspects of trading companies and countertrade than have many US corporations.

I am going to talk about several different areas but I'd like to summarize at the beginning because I think there are only two things that matter a great deal from the stand point of corporations in their evaluation and decision on trading companies.

1) All the successful examples that we have seen of corporations entering or getting into trading companies have resulted from an extention of competitive strengths that the company has, combined with very specific needs and objectives that the company have that relate to the company's own business. Now that is very, very different than basically trading overall where a company or an entity would look at the wide world of internationally traded goods on a wholesale basis and say: "This is a great opportunity, lets look at forming a trading company and then we will find some way to profit from it." Again, <u>the issue is and the conclusion in terms of success is, that every successful venture</u>, that I'm familiar with, <u>has been an outgrowth of a company's competitive advantages in what they are doing currently and it has also been an extension of some of the basic needs and objectives of that company in their current businesses to businesses to international trade or countertrade.</u>

2) The second conclusion is that <u>trading companies are areas that have a tendency of becoming over-planned, over-analyzed, over-extended before anything is done</u> and all companies that we have worked with that essentially have been able to move ahead and get something started as well as get something started successfully have been able to cut through that process of continuing to talk about it or continuing to define it or continuing to analyze it. They have gone back to the basic premises that

we are never going to know all there is before we get into it but we need to define an area that is important to us. We need to simplify it as much as possible, we need to develop an understanding of what trading is and how it relates to our business or how it differs from our business. We need to set up a business plan that has well defined financial objectives, products and other aspects and most important we need to get into the business and try it. And as part of trying it that also includes setting well-defined limits as to how far we are going to go, what we are going to trade in, what kind of financial exposure we are going to have and build a trading business more from the stand point of getting in and trying something rather than continually analyzing or wondering what to do about it.

So again, in summary, two things: the basic business that they get into on a successful basis, is an extention of what their company normally does combined with what the goals and objectives of that company, particularly on an international basis, and then they move ahead quickly to define, understand, implement, limit exposure but basically try it. In connection with the second area, I will cover it in the last three sections of my comments which will have to do with how does a company understand what a trading company is, how it relates to their company, how they put that into a business plan and then finally how they get the proper people to run and effectively make it work within a corporate organization rather than within a trading company. And those are two very different styles of business operations as many of you would appreciate.

Rationale for Developing a Corporate Trading Company

Let's go to that main issue of how do you define, from a corporation stand point, what really is most important about trading and how it relates to their business and how they want their business extended. There is a big, big difference between a company's general reasons for interest in trade and the success of a trading subsidiary. Very often a general interest in trading or trading company has more to do with

1) the rapid growth of international trade, particularly in markets that are growing very rapidly that they may not be extensively involved in already, the rim of Asia probably being the best example of that.

2) Their interest in trade may have to do with the balance of payments of their own country or their own company from that stand point, the degree of publicity about trade in their country and the importance of trade in their country and

3) it also has to do with their perception of the success of other trading companies. And particularly in Canada and the US, that often has a lot to do with the perception of the success of Japanese trading companies. I used that word perception of success because of the way a US or a Canadian corporation operates their business, allocates capital, expects return on investments, there is no way that a Japanese trading company or any of the affiliates of a Japanese trading company can be viewed as the model to emulate or to develop.

There are generally three aspects on that do lead to issues that could evolve into successful trading companies for them.

These are:

Addressing Countertrade Problems:

1) the liquidity crisis in the world and particularly as it relates to the third world and the debt issue and that obviously leads directly into countertrade and I would contend and I think many of you here would agree that you've got to measure the aspect of countertrade by whether there is going to be a great deal of liquidity in the world and whether the debt problem of the third world get resolved or not resolved. If you believe, as many of us do, that the lack of liquidity is virtually the only control over a number of governments who don't have as great a fiscal responsibility in budgets and trade balances (and that implies a relative shortage of liquidity or reasonably high cost of capital) and if you assume that the debt issue as it exists now is not going to be resolved immediately, the implication is that countertrade or countertrade-like transactions are going to be here for a long time and are going to grow. We don't think it's going to go away and I would suggest that your company evaluate that connection with your own business or industry.

Expanding Sales and Markets:

2) The second issue that companies deal with is the whole issue of production capacity. And more specifically, their own production capacity and production capacity in their industry. What we saw was a boom during the 1970's where global production capacity expanded very, very extensively and as a result, particularly in many of the natural resources,

commodity products, heavy industries, there was more production capacity around the world than probably was going to be used up in any reasonable period of time. And as a result, an individual company looks at a trading opportunity more from the stand point of saying: how can I use some of my existing capacity to market my products or services in a greater section of the world or to more countries than I currently am doing? Not, how do I build another plant in another location because we already have enough existing capacity? So again, you have something that relates back to what a company needs to do. That whole issue of capacity that already exists, how do we use it more effectively?

Intelligence Gathering:

3) And then, the final area that has a lot to do with trade and particularly the changes in trade patterns has to do with the whole aspect of competitiveness. There is a whole range of issues that go along with competitiveness that we will talk about for a few minutes.

This issue has something that is a very global phenomenon. They have to keep their own production facilities competitive, on a cost basis, with everyone else and very often that is very difficult to do because there is not a lot of control over things like currency adjustments that affect cost of production in comparison to cost of production in other locations. But there are some aspects of basic efficiency and application of technology that are under the control of the company. So a company looks at an international trading aspect as a way to get a better idea of who is competitive and who is not competitive in the world, in their industry and also then, can learn from that and make some modifications in their own operations.

Purpose:

Let's talk about that well defined purpose that relates to the company's objectives and the company's competitive strength. I break these down into two main categories.

1) One category has to do with either increasing or maintaining the sales of the company's products and that has some implication as to whether you have set up a trading company on a profit centre basis or a cost centre basis. If, in fact, your objective is to maintain and increase sales then you have costs from your internal production and you have a selling price to the outside, you could say that the trading company could be a profit centre.

2) The second area that companies look to for assistance from a trading company or why they would put a trading company together, is a wide range of objectives that don't have as much to do with maintaining sales but have to do with other things that the corporation wants or needs in international trade. Those are mainly services or expertise that a trading company could provide to the operating divisions of a company. And we will talk about some of them. But generally they fall into that category of services that are provided to a fee to the divisions so it is more a cost basis or service centre rather than a profit centre.

Profit Centre Activities:

A) Increasing or Maintaining sales

Let's go back to the increase or maintain sales, because basically the company has to generate revenue and continue to generate revenue. There are five or six different areas why companies actually have looked at and established trading companies:

1) They have looked at trading companies as an innovative or creative marketing vehicle for a fairly low cost entry to new markets they are in or fairly limited markets. Smaller markets that they essentially would not be able to justify putting a plant in or putting a subsidiary in or doing other things. They look at trading companies as a way of getting around some of the issues and they look at trading companies as a way of dealing with LDC's and some of the business practices in the LDC's that they, as a corporation, may not even be as familiar with or as able to, on a policy basis, work with. Many consumer goods companies have actually operated in this way, of trying to get products into countries without essentially producing or building a plant there to get the products there. Other more basic heavy equipment or resource companies have taken the same view where, that is more of an innovative marketing tool or catalyst, and that very often leads into countertrade deals or putting together a trading transaction that may not only involve products from one division but several divisions as their company or divisions of another company.

Countertrade:

2) A second area that has already been touched upon has to do with the whole issue of payments as a result of debt limitations or financial requirements of the Central Bank of a country regarding foreign exchange. This is actually taking place in some of the rim of Asia, the Indonesias, the Malaysias, to some extent but for most Canadian and American companies this essentially has been a phenomenon where they realized most extensively in Latin America. Part of that reason is that American and Canadian companies are well established in Latin America and have had plants and business in Latin American for quite some time. It is not like the rim of Asia where very often they don't have as much activity and haven't had a long history of activity. Plus you combine that with all the debt issues of Latin America and you see that the difficulties in term of getting paid for products that you actually produce in the country or that you basically need to get into the country to produce products.

Innovative Reaction to Rapid and Sudden Currency Changes:

3) A third related area that has to do with debt and liquidity but is slightly different, has to do with the whole issue of low payment and rapid currency change.

A very good example of this was back in Mexico three years ago, could say we could see some of the same examples coming out of Mexico as a result of changes in the last couple of months and continuing changes. But when the peso went from 26 to 250 or thereabout, all of a sudden the cost structure, on an international basis, of Mexico changed dramatically and since many companies had big operations in Mexico they said: "how can we use Mexico now as a low cost of source of production to move products out of Mexico in order to get foreign exchange to get some of the raw materials imported into Mexico to run our plant". Because what happened in Mexico is that essentially imports were cut off and all of those plants in Mexico now had a very low cost of production structure because of the going from 26 to 250 pesos per US dollar. But they couldn't get the basic components into Mexico to take advantage of that. The problem existed however that they never had enough of a free market in terms of international traded goods and because of this had never developed very high quality products. As a result, in terms of producing many goods on a manufacturing basis in Mexico then moving them into the international markets just because the cost of your labour and other inputs dropped substantially don't mean that the quality of the products is sufficient to sell it at any price in any markets, and that caused some limitations. But there were a number of companies, and Clark was a good example of this, in terms of equipment that they essentially made in Mexico, they could use to export, primarily to the U.S., in a way that they could get other products back into Mexico for that plant as well as other plants that they had. So again, you have an innovative approach that basically tees off major changes in currency payments or the complete lack of foreign exchange.

Group Management of Small Markets:

4) Another good example of a way a corporation has used a trading company to be effective in terms of maintaining and increasing its sales is

Honeywell. And Honeywell set up a trading company a couple of years ago that was going to be two basic things: It was going to manage a number of small markets for Honeywell that they had around the world that were getting lost in their big product divisions. These small markets in small countries have very little or small amount of sales in comparison to the world wide product groups that they had and they got little attention paid to them and there was no way of evaluating whether it was good, bad or indifferent. All of these were put within the trading company so that essentially you were looking at all the small markets of the world and be able to evaluate them more clearly and have them stand out more effectively in terms of management attention as to whether they were doing well in comparison to the world wide product groups which were so dwarfed by the OECD markets. So, here was an issue where they used a trading company as a vehicle to essentially focus management attention on a series of countries that were important countries from the stand point of potential business but really small in comparison to the mainlines of business.

Representation of Other Products:

5) Honeywell also did another thing and that was making better use of existing international networks. The second part of what they wanted to do was to be the representative for products that were similar to theirs overseas. Other companies, of course, have tried this strategy. General Electric was the best known in the US in terms of saying: we have an enornous international network that we have operated internationally for many years and we know that other companies have products similar to ours which can benefit from our expertise and our overseas contacts to market them more effectively overseas. And this had a lot to do, what we would call middle markets or smaller manufacturing companies who had a great deal of potential for exporting but for some reason or other never did. It was the GEs and the Honeywells and a

couple of other corporations like those who had the very large existing international networks around the world who said, we then will build a business on representing other products. It is interesting that that business or that type of business doesn't have as much to do with relating to a company's current product lines and business and an extension of that and what's also the interesting thing about it is that at least on the conclusion that we have so far that side of the business or that side of a trading company's efforts hasn't developed well at all. Now part of the difficulties as to why it hasn't developed is that very often companies that would have products similar to the Honeywells' or other large companies have a tendency of viewing those companiesmore as competitors to their products, rather than complimentary to them.

Introduction of New Products:

6) And then finally there is a view that companies can make new profits through new products that are introduced that are similar to products that they currently market but that they may be able to control to markets to or to identify the products from some other manufacturers more quickly than the manufacturers themselves could move and go into the international market. And that is somewhat tied to better use of the existing network but its also tied in the company's ability to understand what else is being produced in their field and being able to identify it and either use it internally or market it to others abroad.

Those are the areas that we have found companies have looked at and to some degree particularly on those initial ones have succeeded in setting trading companies as more or less profit centres. The areas that companies have looked at setting up trading companies as service centres within their corporation had to do with another range of objectives.

B) Service Centre Activities

1) Sourcing - One is the whole area of sourcing or the purchasing of products for the companies and I've noticed, particularly in the US, the issue of production competitiveness is very important because the cost structure in both the US and Canada just doesn't compare as favourably as it once did to cost structures in different parts of the world. What has happened is that many companies have looked not at importing products that compete with theirs but basically importing products that become part of the inputs to their manufacturing process. And again, with all of the industrial capacities in the world, there are many products that are available that are really more sources of inputs of raw materials or semi-processed goods for manufacturing that can be effectively sourced from some country other than where the final production or marketing is done. And companies have paid a lot of attention to that, and I would contend that that actually has been one of the most successful areas in terms of trading company-type businesses. Some companies run directly to a trading company, others just make a very, very sophisticated purchasing department or broaden their purchasing department with a much greater international component that they had in the past.

2) Market Consolidation of Production - Many companies particularly food, beverage and other consumer goods companies, have used trading companies to avoid the establishment of inefficient plants and particularly in risky countries. And they have done this in a way where they have basically taken a position with several countries that have trading relationship among them to say, we will treat this group of

countries as a market and we know that you have trading relations that go back and forth and somehow we will try and balance overall our participation in all of these markets so that we do produce some goods in the countries rather than export goods to the countries. We will produce them in plants that are large enough to be relatively efficient and effective rather than building one small plant for each product in each country. Nestle and General Foods both considered this, Beatrix and Kraft also looked at that as an approach.

3) Offsetting Imports into Foreign Markets - A similar approach that relates only to one country, is a company going to an individual country where they have a big operation and using what they would define as a balance sheet approach. Hewlett Packard has experimented this in Australia. There has been a number of other companies and a number of other countries who have taken a similar position. Essentially, try to tell the country, we need to export some products to your country, we can't make everything in your country but we will do two things very significant to offset that aspect of foreign exchange loss in your country. First of all, we will try to export a good amount from your country, and this gets back to the whole issue of world scale plants and global sourcing of different products, but we'll try to produce a product in your country that we can export rather than just consuming it all in your local market and more importantly they say will generate jobs or value added in your country from the stand point of service or maintenance or warehousing or final assembly or a number of other things that reduce the net foreign exchange cost of products that basically are imported to the country.

4) Technology Monitoring - One of the other areas that you can't really put a profit and loss on is basically the monitoring of technology and the application of technology in similar industries abroad. About one year and one half ago, IBM assigned something like 150 new professional staff to their IBM Japanese operations. IBM Japanese operations was a good, big, thriving, viable business and for a long time was the largest computer company in Japan and I guess now basically seesaws back and forth between Fujisu and NEC. But the whole issue is, did IBM really need another 150 expatriot professionals in Japan to essentially run and develop that market or were they looking at Japan and what was going on a technology basis more from the stand point of how this is going to affect their position on a world wide basis. Now this is inference believe me, I am not really trying to quote or identify IBM's strategy or purpose, I am just saying that there are examples of companies being able, and very often through trading companies type aspects, to look at technology and competition abroad for the basic purpose of making certain that they maintain their competitive production skills and technology application skills. And very often, companies find that it is easier to do it through a trading company because it is a separate organization within their operations and it is perceived of having a greater degree of flexibility and should be understanding and looking at things of that nature.

5) Sales Consolidation and Packaging - Another thing that trading companies are very often formed to do, is to manage very complex deals that often involve countertrade and has also to do with companies that have wide number of divisions within their corporation that either sell a great deal

6) Manage Use of other Trading Companies - Finally, one of the most intriguing aspect of companies forming trading companies, is to evaluate, manage and handle the company's use of other trading companies. And Mike, you alluded to this in connection with what they say how do we reevaluate whether MG services or Philipp Brothers or Continental or Cargil or, any other trading companies that are out there and that are in the market, are really most effective for what we want to do, do we really need to know a bit more about the trading business, so we will set up our own intermediary group, we will become specialist in our trading company to evaluate, when we use an outside trading company, or when basically the company does its own trading or trading type of transactions.

Understanding the Purpose:

A couple of final comments in connection of the objectives and goals then we will move quickly to the last section. We found that it is absolutely essential that the trading company's purpose be very, very well understood by the market, that being its customers or clients around the world, by various suppliers that it would have, and by the management of the company itself. Good examples of how this has work and hasn't work. Sears is an example of a company that had initial difficulty because not too many people understood exactly what they were trying to do nor did many people understood how it related back to Sears' main business or main expertise. This was essentially, as you all know, merchandising, buying and selling products very effectively on a domestic market and on an international basis using the leverage that they may have had in terms of purchasing large amounts of products in various key markets to broaden their trading relationships. But the actual perception of what Sears was trying to do very often related more to what people would perceive a large Japanese trading company was doing rather than some of those basic well-understood competitive advantages of Sears that would relate back to their skills and what their company would want to do. Honeywell, as we talked earlier did a little bit better job of defining exactly what they wanted to do. GE did as well. Both Honeywell and GE ran into the same problem in terms of representing other companies but they both had an internal business that they wanted to take care of more effectively through the trading company and both have been reasonably successful of doing that.

Flexibility:

And then finally, even though you define your purpose fairly narrowly in terms of that basic company objective or your competitive skills, you should maintain some flexibility to take advantage of being in the market, your network of other traders coming across opportunities that are interesting and may lead to other businesses that you find that you may go into. The important thing is let that be an outgrowth of the business as it develops from the basic purpose you want the business to start from. That is helping your company. Don't look at the wide world of trading and say I would like to look at these 15 different sectors several of which don't have anything to do with your company because that's what companies get to the point where they analyze things endlessly and don't do anything.

Planning and Implementing a Trading Company

Question - David Goldfield, Babcock and Wilcox International, Canadian Division - What is your experience with companies where there is a sort of resistance to setting up a trading company as it relates to purchasing and sourcing divisions and what is your advice on how to best deal with that resistance?

Answer - By answering that question, I will be able to get to the last half of my comments. They work with their internal organization in developing business and transactions. That is also the one key difference between an internal corporate trading company and a real official trading company that just basically buys, sells on a wholesale level to make money on the trade or the services associated with the trade. How do you deal with it? Essentially, you deal with it by the time that you do spend on the front end understanding and analyzing trading and what it is. It should be focused to the clear difference between what a trading activity is and what a basic company's business lines are. Very simplistically it boils down to the issue that most companies are in the business of producing products or processing raw materials into products and then marketing them. Where trading companies don't have anything to do with producing or processing, they do have a little to do with marketing products on a world wide basis. Trading companies are interested primarily in the competitive cost of products on a world scale basis from any sourcing that they can find and on the other hand they are interested in the markets of those products and what prices they are willing to pay. Now trading companies make money in different ways by adding a lot of services that relate to logistics and transportation and credit insurance and local value added, market support and warehousing and all these other things. In many instances there is a lot more profit made on those services they provide than there is on the basic margin between the buy and the sell of the products.

But a trading company is very narrowly focused in comparison to a corporation and I say all this because in any aspect of dealing with your company's management, either corporate management or divisions, you have to make it very clear that the trading company is not there to duplicate what they are doing, not there to replace them, but essentially in a corporate environment only, to enhance, supplement or compliment their capabilities. In some instances, to be a catalyst to help them make sales where they would not be able to make sales. In other regards, a way of becoming more competitive in their basic production either through sourcing or knowledge of the cost of production of similar type products in different markets around the world. So that you have to start out with the perspective that a trading company is not a threat to the current organization, but you have to build the case very, very clearly within your organization and divisions as to why it's not. That it has a narrow area, that it has a very well defined area of expertise and that area of expertise is really only used in the divisions when the divisions can't do something by themselves.

Now, you still run into the problem where divisions say we can do everything by ourselves, we market internationally, we really don't need that, that's when trading companies have to give in to the more complex issues of - do you know what other divisions in the company are doing in producing that could be packaged together in an overall transaction that would make your division's sale possible where it otherwise might not be. Or do you really know the cost of production of products that are similar to yours in different markets around the world. So that you are supplying a service to your production unit or your purchasing unit. You're supplying a service for being a catalyst to your marketing unit. So it's basically that distinction and delineation that at least allows you to get to the point of a trading company being viewed internally as something that enhances your divisions or your corporate staff functions capabilities rather than fight for turf.

Now the other aspect of that in terms of the real tough issues that companies face is whether it's a profit centre or a cost centre. And I think that those who have been most successful have tried to avoid that issue as much as humanly possible and when the trading company is involved, it tries to push as much of the profit and the credit for the profit back to the divisions as possible. Basically, the corporation is interested in getting the transaction made and getting the transaction made on an effective basis rather than spreading the profits. As a result, a lot of trading companies don't look all that profitable on a corporate basis but many of them aren't set up as profit centres anyway. They're set up as service centre and that may be one way to break through the mentality or the difficulties in a particular company.

Question - You commented that the Japanese trading house wasn't the one that we should be emmulating and I wonder if you could comment a bit on that particularly because their international network is something that is keeping them going and if you want a trading house to market your goods in areas where you don't have a lot of volume or a lot of presence isn't that the way one should be going?

Answer: There is a difference between trying to emmulate a Japanese trading company and trying to use a Japanese trading company. You may have as a corporation want to use a Japanese trading company. My point was that if you are forming a trading company as a corporation you would never want to emmulate or try and build on the Japanese model. First of all because of that complex international network that is so extensive, that creating it would take an enormous amount of investment in a business that inherently is low investment. If you are talking about high capital cost and high initial investment in a trading company as you would in your manufacturing or development of mine, something is wrong. You basically aren't really looking at a corporate trading company or running a corporate trading company as a trading business. In connection with the Japanese, their structure is in place, it has been developed over a large number of years and it is very effective and efficient. However, they are not very effective in terms of their own profitability from the view that a US corporation and a Canadian corporation would take. To give you a quick summation on that, Japanese trading companies earn about 5 to 8% return on equity. That is with the capital structure that is somewhere in the range of 90% debt. It's not so much true now but in most of the past years that debt was at interest rates that were usually 2 to 3 percentage point below world scale price. So if you took a US corporation or a Canadian corporation and try to duplicate a Japanese trading company you would be running at a loss because you would't be paying 2 or 3 percentage point lower nor would you be able to get 90% debt and you are still left with a business that, even though runs as effectively as a Japanese trading company, is still getting only 5 to 8% return on equity. Is that attractive, is that something you devote resources to? I think you would say no, let's use them and believe me they are very effective organization and they can be used very well.

Interesting thing is that they all started out as importing organizations and so have most of your traditional Hong Kong and European-based traders that have been around for a long time, I mean, and you can still say the basic purpose of a Japanese trading company is to import raw materials into Japan at a cost effective basis but most importantly, to keep those imports coming in to keep the factories and the industrial complex of Japan running and running smoothly. Very different from the sort of real aggressive export basis because most of the Japanese manufacturers eventually do the exporting not the trading companies.

Question - So if you are setting up a trading house, not in-house or countertrade operation, but a trading house maybe the Japanese trading house might be the one to emmulate?

Answer: It would not. If you were going to a US corporation or Canadian corporation my view is that you would never want to emmulate or set it up that way even if you could, even if you had all the resources to establish that network because the basic cost structure in the system that they operate under isn't attractive plus we talked about the network in terms of the one side also have another domestic network that ties back all of the associations with financial institutions and manufacturing institutions in Japan and I don't think we really have time to get into this but all I have to say is the US and Canada's companies aren't structured that way, they don't have that kind of potential ties.

To summarize, it would be too costly to set it up in terms of the actual investment, the experienced people that you would have to get and then once you had it set up you would probably be competing against them and if you are competing against them, they are going to set some of the margins and those margins are going to be at a level that it's going to be very difficult to be competitive. In order to compete well against Japanese trading companies you have to pick littlel niches of products or businesses or areas that they are not as good at.

Balance Sheet Management:

The real key to making profit in a trading company, essentially is one of balance sheet management. And when you talk about balance sheet management, you talk about two things in trading. You're talking about accounts receivable and inventory, turning that cash cycle as absolutely quickly as possible to go from inventory and positions in goods to account receivables and payment. The longer you wait, the more difficulty you have with problem areas. The time value of money eats up what profit you may have made. The interesting thing is that the margins on the actual trading don't guarantee profit. It just allows you to run the business efficiently and manage the balance sheet. And the one clarification to that is the margins that you get from the services provided with the actual trading in goods themselves will lead to large profits which are not quite as price competitive as the deal itself and very often the deal will be closed and the services will be thrown in afterwards. Quite often, companies putting the deal together will make money on the services while they may actually lose money on the deal.

Management Leadership:

Now the real issue is how do you make that transition from how a trading company operates and how it fits into the corporation. My view is that you have to have an individual who fits the people. That is, half a trader and by that I mean he has all of the aspects of a trader, he has a degree of autonomy, he wants to work fairly autonomously, he's basically an entrepreneur, he's willing to take risks, he's willing to make decisions rather rapidly and stake his reputation and his pay in most instances on that position which is a very incentive oriented business what is very often quite different from the rest of the corporations. The guy has a great deal of experience in the trading business in the world which means he has a network of contacts with other traders. Extremely important because that's how he gets his understandings of what world markets are and what cost sources are and that's how he allows himself to basically develop judgment and gives him the view of taking position. So you have that on one hand you need those kind of skills but you also need in a corporate trading company someone who is just as much what you would define an innovative international businessman who essentially is the idea guy that can go back to a company's divisions and work effectively with those divisions who first of all understands the company's structure and all its policies and values, who understand how the divisions operate, what they produce, how effective they are, and understands how to work with people in the divisions to essentially get cooperation in the use of their products or the consumption of products that the traders would bring to their divisions through sourcing. And that's done through the ability not to be just a great judge of what a business is but to be a bit of a diplomat to essentially convince those divisions that you are the catalyst and that you're stimulating business and enhancing business, making it take place that they otherwise could not do. And essentially, that's the way successful trading companies in corporations have been built, it has been built with a fairly small numbers of people. And by building with a small numbers of people, you inherently avoid a lot of the analysis, you don't have a lot a people standing around saying, we are going to do this, we are going to do that, they're in the business of getting deals, coming up with ideas, relating them back to the company and developing a few transactions.

Financial Control of a Corporate Trading Company:

Another issue that is a link between the corporation and its trading company but that I'm not going to have a chance to get into, has to do with what a company's management understands what a trading company is, then what the company does in terms of formulating a business plan, a commitment to doing it and then a financial control linkage that says we will control the trading company through a series of financial constraints on it rather than trying to evaluate every deal the trading company does which will cause it to lose much of the autonomy or flexibility to move quickly.

I think that these are some of the highlights and things that we have observed or looked at or difficulties we have seen and that corporations have faced in addressing that issue of trading companies. Thank you very much.

DEVELOPING A CORPORATE POLICY AND STRATEGY FOR COUNTERTRADE

SEMINAR
Corporate Trading Companies:
A Response to Market Globalization and Countertrade

co-sponsored by:

The Department of External Affairs
and
The Canadian Export Association

Ottawa, June 26, 1986

Presented by: P. Verzariu
Department of Commerce
Washington, D.C.

Good Morning,

It is a pleasure to participate in this program, and to share with you my views on compensatory arrangements (CAs) based on the perspective and experience accumulated during my 10 years of involvement with these practices at the Department, as business advisor to U.S. companies.

For your information, our advisory services provide assistance in the following areas:

(1) Assisting U.S. firms in structuring export packages which may include CAs as one of alternative options.

(2) Organizing in-house countertrade units.

(3) Clearing countertrade-related information on foreign practices and third-party assistance.

(Lately, brainstorming sessions with top corporate officers on CAs as a tool of marketing and finance).

Today, my remarks will focus on the growing need for exporters to acquire expertise in tailoring individual transactions. Such need is a direct consequence of the evolving nature of global compensatory trade which stems from differing economic and commercial needs of trading parties, and which results in nonuniform applications of these practices in different countries. The main contributing factor to this situation has been the evident inexperience of LDC governments with CAs which is affecting the way their bureaucracies handle compensatory applications.

This lack of sophistication and flexibility has resulted in uneven approval processes and unpredictable regulatory shifts affecting compensatory transactions negotiated with western firms. It has limited the number of transactions successfully completed and has resulted in such negatives as:

*Superficial assessments of the potential long-range economic consequences of compensatory impositions for their countries (e.g., pressure on prices of petroleum).

*Hurried enforcement aimed at short-term solutions.

*Lack of understanding or appreciation of negative impacts on foreign suppliers.

*Inadequate bureaucratic structures or incentived aimed at facilitating and promoting CAs.

*Unpredictable implementations and approval processes.

*An inability to develop mechanisms which would insure the separation of trade finance from balance of payments finance.

With time and with acquired experience by all trading parties involved, it is likely that standardized criteria for implementing compensatory practices -- the craft of the feasible if you will -- will be adopted in international commerce, or that the required uniformity and predictability may be achieved through the creation of specialized trading and finance "marts" where standard compensatory transactions could be conducted according to well established and regulated procedures (e.g., the Miami's International Currency and Barter Exchange).

Because current CAs must respond to the differing and changing needs of the trading parties, their structures vary according to the countries, products, and expertise involved. Thus, with no precise model available for structuring CAs, the successful implementation of these transactions depends on the ability of exporters to design applications suited to their individual needs.

You noticed that I referred in my remarks to compensatory arrangements (CAs) in trade rather than just to countertrade (CT). As used in our discussion, CAs do not have to be confined solely to linked imports and exports of goods between two parties (i.e., CT), even though CT practices represent today a major portion of CAs with LDCs.

As used here, CAs also refer to, in addition or instead of CT, to any type of asset transfers from the exporter to the importer -- as a condition of purchase -- that result in tangible and desired benefits for the importer (e.g., domestic content, co-production, subcontracting, investments).

Thus, a main goal of CAs is to reduce or eliminate, over a period of time and through varied alternatives, the net outflow of foreign exchange for the importer. I believe that future expansion of CAs will most likely occur within this broader definition rather than solely under CT arrangements, because of :

(1) The limited ability of world markets to absorb most goods offered in countertrade;

(2) The growing protectionistic attitudes in the west affecting many LDC finished goods; and

(3) The lingering credit constraints affecting merchandise trade with debtor nations.

Current market imperatives are increasingly compelling exporters to include CA options among their marketing strategies. At present, pressures for CAs in the LDCs vastly exceed actual transactions, although the number of completed transactions is increasing. This undoubtely relects the distaste for CAs by many western exporters, as well as the already-mentioned lack of sophistication and flexibility with which LDC bureaucracies handle CA applications.

Notwithstanding their shortfalls, compensatory requirements are now spreading from LDCs to some industrialized countries which, in the past, limited such requirements to their governments' military procurements. Requests for countertrade proposals tied to civil government procurements are today becoming commonplace in countries like Portugal, New Zealand, Israel, Turkey, Cyprus, Malta, and Greece.

Compensatory practices are also becoming an accepted option in the <u>planning process</u> of both western firms and LDC governments. For western exporters CAs may represent a means to circumvent their LDC clients' payment and credit restrictions or a competitive edge against other exporters; for LDCs, adoption of compensatory practices represent a means to redress faltering exports and a vehicle for development in essential economic sectors.

Because of financial considerations, LDC governments are today playing major roles in controlling their countries' trade flows. In many LDCs the public sector is either the largest participant in economic activity and the largest importer, or it controls the type and volume of imports through allocations of convertible currency and import licenses.

In future years, these nations are expected to tie practically all of their government-abetted or approved procurements to conditions for CAs, in order to reduce expenditures of foreign exchange and to benefit from technology or other beneficial transfers to their economies.

Indeed, the long-term supply commitments even now being undertaken by western exporters as a result of compensatory obligations in LDCs, are contributing to the international division of labor and to incremental shifts of production capacity to selected developing countries.

Expectations for continued proliferation of CAs in international commerce are, therefore, based on:

(1) the inertia implicit in the compensatory provisions being currently adopted by governments in LDCs and in some developed countries (today more than 90 countries are active in CAs, up from only 15 in 1972);

(2) The LDCs continued need for economic growth which is dependent on sustained import levels and on export expansion;

(3) The limited or uneven prospects for economic recovery for many LDCs; and

(4) The accommodating attitutes of western exporters competing for shrinking export market shares.

For western exporters, such prospects raise justified concerns about incremental costs of doing business and about assumalbe risk. They have already resulted in a filtering in the number and type of western companies that can afford to be active in LDC markets. They will most likely also result in selective involvement by these firms in only a handful of the more prosperous and stable markets in the third world.

Implications for Exporters - What are then the implications for western private sector firms which will allow them to cope with the situation at hand and turn imposition into opportunity?

First, we must recognize that CAs are not appropriate for all exporters or for all transactions. Such arrangements may involve substantial homework and allocation of company resources, as the transactions may require problem-solving rather than formula approaches, as well as an appreciation of the contracting parties' individual needs and limitations.

Even when they are willing to assume compensatory obligations, many exporters reject the role of trading in unfamiliar products because it detracts resources from their firms' normal business operations.

Involvement with CAs most often requires that the exporters have the capacity to:

* Withstand negative cash flows.

* Engage in trade arrangements involving higher risk elements than those they have been accustomed to in the past.

* Afford protracted negotiation spells.

* Meet the approval criteria of both the exporters' financial institutions as well as those of the importers' government agencies.

Consequently some firms are better equipped to engage in CAs than others because of their market positions, size, product diversification or the products' priority for importers.

Involvement with CAs is viewed by these exporters as an evil necessary mostly for incremental business and/or for protection of established market shares. At the same time, exporters realize that extended compensatory obligations spanning several years pose unchartered risks for them, given: the uncertainties in world markets; the potential for regulatory changes implemented by his customer's government which could impact negatively on the exporter's ability to comply with his contracted commitments; and the exporter's liability for performance on the assumed compensatory obligation (remember that such liability is corporate, not restricted to contracting product division).

To compound the exporter's predicament, any assistance available to him from third-parties, e.g., banks and trading houses, is contingent on these middlemen's ability to make use of their own resources, market positions, and specializations, as well as on the middlemen's perception of risk traditional to their line of business.

Because the entrepreneurial mentality of the trading house is alien to the banker's training, and the banker's attitudes are nowadays often too cautious in supporting the exporter's aims in LDC markets, the exporter himself may be required to develop expertise in structuring export transactions which integrate and reconcile the different risk notions of the traders and bankers with his own, into a commercially viable and bankable project.

While this transaction-tailoring function may avail itself of inputs and the cooperation of outside specialists (e.g., bankers, brokers, consultants), it is, in my opinion best discharged within the exporting firm's own structure because of the complex nature of today's trade and compensatory trade environment.

Indeed, it is important to realize that the nature of today's CAs differs from the barter-like, rigidly structured bilateral trade arrangements of the post-world was 1 and 11 years, which were mostly conducted under government-mandated or abetted agreements.

Unlike then, current CAs involve western multinationals or other exporters with established international experience, market presence, and financial engineering savy, they acquired during almost three decades of consistent world economic growth. Such firms have the potential to world economic growth. Such firms have the potential to multilateralize bilateral commitments by making creative use of the international network of interdependent commercial, financial, and communication links established in the post-war period.

A drill-bit salesman once remarked that his customers did not want drills: They wanted holes. But you don't get one without the other.

The same is true for CAs. Exporters are interested in compensatory practices only to achieve their goals of profit. Yet, as exporters realize the increasing difficulties, risks, and costs incurred in vying in the competitive international trade environment, they will be forced to supplement their current marketing expertise with an ability to tailor individual transactions, taking into consideration the particular circumstances of their export markets and the limitations of their clients.

What are then the requirements, building blocks if you will, for developing a company's expertise in transaction-tailoring. In my opinion, they involve both, vesting responsibility for such activities in a specialized group, the CA unit, and in upgrading the company's planning and marketing strategies.

The In-House CA Unit

Developing their in-house expertise can allow exporters to realize savings in the structuring and negotiating phases of a CA. These functions, if contracted outside the company, usually entail a cost of 1-2% of the compensatory program.

Development of such in-house expertise should aim at improving the company's understanding of the risk elements involved in individual transactions. Along with an improved ability to integrate CAs into finance engineering arrangements, the expertise usually results in a redefinition of manageable risks for the company, as well as in a commitment to sustained proactive planning based on access to current market intelligence flows.

During the early phases of a company's involvement with CAs, a specially formed in-house unit should assist top management in the development of corporate policies involving the firm's participation in CAs and to translate these into guidelines for the company's product divisions. The unit acts as a catalyst facilitating strategic conceptual directives from top down, and concrete and practical information flows from bottom up.

As experience is accumulated by the product divisions and as they become more self-reliant in CAs, the role of the CA unit shifts from overseeing and actively participating in such transactions, to providing only requested support services, information, and liaison with outside specialists which can, on a case-by-case basis, assist the company with the handling of individual CAs (strategic planning example at GE).

A decision to develop the company's in-house expertise vested in a permanent unit has, however, to overcome major internal obstacles.

Typical among these are:

*Unclearly defined charters or objectives for the unit (e.g., cost center with an export-marketing support function vs. profit center, strategy planning vs. marketing responsibility for CT goods).

*Overlapping responsibility with other company divisions (staff vs. than line responsibilities, need to avoid duplication of functions).

*Inadequate allocation of budget and personnel resources.

*Reluctant acceptance of the unit and its functions by the company's product divisions and waivering support from top corporate levels (results in need for self-promotion, corporate politicking, education).

*Allocation of responsibilities which are not backed by commensurate assignments of controls and performance recognition.

*overemphasis on, and expectations for, quick results.

Current activities of most in-house CA units emphasize exclusively the discharge of CT obligations that the company's product divisions assume, by facilitating the marketing of counterdeliveries of goods. Seldom does the responsibility of such units include involvement in market planning or in the structuring of transactions.

Rather, the tendency of most exporters when negotiating CAs is to strictly interpret their linked obligation only as a way to create foreign exchange flows for the customer through CT, rather than as an opportunity to reduce the client's net hard currency exposure through creative approaches (e.g., sourcing of supplies in countries whose currencies or regional trade relations favor the customer).

Although the responsibilities which currently prevail in most in-house CA units relate to important and needed functions, I believe that an additional equally important, yet still mostly neglected function of these units, lies in assisting the company's product division with both transaction structuring and with their long-range marketing strategy plans.

A necessary and required activity of the CA unit in the discharge of its activities related to the disposal of CT goods is the collection of varied information. This information gathering requires continuous involvement with everchanging markets and products, varied sources of information and databases, many types of domestic and foreign trade-related organizations, as well as a generalist's perspective on business techniques.

Adapting data flows from established or new sources, and transforming such information into intelligence appropriate to the company's marketing aims, is both within the capability and a logical ulterior step best vested in the CA unit. Thus, the access to information flows from multiple sources and the marketing-support orientation of the CA unit, if supplemented by the expertise in converting data bases into intelligence, make the CA unit a valuable asset for long-range marketing planning.

Inputs by the CA units could supplement the specialized skills and traditional outlook of the product division in the development of flexible marketing strategies which take into account information on the countries' changing economic conditions, trade regulatory tendencies, local competitive pressures, as well as any requirements for creative financing techniques.

Planning and Strategies

Marketing strategies in the late 1980's will have to strike an acceptable compromise between a western company's desire for quick results, involving limited risk exposure in uncertain export markets, and a developing country's desire to secure long-term access to western capital, knowhow, technology, and markets through joint marketing arrangements such as CAs.

Conditions in many export markets in the 1980's may indeed require concentrating the company's resources and efforts on selective markets instead of striking out at tactical targets of opportunity, or pursuing export initiatives on a worldwide scale.

The identification of the firm's marketing goals within the overall corporate strategic plan must nowadays rely more than ever on flexible corporate policies, on advance preparation and, especially, on an understanding of the customer's operational limitations. Thus, critical to the plan is the input of current and sustained information flows.

Through market assessment, evaluation of non-traditional marketing and finance alternatives, and creation of strategic initiatives, the plan extends the company's current methods of operation, and seeks to improve the company's competitiveness by attempting to predict and create the future.

When CAs become necessary, their use may be specified in the company's marketing plan either as a contingent alternative -- aimed at a particular transaction, project, country -- or as an acceptable method of operations within the general long-range marketing strategies of the firm.

Realizing that acceptance of compensatory demands is but one of the available tools for preserving and enhancing the company's market position, the company planners would recommend to the firm's top management, at various stages of market penetration, alternative marketing approaches spanning direct sales, licensing, coproduction, or joint venturing.

Thus, it is the growth dynamics and evolving characteristics of the importing country -- as derived from inputs by the company's sales force and as supplemented by information flows supplied by the CA unit -- that must condition the marketing strategy of exporters in future years, rather than the quota-oriented marketing methods which were successful in the past.

To summarize then, the skills that our exporters will have to develop or hone when vying in the competitive and challenging international trade environment of the late 1980's, include:

*Formulation of creative finance and marketing options which include CAs as one of several possible alternatives intended to minimize the net outflow of foreign exchange for the customer.

*Assessment of international trade and countertrade risks based on access to current information flows gathered from varied sources (e.g., banks, government agnecies, etc.).

*Development of long-term marketing strategies involving selective choice of export markets and projects, which use CAs as a tool of market presence or penetration.

*Access to a range of assistance services from third-parties whose expertise supplements that available within the exporting firm.

These requirements undoubtely add complexity and cost to international trade. Yet, along with heightened risks, they also offer opportunities to the initiated exporter and to those who contribute to his ability to prosper in the export business.

LUNCHEON PRESENTATION BY

Richard Frankenheimer, President

Combustion Engineering Trading Company

Seminar

Corporate Trading Companies:
A Response to Market Globalization and Countertrade

co-sponsored by

The Department of External Affairs
and
The Canadian Export Association

Ottawa, June 26, 1986

Note: As no taping was made of this presentation, the following point form highlights was based upon the notes of the author and others.

Comments by Richard Frankenheimer:

- Combustion Engineering Trading was established in 1980 in response to countertrade demands being made on 32 separate units of Combustion Engineering.

- It operates on a cost basis and is evaluated on basis of sales that would not have proceeded without a countertrade component.

- Current estimate of countertrade obligations undertaken on behalf of Combustion Engineering range over $400 million and are expected to reach the $2 billion mark by 1990.

- The primary purpose is still to do exports without countertrade. Companies should always try for no countertrade first.

- Corporate trading companies should be structured to suit the corporation and must have support from the top in order to succeed.

- Combustion Engineering trading has a role in working with the project finance department as either backup or in conjunction with developing financing packages for overseas sales.

- Future trends in countertrade will include advanced countertrade to be done by an in-house unit in conjunctions with operations units and the corporations longterm marketing strategy. These may be in the form of an umbrella contract or evidence account with the client.

- Other future roles for in-house countertrade units include:

  1) Playing role in strategic planning in knowing and preparing for future activities;
  2) Being a participant in the selection criteria of markets;
  3) Ensuring operating units become more aware of countertrade unit and how they can help.

- Corporate trading companies should have a role in coordinating future purchases by all corporate units in order to develop countertrade credits or domestic content requirements. Credit for local content from one unit should be credited to other units or company as a whole. The countertrade unit should be part of decision of world wide sourcing.

- More cooperation between countertrade units of North America industrial based capital goods exporters and engineering consulting firms was suggested in order that frivolous countertrade offers not be put forward.

The final comment was not to start an internal trading house unit unless volume warranted it and it has top level support.

PLANNING FOR A CORPORATE TRADING COMPANY

SEMINAR
Corporate Trading Companies:
A Response to Market Globalization and Countertrade

co-sponsored by:

The Department of External Affairs
and
The Canadian Export Association

Ottawa, June 26, 1986

Presented by: **Gary Duke**
Vice-President
Westar Mining Limited

I must say that when Mike Reshitnyk first called me and asked me if I would come here to speak on trading, I was really quite delighted because I thought here at last I could come and talk about something that of course I know a great deal about, something that is uniquely North American and something that we all from early ages got very involved in. So I got out all my hockey cards and I decided what the heck, I'll see what I can get for an old Tim Horton.

I must say I am a little hesitant especially after this morning's speakers, to be standing up here giving advice, realizing that this is generally a thankless business. I have always kept in mind the unconsciously profound summation written by a small school girl, "Socrates, she wrote, was a Greek philosopher who went about giving people good advice. They poisoned him." I hope that doesn't happen to me.

My company, B.C. Resources Investment Corporation in British Columbia, is basically in the resource business as the name would indicate, in coal, oil, gas, lumber, pulp, and we also operate a major terminal facility. I'll get into how that led us down the path of trying to get into a trading company or thinking of a trading company, in a moment.

I guess where we really got started was in two specific areas. We had set up a committee within the company to look at opportunities for divestiture, and with divestiture of anything, to look for diversification as to where we might shrink down in some areas that were becoming more tenuous because of market conditions and expand into areas that would lead us on to new glories, we would hope. And about the same time as we started doing this, we had come through the phase of the original national trading company talk in which we had some interest and were in the midst of the discussions led by Tom Burns that came out with the trading house task force report and we had taken a somewhat active role in that and had come to the conclusion in looking into that that there may be something in that for us. We had seen in that discussion, where trading was in Canada, where there could be a need for it.

To start out with as a company, we felt we had certain expertise at least to guide us. A couple of us headed out around Canada to talk to those people who had either come in contact with the trading company issue or who had been steered to through those discussions. We talked to companies in Canada who had been actively involved in trading for some time. Companies like Noranda, and closer to our own business companies, like Canada Packers International who have been in the business for quite some time and of course, as a director of the Canadian Export Association, had an opportunity to speak to a number of my colleagues on the board of directors of that association who are actively involved in this issue as well.

When we kind of had a look at what this business was, we had the sense that there was an awakening in Canada to the whole trading company issue. We decided what we better do really was to get a little bit of outside objective help to help us go through the exercise of looking at a trading company. So we did, we hired a consultant to help us internally to define the project that we were launching ourselves on, to identify areas within the company where we may have some problems, some doubts and fears etc., to focus us on a business that was really quite different from that which we had been used to, to help us determine the direction that we might take and then put some meat on a proposal that we could take back to, initially the committee which I mentioned earlier, and then as was mentioned, by our luncheon speaker "up through the ranks of the company" to make sure that we were focussing it where the decisions would be made.

So we did get a consultant, I must say we got the lead for a consultant through Mike Reshitnyk, who has been helpful to us through this whole process. He went over our proposal as we identified it, at that time and we set some objectives.

But basically, we set an objective to establish a trading arm for the company that would be a stand alone profit centre utilizing our current expertise and infrastructure. However, it must also be a business which would assist in the expansion of our own product categories, therefore helping our existing businesses. I guess one of the big issues that our consultant focused for us, initially, was the perceived problems we were going to face as we brought this idea in a more concrete way back inside the company. And one of the first things we identified as a problem just even talking around the company, was a definition of what we were looking at.

Our company deals very often, and as a matter of fact in the Westar Mining part of our portfolio we are partners, with Mitsubishi. And so there was this concept within the company of Mitsubishi, Japanese trading companies, we heard this morning from Rod Handeland that that was not the route we should be going and nor was it ever our intention to go that way, but every time we mentioned the word trading company to any of our senior executives, particularly the production oriented people or the legal people or in some cases some members of our board of directors, they always conjured up Mitsubishi, Mitsui,etc. So we had to first of all get away from the idea of trading company equals Mitsubishi equals forget it. So we got away from that quite quickly.

And I guess the other thing that our consultant helped us to identify was the inside problems that we might face relative to turf.

I suppose the biggest area of turf problems, in any company when you move in with a new concept and change, is of course something people always claim they will be quick to accept until it appears to them it may be threatening and that is the marketing area of our current product line. These people, particularly in areas like coal and pulp, who long standing contractual arrangements as opposed to our lumber business which has vast number of customers and is basically treated as a commodity with a board price.

There were some problems. I think it is safe to say that the one area where we didn't run into that problem was in the lumber side because they were used to what we were talking about. We have within our company an established trading floor for lumber sales. So they were all with it but then I found out something I didn't know and that is that nobody else in the company and in any other divisions understood what trading floor guys did. So we knew right away that we had a bit of problem.

And I guess the third thing was just the whole attitude within the company towards the viability and the potential of a trading company. So we went through a process. The process we went through, with our consultant leading us, was that we advised all our senior people right up front what it was we were looking at, what this new venture out of our new venture committee was. At the same time of course, others in that committee were looking at other new ventures. Our consultant came to our office and spent two or three days going around interviewing the key people in our company from the chairman, the CEO, right down through all the opinion makers, both at the corporate B.C. Resources level and within the hierarchy of our operating division, trying to get a feel from them very quietly as to how they viewed various things and of course how they viewed trading, a trading company and so on.

He helped us also to put together our first report, and our first report back to the company was one that basically looked at international trading and what was happening in the world. I think you heard some of that this morning from various speakers. So that we could put our concept in some sort of a proper focus, he then described trading companies and their role and he reviewed our business and the potential that could come with a trading company. He outlined to all of our people some of the fears and apprehensions so that they came out on the table to be dealt with and were no longer sort of back in the back rooms, with people sniping away quietly at you. I think he confirmed for us that a trading unit could be successful but only if everyone bought in on it .

And that idea was hammered home time and time again. He also gave us something which we could not do ourselves, we found, in that he gave us a skeleton look at the make-up of a trading company, and how it would interact with our current operations. Because really, we must remember that we are talking about a completely different business even than our marketing units are used to, which are attached to a mine or pulp mill. I think we also were successful in minimizing the expectations so that taking from the Mitsubishi image and down to something somewhat less grand, we also were able to put into a conservative form so that they also didn't think that this was the great panacea that was going to solve our problems come next Monday morning. So we tried up front to make the thing to the management up front a sensible business venture.

This was then taken to our board for them to have a look at and we got the go ahead for the next step. And the next step was a critical one. The next step was to actually physically develop a business plan. The same as you would develop for any other business within a company such as ours, we tried to form that business plan in terms easily understood by all the people within our company, in other words, translate to get into a resource base company's vernacular. Out of it came a solid recommendation including numbers of dollars, numbers of people, likely products, offices, growth rates, upside, downside, risk factors, all the things that a company would have to look at in order to make a sensible judgement of where we could go.

In this whole process, we had come to realize that we did not have the right person within the company to head up this operation and inevitably, a company such as ours and I am sure a lot of yours, think first and foremost or at least we often should, is this an opportunity to promote from within and we always look at that as our first objective.

But we realized that that was really not going to be possible even with some of the very key and good marketing people that we had in our various organizations. We had to find an outside person to take us into this trading business in a sensible way. So we had to go and find ourselves a president and CEO to set up this business.

What did we need in a way of an individual? We determined then with the help again of our consultant and his colleagues, experienced people in the business, that we needed an experienced entrepreneurial trader but someone who also had experience of working within a corporate structure, because we had a gap that needed to be bridged. This individual had to understand the needs of the producer oriented mentality and be strong enough to build their confidence quickly enough to let the trading company do its deals without a board meeting for each one. As in many large corporations that have the long view, every time you are talking about something worth one to five million dollars or whatever it may happen to be, you tend to have to meet on it for several days.

We did determine that there could be an individual inside who could help bridge this gap and that we should probably look at putting in this organization when we formed it. An internal financial person who could help bridge the gap between the way a trading company would operate and the way we traditionally operate so that we would put people like the chief financial officer's mind at rest. Every time we mentioned the word trading company, he bit his fingers.

Now finding this individual, that is not really an easy task. We decided we had to cast our net pretty wide to be certain, but we also had to set out certain attributes that we wanted in somebody so that we could evaluate whatever few applications we might be able to drum up. So we tried to set ourselves a goal of finding an individual who had worked for a large organization and would have a sense of their needs and their philosophical mentality. Preferably somebody who may have been on the building side of something before, so that they could realize than rather stepping into a going concern and taking their experience to fullfil their needs, they would have to show that they understood what was required in building something. And leading to that someone with the kind of experience who would probably want to break away from an established situation because they felt they wanted to build something of their own, based on their experience. Obviously, be flexible to locations but I find that dealing with trading people that is the easiest thing because they live on airplanes anyway. It's just a matter where they get their shirts laundered.

And another thing which is not uniquely Canadian but certainly something that we all consider from time to time and that is if possible this individual holds a Canadian citizenship for the dual purposes of the work permitting aspect and also someone who may have been working a long time in Canada, maybe not originating here, had an understanding of the Canadian business scene and the benefits that can be derived from a knowledge of that scene and what could be done within Canada as well as outside of Canada.

Well as I said, we had the idea that we would cast our net fairly wide, our consultants agreed that even though they never done this before they would like to try and help us locate this individual. So we ran an ad, about that big, in the Globe and Mail, the Wall Street Journal, the Economist and the New York Times - once. We got 800 applicants from around the world. And I must admit it startled us somewhat. The piles were rather unique in that I think the largest pile or probably 500 of those were from US banking firms who had tried to go into that business before had failed and all their people were being cut loose on a regular basis.

We then began the screening process and no matter what Rod Handeland says about "you want to cut through the red tape and get this thing done quickly", when you got 800 applications that's a long process if you want to be thorough and you want to be good at it. We interviewed a number of people and we focused down on a small group who came to Vancouver. Right now we are at the point of hoping that we can announce very soon the formation of the Westar Trading Company, something which I think we will be able to do very quickly.

In summary, I guess what I would like to say going along with those people who want to catch airplanes, I think I would be remiss if I didn't advise everyone who is going into this to get a good consultant because the business is different and it does require an objective viewpoint. Be aware of the internal fears even though they may not be totally apparent to you. People often times will express that they're on side and yet quietly if you go around behind scenes and find that they are marketing team", "you know, these guys are going to interfere". You really have to kind of flush that out very quickly. Understand the enterpreneurial aspect of the business and how it fits with your current operations. "I think, if I were to put it in perspective, people who are good in the trading business, working 20 minutes cycles, I mean, they pick up the phone and deals are made and away they go. Corporations such as ours who are looking at investing or making an expenditure or taking on a commitment for 200 and 300 million dollars tend to look into a 20-year time frame, you got to get that 20 minutes and 20 years together and believe me it is a long gap. And it has to work the other way too. Your trading individuals must understand the corporation so that they can help you or they can help themselves eliminate some of those problems that you are going to be faced with."

Make sure, as Rod has said and everybody has said, all your key senior people are signed on. And I guess the last thing I suggest is, don't think about it as an instant panacea. We've had people rushing in and saying "when is it going to start, you know, God, the bottom line". Rather it is a commitment to a long term business investment like any other long term business investment you are going to make. You have a period of trial and error, yes, but really you are going to make a long term investment. You better be sure that it is what you want to do, that you are doing it the right way and with the right people. And just before sitting down or taking any questions, I would like to acknowledge my thanks to Rod Handeland, our consultant. Thank you.

COPING WITH OFFSETS

SEMINAR
Corporate Trading Companies:
A Response to Market Globalization and Countertrade

co-sponsored by:

The Department of External Affairs
and
The Canadian Export Association

Ottawa, June 26, 1986

Presented by: Phil Cheney
International Liaison
Canadian Marconi Company

Good afternoon, ladies and gentlemen,

The Canadian Marconi Company is actively involved in primarily the manufacture of high technology goods retaled to the defence industry. We are 51.6% owned by the General Electric Company of London, England. For as long as I can remember, we have designed, developed and manufactured our own Canadian products and our market is the world. Marconi exports something in excess of 80% of its manufactured products to the world. So offsets to us are not new.

We first learned of this way back in the late fifties, and the pattern then, in one sense, remains today and that is licensing. We have found that licensing of our high technology products has been a most profitable and rewarding exercise. It has the happy ending that you tend to lock-up a market for yourself.

As an alternative to licensing, a more recent approach has been joint collaboration in development. All those of you who are engaged in the high technology business, you know only too well the high, high cost of research and development and you never know whether you will end up with a saleable product or not. We have several instances where we have joined forces with experts in other countries for a jointly-developed product. And it has proven to be an interesting experience and we hope, and I think not too optimistically, that we will enjoy a success as a result of this activity. Notably, this has taken place with the People's Republic of China.

Yet another way in which we have tackled the offset problem has been one of technology transfers, as distinct from the licensing. We hand over some technology, normally it's not current state of the art technology, we want to keep something to ourselves, in return for which we have been successful in obtaining contracts. We've had several examples which have been profitable to us in joint partnerships with foreign based concerns in the territory with which we are aiming to do business. Our previous speaker spoke of Mitsubishi. I am happy to say, we worked very happily with Mitsubishi, they have got us in a niche in the Japanese market. It works.

Another form of joint partnership to which we have applied ourselves is the use of local suppliers, not for purchasing parts, because again since we're in the high technology and largely in military areas I'm afraid our parts components have got to meet military specifications and that generally speaking is not available. What we can do, and what we have done, is to establish in the recipient country, a source for repair and overall. To seek out reputable organizations which can undertake installation. To seek out and establish organizations which will undertake maintenance. These three areas are ongoing beyond the period of the contract and again, it provide a local input, employs locals, doesn't cost you very much, and yet, gets you a return.

Another related recent experience I've had, which was a surprise to us, we found that the banks, those good conservative financial institutions, are more than pleased to come along for a modest fee, our experience has been 5%, and handle or take off your shoulders responsibility for a large piece of your total contract value as a countertrade. Notably, we were approached on the low level of defence project in which we were allied with a Swedish corporation by the First National City Bank. They were prepared to take $100 million worth of offsets off our hands for a fee of 5%. Canadian banks also are moving in this area. I am aware of the Royal Bank and the Toronto Dominion Bank. There may be others. So they can be a source of easing of the problems which we all encounter in export trade.

I think the key to success is one of flexibility. Being able to adapt the approach to the specific market which meets the requirements as either stated in the request for quotation or told to you by the foreign government, things they would like to see, and then come up with the plan, before you bid. I do stress that, because all these things cost money and I remember one occasion when unfortunatelly our people had bid a price and then went and talked to the customer. The customer wanted industrial benefits in India. We had to back away because our price had been put on the table and there was no means we could undertake the activity for zero cost. So please do your homework first before you put your price in.

I guess all of our speakers have made the point that to be successful you must have full corporate support. It is in my view absolutely essential in the job I am doing at times, I have to set up competition with the company, for the simple reason that someone says we want a requirement in Western Canada and we happen to be located in Eastern Canada. You must have corporate support.

There are dangers and there are risks. Of course there are. You have to assess for yourselves the dangers that are involved when you take on these obligations, because in most cases they are tied to a penalty for non-performance, and those penalties can be kind of horrendous. More important, to us all as exporters, I am sure, we want to do business tomorrow not just today. So assess the dangers, assess the risks. And then with a little entrepreneurial flair, our experience is that in 90% of the cases you can do business. And there will be about 10% which you will walk away from. But only you can assess that.

I could go on and on, I could talk about the Canadian scene but it's hardly applicable, it is more import-related. However, the bidder on the Canadian scene is faced with the same sort of rules, only Canada's are usually more harsher than most. We claim we originated industrial benefits and we're quite tough. But nevertheless, the same approach is taken and has been taken in my experience with the companies with which we have been associated on major Canadian bids, following the pattern which we ourselves have used for the last two and one-half decades. If I may I would really like to get some questions and I will try and answer them from the experience which I've gained with Marconi.

Question: Could you elaborate upon the proposal you received from the First National City Bank?

Response: Certainly. This was during the low level defense exercise where we were seeking to come up with a one hundred percent industrial benefit offer against the contract value. And out of the blue, we had a visit from a gentleman from San Francisco and he put his cards simply on the table and he said "I am prepared to take from you $100 million of offsets which we will guarantee and am sure that Canadian suppliers in the areas you tell us will be used. We will arrange those exports and we will charge you 5%". Which was a very nominal fee.

Unfortunately, in Canadian contracts that was ineligible. And so we couldn't use it. But it was quite genuine even though they were not going to address the primary industry market which was completely unacceptable under Canadian definitions. They were primarily, going to address small business and it was very attractive to us, but unfortunately, we were not permitted by the rules of the game to use that route.

<u>Question</u>: Why were you not allowed to use this approach?

<u>Response</u>: Very simply, we were told it was ineligible by the program office. They would not accept that form of industrial benefit. Primarily because they said they could not keep an account of it, it was too difficult to count and keep track of the transactions that would have taken place.

<u>Question</u>: Do you find the Canadian industrial benefits rules too inhibiting compared to those of Australia, Korea and others?

<u>Response</u>: Well, regretably I have to reply in the affirmative. Canadian rules are from an industrial point of view, pretty rough and I am not sure whether Canada really benefits under its rules. I think we need more flexibility. That's a personal opinion, the case just cited in terms of the banks coming along and being prepared to take a very substantial slice of the action for a nominal fee was disallowed and we were not permitted to address the primary industry markets which mitigated against certain provinces. One tries to get industrial benefit to some of our Eastern provinces, I assure you it is very difficult, because there isn't the industrial base. We try to play within the rules, we have to.

<u>Question</u>: There appears to be little opportunity to use trading houses under these circumstances at the moment in Canada. Could you comment?

<u>Response</u>: I understand that there is a revision underway within DRIE regarding the rules of industrial benefits. But what they are, I'm afraid I don't know. Another area they would not allow is forward banking. Banking by the way, ladies and gentlemen, is establishing a credit account, which you can then apply against various contracts when they compe up. This is just not allowable. Thank you very much.

INTERNATIONAL TRADE AND BUSINESS DEVELOPMENT
EXPORT CONSORTIA AND JOINT VENTURES

SEMINAR
Corporate Trading Companies:
A Response to Market Globalization and Countertrade

co-sponsored by:

The Department of External Affairs
and
The Canadian Export Association

Ottawa, June 26, 1986

Presented by: Tibor Miletics
Vice-President
Sogex International Inc.

Good afternoon, ladies and gentlemen,

Before I start I would like to convey to you the apologies of Patrick Martin who wanted very much to be here. Unfortunately, he cannot be and he has asked me to substitute for him, and deliver his paper on International Trade and Business Development through the formation of Export Consortia and Joint Ventures.

Export consortia, while not a new idea, are considerably more popular now than they were some years ago. The concept of grouping together to attack the export market has really taken hold in only the last few years, because of a better understanding by Canadian manufacturers, particularly those that are subsidiaries of American firms, of the anti-trust or anti-combines legislation.

Our company, SOGEX, (slide 1) is an export company formed two years ago by three Canadian manufacturing and construction firms, active mainly in hydropower generation, as well as electrical transmission and distribution. The three firms are:

o Marine Industries, manufacturer and erector of hydroelectric power generation equipment. Marine also has a medium-sized shipyard, and a railcar construction capability.

o Cegelec Industries, manufacturer of low to extra high voltage switchgear.

o BG Checo International, manufacturer of electrical and electronic equipment, and a mechanical/electrical contractor, with a particular strength in extra high voltage transmission lines.

Total billings of these three firms are approximately $400 Million. Export sales range from 10 to 15 percent of total billings.

And so, our company is a type of export consortium. I will discuss in more detail what type a little later in my presentation.

In the short amount of time available this afternoon, I thought I would review briefly: (slide 2)

- o Why companies are grouping together in export consortia.
- o How is it done? What types of consortia are being created?
- o What are the results of this experience?
- o Where do we go from here? What does the future have in store.

In order to speak from direct experience, I will limit my presentation to the power sector, commenting specifically on our own group's experience while describing the industry's evolution in more general terms.

1. Why: Causes of the trend to export consortia

Why are companies grouping together more and more to attack foreign markets in what has been called a "Team Canada" approach?

1. Why: Causes of the trend to export consortia

Why are companies grouping together more and more to attack foreign markets in what has been called a "Team Canada" approach?

In the power sector industries, the reasons are rather simple. First of all, there was a sudden new interest in looking seriously at export markets. Up until 1982, there had been such heavy demand for goods and services right here in Canada, that many companies had a hard time meeting the demand, let alone look at export markets. During this period, in fact, many foreign companies from Europe and the United States set up subsidiary companies in Canada to serve the Canadian market.

Then, the crash. The graph on (Slide 3) tells the tale. Projections made 1983 showed an expected 50% drop in the size of the Canadian market by 1987, and a slower rate of growth thereafter.

And so all of these companies made a mad scramble for export markets, to fill their factories (some of which were quite new).

And what did they find? The story was pretty much the same in all the other developed countries. The recession was in full swing, and no markets were to be found with our traditional trading partners.

Besides, most of these countries have severe import restrictions on power equipment. (Slide 4) gives details of the power equipment procurement policies in some of the other industrialized countries. As you can see, except for the USA, there is no market for our products there.

This leads us to the developing countries, (slide 5) whose per-capita energy production lags far behind the industrialized world, and where we can anticipate a great deal of business for our sector as they try to catch up, with our help. This slide shows the expected increasing importance of this market. Note that for the hydro power sector, the developing countries' market may represent 50 times the size of the US market in coming years. It is significant that there is very littly indigenous manufacturing capability at present in these developing countries, so we can expect that our exports to these countries will not be hampered by tariff and non-tariff barriers. And so, this has become the target of the industry.

Here we have a simple matrix, with the horizontal axis showing a range from international bidding, through limited bidding, to negotiated contracts. Obviously, the right side of the scale is the most attractive. Over a year ago, we bid against 16 other bidders on a tender for hydro generating equipment in Iceland. With alternatives, there were 25 separate bids considered. The highest ranked bidder had offered to take payment in fish! Since it costs from $100,000 to $200,000 to prepare a bid of this type, I think you will agree that we cannot afford to bid too many of these, if we have one chance in 25. So we look for situations where there are fewer bidders, or where, ideally, a contract can be negotiated directly.

Now let us look at the vertical axis. Here we show a range from product to project. Our point is that the low end of the scale is the sale of a product, such as a turbine, by itself. The high end, the "noble" objective, is to sell a project, an entire system. Canada has a wealth of engineering expertise, and should be in an advantageous position to put together an entire package like this; however, until recently, the segmented sectors of the industry i.e. engineering, construction, manufacturing, have led us to very successfully sell our know-how, our engineering, overseas, without linking it to the sale of our products. How many Canadian designed projects were built by Koreans with equipment supplied from Japan?

Our European and Japanese competitors realized this long ago. Some of our competitors are huge organizations or permanent consortia, with as many as 200,000 employees and worldwide distribution networks. They found that by linking products with know-how in an overall package, you are more likely to sell a broad range of your products, and not just the few where you are the recognized world leader. Furthermore, you are faced with fewer competitors able to put together an entire package; in a bid in the Middle East last year, our consortium was one of only eight competitors. (We placed third, by the way.)

In addition, the stated objective of aiming for a negotiated contract is normally only possible in the case of a package approach, including design, construction, manufacturing, and financing (very important).

So the conclusion is obvious. We must aim for projects rather than products, and identify situations where there are few bidders, or, ideally, where a negotiated contract is possible. In other words, we aim for the upper-right quadrant on the chart.

The importance of these conclusions to the health of our industry is underlined by the fact that the obtention of just one such medium-sized project per year would double Canada's exports in this sector.

2. How: Forms of Consortia

What types of consortia are being formed. We believe these can best be described, in general terms, through the use of another matrix chart (Slide 7).

Here we show, very simply, the range of degrees of permanence or of commitment on the vertical axis. At the low end of the scale, we have the Ad Hoc consortium. This was the typical early Canadian response to meet the international competition. The results of this approach leave much to be desired. In most cases, while the Canadians were still deciding with whom to team up, and negotiating a consortium agreement, the competitors had already bid the project. It was obvious that a more permanent relationship between likely consortium members was required. Nonetheless, many Canadian companies are still trying to approach the international market in this way.

At the top end of the scale, therefore, we show the Permanent Consortium. This is often an incorporated company, formed as the result of an agreement between certain companies to always work together in a stated way in certain pre-defined situations. This form of consortium can most quickly respond to a given business opportunity. Some firms may, of course, feel that it lacks flexibility to respond opportunistically to a prospect.

In between these two extremes, we have shown a middle ground, with what we call the Marketing Consortium. This can be described as an agreement between several companies to share market intelligence exclusively, with the objective of identifying opportunities to work together. In such cases, the nature of the eventual consortium agreement is generally determined in advance, thus removing the main objection to Ad-Hoc Consortia. In higher forms of Marketing Consortia, the consortium may even be an incorporated company with a permanent staff. Such a company may even be able to identify opportunities for individual firms in the group, in addition to its stated target of prospects for consortia.

On the horizontal axis, we have shown the degree of complementarity of the consortium members, ranging from the case where the consortium is formed by companies that normally compete with each other, to the case where the companies are fully complementary; i.e., they do not manufacture or sell the same products or services, and, ideally, the products and services of the different firms fit together to form a package.

There are examples of all these types of consortia today in Canada in the power sector. A consortium has a better chance to succeed as it moves along the scale toward permanence, and toward complementarity. In other words, in the direction of the upper right quadrant.

Admitedly, a permanent consortium of competitors can offer important advantages, if it is truly permanent and exclusive. For one thing, it is a way to share a market, while forming a very powerful group. But an ad hoc consortium of competitors is extremely difficult to put together in time to be able to bid a tender. A marketing consortium of competitors suffers from the mistrust competitors will naturally have in the sharing of market itelligence.

Our own company, Sogex, on this chart, would be placed in the right-hand column, near the top.

3. <u>What are the results?</u>

Here, I will speak specifically only of our own experience.

Our company is about 2 years old now. We gave ourselves three years to judge the performance of the grouping of the companies, and this 3 year trial is based essentially on the proven cycle from project identification to obtention of a major contract.

While it is too early to put the results in dollars and cents, we can list some of the positive and negative aspects of our experience as follows:

(Explanation of <u>Slide 8</u>)

All in all, a relatively positive experience.

4. Where do we go from here? (Slide 9)

Based on our experience thus far, and in order to continue to be responsive to market opportunities, we see ourselves growing in the following ways:

- o Enlarging the group, by bringing in additional partners offering other products and services. We are already in discussion with potential new members.

- o New areas of activity, such as barter and countertrade. This is becoming a pre-requisite to putting together a turnkey package in many countries, and we are deciding to confront this problem straight on.

- o Consortia of consortia, and international consortia, regrouping consortia from different countries for a specific project. For example, our group teamed up with a Yugoslav group of three companies, and a French consortium of three companies, to bid a $400 Million project in the Middle East. Because of the difficulty of putting together a total large financial package today from just one country, it was necessary to consider joining with one or two other countries.

We will be seeing a lot more of this in the future.

SOGEX CONSORTIUM EXPERIENCE

SOME POSITIVE ASPECTS

- o marketing cost savings; more efficient.
- o image of large group.
- o presence in important markets.
- o able to pursue opportunities of a magnitude and type never before possible.
- o exposed to non-bid opportunities.
- o synergy, critical mass.
- o client acceptance.
- o seen as a "player".
- o opportunities identified far upstream

SOME DIFFICULTIES

- o initial overlap; growing pains.
- o seen as a new competitor by some.
- o marriage of contractor with manufacturers

CONSORTIA: THE FUTURE

- larger consortia; more members.
- new areas; barter, countertrade.
- consortia of consortia
- international consortia

SLIDE 1

SOGEX
INTERNATIONAL INC.

MARINE INDUSTRIES	CEGELEC INDUSTRIES	BG CHECO
Manufacturer and erector of hydroelectric power generation equipment	Manufacturer of low to extra high voltage switchgear.	Manufacturer of electrical and electronic equipment and mechanical/ electrical contractor.

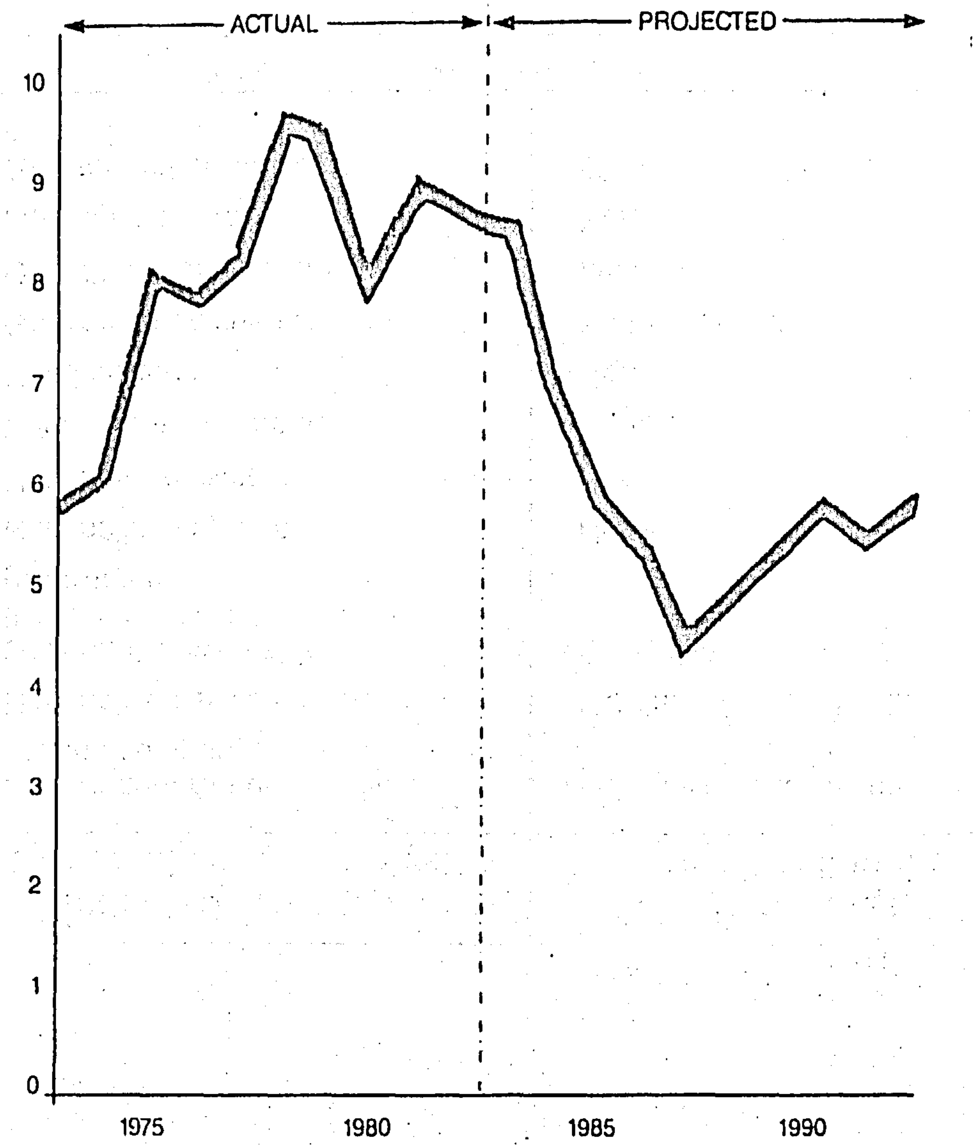
SLIDE 2

EXPORT CONSORTIA

- Why are companies joining forces?
- How: types of consortia?
- What results?
- Where do we go from here?

CAPITAL EXPENDITURES BY CANADIAN POWER UTILITIES

1973-1992



ANNUAL CAPITAL EXPENDITURES IN CDN $ BILLIONS (1983 dollars)

SLIDE 4

POWER EQUIPMENT PROCUREMENT POLICIES IN OTHER INDUSTRIALIZED COUNTRIES

Country	Extent of Government Ownership of Power System	Utility Purchases of Foreign Equipment
Austria	Government run under one holding company	If domestic unavailable
Belgium	Nationalized system	If domestic unavailable
Canada	90% public ownership through provincial government	Extensive
England and Wales	Nationalized system	None
France	Nationalized system	None
West Germany	70% federal ownership	None
Italy	Nationalized system	None
Japan	Government owned system	Prototypes only
Sweden	Over 50% public ownership	Limited
Switzerland	Municipal control	None
U.S.A.	70% federal or municipal ownership	50% of market open

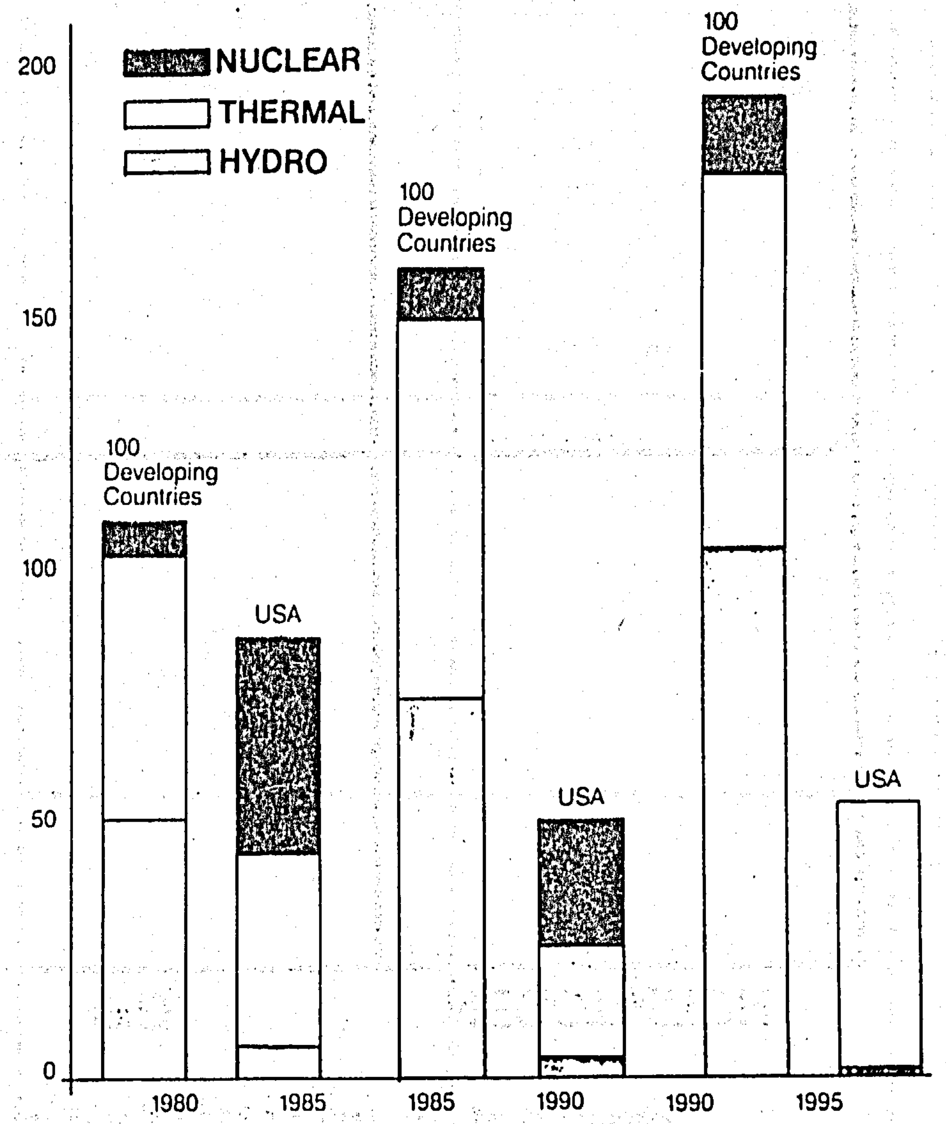
SOURCE: "Towards the Electrical Economy An Industrial Strategy for the Electrical Industry in the 1980's"; Industry, Trade and commerce; November,1980

SLIDE 5

GENERATING CAPACITY ADDITIONS IN UNITED STATES AND 100 DEVELOPING COUNTRIES,

1980-1995

INCREASE IN GENERATING CAPACITY (GW)



SOURCES:
1 Developing country data from World Bank
2 USA data from **Electrical World**, September 1983

SLIDE 6

CONTRACT TYPES

	BID	NEGOTIATION
PROJECT		
PRODUCT		

SLIDE 7

TYPES OF CONSORTIA

	COMPETITIVE	COMPLEMENTARY
PERMANENT		
MARKETING		
AD HOC		

SOGEX CONSORTIUM EXPERIENCE

SOME POSITIVE ASPECTS

- MARKETING COST SAVINGS; MORE EFFICIENT.
- IMAGE OF LARGE GROUP.
- PRESENCE IN IMPORTANT MARKETS.
- ABLE TO PURSUE OPPORTUNITIES OF A MAGNITUDE AND TYPE NEVER BEFORE POSSIBLE.
- EXPOSED TO NON-BID OPPORTUNITIES.
- SYNERGY, CRITICAL MASS.
- CLIENT ACCEPTANCE.
- SEEN AS A "PLAYER".
- OPPORTUNITIES IDENTIFIED FAR UPSTREAM.

SOME DIFFICULTIES

- INITIAL OVERLAP; GROWING PAINS.
- SEEN AS A NEW COMPETITOR BY SOME.
- MARRIAGE OF CONTRACTOR WITH MANUFACTURERS.

CONSORTIA: THE FUTURE

- LARGER CONSORTIA; MORE MEMBERS.
- NEW AREAS; BARTER, COUNTERTRADE.
- CONSORTIA OF CONSORTIA.
- INTERNATIONAL CONSORTIA.

INCREMENTAL BENEFITS FROM A CORPORATE TRADING HOUSE

SEMINAR
Corporate Trading Companies:
A Response to Market Globalization and Countertrade

co-sponsored by:

The Department of External Affairs
and
The Canadian Export Association

Ottawa, June 26, 1986

Presented by: **Karsten J. Westphal**
Director/Trading
Spar Aerospace Limited

In a world that is changing and growing smaller, the ways of conducting business are changing with it. Successful selling is no longer a straight-forward combination of value and quality, but is increasingly an exercise in creative marketing. There is a growing need for companies that want to operate in certain markets to master the art of supplying benefits to a broad constituency in the buying country.

In the business segments and markets where Spar has chosen to compete, innovative trading arrangements are the rule and no longer the exception.

In its field, Spar is a David competing against Goliaths. Its most promising markets are the least economically favoured. Spar has no choice but to look to the imaginative and the unorthodox to maintain its competitive edge.

Spar first confronted the challenge of offsets in Brazil, but in the process of finding a solution has found that the benefits of meeting these commitments went far beyond what was originally conceived or intended. What was first regarded as a necessary burden added to the sale of a satellite system, has evolved into a formula for success that has provided a distinct competitive advantage to the company as a whole.

But, before I outline how Spar itself benefits from arranging industrial benefits for its customers, I want to tell you a bit about the company and our export agreement with Brazil, which is linked to what we prefer to call a "Brazil Trade Enhancement Program".

As most of you know, Spar is a Canadian company, involved in the design, development, manufacturing and servicing of products for the aerospace, aviation, communications and defence industry. Prior to 1982, Spar had participated in the production of more than 50 satellites around the world. In 1982, Spar was awarded a 160 million dollar prime contract to provide two satellites and related ground control systems for Embratel, the Brazilian government-owned telecommunications company.

This space project marked a number of historic firsts:

- the first domestic communications satellite in South America;
- the first joint Canadian-Brazilian effort to bring to Brazil the benefits of satelite communications;
- the first Canadian prime contract for satellites and related ground equipment to serve an international market.

In December, 1984, we inaugurated the tracking and control centre in Guaratiba, outside Rio de Janeiro. Twenty-two additional earth stations have been built during 1985 and 1986, serving telephone and television needs of private citizens, government, industry and off-shore platforms. The system reaches 175 cities in Brazil.

Spar, being the prime contractor, entered into an offset agreement with the government of Brazil. Under the terms of this, Spar would develop 60 million dollars worth of Brazilian exports globally and pursue an additional 105 million dollars worth of business on a "best effort basis".

Our business with Brazil for a satellite communications system means a long-term involvement, hopefully leading to further satellite sales in the future. It means the transfer of technology in which we became partners with Brazil, working with their engineers and technicians in the construction of the satellites.

In other words, we expected that our ties with Brazil and its people would develop further in the future. Therefore, we designed an offset program which would enhance and strengthen this relationship.

We looked at a number of options to fulfill our commitment. We considered and eventually rejected proposals from third parties to generate the needed offset credits. Quite simply, outside agents simply do not have the same stake in Brazil as we do at Spar.

We felt it was important to communicate to the Brazilian government, in a tangible way, that we intended to be a reliable partner in both the letter and spirit of the contract and that we were in it for the long haul.

Spar decided to do this by dedicating its own resources and the result was a trading office set up in the summer of 1984. The goal was to work closely with Brazilian manufacturers, export firms and trading companies to develop business opportunities with long-term export potential.

A little more than a year and a half later, a lot of hard and sometimes frustrating work has produced export figures that have demonstrated to the Brazilian government our commitment and our good faith. We have completed 45 million U.S. dollars worth of export transactions and negotiated a further 96 million on a best effort basis. Given the deals we are currently pursuing, we feel confident of fulfilling the balance of our obligation on time.

Our approach is straight-forward business development. We go after genuine deals that stand on their own commercial merit. Scrupulous attention is paid to generating new business and demonstrating to the Brazilian government that our activities are geared to trade creation, not trade diversion.

That we can demonstrate new job creation in Brazil through our trading efforts is not lost on the key decision makers in government who will soon be considering other satellite contracts.

These decision makers within the government and the business community at large, form a potent coalition of support that we hope to keep on side through our trading efforts. By exporting Brazilian goods we furnish them with the political ammunition they need to justify importing Canadian technology. In fact, a recent article in a Brazilian daily began by stating that "... 34 million dollars in Brazilian merchandise have been exported during Minister of Communications Antonio Carlos Magalhaes first year in office." Such positive news coverage is important to Spar, since its reputation in this area is enhanced in direct ratio to the ministry's favorable publicity.

A coordinated P.R. and press campaign is an integral part of our trading efforts and is facilitated by having our own in-house Trading unit that is fully aware of this important role.

By its nature, trading involves Spar intimately with the business and government infrastructure of the country and this has created a substancial element of Spar partisans and advocates who will serve us well in years to come.

Spar's network of trading contacts in Brazil parallels and complements contacts in the country's communications industry. This doubles our ability to serve Brazil and improve our future business prospects. It also increases our sensitivity to the issues of the country and the upcoming needs of our customer.

When it embarked on the Brazil offset program, Spar knew that there would be no penalties imposed for non-performance. But it was clear that failure to live up to the spirit as well as the letter of the agreement would mean the company could be shut out of future opportunities in Brazil and possible other markets where customers were monitoring closely Spar's credibility with potential customers.

Nothing speaks louder than a track record and in this way, the presence of in-house expertise represents a real asset for the company in the current situation as well as for future contracts.

A corporate trading department can be put to use in a number of scenarios to further the interests of the company. Of course, it can be called in to deal with specific obligations after marketing has signed a contract. This was the case with Brasilsat.

But Corporate traders can also be used more proactively by arranging export transactions before a contract is awarded and thereby improve the probability of getting the deal.

Finally, an in-house trading department can fulfill an advisory role and assist marketing executives in negotiating contracts where offsets are expected to be a factor. This can put the exporter in the position of directing discussions in such a way that the final obligations are drafted in a workable way with a manageable degree of risk.

In one case, the presence of specialized in-house staff can pre-empt the problem, in the second case, help to neutralize it.

Clearly, the creation of a corporate trading company is practical only for firms of a certain size which can dedicate resources for an extended period. It is a formula that works where there is a long-term involvement and a commitment to the idea at the most senior management level.

TRADING COMPANIES IN THE WHOLESALE/RETAIL CONTEXT

SEMINAR
Corporate Trading Companies:
A Response to Market Globalization and Countertrade

co-sponsored by:

The Department of External Affairs
and
The Canadian Export Association

Ottawa, June 26, 1986

Presented by: Michael Sipos
Managing Director
C.S.G. International

A recent government task force report contains the specific recommendation that wholesalers and retailers explore an involvement in trading.

Hypothesis: Retailers Can Successfully Engage in Trading

In making this recommendation the report cites the expertise and strengths of the distributive industries as particularly suitable to facilitating trade. Among the specific expertise and strengths cited are:

- Product sourcing and evaluation capability including knowledge of suppliers' reputation, financial standing, and manufacturing, delivery and quality control track records;
- Logistics management including transportation, customs, warehousing, inventory control and distribution;
- Established financial and banking relationships contact goodwill, and market (or volume) clout.

It is only logical that the report's authors suggests that these strengths could be readily applied to trading. However, most retailers perceive that domestic distribution is their primary business and the involvement in the international market should be limited only to sourcing. In a way, there is a mentality conflict similar to that which bankers experience with bank-owned trading companies. There's one major difference, however, in the distributive sector: retailers understand trading.

Testing the Hypothesis: Unloading Excess Inventory at a Profit

A major Canadian retailer decided to test the task force's hypothesis and set up an experimental trading facility giving it a mandate to explore opportunities in exporting. The first task that the trading facility faced relates to a problem common to retailers: finding a way to unload excess inventory. Those of you in retailing know how significant this problem is. Normally, excess inventory is sold to liquidators at a significant loss, frequently at 10 to 60 cents on the dollar. Thus, rescuing profit became the first objective of the trading facility. However, things are never quite so simple, and a second objective was added to the first: finding a way of reducing advertising print costs.

Endowed with these simultaneous objectives, the retail trading facility made a rapid study of the print industry and assembled a transaction involving the retailer (as exporter), a printing company, and third party on offshore retailer (slide #1).

In this transaction the trading unit offered to finance selected printing costs - paper, ink and a certain press for the printer. In return. the trading facility earned a specific dollar print credit plus x% representing a commission for the finance service. The print credit, plus the earned commission, expressed in x% printing credits was passed on to the retailer's advertisement department, which in turn, repaid the trading facility partially in cash ($10,000 in this example) and the balance of x% in obsolete goods (slides #2 and #3).

But now the trading facility had to convert the excess inventory into cash. The goods had been sitting in a domestic warehouse for more than a year, so the obvious answer was export. And here is where the vast network of retailer contacts is of major strategic advantage. The trading facility merely exploited this advantage and within two weeks off-loaded the inventory to an off-shore buyer not only at cost, but at a profit! (slides #4 and #5).

While the transaction's concept is not new, the local application certainly is. And given the success of this first venture, the retailer is now embarked on employing the same "profit/cost reduction via-trading" formula to a variety of other corporate cost centers.

Testing the Hypothesis: Retailer as "Associate Exporter"

In the second test of the hypothesis, the same retailer also had twin objectives. This time to diversify its supply base and to enter new markets.

The players in this transaction are a Canadian high-tech exporter, a newly industrialized country, the retailer with its trading facility, and other non-competitive retailers (slide #6). The transaction is of the offset variety such as the one mentioned earlier involving the Spar Aerospace Co.

In this transaction the high tech exporter sells equipment to the newly industrialized country and, luckily enough, gets paid in full in hard currency, but incurs an obligation to generate x% of the contract in that country's exports. So the retailer trading facility organizes its own and other non-competitive merchandizing companies to meet the obligation. The retail trading facility executes the agreements, conducts the purchases, and distributes the goods. All of which proves very attractive to the retailer attempting to enter new markets and find new sources of products and to do so at a higher gross margin with greatly improved profit performance. The retailer also secures goodwill by assisting the exporter and thus acquires a new role as an "associate exporter" (slide #8).

Validating the Hypothesis: Retailers can be Successful Traders

In this one retailer's experience of less than six months, the evidence suggests that the government task force hypotheses is valid. Involvement in trading creates a "win-win" situation and provides significant, tangible benefits for participants.

But it also seems that to obtain these benefits, it is wise to observe certain guidelines:

1. Launch trading efforts under a protective and committed corporate umbrella;

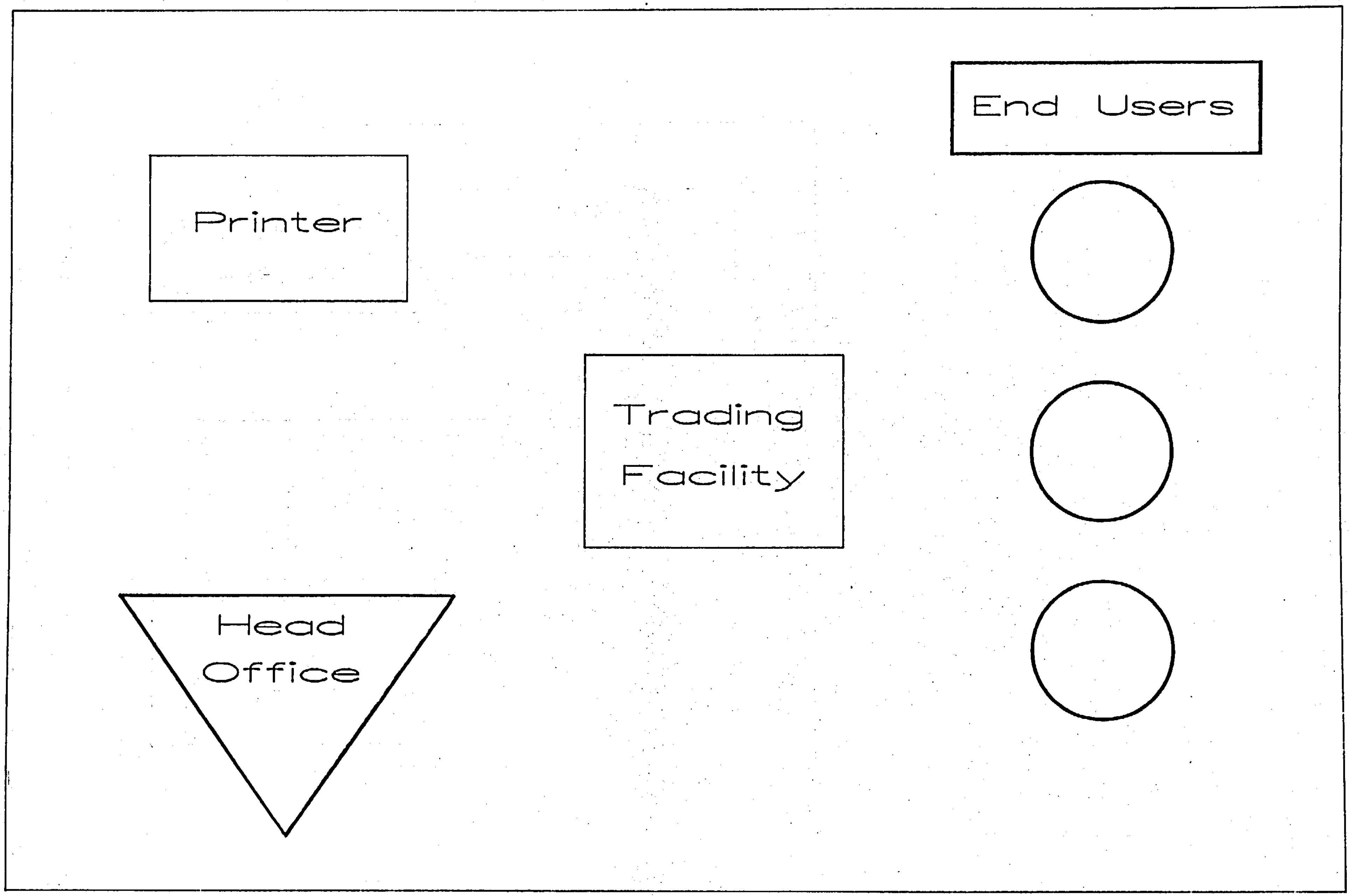
2. Integrate both import and export functions within the trading facility;

3. Deliberately, exploit existing functional expertise; product knowledge, inventory management, credit, warehousing and distribution, etc;

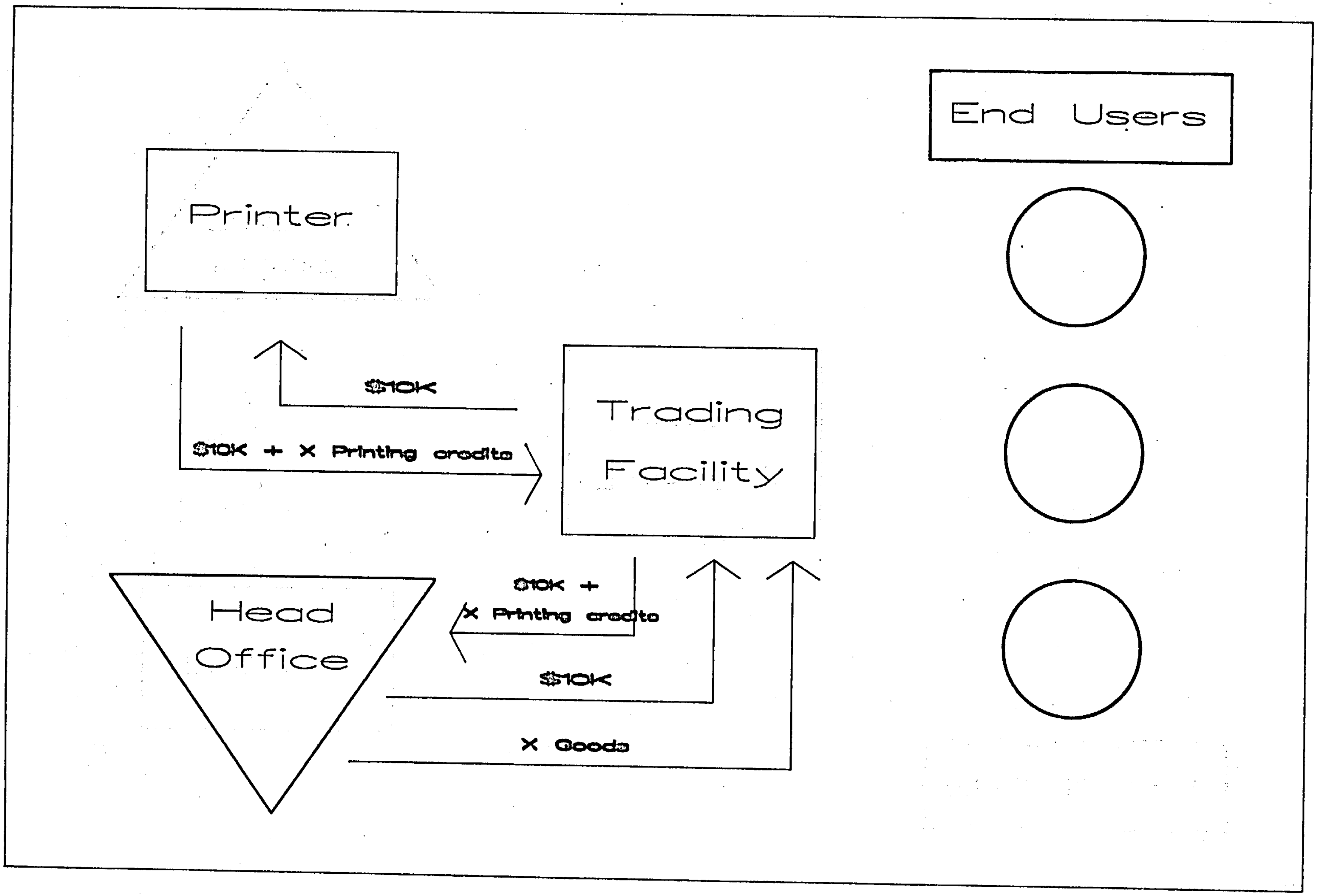
4) Expand financial capacities to include trade finance;

5) Partner with big name firms whose recognition and reputation and respect are hallmarks; and finally,

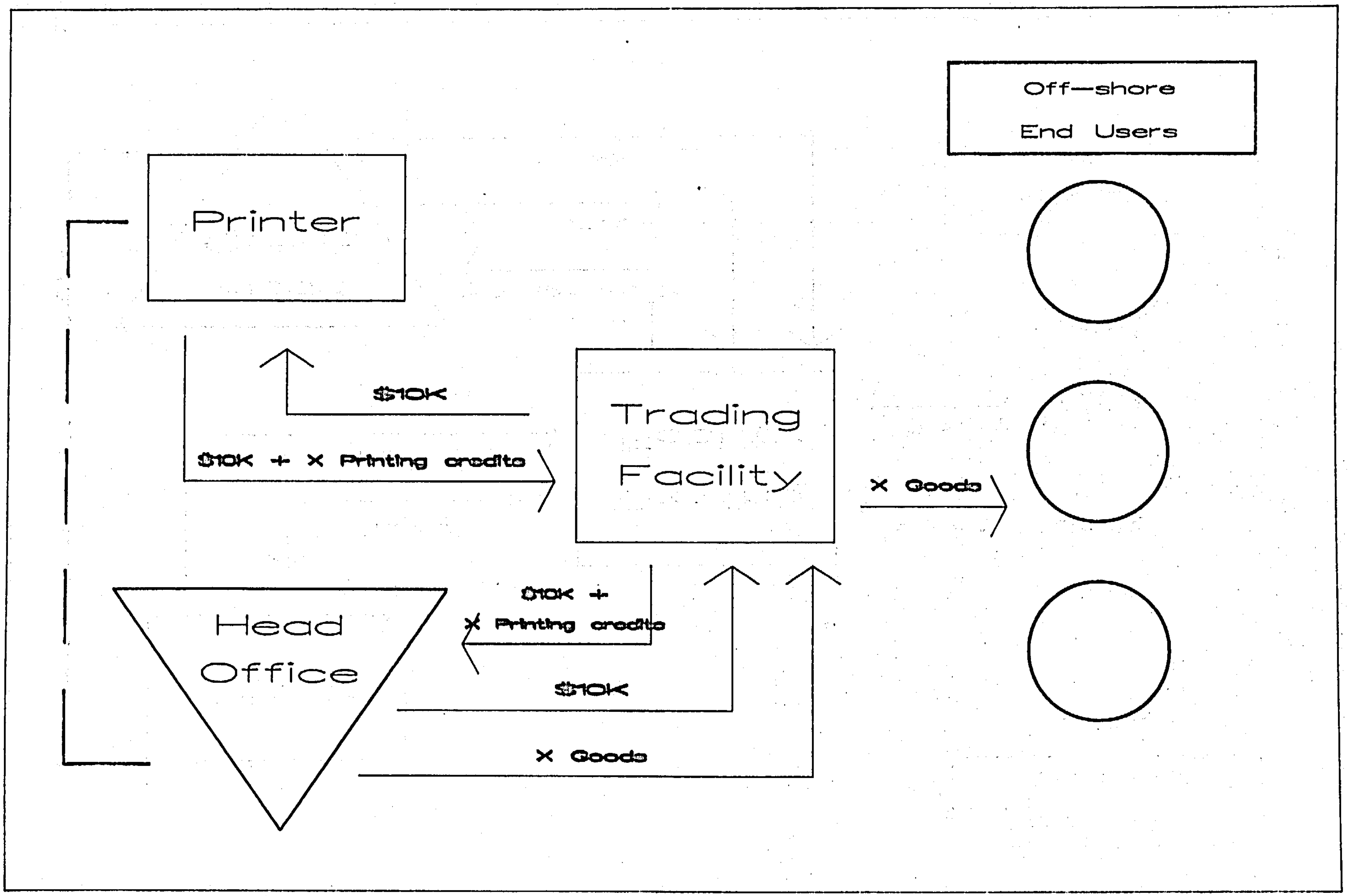
6) Know what do you want to be when you grow up. The role of international trade has many players and many possible links. The trick is to find the right links for a given retailer in a given market position.



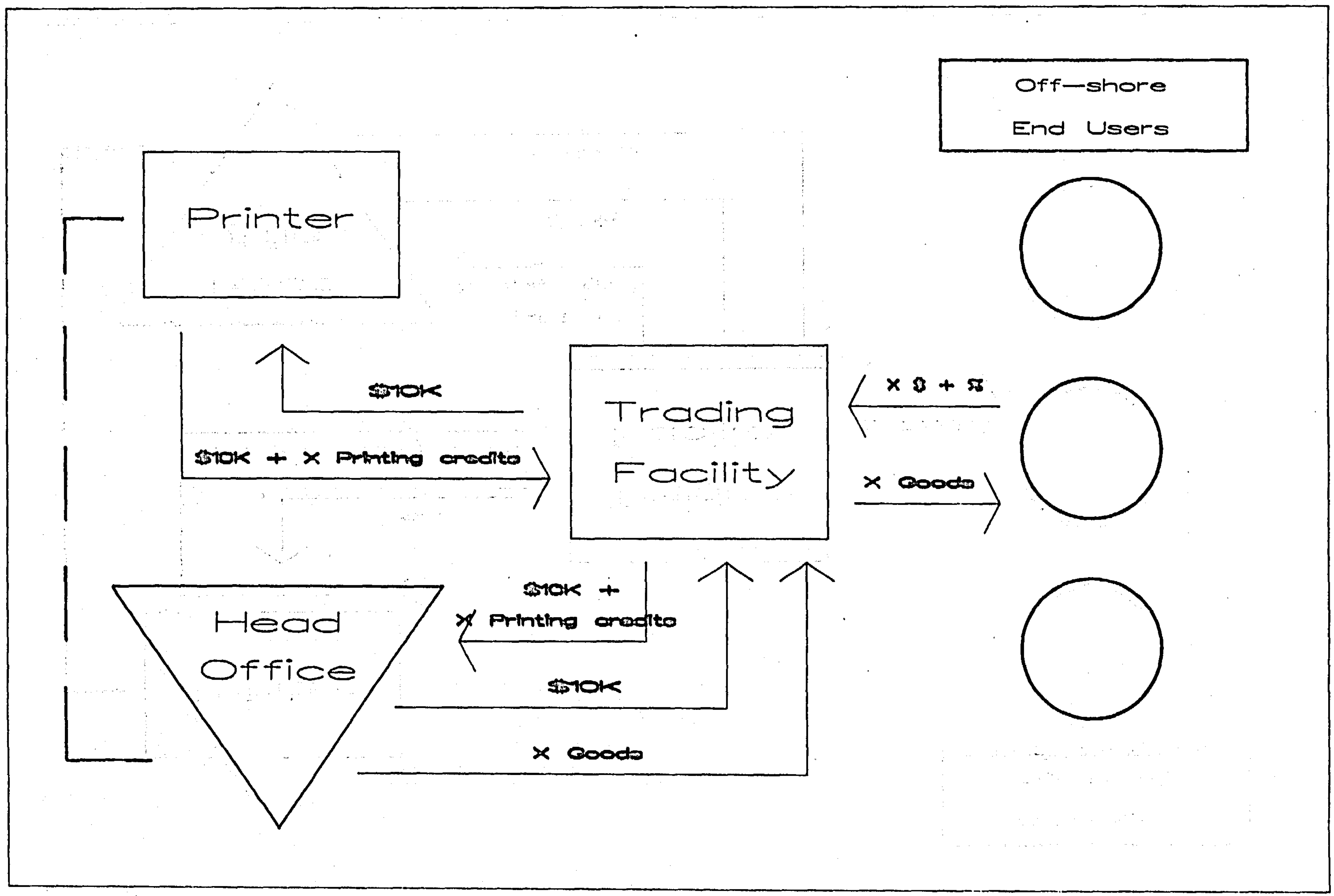
SLIDE #1


End Users
Printer
$10K
Trading Facility
$10K + X Printing credits
Head Office
$10K +
X Printing credits
$10K
X Goods

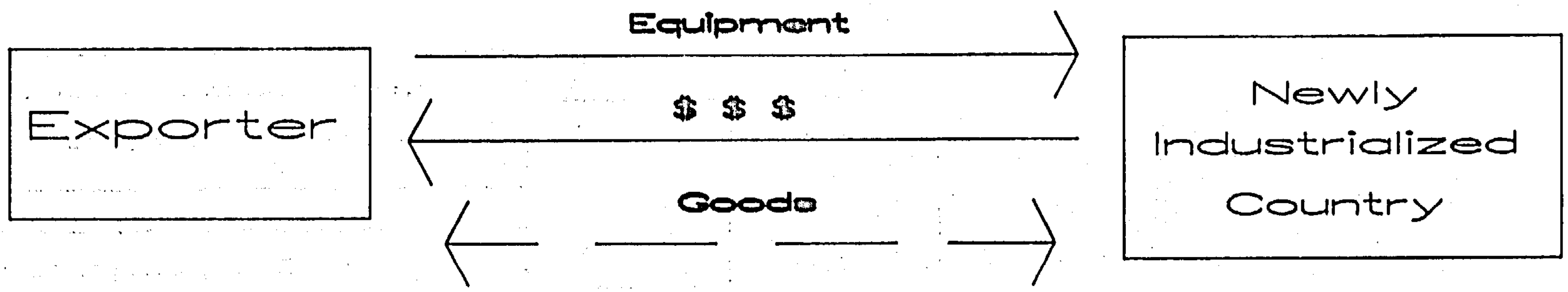
SLIDE #2


Off-shore
End Users
Printer
$10K
$10K + X Printing credits
Trading
Facility
X Goods
Head
Office
$10K +
X Printing credits
$10K
X Goods

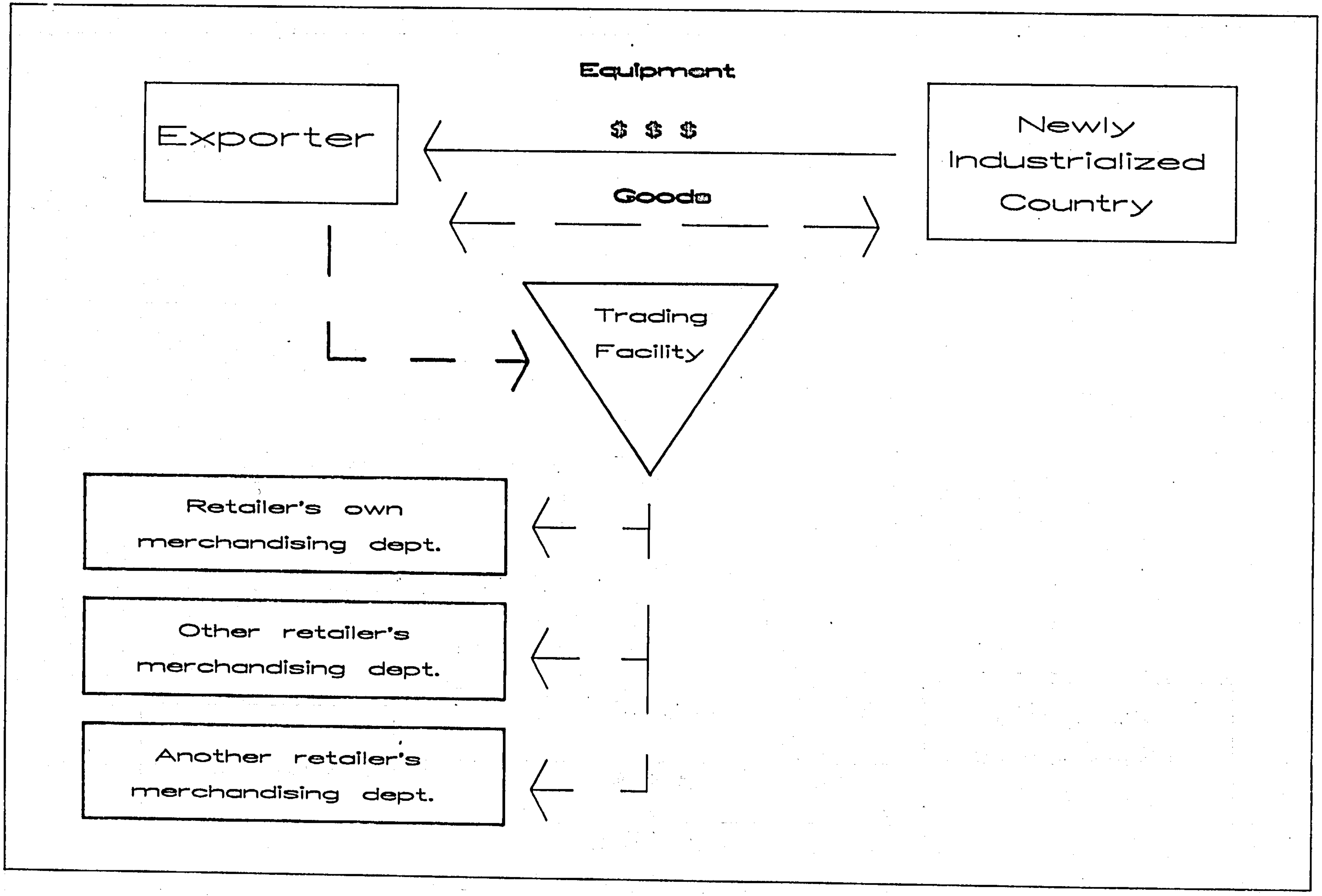
SLIDE #3


Off—shore
End Users
Printer
$10K
$10K + X Printing credits
Trading
Facility
X $ + %
X Goods
Head
Office
$10K +
X Printing credits
$10K
X Goods

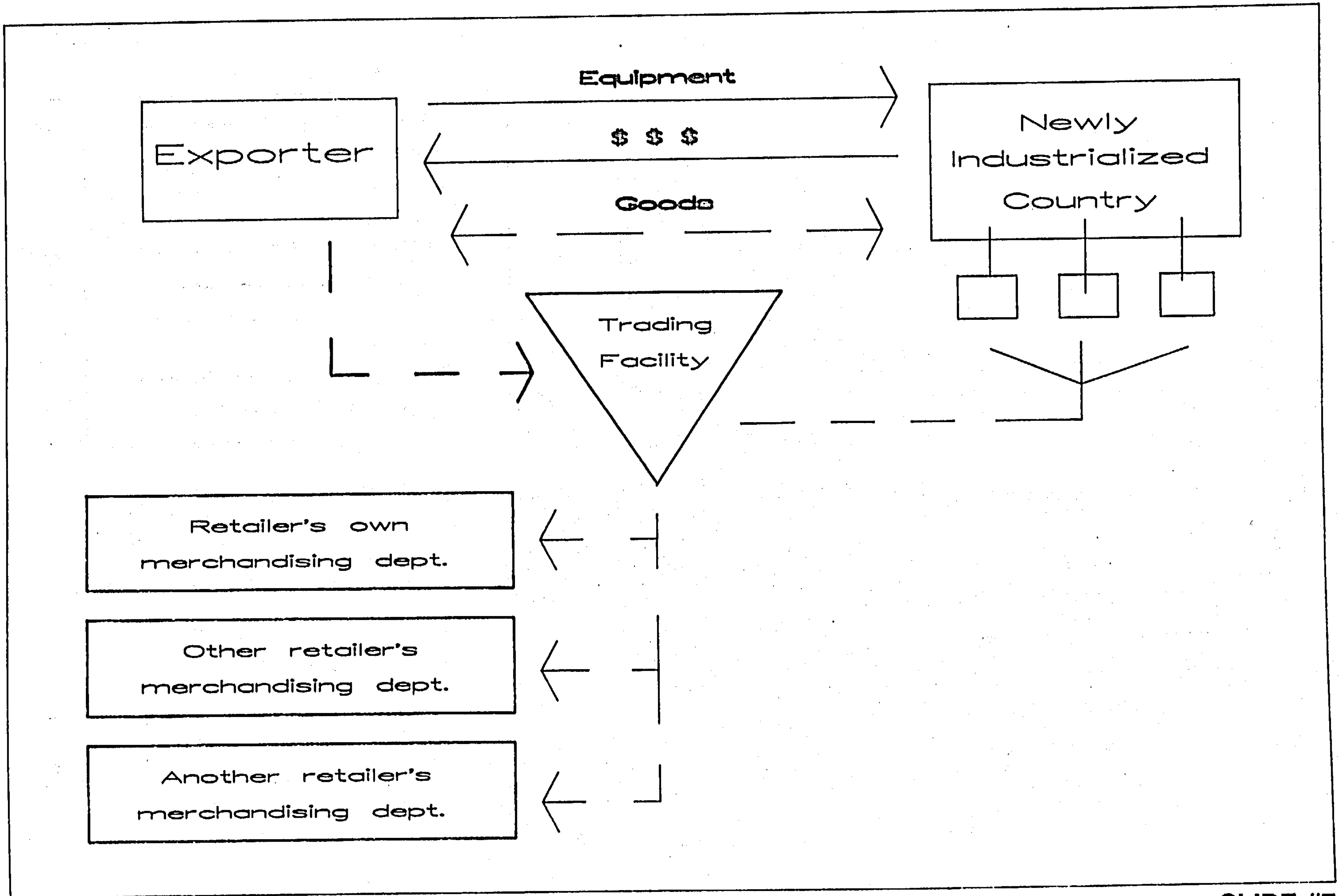
SLIDE #4



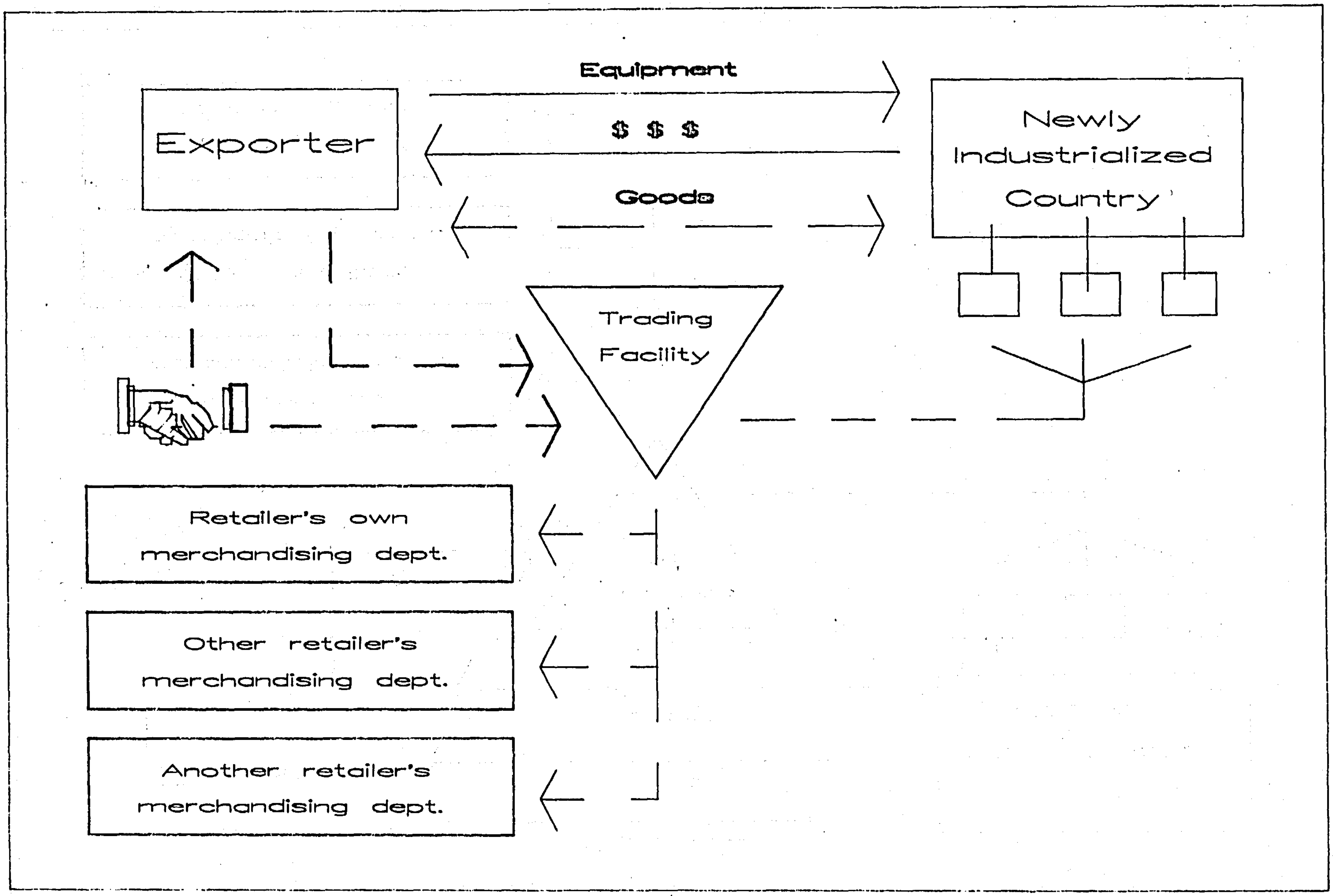
SLIDE #5


Equipment
Exporter
$ $ $
Newly Industrialized Country
Goods
Trading Facility
Retailer's own merchandising dept.
Other retailer's merchandising dept.
Another retailer's merchandising dept.

SLIDE #6


Equipment
Exporter
$ $ $
Newly Industrialized Country
Goods
Trading Facility
Retailer's own merchandising dept.
Other retailer's merchandising dept.
Another retailer's merchandising dept.

SLIDE #7


Equipment
$ $ $
Goods
Exporter
Newly Industrialized Country
Trading Facility
Retailer's own merchandising dept.
Other retailer's merchandising dept.
Another retailer's merchandising dept.

SLIDE #8