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International Business

African trade zone strengthens bargaining power

The African continent's zone will have estimated GDP of USD 624 billion and cover more than 527 million people

Three African trading blocs have created a free trade zone of 26 countries – stretching from Egypt to South Africa – with a GDP estimated at USD 624bn.

It is hoped the deal will ease access to markets within the continent for global investors and end trading problems arising from the countries' membership of multiple trading groups.

The deal also aims to strengthen the continent's bargaining power when negotiating international deals.

Analysts say the agreement, signed in October 2008, will help intra-regional trade and boost growth. The agreement is also expected to stimulate joint infrastructure and energy projects in the zone.

The three blocs that struck the deal were the Southern African Development Community (SADC), the East African Community (EAC) and the Common Market for Eastern and Southern Africa (Comesa). Six heads of state from the 26 countries attended a meeting in the Ugandan capital, Kampala, to sign the agreement. They plan to set a timeframe for integration within a year.

"The greatest enemy of Africa, the greatest source of weakness, has been disunity and a low level of political and economic integration," says Ugandan President Yoweri Museveni. "Bigger markets are a strategic instrument of liberating people from poverty."

Many of the leaders and representatives consider the new pact a way of giving Africa a greater voice on the world stage. President Museveni says that it is a step in the right direction for a continent that suffers unfairly within global trade.

South African President Kgalema Motlanthe says: "By coming together, the member states will have a strong voice in advancing our interests on the international scene.

"While Africa and other developing countries have marginal influence over the decisions that have brought the international finance systems to the brink of collapse, unjustifiably, African countries will bear the brunt.

"Developing countries must be included in the governance of all international financing institutions to mitigate adverse effects on them."

Director-general of South Africa's department of foreign affairs, Ayanda Ntsaluba, says: "When we have a pan-regional free trade area we will have a legitimate base to negotiate as a bloc. Then some of the internal contradictions that arise as we negotiate as separate regions begin to be taken away."

Debbie Goldthorpe, chief operating officer at Africa Matters, which helps companies conduct business in Africa, believes the free trade zone will open up more opportunities for investors in the continent. Although "some way down the track", the bloc will enhance investors' experience of trading conditions, such as in cross-border delays and different import and export duties.

The three blocs merging together are already well-established in their own right: they cover varying swathes of land and numbers of people.

The SADC covers a population of 248 million people and a zone where cumulative GDP is USD 379 billion (2006 latest figures).
The SADC's members include South Africa, Tanzania, Zambia and Zimbabwe.

Comesa covers 398 million people. The area has a combined GDP of USD 286.7 billion (2006 latest figures). Among its members are Uganda and Sudan.

EAC is the smallest of the group in terms of GDP – USD 46.6 billion in 2006.

In all, the pan-Africa trade zone covers Angola, Botswana, Burundi, the Comoros, the Democratic Republic of Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Lesotho, Libya, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Rwanda, the Seychelles, Sudan, Swaziland, South Africa, Tanzania, Uganda, Zambia and Zimbabwe.

Declared targets of the new zone are to help streamline access to African markets; boost growth and intra-regional trade; establish joint infrastructure and energy projects; and establish a single customs union. It will encompass more than 527 million people.

Globalisation of international supply chains, resulting in an immense increase in the volumes of cross-border flows of goods, also provide an opportunity for the zone to present savings in indirect taxes.

But of equally prominent interest to the zone is investment from China. Already, individual economic zone arrangements are operating between individual African states and China, such as the Chambishi Multifacility Economic Zone, Zambia. Based on its copper mine, it has obtained a promised USD 650 million investment from China over the next five years. Use of that zone is perceived to be an opportunity almost exclusively reserved for Chinese companies.

Several African governments, anxious to attract Chinese investment, are entering into similar arrangements. China is negotiating to open five 'economic cooperation zones' in various parts of Africa. All are likely to provide tax exemption and favourable rights of access to local minerals, in return for the creation of thousands of jobs.

Trade zone structures

Specialised areas offering tax incentives to foreign companies meeting certain conditions are common in developing markets.

At least 3,000 free trade zones – duty-free areas, providing warehousing, storage and logistics facilities, aimed at the trade, trans-shipment and re-exporting markets – are scattered around almost all parts of the globe.

The recognised market leader is the Jebel Ali Free Zone, Dubai, United Arab Emirates, which has grown from 19 companies in 1985 to more than 6,000 companies from over 110 countries. It is the flagship of the Dubai Government-owned Economic Zones World (EZW), which has been developed to harness Dubai's expertise in this market and to export that expertise to sites across the globe.

EZW has recently developed agreements with Misurata Economic Zone in Libya and Djibouti Free Zone at the gateway to the Red Sea – moves intended to be the start of increased involvement across most of the emerging markets.

Other markets developing major free trade zones include Morocco, Turkey, Egypt and Jordan.

An extension of the traditional free trade zone is the export processing zone, which accommodates manufacturing and related facilities for the export market. Such zones are large and usually comprise several industrial estates. A variation is a hybrid that has a second area open to various businesses, alongside the export designated area.

Some zones are single factory export processing zones, where individual investors reach agreements with governments for an exclusive manufacturing arrangement, in return for tax and other concessions.

Special economic zones, sometimes called freeports, are widely used in China and are more ambitious in scope and larger than traditional free zones. Many accommodate any type of industrial or service sector and allow senior staff in investing businesses to reside on-site. Such zones may cover areas that include free trade zones and export processing zones within them.

Enterprise zones provide tax incentives and investment grants to businesses locating in deprived areas. They are mostly located in developed nations.

UHY's African continent firms are in Angola, Egypt, Kenya, Mauritius, Morocco, Nigeria and South Africa.

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Identifying risks through the eyes of our clients

An analysis model heralds a new approach to performance and risk assessment

One of UHY's member firms, Govers Accountants/Consultants, was founded more than 80 years ago in The Netherlands in the very heart of what is nowadays called the Brainport region, a hotspot within south-east Netherlands' top technology zone.

There, sophisticated supply chains keep products moving in high tech, health, automotive and food industries. The companies that operate these supply chains are well represented in the Govers client portfolio.

"The leading thread that has always run through the history of our firm is the recurring question about the story behind the success of companies: what is it that makes the difference between poor, good and great performance?" asks partner Paul Mencke.

"What do the annual accounts of companies tell about the reasons behind companies' performance? Are there any universal patterns hidden in the financial data, and what lessons are there to be learned?"

Faced with these questions, 30 years ago he and fellow partners developed their own unique approach, known as the financial analysis HARR® model.

This model rearranges the profit & loss accounts of companies – and often produces surprising perspectives. Managing partner Peter Dubbers says the firm's model "enables us to make the analysis very quickly, while supporting the outcome of the analysis with a wide variety of business knowledge".

To appreciate the model, it's important to explain its conceptual aspects. "We make a distinction between the transaction activities of the company on the one hand, and the supporting activities on the other hand," says Mencke (as in figure 1 below).

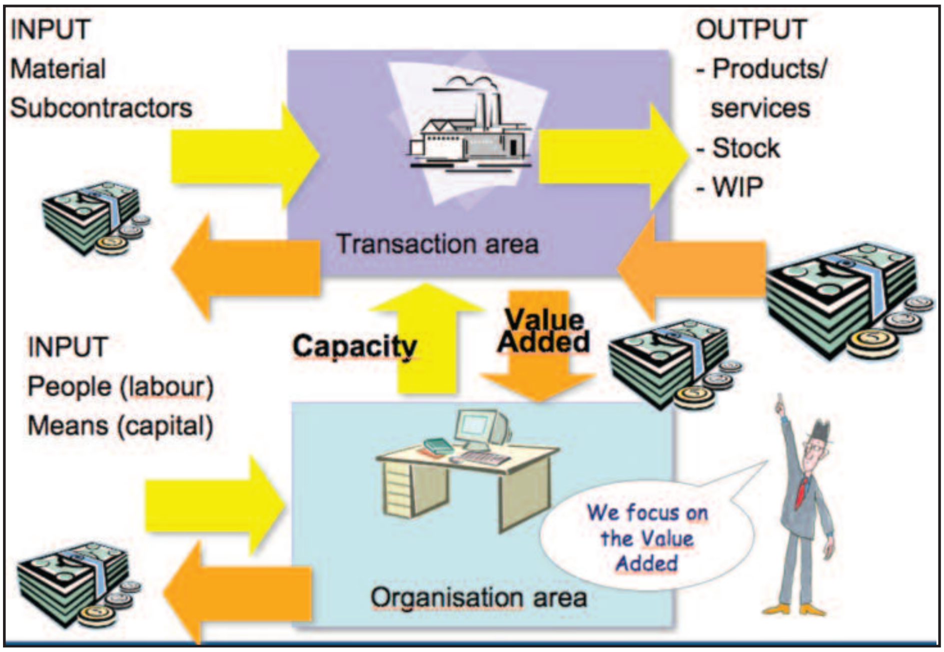

Figure 1: The analysis model, money flow

Figure 1 shows the conceptual distinction within companies between the transaction area (where the primary activities take place) and the organisation area (supporting activities). The logistic movements within the company are shown in yellow arrows. The orange-coloured arrows show the opposite flow of money.

The model shows the divide between primary and support activities of companies; stresses the value-added margin as a key element in business; and shows the connectivity of companies with their suppliers and their clients.

The transaction area is the place to discuss topics like the strategic position of the company in the supply chain, stock control, cycle time reduction, cash conversion, and reduction of waste.

The organisation area of the company is the place to focus on productivity, a lean approach, production automation, robotising and 24/7 concepts with unmanned hours.

While the ratios within the transaction area differ per industry and per company, Mencke found through empirical research that the ratios within the organisation area follow more universal rules. Labour costs have a natural maximum of 60% of the value added, and both the cost of capital expenditure 'Capex' and 'Other' costs have a natural maximum of 20% of the value added.

As an example of the model, Mencke compares the 2007 figures of two European airlines. Air France-KLM as an established party; Ryanair as the challenger (figure 2 below).

Rearranged in the HARR® model format, the analysis shows the higher productivity of Ryanair:

- 9,679 passengers per employee per year at Ryanair, versus only 715 at Air France-KLM

- The less overhead ('point-to-point routes', instead of 'from anywhere to everywhere'), identical cost of capital expenditures and eventually a huge gap in profits.

Dubbers points out that the cost of capital expenditures includes both on- and off-balance investments.

"Our approach rightfully ignores the question whether tangible fixed assets are bought or rented," he says.

The model helps UHY's Dutch member firm deliver value for its clients. "By looking at our clients through our clients' eyes, we identify risks that we wouldn't discover through a standard audit approach," says Mencke.

"With the high level of wages in our country, Dutch companies can't compete on labour costs anymore. It is very important to develop business formats with high labour productivity."

"By using our HARR® analysis model, we are able to visualise the financial results of the introduction of production automation, robotising, 24/7 concepts. HARR® can be used to review the separate results of specific years.

"But the approach is even more powerful when used on the results of a longer period to identify trends, or when used to compare companies as part of merger and acquisition processes."

- HARR® is an acronym for the Dutch words 'Huur' (Rent), 'Afschrijving' (Depreciation/Amortization), 'Rente'(Interest) and 'Resultaat' (Profit).

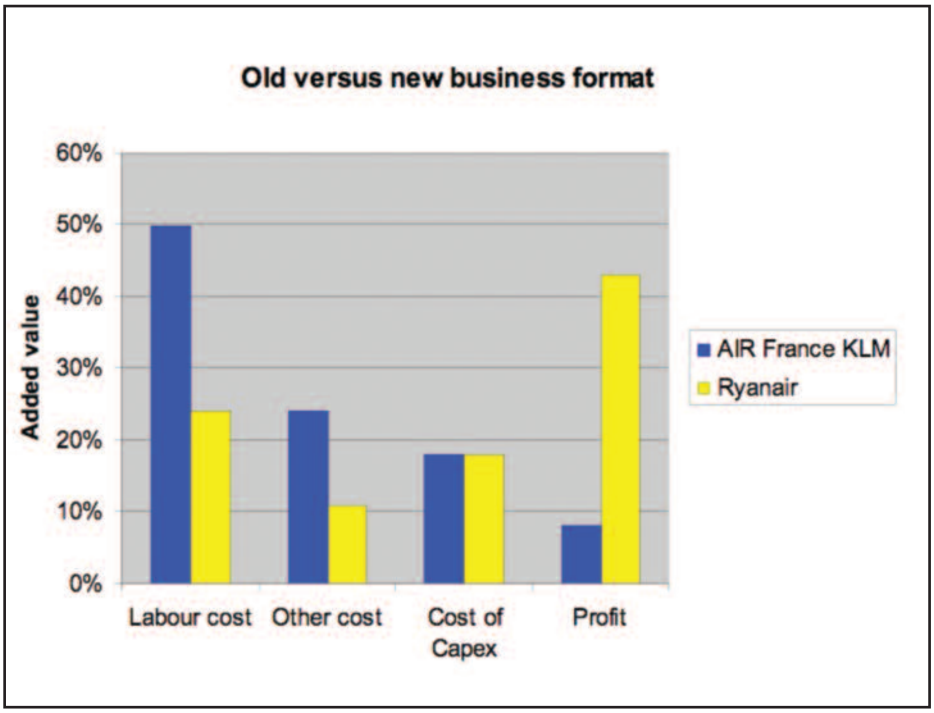

Figure 2: The model applied to two European airlines

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Pharma giants underpin biotech minnows

Germany's established presence in life sciences began with the founding of its market leader, Qiagen, more than 20 years ago

Qiagen, a multinational with more than 30 subsidiaries in over 18 countries, is Europe's largest listed biotechnology company. It has a portfolio of more than 500 products and more than 1,000 patents – and it was the first German company to go public on NASDAQ, the US stock exchange, 12 years ago.

Now, 15 German biotechnology companies are listed in regulated markets, and more in open markets, and the industry in Germany has more than 500 companies employing nearly 15,000 people, with a turnover of 2.19 billion euros (USD 2.99 billion) (2008 figures). A further 15,000 people are employed in academic and public sector biotechnology departments.

Most German life science companies are small to middle market-sized (SMEs). The average number of employees is 30; more than 40% of companies have fewer than 10 employees; and only 5% of companies have more than 100 employees.

More than half of all employees in the sector have a university degree and the sector is also highly research-driven: 88% of companies conduct their own research and development, and more than half of all revenues goes into research and development.

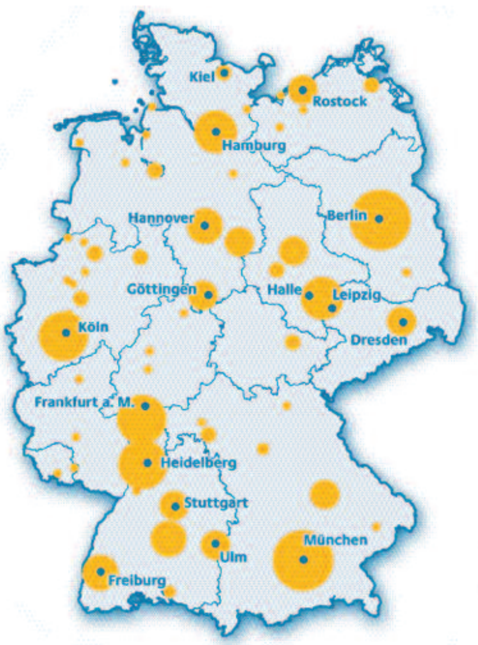
Such has been the growth in the industry that in 2008 alone, 202 million euros (USD 276 million) was invested into it by venture capitalists.

Over those same years, UHY's group of German firms, UHY Deutschland AG, has gained considerable life science expertise as it extends its reach significantly into the industry.

"Then the global credit crunch took hold…" says Reinhold Lauer, of UHY Deutschland AG. "It has been a particular problem for 'seed' companies such as in the biotechnology sector. Venture capitalist investment dried up."

Consequently, another source of finance has become important: it has resulted from alliances between biotechnology 'minnows' and 'giants' of the pharmaceutical industry, such as Glaxo and Pfizer.

Government grants for SMEs have also been a major financing source – they can amount to 50% of fundable costs. Conditions apply: a certain number of people have to be employed over a specified period, variable from state to state.



And the Government has continued to actively promote the industry – since 1996 it has staged the Bio Regio competition that grants subsidies to 'clusters' of biotechnology companies that can be found regionally around major cities (see map below). The launch of the Bio Regio competition spawned an upsurge in new biotechnology companies.

The UHY Deutschland AG group head office is at the heart of one of the principal 'clusters', in Berlin; it has branch offices in Bremen, Hamburg, Cologne and Munich – and is actively engaged in extending into other major German business centres.

About 40 established biotech companies are clustered in the same area as the UHY group's principal office, in Berlin and Brandenburg. Ten of them are UHY Deutschland AG clients. "In Berlin, in biotechnology, it is either a Big Four firm or UHY Deutschland," says Lauer, highlighting UHY Deutschland AG's long-standing expertise.

That expertise sets the group apart at business pitches in this sector, but now, in particular, its services are even more in demand because biotechnology companies are facing special tax problems:

- Tax losses carried forward are not deductible partly or in total when more than 25% of all shareholders have changed

- The transfer of shareholder loans into equity might under certain circumstances be treated as taxable income.

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Indonesia enigma: where now?

Indonesia, a vast, 'pearlstring' polyglot nation, has been an enigma for investors over the years

There's no question – Indonesia has made significant economic advances under the leadership of President Susilo Bambang Yudhoyono, the country's first directly elected president in newly democratic elections, since he took control in 2004.

Stability also seems assured as his Democratic Party emerged from the April 2009 parliamentary elections as the largest party, with nearly 21% of the vote – and analysts see this result as an indication of voting trends in the 8 July presidential poll.

But the government of the world's third-largest democracy and home to the world's largest Muslim population faces huge challenges stemming from the global financial crisis and world economic downturn.

So, is it a good time to invest in the country – or should investors give it a wide berth, at least in the short-term?

Indonesia's debt-to-GDP ratio in recent years has declined steadily because of increasingly robust GDP growth and sound fiscal stewardship. The government has introduced significant reforms in the financial sector, including in tax and customs, the use of Treasury bills, and capital market supervision. Indonesia's investment law, passed in March 2007, has addressed many of the drawbacks facing foreign and domestic investors.

Yet the country still struggles with poverty and unemployment, inadequate infrastructure, corruption, a complex regulatory environment, and unequal resource distribution among regions. The non-bank financial sector, including pension funds and insurance, remains weak, and despite efforts to broaden and deepen capital markets, they remain underdeveloped.

Economic issues in early 2008 centered on high global food and oil prices and their impact on Indonesia's poor and on the budget. The onset of the global financial crisis dampened inflationary pressures, but increased risk aversion for emerging market assets resulted in large losses in the stock market, significant depreciation of the rupiah, and a difficult environment for bond issuance.

As global demand has slowed and prices for Indonesia's commodity exports have fallen, Indonesia faces the prospect of growth significantly below the 6% or more recorded in 2007 and 2008.

Foreign investment inflow

However, the global financial crisis has yet to stem flows of investment into Indonesia: foreign direct investment (FDI) in January 2009 jumped by 61% from a year earlier. It reached USD 710 million, far more than the USD 440 million recorded in the same period in 2007, according to data from the Indonesian Investment Coordinating Board (BKPM).

"In the face of the global economic crisis, BKPM will continue to attract FDIs by continuing to reduce bureaucratic constraints, while modernising and simplifying investment processes," said BKPM chairman Muhammad Lutfi when these figures were announced.

On the domestic front, statistics are equally buoyant. Actual domestic investment rose by 33.3%, to Rp 0.76 trillion from a year earlier at Rp 0.57 trillion.

In total, realised investment increased by 57.8% to Rp 7.15 trillion, up from Rp 4.53 trillion in the same period last year.

However, says Lutfi: "In the long run, domestic investment growth may outgrow FDI. Last year FDI growth was around 40%, but this year it may drop to around 20%, while domestic growth will be higher than FDI in the full-year."

Yet, in January, the rubber and plastics industry recorded the highest domestic investment value of Rp 300 billion. The construction sector recorded the highest FDI value of USD 384.6 million, followed by the trading sector at USD 74.4 million.

So is impending FDI gloom a reality; or if or when it happens, will it last long, especially as global surveys (reported in the last *UHY International Business*) indicate that the Asia-

Pacific region will recover from economic woes much faster than elsewhere in the world?

Says Lutfi: "There are no countries in this world that can withstand the global economic crisis, but I believe our national economy is dealing with the crisis better than most."

Currently, however, BKPM is focusing on investments in three sectors — agriculture, infrastructure and energy — to address the issue of a potential slowdown in investments during 2009.

Overall, BKPM projects that investment, both domestic and foreign, will grow by 10.7% to 11.2% this year, although this growth still represents a decline on the 20.5% growth recorded in 2008.

With exports already hit by the global economic slowdown reducing demand, Indonesia would still need a boost in domestic consumption and investment to achieve a 4.5% GDP growth, as targeted by the government under revisions to the 2009 state budget.

Macroeconomic outlook

After July's presidential elections, a high-level conference is destined to bring together regional and country heads to discuss the outlook for Indonesia, and the challenges and opportunities of doing business in South-East Asia's most populous market.

Indonesia's main exposure to the current crisis lies in its exposure to changes in capital flows, much like it did in the Asian financial crisis of 1997-98.

International reserves once again look small, covering around 150% of the country's short-term debt, well below the Association of Southeast Asian Nations (ASEAN) median of almost 600%, and putting it on a par with countries in the ailing Eastern Europe region.

However, unlike 10 years ago, and unlike most countries in Eastern Europe, Indonesia is set to run a current account surplus in 2009, just as it has done every year since 1998. This current account surplus will be an important source of capital inflows, and it means that despite its piles of short-term debt, Indonesia should have more than enough reserves to cover its expected external financing requirements in 2009.

The government's finances also look strong. Public debt fell to just 30% of GDP in 2008, from a peak of 100% in 1999. Furthermore, the fuel price subsidy bill has been slashed by a big fall in global oil prices. This has freed up funds for more productive spending in areas such as infrastructure and education.

Furthermore, in 2009 the government is also set to deliver a large fiscal stimulus, which will see the budget deficit rise to 2.5% of GDP, from 1.1% in 2008. The main goal of this stimulus is to support economic growth in the short term. And Indonesia's corporate income tax rate is reducing – from 35% last year to 28% in 2009 and down to 25% (the highest rate) in 2010.

One less favourable contrast between now and the Asian financial crisis, however, is that, as the developed world suffers deep recession, Indonesian export demand is extremely weak.

In the region, Japan saw its exports fall by 50% year on year in December 2008; Singapore experienced a 35% fall; Taiwan a 42% drop. And Indonesia has not escaped – its own exports fell by 36% in January 2009.

Japan, its largest trade partner, is expected to experience an economic contraction of 5.5% in 2009, suggesting the export picture will remain bleak. Importantly though, Indonesia is one of the least trade-exposed countries in Asia – just 33% of its GDP was accounted for by exports in 2008.

This advantage will not be enough to help it avoid economic recession in 2009, but its economic contraction is likely to be smaller than that experienced by many of its neighbours.

Where that leaves investors is, as always, a matter of judgement – no investment in an emerging economy is without risks. The question is: does profit potential from a hugely populous nation outweigh risk? Current investment levels suggest it does.

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