Local Knowledge = Better Returns

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Introduction:
Start by asking country managers questions, not by giving advice

The worst mistake any investor can make when placing funds in an emerging market is to ignore the situation on the ground. Too often, investors think they know better than the local people about how to make a business succeed. Too often, investors go into a situation without properly investigating the business, legal, political and other risks that are going to affect the enterprise from the very beginning. It’s all too easy to discuss with your colleagues in Europe or America how things should be in Africa; when you get there, you’re going to find out things are different than you expected.

We have been asked to provide “reflections from practice” that will give executives actionable advice they can give their country managers. I think it is imperative to turn the question around. Rather than starting by giving advice to our country managers, we must decide what questions to ask the country managers and then rely upon those answers to make context-specific decisions. Or, if we think we cannot do that, we need to fire the country managers and find someone whose answers we can rely on.

Country managers, properly selected, are natives of the country in which they are operating when possible. They draw on their professional experience, their networks of professional colleagues, friends and family, and their understanding of your needs as an investor. Now, to be honest, working with local staff rather than sending one of your own to the field to run things can create tremendous difficulties of communication and trust. You need to overcome these in order to work successfully.

Let me be completely transparent: I write from the prospective of Oikocredit International, a company whose mission is to reduce poverty—so we have a “double bottom line.” We must achieve both social impact and sufficient profit to sustain our operations and build our capital base. With over USD 600 million invested in 70 developing countries, we have virtually no government support or donations whatsoever. Instead, the company relies on equity investments, requiring that it be financially sustainable. Despite all odds, Oikocredit has had great success. Formed by the World Council of Churches in 1975, 500 churches and 36,000 individual investors have invested close to USD 1 billion over the years. Profits as well as social impact have risen dramatically during the past 15 years, increasing disbursals from about EUR 2 million in 1995 to EUR 200 million last year.

Our business model is closely tied to our values: respect and honor your clients as you would yourself. To lend or extend equity to the poor is to enter a respectful business relationship. For us, this means adapting our operations, products and procedures to local conditions wherever possible. Above all, it means we rely heavily on local staff who select and recommend each investment. Our 40 international offices are virtually all headed and staffed by local employees.
who are paid locally-appropriate salaries. We hire them for their networks, their knowledge and their integrity. We never send someone from headquarters to run their operations. To combat the communications issues, all must speak English well, and a Western education is a great plus.

Even though Oikocredit has a “social mission,” many of the lessons that Oikocredit has learned in 35 years of work in developing markets are directly applicable to those companies are wholly profit-driven. Even so, to my commercial readers I say: Please don’t forget the moral imperative of working in poor countries. Let’s try to make things better. It will give you satisfaction and please your shareholders beyond just making profits.

Wikipedia defines “impact investing” as: “an investment strategy whereby an investor proactively seeks to place capital in businesses that can generate financial returns as well as an intentional social and/or environmental goal. This concept of combined financial and other benefits is known as ‘double bottom line’ or ‘blended value’.”1 This has also been described as “an emerging hybrid of philanthropy and private equity.”2

Whatever the description, the purpose is the same: to do well and to do good. Is this possible? Absolutely. Is this difficult? Absolutely. But is it worth it? Absolutely. We have an ethical obligation as well as sound business reasons to have beneficial impact on the places where we place funds. The disparities in income and well being currently existing between 20 percent of the world’s population in the western democracies and the other 80 percent of the planet can be truly horrifying. It is hard to ignore the moral imperative that exists when you go into a poor country with large amounts of money to invest. This does not mean we should be stupid. Nobody should lose their money or let it be stolen. The money needs to do what it’s intended to do. But working in poor countries is even more difficult under any circumstances than working in a developed country.

Case Studies from Africa and Peru

I. Loan in Africa

A U.S. investor lends USD 1 million to a diamond mining company located in Botswana. The loan is secured by a first mortgage on the diamond mine. Based on common international legal practice, New York law is applied to all of the agreements. The investor uses its U.S. lawyer to prepare the documentation. However, the due diligence is not performed on the borrowers using local counsel.

Two years later, the Botswana company decides it is moving its mining operations to South Africa, and asks for the following changes to the loan:

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- Transfer 50% of the loan to a subsidiary company in South Africa, because most of the revenue and assets are now located in South Africa.
- Transfer the remaining 50% of the loan to a Dutch company that has purchased control of the Botswana company. The Dutch company is privately held and secretive, but audited financials show a strong balance sheet.

The situation is highly pressured, because the South Africa deal will fall apart unless all parties agree quickly. The U.S. investor decides to sign an agreement with all parties to make these changes. Again, the U.S. lawyer prepares the documents using U.S. law and all parties agree.

Three years later, the loan is in default. The lender tried to enforce rights against the Dutch company and the South African company. What happens?

- The lender wins his claim against the South African company, but cannot remove the money from South Africa because the Central Bank of South Africa did not give approval of the transfer of the loan when the debt was created. The U.S. lawyer did not investigate the effect of South African exchange controls, because no money was entering South Africa. Effect: The lender can collect any proceeds gained from the lawsuit, but will need to leave them in South Africa. Not being a South African-registered company, the investor has tremendous problems opening a bank account in that country to receive the funds, so he puts the money in a lawyer’s trust account until, hopefully, a solution will appear.
- The lender sues the Dutch company in a New York court and wins a judgment, then discovering that the Netherlands and the United States do not have a “treaty of judicial enforcement” that allows for automatic enforcement of this judgment in the Netherlands. The lender will have to bring suit in the Netherlands, starting from scratch with a New York contract that conflicts in many ways with Dutch civil law.

Lessons to be learned:

- It is essential to do local due diligence. Although business circumstances create pressure to move very quickly, investigate the local laws and procedures that will affect your transaction in case of default.
- Determine whether your counter-party is sufficiently large and internationally known that reputation risk will be enough to force them to comply with the contract, i.e., will they pay just to avoid the appearance of unreliability? If your counter-party is relatively small and local, you will have to rely on local courts at the end of the day to collect assets. Bear that in mind.

II. Equity investment and loan in Peru
A U.S. rose wholesaler invests USD 1 million to take a controlling interest in a Peruvian rose-growing company. The Peruvian company is owned by a local family, and the shares are in the name of the wealthy father and his son. The investor lends an additional USD 500,000 to the company to provide working capital. The loan is to be guaranteed by the father and son.
The U.S. company sees major advantages to obtaining roses at a low cost from the Peruvian company, and is eager to do the deal quickly in order to lower operating costs. The Peruvian company has a complex structure, including extensive debts to a Chilean company that is also owned by the father and son. The books of the Chilean company are not available, although the loan documents, which are entirely in Spanish, are.

As part of the deal, the U.S. company will get a seat on the board of the Peruvian company, and control over major decisions such as executive compensation, naming the MD and other significant business decisions. It is understood that the Peruvian father and son will continue to run the day-to-day operations of the company. The investor uses its New York lawyer and applies New York law to the transaction, to which the other parties agree.

Shortly after the investment, the Peruvian rose harvest fails as a result of a plague of pests. The U.S. investor tries to liquidate the company, and discovers:
- Father and son have liquidated existing assets to pay off the debts owed to the Chilean company.
- The stock the U.S. company purchased is denominated in Peruvian soles, as required by Peruvian law, and the Peruvian sol has declined badly against the dollar.
- Peru, being a civil law country, requires that personal guarantees be notarized by a Peruvian notary in order to be valid. Having failed to do that, the father and son’s guarantee of the loan is not enforceable.

Lessons to be learned:
- When dealing with closely-held companies, remember that the management is often in a more powerful position than the board or the shareholders.
- Avoid corporate structures that are too complex unless you can understand their true business purpose.
- Respect local formalities to secure the obligations of local persons.

**Conclusion: General Lessons Learned**

In general, the lessons I have learned and believe to important in doing business in emerging and frontier markets are as follows:

1. **Think Local.** India is not Kenya, and Kenya is not Peru. Ignoring local customs, business practices, challenges and opportunities is an easy way to set up future complications.

2. **Ask local people what they need.** Coming with the attitude of being the “expert” leads many organizations to skip this step. Here again is where country managers who are native to the country of operation can provide valuable insight and open you up to their network of other people to consult.

3. **Ask local people how to best structure the deal.** Deal making in each individual country is likely steeped in traditional structures and bureaucracy. What steps need to take place before
someone can sign on the dotted line? Again, be sure to consult with your in country experts to avoid conflict or misunderstanding.

4. **If local assets are at risk, use local law, not New York or UK law, for at least part of the deal.** The real question here is the likelihood of litigation to collect local assets. If all parties are large international companies, reputational concerns make litigation unlikely in some cases. But in other cases, if local assets are at stake and litigation is a real possibility in case of dispute, at the end of the day your case will need to be presented to a local court to effectuate a judgment. It is much easier and faster to explain local claims to local judges when local lawyers and law is used. Moreover, the Anglo-American model often used in international contracts can overlook formalities (notarization, registrations, etc.) that are essential to legal enforceability. For equity investments, local law will be unavoidable, and it’s best to know the legal issues up front.

5. **Trust your feelings about whom to trust, and take time to build trust.** Do not underestimate the importance of relationships and relationship-building in getting things done in developing countries. Learn the local customs; greet people in their local language or ask them about their family. Take extra time for business conversations. The small-talk and tea-drinking are not extraneous—they are part of the process of building trust. These simple steps help bridge cultural divides and ultimately lead to more fruitful business relationships.

6. **Acknowledge local limitations and opportunities.** The risk profiles are different than those in your hometown. The risks in the country of operations are different than you imagined. Forget much of what you know.

7. **Forget much of what you believe.** Our preconceptions about how things work in developing countries are often quite different from the realities. These countries have operated more or less successfully for centuries. You need to take advantage of their strengths (cheap labor, tightly-knit social structure, abundant natural resources), and you need openly to acknowledge the difficulties (ineffective legal system, corruption, political risk, weather risks).

8. **Change the timeframe.** Give yourself several days for tasks that in your home country would take at most one. Things will probably take longer than you think. In countries where phones are unreliable, internet connections are slow, traffic is truly terrible and many institutions are unstable, most people are hedging their bets. Strikes occur, rains flood the roads or someone you are relying on to complete a task may be called up country for a funeral or family engagement. Unpredictably in these contexts add time to every transaction.

Those who seek new markets should keep the developing world firmly in mind. Brazil, India, China, and Korea have all created economic miracles in recent years, and such countries are where future growth will lie. But operating there is also a minefield for the uninitiated. Take time and care, follow your instincts, and consider the principles I have mentioned and you could be richly rewarded. Above all, respect the places and people you to whom you bring your capital and knowledge. They also have much to contribute to your success.