Foreign Direct Investments as Initiators of Change

The"Swedmilk" dairy case- Reasons behind the failure

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Abstract

Institutional problems and the corruptive use of social capital give ground for misuse of institutional gaps and cause intentional failures for financial benefits. Based on social capital theory and transaction cost economics (TCE) this paper describes how the institutional environment in the Former Yugoslav Republic of Macedonia (FYROM), affects success or failure of business endeavors, such as the Swedmilk case. Foreign Direct Investments (FDI's) are expected to be the drivers of positive economic development for economies in transition. Hence, the major question addressed in this paper is: How does a Greenfield foreign direct investment of 25 million Euros, manage to collapse in such a short period? The paper also describes the "official" plans and actual outcomes of the dairy, as well as the situation in the dairy sector before and after the Swedmilk failure. The financial problems occurred in October 2008, so the case of Swedmilk is quite recent and has not been included in any kind of research. Being a recent case the real implications on the dairy farming and sector are yet to be explored.

Key words: social capital, institutional environment, dairy sector, Swedmilk dairy, foreign direct investments.

1. Introduction

FDI have been proven to be the "engine of change" in the restructuring processes of the dairy sectors in most of the countries in transition. By initiating a variety of more sophisticated models of vertical coordination (VC), they introduce important changes in the sectors and the country's economises. Closer VC also helps in dealing with the existing problems of contract enforcement, demand for quality supply, low trust and reliability, and other problems in the farmer-dairy relations that appear during long transitions (Dries at al, 2009) as in the case of FYROM.

Due to absence of foreign investments in the sector, caused by the political and economical instability, insecure property rights, absence of key reforms, low incomes (Dries at al, 2009), the Swedmilk dairy was an interesting case for our research. Being the first FDI of this kind and magnitude, our intention was to present a good example; a successful story expected to introduce new technology and management strategies leading to the most needed changes in the dairy sector. With an official investment of 25 million Euros, it was the largest investment in the dairy sector. However, after the unexpected development and the collapse of the Swedmilk dairy, the dairy sector on farm level experienced important structural changes. The absence of appropriate institutional frameworks and corruption was shown to be of key importance in the malfunctioning of the new production technologies introduced by the dairy.

Institutional problems and the misuse of social capital give ground for misuse of institutional gaps or low-quality institutions and cause intentional failures for financial benefits. “It pays to break the rules”, which accordingly destroys trust and increases the level of transaction costs in this kind of markets (Svendsen, 2003, p.g. 6)

> *“Culture of corruption”- may impose high economic costs and require many “off-the book” transactions (and TC) to carry on normal production of goods and services”(Granovetter, 2005, p.g 35)*[1].

Despites all the efforts and proposed solutions the dairy declared bankruptcy along with the on-going criminal investigation on the case. To this moment no solution for compensation of farmers for their milk was found.

2. The dairy sector and institutional environment

The dairy sector has been traditionally seen as one of most developed Agricultural sectors in the country. At the same time it is a sector characterized by high risks and uncertainties in all the segments of the dairy chain. With iindividual, private farms producing almost 90 % of the cow milk production (Country report 2006), the dairy farming in FYROM is mainly constituted of traditional farmers with 1-5 cows (86.4 % of the total number of farmers, or 54% of total number of cows). There are 48.741 farms, according to Sector analysis from 2007 (Brandth, 2007)

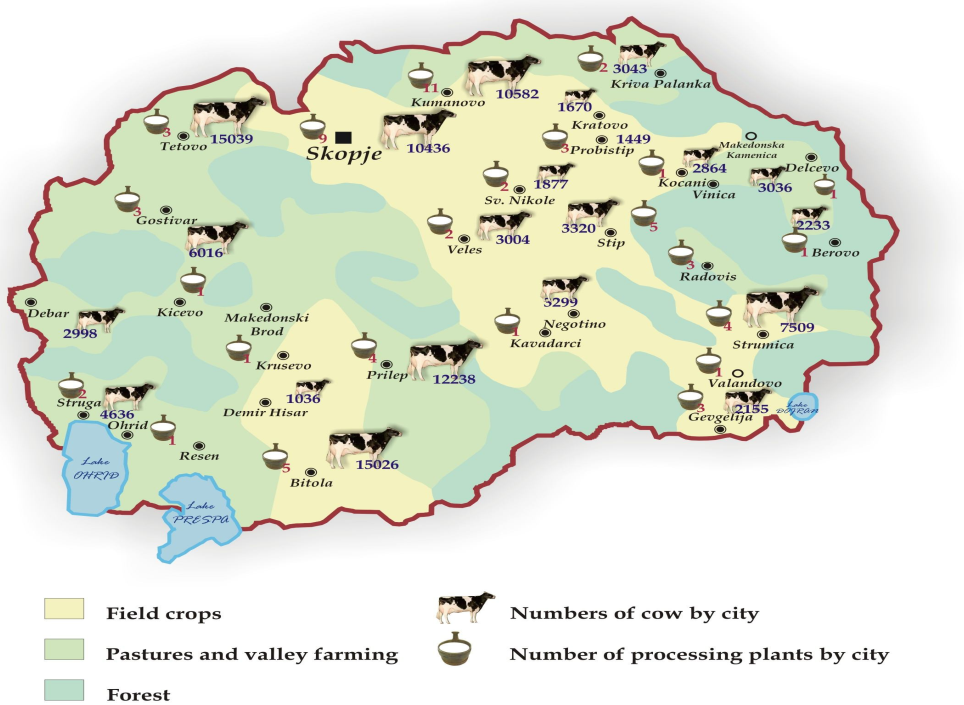

Figure 1. Map of FYROM and registered dairy plants (2007)
Source: Brandth, 2007

[1] “corruption”- Economic actors buy and sell political influence, threatening to merge political and economic institutions (Granovetter, 2005)

The veterinary inspection n FYROM has officially registered 85 dairies with operating capacities of 200 to 0.2 tones per day. The processing capacities differentiate from modern facilities to small, simple facilities for milk process, widely dispersed over the country (see figure 1).
Greenfield investments are relatively rare in the transition economies (Simonsen, 2003) and especially in small countries such as FYROM. This is one of the reason why larger dairies such as Nestle, Danone and Meggle do not have their own structures, and are mainly present in the country through international wholesaler trading companies. Investing in a dairy plant of such size was of great importance not only for the sector, but also for the overall economy. The largest two dairies (period before Swedmilk) were covering 39.4% of the total market share, with the local brand "Bitolska mlekara" – Bitola covering 74.7% of country's needs (51.9% of country's needs of UHT milk, depending on fat content and packing size).

Table 1: Largest dairies and processing capacities (more details in app. 1)

Dairy	Raw milk processing capacity	Processed raw milk	Market share
Bi Milk	200 tones/day	120 tones/day (winter) 170 tones/day (summer)	26.4%
Ideal Shipka	100 tones/day	80 tones/day	13%
Zdravje Radovo	20+30 tones/day	18 tones/day	6.9%
Swedmilk	250 tones/day	50 tones/day (2007)	/

Source: Brandth, 2007 (Sector analysis), Swedmilk 2007

Six of the domestic dairies export in the neighboring countries, but only one of these dairies (Bitolska Mlekara-Bitola) is meeting the food safety standards in the processing industry and is "certified" for EU export. The Agriculture and Rural Development Programme from 2007 concludes that to this moment, there are not many dairies in the country that can fulfill the EU requirements. In their opinion, at least 50% of the dairies will not be able to upgrade the process, facilities and management to reach EU accreditation (ARDP, 2007).
The traditional products of the dairies are UHT/milk, different local cheese, yoghurt and sour milk. Other product like fruit that require higher hygienic standards of raw milk, are almost completely provided by foreign diaries mostly from Slovenia and Croatia.
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ARDP (2007) also describes the relations between the dairy factories and the wholesalers or retailers as "often week". This was explained as a logistic problem, occurring because of delayed product delivery, sometimes even done without cooling trucks. The dairies and some small wholesalers deliver their products directly to the shops or supermarkets. The only existent distribution centres are located in the main market in Skopje and are owned by the three largest FYROM's dairies. Supermarkets do not own distribution centres yet (EU framework contract, 2006) (see figure 2 for detailed description of the dairy chain transactions). The main problem for the consumers in the country is the

inconsistent quality and taste of the local products, mainly caused by un-unified, low raw milk quality, week processing management and lack of cooling equipment especially in the summer period. Also, marketing advertising and packing of the dairy products is still unable to meet international standards.

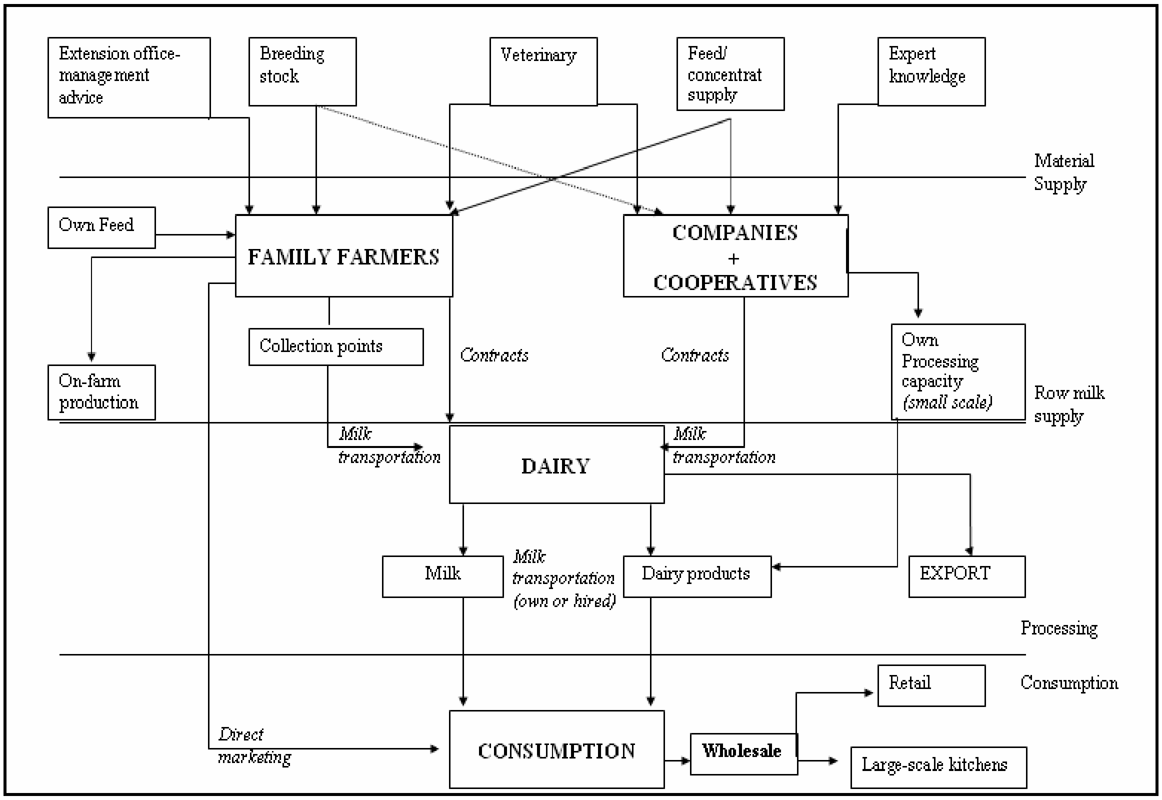

Figure 2: Presentation of the key transactions in the liquid cow milk chain

2.1 Institutional environment

The judicial and executive governance in the country are identified as week, unclear, and rarely implemented (Country report 2006). Contract enforcement is often costly and inconsistent. This problem experienced by most of the countries in transition is manifested by payment delays or non-payments for delivered products to the dairies, causing problems in the essential cash flow for the farmers (Swinnen at all, 2006). FYROM farmers often face opportunistic behavior like hold-ups by the dairies in order to lower the price for raw milk and often by payment delays (sometimes more than two or three months). Furthermore, farmers do not feel that they rely on the dairies' own measures for milk quality, since the large dairies sometimes misinterpret the measures in their favor (AASP 2006). On the other hand, the biggest problem often embraced by the dairies is the problem of opportunistic behavior by farmers, in terms of inconsistent milk quality and adding water to the milk. All these factors give rise to higher cost due to high risk, lower efficiency and product quality as well as conduct mistrust between the partners in the farmer-dairy segment of the dairy chain. Quite often farmer's revolt is manifested by farmers blocking the performance of the dairy processing facilities, not delivering milk to the milk processors, and instead pouring it in the streets (most recent case: august 2008). The producers are not organized in cooperatives or in any other form of production organization and are seldom informed about market issues.

The relations between the dairies and the farmers are mainly regulated by contracts, evaluating milk on quality basis (figure 2). The ARDP (2007) qualifies the problems of the sector as basic concerning the raw milk quality, problems with production management competence, problems because of the absence of HACCP standards, and the disability for meeting international hygiene standards. Moreover, the variations in raw milk quality causes further problems in the supply chain affecting milk shelf life, and causing inconsistence in product's quality and taste. So, the need of additional investments in on-farm machinery like milking and cooling equipment, and in animal welfare standards are believed to have a positive effects on the entire dairy sector. High prices of inputs and especially the expensive animal feed are also causing problems in the raw milk production. Milk producers are additionally constrained in developing their production by rigid rules for access to credit lines, high levels of interest rate accompanied by short period for credit repayment. The lack of sufficient capital inflow is influenced by many factors, but the main one is the unregulated land ownership and legal structure of land heritage (AASP 2006).

In this respect, Swedmilk" was the first dairy that was granted an official export license to EU member States according to the new Rulebook. By adopting this license, the dairy started finalizing the basic export arrangements with France, Bulgaria and some other countries. Until June 2008, the dairy also completed the six-month testing period for obtaining HACCP certificate. Until the same period the official investment amounted to 25 million Euros, and announced launching 70 new products by the end of September 2008 (Bulletin, 2008). The dairy had 120 employees and signed cooperation agreements with about 1200 farmers (MINA, 2008[2]).

3. The "Swedmilk" Story

3.1 Organization and ownership structure

"Swedmilk" was founded as a partnership scheme by Sweden's Swedfund, FYROM's beverages producer and distributor M&A Beverages (as a strategic partner, and exclusive distributor of Swedmilks milk), and private individuals. The type of capital was characterized as an equity, plus loan with a total sum of 13 707, million SEK [3]. The Swedish Government (Swedfund) was the stakeholder owning 30% of the Swedmilk Macedonia's stakes and all together the dairy was a 50, 5% Swedish-owned[4].

"Swedfund" is the Swedish Government's risk capital company specialized in investments in developing countries. They offer expertise and capital to the Swedish companies for investments in new markets in order to develop profitable business and at the same time reduce poverty in the particular countries. Stefan Ahl, the Investment Manager of Swedfund characterized this venture as *"A promising investment with great potential[5]"*. "The dairy investments were announced in "Swedfund's" annual report

[2] http://macedoniaonline.eu/content/view/2585/52
[3] http://www.swedfund.se/media/28751/annual_report_2007-company_presentation.pdf
[4] Macedonian News (29.12.2006), FlexNews (07.11.2007)
[5]Swedfund International, 2007- Official Swedfund site

(2007) as investment in a top modern dairy, which will meet the highest EU standards in terms of environment and recycling. This would have made “Swedmilk” the only dairy of this kind in the Balkan region (Swedfund International, 2007).
The establishment of the Swedish dairy started as a successful story with extensive publicity. The foundation stone was laid on December 27, 2006 by the Prime Minister of FYROM Nikola Gruevski, and Roger Oscarson, the Director General of “Swedmilk Macedonia”. It was announced that 15 million Euros will be invested only in the first construction stage of the dairy. The ambitious plans included employment of 100 employees, and contracts (agreements) for milk purchase with around 5.000 local milk producers, which would provide the dairy with 250 tones of milk.

> *”Our ambition is to become a leading competitor in the dairy products market, and we will pursue that goal in line with the highest EU quality standard. We are investing in Macedonia because we see clear business opportunities and strong potential for development of the milk industry…we are investing in Macedonia because we see clear business opportunities and strong potential for development of the milk industry* (Roger Oscarson’s statements in his first public appearance)

The statements of the government representatives were expressing expectations that these kinds of investments are always welcomed since they are creating job opportunities and enable the farmers to develop their house businesses. This particular investment was thought to be the solution that will eliminate the danger of new milk crises in FYROM. Roger Oscarson was Tetra Pak’s southern manager and for five years he and his associate and company manager for Macedonia Josif Sarzovski, tried to develop raw milk production in FYROM as a supplier to the dairy industry. Since they thought that progress is slow they decided that building a dairy of their own will speed the process. The idea was to build a dairy that would satisfy the EU standards and also retain environmental consciousness[6]. This dairy was also aiming to end the monopoly established by the Bitola dairy, which was the sole, larger buyer of raw cow milk at that time.

3.2 Vertical coordination, Relationship with farmers and contract design

The commercial production and buying milk by the dairy started on December 1, 2007[7]. The criteria for selection of farmers were strictly defined, and their agreements were planed in a way that would promote international cooperation, quality standards, quantities, and prices. In one of the meetings with the dairy farmers, “Swedmilk Macedonia” presented their future plans. The ambitions were to develop long term contracts with expiry period ranging from three to five years. “A partnership between equals”, was the characterization of the relationships, where both parties will share the same goal for growth and profit earning. In terms of payments, it was promised that there will be clean payments, meaning payments on time and in MKD[8]:

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[6] http://www.swedfund.se/media/28751/annual_report_2007-company_presentation.pdf
[7] http://www.investinmacedonia.com/news.aspx?news39
[8] R.M currency

"We are honest partner which keeps his word and promises, because we want to work on long term relations, meaning that we will not pay in, but in cash and on time." (Roger Oscarson - meeting with Bitola farmers, 2008[9])

Payments were to be on standard terms of 30 days, before the 15th of the next month. Additionally the dairy has made agreements with NLB Tutunska Banka, to enable cash payments at the day of delivery. This would have meant, that the farmers, partners of the dairy, would get a Bank loan on a cost of around 0.2 MKD/per litre if the price is 16 MKD/per litre (1.2% per month), and at the end dairy will clear the loan. During the period of cooperation, the farmers would have been able to cancel the contract with 90 days notice, whatever the reason for this decision was. "Swedmilk" also had the chance to cease the collaboration when the farmers would not meet the contract terms and conditions.

The plant intended to follow official FYROM's law on raw milk pricing as per quality standards. The average price was varying from 12.81 MKD/ litre for the lowest quality, to 17.93 MKD/ litre (+12%) for extra class row milk. Regardless of these announcements, the dairy offered much higher prices for the row milk in order to attract farmers to cooperate with them. Making large investments in the processing facilities, the Swedmilk dairy gave positive signal of the" serious" intention for long-term existence on the dairy market in the market. This and the attractive prices and favorable contracting conditions attracted many dairy farmers to cooperate with this dairy. It also created incentives for the farmers to invest in their assets, increasing the investments in their farms and heard size. The declaration of the Swedish ownership only enhanced the reputation and increased the trust in positive relations and improvement of the farmer-dairy relations in the sector. Yet reputation can be used as a mechanism of trust with great caution and only in more developed markets "*with extensive communication and transactions among the partners"* (P. K. Rao, p.g. 92).

Table 2:Cow milk prices on farm level and number of dairy cows.

Year	2004	2005	2006	2007	2008	2009	2010 (till September)
Milk price den/liter	17.3*	17.04*	16.51*	18.16*	23.45**	15.32**	16.00**
Number of dairy cows	161.554	156.950	164.013	143.217	147.519	/	/

Source: MAFWE (*SSO 2009, **MAFWE)

After the Swedmilk case, major structural changes on dairy farm level happened, which lead to decrees in the number of dairy cows. Official number of dairy cows for the years after the dairy bankruptcy is not available yet (table 2).

Further more, the dairy obliged not to force farmers to use products or fodder provided by the dairy if the farmers decided to mix the feed themselves and buy cheaper fodder and other supplies. Swedmilk would have offered help and support. As it was the case in many transition countries, the dairy planed to offer assistance programs, and promised loans to each of the farmers that will sign partnership with the factory. The aspirations were to help registered farmers or farmer's groups in collaboration with one of the banks,

[9] "Vest" Newspaper, No. 13713, 2008.01.30.

to gain access to finances for lacto-freezers or complete collection points. Furthermore, the dairy suggested ways for promoting collaboration among farmers, by assigning a limit in minimum size of each collection point of 500 litters. These indicated the need for building social capital by joining forces among small farmers in forming group collection centers.
The potential partners were specified as: subcontractors, with own milk collection points; farms with own lacto-freezers; group of farmers, with common lacto-freezers; subcontractors, with own organization for milk collection. All of these activities were as they said aimed at putting pressure on farmers for the changes that were about to happen in the milk production and dairy processing sector. They were to rebuild the confidence and reduce the uncertainties and risks, traditionally present between FYROM's dairy farmers and the dairy industry. This promising start induced optimism in farmers which expressed satisfaction the cooperation with the dairy in the sense that it offered relatively higher prices and started with issuing documents for the sold quantities of milk (which was not the case before, in the collaboration with the other existing dairies).

Besides the large investment done in the dairy plant, "Swedmilk" also invested in modern trucks, specialized for collection and transport of fresh milk for dealing with the product perishability and quality. However, the dairy decided to distribute processed, long-life milk through M&A Beverages who was their partner in the country. At the end the managers pointed this partnership, and the opportunistic behavior by M&A Beverages as the main reason for the bankruptcy of the plant.

3.3 Events leading to failure

The financial problems occurred in November 2008, and they were manifested by the delayed payments of milk to the farmers. Provoked by the situation, farmers organized road blockades and announced protest. The reasons for the problems were explained as a "diversion" by the strategic partner "M&A Beverage", which were the dairy's stakeholder and distributer. The diversion by "M&A Beverage" meant a debt of the company towards the dairy, leaving it without financial assets to pay the purchased milk and the dairy employees (Utrinski Vesnik, 2009). Country's Medias quoted CEO Oscarson in his statements that he is looking for ways to resolve the existing problems, saying that two companies were interested in setting a joint venture[10]. However, the real reasons for such enormous debts for such a short period are much more complex. In informal interviews and personal contacts, some of the actors in the field speculated that one of the reason that the investment was doomed from the beginning, was the absence of processed products other than milk and yogurt, which in their opinion was not profitable. The dairy did not express plans to process the fresh milk in other dairy products, or milk powder. Other reasons were the intentional un-economical performance of the management.
Swedfund" as s minority shareholder by recommendations from the Government of Macedonia expressed willingness to permit the proposed reconstruction and to avoid a bankruptcy, which would affect dairy farmers, and transferred their shares to Phoenix Energy. Swedfund declared itself prepared to sell shares in Swedmilk for EUR 1, in

[10] http://www.kamcity.com/namnews/asp/newsarticle.asp?newsid=45484

order to facilitate finding a good solution[11]. The U.S-Israeli fund "Fenix Energy USA LLC" became the sole owner of the Swedmilk dairy. This is an export-import company offering broad spectrum of products and services to meet the needs in consumer goods, commodities and industrial products (Fenix Energy, February 2009). But the problems are not solved yet, and the debt of the dairy towards the farmers has not been paid till this moment (July, 2009). Furthermore, the management of this company additionally worsened the situation by its unserious intentions.

4. Conclusions

Foreign investment plays an important role as an initiator of change and institutional innovation" (Dries at al., 2009). However, FDI's are not always a success story and can cause great sector restructurings; such was the case in the dairy sector resulted from the collapse of the Swedmilk dairy.

With an investment of around 25 million Euros, this modern processing plant aspired to become the leading producer of quality milk in FYROM. The offered assistance programs were aimed to rebuild the confidence in the most sensitive part of the dairy sector - the relations between the dairy farmers and the dairy processors. The project was saluted by both the Swedish and FYROM's Government, and yet, contrary to the ambitious plans and expectations, the dairy escalated the critical situation of the dairy sector in the country. Despite all the efforts and proposed solutions, the dairy declared bankruptcy and to this moment, no solution for compensation of farmers has been found.

The possibilities of the informal economy practices create incentives for opportunism in avoiding regulations and expropriation of rent. Opening an official investigation confirms the fact that the Swedmilk case is presumed to be a case of corruption enabled by the institutional problems, as often experienced in post-communist transition countries. Corruption and weakly established legal systems give ground for unlawful activities. Using Swedfund as a shareholder and providing favorable prices and conditions attracted both farmers and potential shareholders. The "Swedish" concept, as a fresh foreign investment in a troubled industry, promoted trust and confidence, both for the milk suppliers and the consumers. The development of this case made a deep impact and created a chain reaction in the dairy sector. The dairy farmers in the country experienced bankruptcy because of the investments encouraged by the dairy plant. All the investments on farm level were acknowledged, but officially not supported by the dairy, so the farmers now face great problems paying out their credits towards the banks. The case is still not closed - the real implications on the dairy farming and sector are yet to be explored.

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