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# COMPETITIVENESS OF GEORGIAN AGRICULTURE: INVESTMENT CASE STUDIES

MARNEULI FOOD FACTORY

15 September 2014

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# **COMPETITIVENESS OF GEORGIAN AGRICULTURE: INVESTMENT CASE STUDIES**

MARNEULI FOOD FACTORY

USAID ECONOMIC PROSPERITY INITIATIVE

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## ABSTRACT

*This case study tells the story of a unique Swiss-Georgian partnership that goes back to the early years of Georgia's post-Soviet transition. Founded by Avtandil Svimonishvili and Thomas Diem in 1996, the partnership resulted in the creation of several enterprises, led by Margebeli Tskhali (Healthy Water), the producer of Nabeghlavi mineral water. Established as part of this group in 2007, Marneuli Food Factory (MFF) was built on the foundation of a defunct factory that was a key supplier of canned food, brandy and wine to the Soviet Union. Over US\$25 million has been invested in MFF and Marneuli Agro (a sister company supplying raw materials), allowing the company to capture 30% of domestic market share of canned and bottled preserves and providing the group with a product base that extends beyond bottled mineral water.*

# ACRONYMS

<b>CSR</b>	Corporate Social Responsibility
<b>DCFTA</b>	Deep and Comprehensive Free Trade Agreement
<b>EBITDA</b>	Earnings before interest, taxes, depreciation and amortization
<b>EBRD</b>	European Bank for Reconstruction and Development
<b>EPI</b>	USAID's Economic Prosperity Initiative
<b>EU</b>	European Union
<b>M-Agro</b>	Marneuli Agriculture
<b>MFF</b>	Marneuli Food Factory
<b>SSA</b>	Social Service Agency
<b>USAID</b>	United States Agency for International Development
<b>VAT</b>	Value-Added Tax

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# I. EXECUTIVE SUMMARY

Established in 2007, Marneuli Food Factory (MFF) is a classical story of an old Soviet factory brought back to life through the establishment a proper supply base and massive investment in new products, modern machinery and management. Yet, it is also a story of a unique friendship and business partnership between two families: the family of Avtandil Svimonishvili and his wife Nino Ramishvili, on the one hand, and that of Thomas Diem, a Zurich-based Swiss psychologist, on the other. The two stories are so intertwined that it is impossible to fully appreciate the business success of MFF without understanding the human and ethical aspect of this venture.

The Swiss-Georgian Margebeli Holding, of which MFF is a part, includes four subsidiaries: Tskhali Margebeli (producer of Nabeghlavi mineral water), Marneuli Food Factory (manufacturer of canned food), Marneuli Agro (producer of agricultural raw materials), and Engadi (food distributor, including own products and imported goods such as mustard and olives).

MFF was built on the foundations of a defunct factory that was a key supplier of canned food, brandy and wine to the Soviet Union. When it was purchased in 2007, none of the old machinery at the plant was suitable for production. Thus, the bulk of initial investment had to be made in renovation of the factory shell and new equipment, including a tomato paste line from Italy. Lack of a stable raw material supply base was quickly identified as a key constraint for the business. This bottleneck was addressed through the establishment of a sister company, Marneuli Agro, and direct engagement of Georgian suppliers, including both farmers and traders.

Since its inception in 2007, MFF has captured 30% of the domestic market of canned and bottled preserves, and it is a major buyer of fresh produce from throughout Georgia. Based in the rich horticultural districts of Marneuli and Gardabani, in southern Georgia's Kvemo Kartli region, MFF is partly vertically integrated with Marneuli Agro, which accounts for 40% of its raw materials, while also maintaining longstanding supply relationships with more than 150 small and mid-sized farmers.

More than US\$25 million has been invested in MFF and Marneuli Agro since inception, including purchase of land and agricultural machinery, renovation of physical assets and installation of new production equipment. After a number of start-up years, the company was able to generate positive earnings (EBIDTA) in 2013. Most importantly, however, the wide range of essential products it places on Georgian shelves provides a revenue and market base beyond bottled water, which is still a luxury for the majority of Georgian households.

MFF's success demonstrates the viability of import substitution as a business strategy for investors in Georgian food production and commercial agribusiness. Its cooperation with the holding's distribution and agricultural production arms (Engadi and M-Agro, respectively) point to vertical integration as a useful mechanism of overcoming deficiencies in market support systems, which in Georgia include a highly fragmented supply base and weak business services.

Based on the findings of this case, our main recommendation to the Georgian government is to proceed carefully in the implementation of EU-style food safety requirements, for which Georgian producers are far from being ready. The Government should also repeal the ban on foreign investment in farmland, offer tax breaks and other appropriate incentives to compete with rival FDI destinations, and reform VAT administration to reduce its impact on companies' cash flow, The GoG should also reform welfare regulations to strengthen incentives for formal seasonal employment conforming to Georgian labor legislation.

Our main recommendations for foreign investors are to seek reliable local partners to develop and secure their assets, consider a vertically integrated structure combining processing with commercial production base and in-house distribution; and manage payment risk by maintaining a mix of large, mid-scale and small-scale retail customers. Large retailers can be enticing, but a good customer is one who pays his bills.

## **II. APPENDICES**

- A. BACKGROUND
- B. METHODOLOGY
- C. FINDINGS
- D. RECOMMENDATIONS
- E. ADDITIONAL INFORMATION

## A. BACKGROUND

Having risen from post-Soviet ashes in 2007, Marneuli Food Factory (MFF) is a classic story of a Soviet factory brought back to life through the establishment a proper supply base and massive investment in new products, modern machinery and management. It is also a story of a unique friendship and business partnership between two families: the family of Avtandil Svimonishvili and his wife Nino Ramishvili on the one hand, and that of Thomas Diem, a Zurich-based Swiss psychologist, on the other. The two stories are so intertwined that it is impossible to fully appreciate the business success of MFF without understanding the human and ethical aspect of this venture.

MFF was founded in 2007 as part of a Swiss-Georgian Margebeli holding (to be formalized only two years later, in 2009) which comprises four subsidiaries: Tskhali Margebeli (producer of Nabeghlavi *mineral water*), Marneuli Food Factory (manufacturer of *canned food*), Marneuli Agro (producer of *agricultural products*), and Engadi (*food distributor*, including own products and imported goods such as mustard and olives). This case study focuses on MFF while making occasional reference to its sister companies.

MFF was built on the foundations of an old factory that was a key supplier of canned food, brandy and wine to the Soviet Union. Having lost its input base and product market in the political and economic chaos of the early post-independence days, the factory, much like Georgia's entire manufacturing sector, quickly turned into a heap of scrap metal (the country's leading export commodity until well into 2000s).

In line with many other transition economies, canned or bottled preserved goods occupy a more significant percentage of weekly grocery shopping in Georgia than in more affluent countries. This is particularly true in very low income families who do not own a refrigerator. Yet, the collapse in Georgian agricultural production and processing after 1991 led to manufacturers abroad, predominantly from Turkey but to a lesser extent from Europe, capturing almost 100% of Georgian market share in preserved fruit and vegetable products, as well as jams and preserves.

Since inception in 2007, MFF has captured 30% of domestic market share of canned and bottled preserves, and is a major buyer of fresh produce from throughout Georgia. Based in the rich horticultural districts of Marneuli and Gardabani in southern Georgia's Kvemo Kartli region, MFF is partly vertically integrated with Marneuli Agro, accounting for 40% of supply, while also maintaining longstanding supply relationships with more than 150 small and mid-sized farmers.

The high value associated with MFF's "M" brand today only serves to underline the long and winding road the company has travelled since its modest beginnings only a few years earlier. As Thomas Diem recollects, when Avtandil Svimonishvili came to him with the idea of setting up MFF in 2007, Tskhali Margebeli, the financial cornerstone of the holding, was selling more and more Nabeghlavi water:

### THOMAS DIEM'S FIRST ENCOUNTERS WITH GEORGIA AND GEORGIANS<sup>1</sup>

"My relationship with Georgia started in my youth when I first heard Gurian polyphonic singing. It took years until I was able to realize my dream to go and visit the country. In 1993, I joined a trip to the sky-high mountains surrounding Tusheti, an isolated valley on the border of Chechnya. This turned into a very emotional experience, strengthening my passion for this country.

In 1996, I joined another trip, led by Thomas Heuzermann, an enthusiast of Georgian traditional music. He visited remote villages and encouraged old people to sing traditional songs that were not cultivated during the Soviet times. Avtandil Svimonishvili was the host and organizer of our trip.

After the establishment of independent Georgia the country was lying in ruins. People were merely trying to survive, by any means. The very rigid structure of Soviet politics was broken. What emerged was a system of clans. Most of these were criminal and it was my fortune to bump into a "good" clan, that of Avtandil Svimonishvili.

Avtandil is about my age, a former diplomat, a survivor by nature. Together, we started Tskhali Margebeli (Healthy Water), producer of Nabeghlavi mineral water."

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<sup>1</sup> Based on an interview with Thomas Diem, held by Eric Livny on 14 July, 2014.



"I thought we could consolidate and relax. However, it is a probably a pattern that new ideas and challenges tend to appear at such moments. When we came to Marneuli to observe it for the first time, we saw a poor locality, everything broken and stolen from a former Soviet factory. I said, 'God, not again!' Avtandil's point was that 95% of products on the Georgian shelves are foreign products. In the past, Georgia and Ukraine were able to feed the entire Soviet Union and there must be a way to turn the situation around. ... Avto and I are patriots of our countries. When we do business we may want to make a profit but we also want to serve the countries we love and help our people. In a certain way, our lives are easy and simple because we don't waste psychic energy on trying to resolve conflicting values. Instead we put all our energies in achieving our objectives."

The partners' learning about the sorry state of Georgia's agriculture started in 2004-5, well before their investment in MFF, when Avtandil's son and the group's current General Director, Mikho Svimonishvili, served as minister of agriculture in the early days of the Saakashvili administration. Mikho reflects on the decision to set up the factory as an act of patriotism. "The idea", he says, "came from my father and Gia<sup>2</sup>, another key shareholder in the company. Thomas was fully supportive and agreed to reinvest the profits generated by Nabeghlavi in a new venture because he thought the country needs it."

In quite a number of ways, MFF followed the familiar but costly learning-from-own-mistakes path trodden by the partners since their very first joint venture. "In every one of our endeavors," recalls Thomas Diem, "be it Nabeghlavi, Marneuli, agricultural production, or education<sup>3</sup>, Avtandil, Mikho and Gia threw themselves into a new field and studied every detail of it, sometimes at a very high price. We paid millions of dollars to gain the experience and reach a point when our products are of excellent quality and people want to buy them."

"I never thought it would be so difficult", chimes in Mikho. "Renovation and new machinery were just the tip of the iceberg. We thought we could pull it off with US\$1mIn but in reality it cost much more because we lacked essential knowledge, and lost money and product. We survived [only] because of our ability to take cash from Nabeghlavi. We've learned a lot in the process, however, and are ready for bigger challenges ahead."

Over US\$25 million has been invested in MFF and Marneuli Agro since inception, including purchase of land and agricultural machinery, renovation of physical assets and installation of new production equipment. According to Thomas Diem, MFF has finally started generating profits in 2013. Most importantly, however, the large array of essential products it is able to place on Georgian shelves – more than 60 items including tomato paste, pickled vegetables, sauces, marmalades, jams, and compotes – provides a broader base for the group, beyond water, which is still a luxury for the majority of Georgian households.

## B. METHODOLOGY

This case study is based on a series of interviews with Marneuli Food Factory shareholders and management. This includes Thomas Diem (the Swiss founder and shareholder), General Director Mikho Svimonishvili, MFF Director Irina Gaprindashvili, and Engadi's Tinatin Makharadze. Business representatives shared confidential information such as medium-term business strategy, productivity, employment, relations with local and national government and innovation. These interviews helped identify the key issues for foreign investment in Georgia's agricultural sector as well as lessons learned and themes of broader significance for improving the national investment climate. When possible, ISET sought to identify other voices to ensure that alternative points of view were included in

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<sup>2</sup> Gia Gogoladze, is director of Tskhali Margebeli (producer of Nabeghlavi mineral water).

<sup>3</sup> In 2011, Avtandil Svimonishvili and Krayer Family Foundation of Switzerland have founded a prestigious private school catering to more than 1000 Georgian students. The school is located in the central Sololaki district, in a historical building on Lado Asatiani street, which has been renovated and refurbished by the owners. Nino Ramishvili, Avto's wife, is the school's director.

the report. When included, ISET clearly identified instances where stakeholders' views differ significantly or are contradictory.

## C. FINDINGS

### BUSINESS ENABLING ENVIRONMENT

MFF owes its existence to a Swiss-Georgian holding company created and gradually consolidated in the context of what was effectively a new country. Georgia was barely emerging from a civil war and ruled by mafia clans with little respect for formal contractual obligations and legal proceedings. The single most important asset for any company created under these trying circumstances was **trust**. First, *internal* trust of the partners in each other's professional qualities and integrity, and, second, the trust commanded by the company as a whole in its dealings with *external* stakeholders, including legal and "extra-legal" law enforcement agencies, suppliers, service providers and clients. An additional attribute of successful new entrepreneurs in the early days of Georgia's post-Soviet existence was the ability to quickly learn and solve problems on the go.

These two attributes (or assets) of the entire team behind Nabeghlavi were instrumental in the success of MFF and its sister company Marneuli Agro (M-Agro). The partners' trust in each other was the basis for the initial decision to reinvest Nabeghlavi profits in a new risky activity. MFF was established in response to a situation in which canned goods on sale in a country that was once a supply base of the entire Soviet Union<sup>4</sup> were almost entirely manufactured in Turkey.

Having not been engaged in agriculture at all before 2006, the company's management encountered a steep learning curve. At this point it was the learning capacity and the financial, technical and managerial ingenuity of the Georgian partners – Avto, Gia and Mikho – that transformed the decision to set up MFF into a commercial success. Initially, the factory was 100% reliant on outsourced raw material supply, but after discovering that cost of production exceeded that of Turkish competitors using this system, they pursued partial vertical integration.

Beyond renovation and technical re-equipment of the factory, the main challenge for MFF was to establish a reliable raw material supply base, using a combination of own production (through M-Agro) and a network of small and medium sized farmers. This had to be achieved in a very short period of time, while carefully managing quality and production costs in order to be able to substitute for imports in an extremely liberal trade policy environment.

### GENERAL COMPETITIVENESS CONDITIONS

While benefiting Georgian consumers, the free trade agreement between Georgia and Turkey and the generally **low level of tariff and non-tariff protections** weakens the competitive position of Georgian start-up agribusinesses vis-à-vis larger scale and technologically more advanced (and often subsidized) foreign competitors. As a rule, Georgian start-ups face higher cost of financing, lack scale, and suffer from deficiencies in knowledge and experience.

According to Mikho Svimonishvili, taking global competition into account, the level of Georgian **wages** is no longer very competitive either, as labor costs rise above major agricultural producers like China and Vietnam<sup>5</sup>.

Still, while Georgian labor is not very productive, increasingly in short supply and expensive, other factors should be considered as well. While it is still more costly than in Romania, Ukraine, and

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<sup>4</sup> The Marneuli district in Soviet times hosted a large number of canneries and preserving companies, with produce such as tomato paste, canned tomatoes, jams and canned fruit commonly sold throughout the Soviet Union.

<sup>5</sup> In the authors' experience, the **per-worker output** of Chinese farm laborers is double that of Georgian workers. Georgian labor also costs twice as much, leading to Chinese labor being four times more productive from a financial perspective.

Belarus, Georgia's **agricultural land** is still relatively cheap. At the same time, Georgia enjoys a **longer growing season** compared to many of its European competitors. The **soil and climate conditions** in Kvemo Kartli are quite suitable for horticulture. With proper land preparation, Georgian producers should be able to reach very good yields that are comparable with those achieved by their Turkish competitors.

**Taxes** are lower in Georgia than in other relevant jurisdictions, but companies also receive little in the way of returns for their tax contributions. There is negligible state-funded vocational training of potential employees, infrastructure is ever a work-in-progress, there is no state technical support at any moment, and state health care for workers is rudimentary.

The **domestic market** is slowly growing in Georgia, as in Turkey, with stagnant growth in the EU and very rapid growth in packaged and preserved foods sales in China. Turkey offers free farmland to investors for fifty years in its more backward eastern regions, and many German states will subsidize half the cost of a new factory built in their jurisdiction. China's more remote southwestern and northwestern regions will offer substantial tax concessions to food processors establishing there, especially in regions populated by ethnic minorities.

**Diesel** – a key input of agricultural production – is very cheap in Georgia. If Georgia reduces or cancels the excise tax on fuel for agricultural producers, it would be even more competitive in this respect. While not universally available due to infrastructure deficits, irrigation is much cheaper in Georgia compared with Turkey and most European countries. Finally, and unfortunately, Georgia is far behind on the cost of capital, knowledge (e.g. seeds), and machinery. This is an area where Germany is far ahead.

## **ACCESS TO FINANCE**

Like many successful enterprises in Georgia, financing has overwhelmingly come from personal sources and foreign investment. Access to domestic finance, whether through competitive commercial loans or working capital markets, has played no appreciable role.

There is little doubt that Tskhali Margebeli (producer of Nabeghlavi), Marneuli Food Factory, Marneuli Agriculture and the entire holding would not have been possible without what now seems like a legendary encounter between Thomas Diem and Avtandil Svimonishvili in 1996. Back then, Avtandil and his wife Nino Ramishvili, both Persian language and history specialists and amateur musicians (their son Mikho was a chorister with the [Martve choir](#)) were surviving by organizing and guiding tours of Georgia's cultural heritage sites. Thomas Diem was a member of a group of music enthusiasts, organized and hosted by Avtandil Svimonishvili. Neither Avtandil nor his guest – a Zurich-based psychiatrist and psychoanalyst – had any prior business experience or business aspirations.

The trip took them to the defunct Soviet-era mineral water factory in Guria and the nearby Nabeghlavi village. Enjoying the unique flavor of local polyphonic music and mineral waters, Thomas asked his host how much it might cost to re-launch the factory. Avto promised to do some basic calculations with the help of his sons. A rough business plan was delivered to Thomas two weeks later, estimating the total cost of investment at US\$40,000. Acting purely on the basis of instinctive trust, Thomas mobilized personal savings and transferred this initial sum to Avto, with no paperwork, official or otherwise. While very generous by Georgian standards of the time, this initial infusion of capital was sufficient for only a few months. Many times that sum have since been spent on production, logistics and marketing, allowing Nabeghlavi to become a substantial beverage brand in Georgia and abroad.

The financing of MFF was a totally different matter. The holding company has been able to finance almost the entire investment by reinvesting the profits of the group's cash cow, Tskhali Margebeli (producer of Nabeghlavi mineral water), and a relatively modest loan from the EBRD. Access to internal financing allowed MFF to gradually resolve a host of technical issues, despite considerable losses due to mistakes, and acquire relevant operational management and marketing expertise.

## THOMAS DIEM: FROM A FOREIGN INVESTOR, WITH LOVE



Thomas Diem, 72, with his daughter Rona in Guria, 2012

"I was born in Switzerland in 1942, and grew up with the consciousness of being spared the terrible fate of others. So, when investing I wanted to do good, help decent people to start their business, help a country I felt very much attached to. The same is true about my Georgian partners. In 2008, Mikho, Avto's son, was in the Georgian army, driving his Toyota to help evacuate people at a time when others used their SUVs to flee to Baku.

At the time I came in with USD 40,000, which I was able to put aside while practicing my trade as a psychiatrist and psychoanalyst in Zurich. For a few years we've experienced the misery of people who had a little bit of money to carry out their business, but far from enough to be truly successful. When I tried to arrange larger Western funding, we experienced many failures. I learned the feeling of not being liquid and taking more risks because of that. To mobilize funds, I sold some of the paintings I inherited from my parents, including one painting by Ernst Ludwig Kirchner (who was a family friend), and the shares I had in the *Neue Zürcher Zeitung*, a famous Swiss newspaper.

My investment so far totals about US\$ 750,000. We have never taken any money from the company and only about two years ago, for the first time, decided to pay some dividends, to help my Georgian partners.

2003 was a turning point in the history of our company. Georgia had its revolution in the same year, and I managed to convince Claude Dreifuss, a friend of a friend and a Swiss financier, to make a trial investment in the company. This allowed us to buy new equipment and to significantly increase production. Eventually Dreifuss declined the opportunity to continue investing in the company but we never looked back again. The market always wanted our product. The problem was and continues to be to produce enough. A good problem to have.

Georgians are extremely short term in their approach to life and business. We, the Swiss, are planning ahead. The company is a family company. The real asset is the loyalty between shareholders. It is like blood brotherhood. I brought more money than my Georgian partners, but I always wanted them to have more than 50% of the shares.

Materially, I am ready to lose everything I gained through investment in Georgia. What I did was to allow the career of Gia and Mikho, and gain the friendship of Avtandil, Nino and their family. This nobody can take away from me. I should also mention the very important contribution of Gia Gogoladze, the third partner in our company. Gia comes from an important family in Guria - his father was a senior executive in Nabeghlavi and was with us from the very beginning, providing technical (and now also financial) management of the plant.

The firm does not need me now in any practical sense, but I am acknowledged as a key sponsor of the enterprise. This is something deeply shared between me, Avtandil and Nino Ramishvili."

## ACCESS TO AGRICULTURAL LAND AND PROPERTY RIGHTS

MFF is located on a relatively small plot of industrial land some two kilometers from Marneuli, and it has had no issues with accessing its property. Its location and the fact that the factory creates employment while not carrying any negative externalities for the neighbors (e.g. by taking land or straining the water or electricity infrastructure) have positively affected local community relationships. Management currently faces no disputes and crime.

Marneuli Agro owns and cultivates 1000 Ha of agricultural land in Gardabani, in the Kvemo Kartli region. Having bought land on the secondary market, they feel certain that they have not unfairly infringed the rights of marginalized rural residents. That said, Mikho admits to facing problems with neighbors in the past. According to him, these problems have been effectively managed by nurturing village leadership and providing assistance with knowledge, machinery and old irrigation equipment.

As a foreign-invested enterprise, Marneuli Agro is still subject to the moratorium on foreign-invested entities purchasing Georgian farmland. Unless lifted, this moratorium will hinder the ability of the firm to expand its operations, subjecting MFF to increased price risk and supply risk. Until such time as this policy is repealed, the firm must focus on improving internal productivity at M-Agro's existing estates and improving MFF's supply chain relationships with existing and new contract suppliers.

## ACCESS TO QUALIFIED LABOR

Since its inception, the company has been led by an exceptional group of Georgian entrepreneurs and managers, who found their leader in Avtandil Svimonishvili. According to Thomas Diem, Avto was a key person in the early days of Tskhali Margebeli, while two younger partners, Gia Gogoladze and Avtandil's son Mikho, became increasingly involved in the post-2003 phase. Thomas characterizes Gia as a “genius of technique and finance”; and Mikho as a “genius of the market”. The next generation of the holding's top managers is represented by MFF Director Irina Gaprindashvili, and Engadi's Director of Marketing, Tinatin Makharadze. MFF has never employed any foreigners.

Having grown from within the company – and with it—the management of the holding is quite young. According to Irina Gaprindashvili, attempts to hire experienced managers outside the company have not been successful, as there is no strong food processing cluster in Georgia from which to draw qualified personnel. With the inevitable “learn-on-the job” approach that this requires, all company leaders we interviewed admit to having made costly mistakes. They see these as a price to be paid in order to learn and become professionals in their respective fields.

Management assesses the labor force to be of sound work ethic, but they also note that workers lack both formal education and practical skills. MFF's workforce is multiethnic, including Georgians (Kvemo Kartli Georgians and Svans), Azeris and Armenians.

According to management, finding workers has not historically been a problem, due to the sorry state of employment in the region. **Recent welfare policy innovations, however, have severely hampered the availability of seasonal labor.** Many low income households receive income support payments of GEL60 per person per month from the Georgia Social Service Agency (SSA), but if one family member in the household is registered as being employed, it jeopardizes SSA payments to all the individual claimants in the household. This can result in support payments being withdrawn for up to a year.

It is a Georgian legal requirement that all laborers, be they full time or casual, be bound by a labor agreement, covered under workplace insurance against accidents, and have tax withheld from their wage payments by the employer; in most cases this withheld tax is rebated to workers earning less than GEL 6,000 annually. Unfortunately, employers who seek to comply with the law are placed at a significant disadvantage to those who flout the law, as fear of losing welfare payments for a year makes many potential workers unwilling to sign labor agreements and be documented as taxpayers.

Until this situation is rectified, either by revisiting welfare payments or developing a more reasonable approach to phasing them out for those with seasonal work, Georgia's labor labor-intensive

### Mikho Svimonishvili: Portrait Of A Young Georgian Entrepreneur

Having graduated from the business and economics faculty of Tbilisi State University, Mikho Svimonishvili chose (and was chosen) to continue his education in a vocational college in Karlsruhe, Germany, in 1995-6. In less than two years he completed a program that should normally take three years, passing a state exam and receiving a diploma. As is typical for Germany's vocational colleges, each week of the program included two days of studies and three days of apprenticeship in a food enterprise. Such was Mikho's first encounter with the German culture and work ethics, which, he refers to as an “incredible formative experience”. “I learned more during this period”, he says, “than ever before or after. I was paid 800DM – only enough for food, and sometimes not enough, but was able to earn my own money by working overtime. Soon I was able to put some money aside.” He notes that in Germany and Switzerland, over 70% of school leavers are educated in very good vocational schools rather than universities. This, in his view, has contributed to both countries' high level of technical efficiency and industrial prowess.

In 1997, having completed the program in Karlsruhe, Mikho moved to Switzerland, for MBA studies at the University of Zurich. The four semesters in Zurich were an altogether different kind of experience, complementing the German work and study “boot camp”. Mikho recalls having some very good professors with whom he is still in touch, but by 1998 the zeal to go back and put all his energy in Nabeghlavi was too strong to be resisted. He hasn't completed his MBA and joined his father and Gia who were then making their first steps with Tskhali Margebeli.

Mikho judges the years he had spent in Germany and Switzerland as the best possible preparation for what was coming next in his life. This was not just about acquiring an understanding of business and industry, but the whole cultural experience of working in a German environment. “Having come back I was not ashamed to work in distribution and sell at football stadiums”, he concludes.

agroindustry will have a hard time competing against producers in Turkey and Asia. At present, SSA policies have already had the effect of raising potential workers' reservation wage for *formal* seasonal employment by businesses such as MFF. This year, the company had for the first time experienced difficulties in finding suitable seasonal workers at its standard wage of 24 GEL/day (including income tax remittance of 4 GEL/day).

### **MARKET ARRANGEMENTS**

Market arrangements between Georgian farmers and Georgian processors as a rule are quite primitive. Forward contracting is generally not successful, as it becomes a one-way bet for processors: small farmers will honor supply contracts if the market price is inferior to the contracted price, but an upward movement in spot price inevitably leads to farmers defaulting. Litigation costs against individual farmers are prohibitive, which small farmers all know.

MFF has been working to draw its 150 contract suppliers into a closer relationship in many ways. One is by using social media to communicate how M-Agro, as a flagship production enterprise, conducts its operations to a high standard and in the Georgian language. Another is by arranging field days and farm visits for existing and potential suppliers to demonstrate key technological innovations, like drip irrigation, modern fertilizer protocols and crop protection.

M-Agro has also developed its own seedling nursery for key vegetable species used by MFF, using both grafted and non-grafted seedlings produced from top European vegetable genetics companies. The company performs its own in-house trials at Marneuli Agro before using produce on a commercial scale and distributing seedlings commercially to MFF's suppliers.

Mikho has commented quite vociferously regarding the state of the Georgian supermarket retail trade and its impact upon firms like his. The near-bankruptcy in the past year of Populi and Goodwill, two of Georgia's four major supermarket chains, resulted in many suppliers not being paid for over six months. But Mikho is also skeptical that there is a role for international donor agencies in addressing this breakdown, given that Populi is owned by SEAF, a fund management business financed by many aid agencies.

### **MARKET SUPPORT SYSTEMS AND SERVICE PROVIDERS**

The group is not yet fully vertically integrated, making it reliant on outside contractors for raw material supply and some services.

#### **Transportation & Storage**

Outside contractors make their sales on a delivered-to-factory basis, organizing their own transport. Almost none of the trucks available are refrigerated, and indeed many body trucks have no roofs. Combined with inadequate post-harvest management and poor pre-delivery sorting and packing, deterioration of cargo—MFF's raw material—is inevitable. Occasionally an entire consignment must be rejected, or MFF will apply a discount to allow for the increased cost of sorting through damaged and unsuitable product. The longer the distance (and some of the fruit, e.g. tkemali, comes from Western Georgia), the higher the damages. Improvements in post-harvest handling would make a difference, and in-transit losses could be dramatically reduced through the use of refrigerated trucks. Given the atomized nature of MFF's supply base and the obvious expense of creating its own fleet, the company has not yet sought to undertake this step.

Georgia has no government-owned storage and very little private storage capacity. MFF has its own storage capacity on site, but as a general rule raw material is processed into saleable product within a day of arrival.

## **Machinery**

The existing machinery at the plant, when it was purchased in 2007, was no longer suitable for production. MFF introduced new equipment at the time, including a tomato paste line from Italy. A major source of production inefficiency is that modern European equipment must be used 24 hours a day at full capacity for production cost per ton to be competitive. For instance, the Italian tomato paste line is designed to process 500 tons per day, but the company has never achieved more than 420 tons per day since 2007. For most of the season, MFF's production lines are only operating at 30% of capacity. M-Agro owns all of its farm machinery and does not rely on outside contractors.

## **Supply of raw materials**

Both Irina and Mikho pinpointed the reliable supply of quality raw materials as a key constraint to the development of MFF. In an effort to address it, the holding purchased about 40ha of agricultural land in 2007, in parallel with the establishment of MFF. They started growing tomatoes, but a year later it became abundantly clear that local supplies of other raw materials were both insufficient and very expensive. "We started exploring the problem, recalls Mikho. "[We] invited experts and decided to develop our own supply base."

Today, MFF manages its own supply chain directly, using a combination of vertical integration—expanding its own capacity under M-Agro—and outsourcing. M-Agro, supplies about 40% of all the vegetables MFF uses for raw materials. The remainder comes from a diverse network of about 150 Georgian farmers that MFF has cultivated over time. The network includes individual farmers with plots from 1-40 ha as well as produce consolidators and traders who source products from small producers.

Unfortunately, MFF's experience in trying to develop long-term supply contracts with farmers is not different from that reported by other Georgian food processors. Farmers would regularly renege on supply contracts if they saw opportunities to sell at a higher price, sacrificing long-term relationship potential for short-term gain. Another supply-related issue, which is likely to become more of a problem as EU food safety norms begin to be implemented in Georgia, is the lack of documentation throughout the production cycle; products are currently screened on arrival at the factory.

According to Irina, they would not face similar challenges in a similar operation in Switzerland. MFF and M-Agro's main priorities for the moment are to increase productivity in the fields and resolve supply issues. Swiss companies would have all major supply and production problems solved, allowing them to focus on fine-tuning the operation and improving manufacturing productivity through labor, energy and other efficiencies.

The fragmented and uneven nature of MFF's supply chain ultimately limits its production capacity to well below its potential. The Georgian market, while actually quite small from a global standpoint, would still easily absorb much more production if MFF could upgrade its capacity to meet demand. At present, MFF simply runs out of stock in the November-to-June low season, maintaining its operations by re-processing purees of apple, tomato, peach, plum, and tkemali.

MFF must also rely on foreign suppliers for the vast majority of its non-agricultural inputs. While relationships with foreign suppliers are sound, the requirement to import significant inputs has cash flow implications (see *Tax Administration* below).

## **Business services**

For the services it requires to operate its business, MFF benefits from being part of a larger holding. In addition to sharing administrative space in its Tbilisi headquarters building, MFF is able to rely on its

sister company Engadi<sup>6</sup> to handle distribution in Tbilisi, Batumi, Kutaisi, and Poti. In smaller local markets MFF works with independent distribution companies. MFF equipment is regularly serviced by a group of highly qualified technicians employed by the holding as a legacy of its Nabeghlavi enterprise. Marketing and limited advertising are handled by MFF's own marketing department.

### **Technical expertise**

For all major agricultural and industrial production planning and installations, the holding has exclusively relied on foreign expertise. A German engineering company planned and executed MFF's production facility, a Swiss private expert helped establish the dairy farm, production of cucumbers was commissioned to a German company, an Australian company has helped (with EBRD funding) with the growing of tomatoes, and an Italian expert has been provided by the EBRD to improve food production and develop new recipes (EBRD).

### **TAX ADMINISTRATION**

MFF has faced a number of cash flow and other constraints associated with Georgian VAT regulations. While M-Agro's farming activities and a limited number of inputs (like fertilizer) are VAT-exempt, many critical inputs are not. Farm machinery and diesel fuel are fully VAT rated, and it is not possible to pass this cost on to MFF, its customer, through a VAT liability. Instead, the company is permitted to retain these VAT payments as a credit against its future tax liabilities.

While offsetting one tax liability with another may seem like a reasonable solution, two to six years can pass between breaking ground on a project and it turning a taxable profit. As a result, an additional 18% of key development and operating expenses is tied up for months, even years, in what is effectively an interest-free loan to the government. Cash flow that could be used to expand operations, create jobs or otherwise invest in productive activities is not available. In an environment where the cost of capital ranges between 1-2% a month, this represents a substantial impost.

MFF also experiences cash flow constraints associated with VAT administration. The cost of manufacturing supplies like jars, labels or other foreign-manufactured items is often most competitive if purchased in bulk, annually or semi-annually.<sup>7</sup> These materials, once purchased, may not be used in manufacturing for six to twelve months, but the VAT associated with their import payable as soon as the items enter Georgian territory. With VAT collected on raw materials in inventory that cannot be recovered from the sale of finished goods for half a year or more, VAT administration presents a constant drag on MFF's cash flow.

In addition to its financial and operational impact, MFF view this VAT issue as a competitive boost to importers. Companies that bring finished goods into Georgia have a relatively short sales cycle of 1-2 months between import and final sale, reducing the impact of the VAT payment/recovery lag. Companies like MFF, which manufacture goods using Georgian inputs and raw materials and create jobs in Georgia, face up to a year's lag between the purchase of raw materials and final sale. Georgian manufacturers effectively carry a cash flow burden that importers of finished goods do not face.

### **INFRASTRUCTURE**

The road, gas and electrical infrastructure at MFF are all of a sound, if basic, standard. Beyond MFF's immediate vicinity, however, the road infrastructure becomes more uneven. Roads to key raw material supply bases range from sound to very poor, which contributes to supply chain management issues.

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<sup>6</sup> Engadi also distributes non-MFF products, such as Nabeghlavi Mineral Water, Tobasco sauce, Dijon mustard, Turkish vinegar, and Spanish olive oil. Controlling distribution and hence payment in markets that account for 2/3 of Georgia's GDP is a prudent move by the holding.

<sup>7</sup> For example, MFF purchases 5 million jars ahead of season, tying up GEL 300,000-400,000 in VAT until it can be recovered in sale of finished product much later.



Poor roads cause excessive wear and tear on fleet vehicles, which discourages owners of quality cartage fleets from servicing villages that lack that basic infrastructure. Poor roads also directly contribute to the deterioration of cargo en route, due to both the jostling of cargo and extended transit times without refrigeration. These costs are inevitably passed on to consumers, which contributes to high raw materials costs for MFF. MFF managers note that a new road linking Marneuli and Rustavi would, if built, substantially reduce transit costs and transit time for raw material passing between the Rustavi and Gardabani districts and the Marneuli factory.

While the energy grid is generally sound, early on MFF faced electricity supply interruptions as a result of old transmission infrastructure in the Marneuli region. This posed a risk to expensive equipment, and as a result MFF invested in their own generators and uninterrupted power supply units.

M-Agro does not face any significant infrastructure issues. It is well served by the irrigation infrastructure, which has allowed them to install Netafim drip irrigation equipment on 700 Ha of land.

## **THE EFFECTS OF THE INVESTMENT IN GEORGIA**

### **PRODUCT AND PROCESS INNOVATION**

#### ***Manufacturing***

MFF currently produces 60 product lines, including tomato paste, pickles, sauces, jams and marmalades. None of these were produced on a commercial scale in Georgia between 1991 and when MFF entered the market in 2007. New products launched this year include vegetable salad in tomato puree and fruit compote, adding to recent additions of products incorporating cauliflower and broccoli and purees of peach, plum and tomato.

Before being processed, all incoming product is tested in the company's own laboratory for sugar content, bacterial contamination and acidity. Quality assurance staff is made up of Soviet-trained food technicians, who record their data in simple spreadsheets.

The factory does not yet possess any international food safety or QA certification, and the owners see no current demand for such certifications by Georgian consumers.<sup>8</sup> If MFF were to seek out international certifications, they would probably face difficulties with the existing Soviet-built shell. Similarly, Georgia's intent to harmonize its food safety laws with those of the EU under the Deep and Comprehensive Free Trade Agreement (DCFTA) will present challenges that can almost certainly not be met in the Marneuli factory. When Georgia begins to make progress on those requirements, MFF will likely co-locate a new purpose-built EU-standard food factory its production estates in Gardabani and decommission the Marneuli facility.

#### ***Agricultural production***

Yields at M-Agro are generally 200-400% greater than the regional average due to superior genetics, irrigation, crop protection and nutrition. The company's philosophy is "one hectare is one hectare, here, in Germany and everywhere". By working with the leading seed companies and experimenting on a small scale, M-Agro managed to bring yields to internationally acceptable levels, which is a must for Georgia given its small size. Typical tomato yields are 60-70 tons per hectare, with some plots yielding as much as 100 tons per hectare. Yields for cucumber, carrots and onion are 70 tons, 50 tons, and 50 tons per hectare, respectively.

M-Agro still uses simple flood irrigation on about 30% of its property and Israeli Netafim drip irrigation systems or PE reel sprinkler irrigators on the remaining 70%. The company has established stable

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<sup>8</sup> According to Mikho, there are no local benchmarks for QA in food processing, except for, perhaps, Kula, which has been created on the basis of the Gori baby food cannery. MFF has no local competitors, other than importers.

supply chain relationships with international seed companies like Nunez and Heinz, and each it year trials new varieties before encouraging its suppliers to try them.

Unlike many vegetable growers, M-Agro's management is acutely aware of the importance of crop rotation to break plant disease cycles, and it uses irrigated wheat cropping for this purpose. Wheat yields are typically 4-6 tons per hectare, comparing very favorably with regional averages of around 2 tons per hectare. Feed wheat is sold to feedmillers for farmgate prices of around GEL 470 per ton.<sup>9</sup>

### **Management**

As Mikho Svimonishvili puts it, "Building factories is not so difficult. The key to success is management of inputs and raw materials." Cost management has indeed been one of the holding company's main worries, prompting it to contract a global accounting firm (BDO) and begin with the installation of a high quality Enterprise Resource Planning (ERP) system. Better accounting is also seen as a necessary step toward larger scale investment and international partnerships.

A special concern for Mikho is management incentives. His policy is to give managers a share of positive EBITDA (earnings before interest, taxes, depreciation and amortization) rather net profit at the end of season. He prefers such a bonus system because it directly links compensation to quality of operational management, and it does not depend on factors that are beyond the manager's control. The bonus system also allows employees to put some money aside, which conforms to his view that successful employees have to be able to make at least one large investment in durables every year.

### **LOCAL EMPLOYMENT AND WORKFORCE DEVELOPMENT**

MFF is a significant employer in the Marneuli district, and most of its employees are women and ethnic minorities from surrounding villages. The factory employs 80 full-time staff, of whom around 15 are administrative and 20 are operational/technical personnel. MFF employs another 150-200 seasonal workers at the plant for unloading, sorting and various other unskilled tasks. M-Agro employs 25 full-time staff and up to 500 seasonal workers for harvest. Most of these workers are women.

Permanent MFF employees, like machine operators, have been trained by international machinery suppliers. Otherwise, the company has no specialized training unit. New workers are trained in-house by more experienced workers and foremen, including on topics of safety. Some of the seasonal staff have also been trained in-house on production line operations and return each year.

A number of managerial staff have been sent to Switzerland and Germany for additional management training, and staff from both MFF and M-Agro are sent to European trade fairs to stay abreast of industry developments and meet new suppliers.

### **DEVELOPMENT OF SUPPLIERS/SERVICE PROVIDERS AND IMPACT ON THE COMMUNITY**

The situation in the Kvemo Kartli region remains economically difficult. Given the region's mixed ethnic composition, this creates special political sensitivities. The holding's investment in MFF created hundreds of jobs and in this way helped revive the local economy. But MFF has also had a significant ripple effect of MFF activities on the broader picture of employment and income generation in Kvemo, Kartli and Georgia as a whole.

- MFF sources 60% of its inputs from **150 contract growers**. Many of these operate mid-sized irrigated estates, which in turn employ moderate numbers of full time workers and scores of seasonal laborers.

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<sup>9</sup> Well above world market price, as local prices are often 30% higher than global.

- Many of MFF's **workers operate their own farms**. Management has been keen to introduce M-Agro's seedlings<sup>10</sup> and technical support programs to these farmers as a means of developing a more robust and sustainable relationship between the company and its labor, on the one hand, and expanding its reliable supply base on the other. By developing their own farms and selling to the factory, workers can better utilize their time and smooth household cash flow. This works very well given that land preparation and sowing happens in the low season, while workers are underemployed by MFF, and the family can do the harvesting and delivery.
- Some local traders have established commercial farms growing **new products**, which were not previously grown commercially in the region. These include horseradish, which used to be considered a weed, and herbs for MFF product lines.
- M-Agro is currently testing a scheme to retain **share farmers** to operate large plots within its 1000 Ha estate, to determine if this is more efficient than estates being 100% under M-Agro control. A former employee who gained some farming experience in Australia has agreed to grow tomatoes on 30 Ha of M-Agro land. The company will provide machinery services and buy the entire harvest at an agreed-upon price;
- According to management, having observed M-Agro results many suppliers have started to **imitate M-Agro methods**, including land preparation, drip irrigation and application of chemicals. The main limitation to a broader propagation of modern methods is lack of farmers' liquidity and an inability or unwillingness to learn new tricks.
- The holding company operates a small dairy farm in Teleti,<sup>11</sup> and is interested in opening a **vocational college and extension center** linked to the farm to teach cattle breeding to young Georgian farmers. This idea has been discussed with a number of donors but a serious follow up effort will be required to make it happen.

## GOVERNMENT REVENUE AND IMPORT SUBSTITUTION

Last year MFF turned over GEL 8.6 million. Because there are no other Georgian manufacturers of these goods,<sup>12</sup> 100% of this figure represents substitution of imports from Turkey, the EU and other sources. MFF forecasts 13% higher turnover in 2014, which will bring the import substitution effect close to GEL10 million.

Despite positive EBIDTA, the enterprise is not yet making a profit, so it has yet to pay corporate profit tax.<sup>13</sup> As a substantial employer in Marneuli, 20% of payroll is remitted as personal income tax to the Georgian government each month, and the company's payroll is steadily increasing every year. An amount equal to 1% of the factory's rated value is paid as property tax each year. In addition, Marneuli Agro pays GEL 75,000 of land tax per year and about GEL 50,000 in annual irrigation charges to the state-owned United Amelioration Company. It also pays personal income tax on employees' wages. Transfer pricing between Marneuli Agro, MFF and Engadi is done on an arms-length basis to stimulate efficiency and avoid problems with the Revenue Service.

MFF is quite certain that it could meet 100% of demand from the Georgian market, but the chronic shortage of suitable raw materials is a major hindrance to this goal. Management were blunt in their

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<sup>10</sup> 5mln seedlings were sold in 2013 at cost, which is far below potential in the company's assessment.

<sup>11</sup> The farm started with 500 Swiss Brown cows but has been downsized to 200 head, to match feed production possibilities. Cows produce 6000l per lactation at the minimum, which is very high for Swiss Brown. For comparison, Georgian cows produce 1800l per lactation. Fresh milk is sold to Eco-Food at 1GEL/liter on the basis of a long-term supply contract.

<sup>12</sup> In particular, MFF estimates 20-25% market share in tomato paste and 30% in pickles.

<sup>13</sup> This of course severely reduces the utility of being able to apply VAT credits to offset profit taxes.

evaluation of the current move towards EU-standard food safety regulations and traceability, perceiving it to pose a major threat to Georgia's quantitative output of raw materials and entrenching the dominance of imported brands.

## D. CONCLUSIONS AND RECOMMENDATIONS

### GENERAL CONCLUSIONS AND LESSONS LEARNED

#### **IMPORT SUBSTITUTION AS THE "LOW-HANGING FRUIT"**

Georgian government policy strongly encourages exports of agro-industrial products, which is a laudable aim and an important component in an overall strategy for development of the rural economy. However, it is not clear that policymakers understand how complicated, expensive, and demanding of management resources an export-oriented enterprise really is.

Given a very fragmented and uneven supply chain, poor or non-existent documentation of suppliers by fresh produce traders, and poor record keeping by farmers, MFF would not have survived if it had targeted export markets from the beginning. It would never have been competitive in price or volume with Turkish or European manufacturers, and it would never have met the food safety standards required by the EU or lucrative Gulf State markets. By pragmatically focusing on the domestic market, where regulations were considerably more liberal than key export markets, Margebeli Holding was able to bootstrap MFF into the market leader's position with relatively modest capital investment and in only a few years.

While the regulatory environment is changing and the firm will have to adapt to new conditions, it is easier to do this with a brand that is already well accepted with sound credit records. Had MFF entered the market in 2014 instead of 2007, it would likely have turned out to be a much smaller and less successful enterprise.

While the *laissez faire* policy agenda in Georgia's food sector has been suspended, import substitution opportunities still exist for investors adhering to sound food safety standards that do not necessarily accord with EU norms *in toto*. The regulatory framework in Georgia is likely to change steadily over the next decade, and moderate capital investments in food processing will yield good results if production, processing and distribution are well managed.

#### **WELFARE REFORM AND FUTURE COMPETITIVENESS OF LABOR-INTENSIVE AGRICULTURE IN GEORGIA**

Seasonal work has supplemented the household incomes of Georgia's rural population for centuries, and it is a normal, dignified part of village life that must be comprehended by policymakers. Income support payments may be very popular with low-income voters, but when they move from a necessary safety net to become a disincentive to work they may trap low-income households in permanent poverty. Welfare policies that actively create disincentives for supplemental or seasonal employment help neither the recipient nor the businesses that require the labor.

The authors are familiar with numerous operators of agribusinesses in Georgia considering investment in hundreds of thousands of dollars of labor-saving devices, as they no longer see a future for manual labor in Georgia because of changes in government policy. While such labor-saving technologies might be completely appropriate in jurisdictions like Australia or the US, with near-total employment and very high labor costs, they are counter-intuitive in a transition economy with a nearly 60% rural unemployment rate.

## **FOREIGN INVESTED FIRMS AS CENTRES OF EXCELLENCE FOR TECHNICAL TRAINING**

M-Agro, through its field days and its seedling business, seeks to draw enterprising Georgian farmers into its supply chain, offering not just a market but also advanced inputs and training in how to get the most out of them.

This program should be emulated by other firms, and government should provide an enabling structure to support innovative processors/input suppliers willing to join forces with financial institutions to couple this capacity building with provide farmers with access to finance. Smallholder farmers, cooperatives and mid-sized rural ventures that have access to integrated packages of technical assistance, inputs, training, risk management and market linkages naturally present a lower risk to banks, insurers and other financial services providers. With the right support and cooperation between the stakeholders, this kind of support could be the basis for lower insurance premiums and interest rates on farmers' loans.

## **COMMUNICATIONS AND COMMUNITY ENGAGEMENT**

Many Georgian food processors are reluctant to spend money on advertising or PR, even though these can generate positive returns. Even without heavy investment in advertising, social media, television interviews, and advertising on TV and in print media have all been useful in building the Marneuli brand among consumers. They have also helped raise awareness of their modern production techniques among Georgian farmers, many of whom are potential suppliers

## **RECOMMENDATIONS FOR GOVERNMENT**

Marneuli Food Factory is a successful import-substitution enterprise that has proven to have a positive impact on surrounding communities, its own employees, food security, and state finances. The government should set a firm target of attracting a hundred ventures of similar scale in the next five years as key regional enterprises, whether in horticultural products, dairy, fisheries, tea or any other number of food or natural fiber product classes. Whether such enterprises are 100% Georgian-owned, joint ventures like MFF, or wholly foreign-owned should be immaterial.

- **Use a phased approach to implement EU-style food safety and product traceability requirements.** In the words Mikho Svimonishvili, these DCFTA-related requirements “will not stop us.” But Georgian farmers and food processors are currently very far from having the capacity or being able to bear the cost of the investment necessary to implement those standards and remaining competitive. (For MFF, for example, it would entail building a new EU-standard food factory). Given global food supply shortages and rising prices, Mikho's view is that traceability requirements are likely to remain on paper in many underdeveloped jurisdictions that are supplying the world with key agricultural commodities. For Georgia, the top priority should be to learn how to do farming, and how to raise productivity to international standards. While important, traceability requirements should come later, and as part of a careful, phased approach that recognizes the fragility and limited capacity of Georgian farmers and agri-businesses.
- **Repeal the ban on foreign investment in farmland:** It is highly unlikely that a foreign invested company like Margebeli Holding would have been able and willing to establish a capital-intensive venture like M-Agro under what amounts to a nominee arrangement. The current policy context, in which enterprises with any foreign shareholders are prohibited from purchasing agricultural land and travel restrictions are being applied unevenly to foreigners, would prevent an MFF or an M-Agro from being founded. Laws that discriminate against foreign investors over domestic ones, including in the acquisition of land, have a dramatic chilling effect across all sectors, and particularly on investment in land-dependent activities like agriculture. An honest appraisal of the damaging effects of the ban needs to be performed,

and the policy needs to be reformed to restore the momentum in FDI into the agricultural and food processing sector.

- **Carefully study incentives offered by rival destinations for FDI, and maintain a competitive position that is consistent with broad economic policy:** Foreign enterprises have an embarrassment of choice of destinations for food or agribusiness investment. Many of these competing jurisdictions will sweeten the deal with tax concessions, subsidies or construction grants. Georgia arguably does not have the resources for sizeable subsidies and grants, but it could very arguably afford tax concessions for enterprises making substantial contributions to technology transfer, rural employment, import substitution or export development. At the very least, tax administration and policy should level the playing field for enterprises seeking to serve the domestic market. Further tax credits could be considered for enterprises doing much of the state's heavy lifting by providing health insurance and pensions to workers, or financing smallholder suppliers. At this time few government officials are aware of concessions offered by CIS countries, Middle Eastern states, Asian countries or African agribusiness destinations. This means few policymakers understand the competitive environment in which Georgia finds itself. This needs to change.
- **Reevaluate and reform income support payments to take into account seasonal employment patterns in rural areas:** With up to 60% of rural Georgians considering themselves unemployed, any measure that stands in the path of people gaining paid employment needs to be examined very rigorously. Under current policy, otherwise employable citizens are actively and aggressively discouraged from seeking seasonal work to supplement family incomes for fear of the whole household losing welfare entitlements. Both the vulnerable families in question and the enterprises starved of labor are losing valuable opportunities as a result. While total abolition of these payments would likely present too dramatic a disruption, the government should explore ways to reduce the disincentive for able-bodied citizens to work. Options might include phased discounts to welfare payments for households whose members seek seasonal work or distinguishing between structurally temporary labor—like seasonal farm work—and other forms of employment.
- **Consider VAT reform on agriculture and food manufacturing:** Some aspects of Georgia's tax policy are quite attractive to foreign investors, such as the recent innovation allowing 100% depreciation of mechanical equipment purchases in the year of purchase and the ability to carry this deduction forward. Exempting agriculture and key inputs like fertilizer from VAT, are also very positive steps. However, in light of the cash flow implications of current VAT administration practices, the government should strongly consider further improvements to the policy framework. In particular, a system of monthly rebates of all VAT paid on non-zero rated inputs for agricultural enterprises and food manufacturing businesses, to be processed in 10 working days, would place substantial additional resources in the hands of entrepreneurs and reduce their reliance on banks for overdrafts. Such rebates could be tied to investment or employment milestones to ensure that Georgian taxpayers are seeing value created for this revenue abatement. The negative short-term effect upon state cash flow related to such reforms will be compensated for by accelerated fixed capital investment in productive assets and increased employment.

## RECOMMENDATIONS FOR INVESTORS

MFF's stakeholders have been quite frank about early shortcomings in management and have provided valuable insights as to how they overcame these problems.

- **Seek and build strong relationships with reliable Georgian partners.** Margebeli Holding and any of its constituent parts would not have been possible without the personal friendship and professional respect between its founders, Avtandil Svimonishvili and Thomas Diem, their families and younger partners. Mixing patriotism, ethics and business, this Swiss-Georgian

alliance has withstood the test of time, political upheavals, financial storms and business mistakes. The synergies made possible by successful partnership with a respectable Georgian family or “clan” can be particularly powerful given the highly personal nature of Georgian business and politics. In Georgia one cannot overstate the importance of informal connections and social networks in gaining access to valuable information, relations with policymakers, local communities and other businesses.

- **Rigorously analyze the cash flow analysis of potential investments before disbursing funds:** MFF underestimated the cash that would be required to restructure the factory and purchase raw materials in the first few seasons. Thankfully, being backed by well-resourced investors, the company managed to manage shortfalls in cash flow, but prudent financial planning can reduce this risk. Enterprises will need the assistance of a skilled local accountant to help them maneuver their way through the complex Georgian VAT administration system. They will also need to budget adequately for the serious cash flow impact of VAT on their operations and enterprise.
- **Consider a commercial production base and in-house distribution as part of the business structure:** Unlike very orderly European jurisdictions, Georgia’s agricultural supply chain is fragmented, chaotic, and very irregular due to weather events and market fluctuations. Relying 100% on outsourced supply of raw material is a very risky strategy, and it will almost certainly result in unfeasible product lines and uncontrollable raw materials costs. While an in-house production base is capital-intensive and very demanding of management resources, it provides some continuity of supply, a buffer against price fluctuations, and capital gain from the farmland asset. The production base can also act as a useful demonstration and training center for potential and existing contract suppliers. Given that the margin between ex-works product price and delivered-retail outlet price is substantial in Georgia, business should also consider investing in own distribution capacity. The costs of distribution are modest and IT investments can substantially improve efficiency of logistics.
- **Manage payment risk intelligently:** Just because a retail outlet is large and foreign-invested does not mean that they are a good credit risk. In markets like Georgia, large retail chains often use their market power to abuse suppliers, by defaulting on payment. Manufacturers and distributors should maintain a solid mix of large, mid-scale and small-scale retail customers without being intoxicated by the size of larger retailers. A good customer is one who pays his bills.

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