THE AFGHANISTAN BEVERAGE INDUSTRIES LIMITED: "CRISTAL"

Case study prepared for the Enabling Environment Conference

I. BACKGROUND

Afghanistan is in the process of reconstructing its post-conflict economic and physical infrastructure, a vital part of which is the provision of clean and safe drinking water. However, Afghanistan's capacity to provide safe and clean potable water is limited, despite the booming domestic demand for it. Currently, Afghanistan imports most of its beverages, as well as food products, from the outside. The potential for the production of mineral water is enormous, with a population of 25 million and very little domestic production of it thus far.

The experience of Afghanistan Beverage Industries Ltd. (ABI) demonstrates the potential for new businesses in the current context and, at the same time, underlines the multiple challenges companies face to achieve their business objectives.

The "Cristal" Story

Afghanistan Beverage Industries Ltd. (ABI) was the first company in Afghanistan to undertake the complex task of providing safe bottled water which it called Cristal Quality Mineral Water. ABI's objective is to satisfy the demand of the Kabul municipality, in the absence of an adequate municipal water supply. Representing a US$ 16 million investment, the company was registered with the Ministry of Commerce in 2002 and with AISA in 2003, as well as with the Kabul Municipality (for permission to manufacture and sell within the city of Kabul). It currently has 170 local employees and 15 expatriate employees.

In addition to the much needed locally produced safe drinking water, ABI plans to manufacture and sell high quality non-alcoholic beverages, juices and UHT milk in special PET and aseptic packaging. ABI is aiming to expand and increase the variety of its products and become a full spectrum local supplier of milk, juice and soft drinks at affordable prices.

II. ISSUES

Inconsistency in customs tariffs

ABI worked with three other main beverage companies in the context of an informal industry association to build understanding within the government that the tariff structure applied to raw materials for their production, relative to the tariff structure applied to foreign-produced imported beverages, was a disincentive to domestic production. Import tariffs of 10 percent were being applied on raw materials, whereas import tariffs of only 2.5 percent were being applied to finished goods coming in from neighboring countries. This was a strong disincentive for industries, such as that of beverages, which had to import raw materials (e.g. bottles, labeling, concentrates and bottle caps) from the outside.

Working together in a process of dialogue with the Ministry of Finance, the informal industry association of beverage companies asserted the importance of distinguishing between traders and domestic production industries, and argued successfully in favour of a tariff structure that would encourage domestic production by levying higher tariffs on finished goods than on raw materials (as is the case in most countries).

The two main companies in the sector were able to obtain, through the intervention of His Excellency the President, the Minister of Finance and the CEO of AISA, a new import tariff structure of 40 percent on finished goods and one percent on raw materials for production industries. This decision was an important breakthrough for the companies. The application of such a tariff structure across other industries would represent a more systemic solution in line with international practice.

Unpredictability in the fiscal and legislative environment

In order to encourage and improve the investment environment, eight years of tax exemption for foreign investment were offered by the Government under the 2002 Law on Foreign and Domestic Investment in Afghanistan, provided that companies started their production within a year. In the subsequent 2005 revision of the investment law, the tax holiday was not incorporated and several companies had their tax holidays denied. The two major beverage companies challenged this revision up to the President, and the tax holiday was ultimately respected for the two companies.

High cost of security measures

The current insecurity in Afghanistan is a major constraint to attracting foreign investment. The primary concern for companies is of course the physical safety of its staff. Following the loss of several ABE employees, there has been an understandable reluctance for expatriates to come or to continue working with ABI.

Beyond the primary concern of human security, the expense of providing security protection takes up a significant part of the cost structure of ABI: out of the 185 staff, 36 are security personnel. Compared to other parts of the world, this considerable extra expenditure for maintaining a security presence represents a distortion in the cost structure of the company, and thereby puts ABI in an unfavourable position in the face of foreign competition.

Lack of qualified local man power and high capacity-building costs

Despite a clear policy to hire locally, ABI is forced to bring in key staff members from outside of the country due to the absence of qualified skilled labour in the local market. Bringing in staff from abroad in the areas of finance and HR, for example, is costly for the company; and where skilled labour is available within the country, the cost is double that of Pakistan.

ABI's preferred approach is to have expatriate staff provide on-the-job professional training to locally-recruited personnel. At present, the local staff consists of 20 young Afghans educated in Iran and Pakistan.

Like many Afghan organisations, ABI faces competition in hiring from better paying international organisations and from newly established companies seeking to capture the investment in human resource development from longer established companies. A gentlemen's agreement has been signed by the beverage association, stating that no company will poach staff from another, helping to assure that staff trained in the specific skills of the industry will remain on the job.

High cost of electricity

In the absence of a reliable supply of power, diesel-fuelled generators have been imported. The cost of electricity is high, stemming from both the diesel fuel and the cost (including customs) and maintenance of the generators. In Afghanistan, ABI pays US$ 70,000 to US$ 80,000 for its power. In Pakistan, by comparison, a similar plant would pay US$ 5,000 to US$ 6,000 per month. This puts domestically made products at a further disadvantage in terms of competition with imported products.

Lack of quality control

The Ministry of Health is charged with assuring quality control of foodstuffs production, but has no capacity to do so. Therefore, ABI controls its own quality, in addition to meeting the standards used by the Ministry of Public Health. Currently, there are many poor quality goods in the market due to age (past the expiration date) and inconsistent quality at the time of production. Increasing the knowledge and capacity of public health officials to set standards, and assure that they are respected, will serve to increase the quality of Afghan products.

III. CONCLUSION AND RECOMMENDATIONS

ABI has been able to introduce a high quality product in Afghanistan and expand its market share. It has solved a number of issues regarding the business environment, but only with a considerable time investment and continuing uncertainty as to the final result. The solutions found in the cases of the tax holiday issue and import tariffs have been industry-specific rather than systemic.

Based on their experience thus far, ABI's investors outline the five straightforward elements required, from their point of view, to attract investors to Afghanistan:

- Good Governance
- Security
- Clear decision-making structures
- Consistency in laws and their application
- The promise of a reasonable rate of return

Their specific experience suggests the following set of recommendations:

1. Change the short-term mentality of the Government and increase its commitment to creating a better environment for business. In order to increase confidence among local as well as outside investors, a clear commitment from the Government is required to create a better environment for business by constructing roads, providing power and applying investment laws consistently.

2. Apply fiscal regulations consistently. (i) The tariff structure for imports should provide fair incentives for domestic production, charging higher tariffs for finished goods than for raw materials. This tariff structure should be applied consistently across manufacturing and processing industries. (ii) Where tax holidays are legitimately granted, they should not be reversed.

3. Introduce quality control mechanisms. Increase the capacity of the Ministry of Public Health (in the case of ABI, and other ministries in the case of other industries) to set quality standards and to put into place technically sound control mechanisms with trained staff.

4. Providing power (energy). Work to continue to increase the supply of power; introduce a schedule of lower tariffs for industry.

5. Eradicate corruption within Government. Build confidence of government officials about their future by providing wages which will provide for their livelihoods. Dismiss corrupt officials.

IV. QUESTIONS FOR DISCUSSION

1. From the perspective of a company such as ABI, what are the most important conditions required for foreign investment in Afghanistan? What did ABI's investors look for before launching the company in Afghanistan?

2. What are the main challenges that other companies/SMEs have faced since 2002?

3. What lessons can be learnt from the successful resolution of ABI's fiscal issues? What experience of other countries provides insights into government decision-making structures? How could government decision-making be improved?

4. How has the informal beverage industry association been able to work together to resolve common problems? What lessons can be learnt for the future of this association and for the future of other industries?

5. What can be done to counter what has been described as the short-term mentality of Government? How can businesses increase the confidence level of Government and vice versa?

6. What are the main changes in the investment environment that would be required to attract a far higher level of foreign investment in Afghanistan in companies such as ABI?

This case study was prepared based on a series of interviews with Sameh Panah, CEO of Afghanistan Finance Company, the lead investor in ABI and Cecil Galloway, Operations Director at ABI.