Lobatse Clay Works

LOBATSE, BOTSWANA

Case Description

Case Location: Lobatse, Botswana

Industry Focus: Clay brick manufacturing

Functional Emphasis: Joint venture agreements, business

and government relations

Issues Raised by the Case:

- The role and responsibility of government in private enterprise development, and;
- The relation between foreign-owned private enterprise and parastatal development organizations.

Study Questions and Discussion

I. Why does Botswana need a domestic brick industry?

At the time the Botswana Development Corporation (BDC) commissioned the feasibility study for an indigenous clay products manufacturing facility, the country did not need its own brick factory. The South African suppliers were easily able to supply all of the face and stock bricks needed by the construction industry in Botswana. The BDC decided to create a modern factory so the country would not be dependent on South African companies if the political situation in South Africa worsened over the coming years. The BDC had the financial resources to develop its own industry because of the wealth generated by diamond sales.

2. What should the government's role be in creating housing?

There is no correct answer to this question. Because of Botswana's small population, 1.3 million, there is not a lucrative market for private construction companies. South African construction companies have focused on government contracts for their profits. Commercial structures for the national and local governments, and residual housing for the Botswana Housing Corporation have been approximately 90% of all construction projects in Botswana for the past 15 years.

Some students will argue that a government that controls the main source of wealth in the country should be responsible for providing its citizens with proper housing and other primary needs. Others may look at the situation as being too "socialist" and hindering private enterprise.

3. Should ICA have been involved in this joint venture?

There is no "right" or "wrong" answer to this question. ICA based its business on building ceramic manufacturing facilities in developing countries. Before the joint venture with the BDC, ICA had focused on short-term "turn-key" ventures and not on long-term agreements. The primary reason for ICA's decision to seek out the BDC for a long-term partnership was the economic and political stability of the Government of Botswana. ICA felt that the "booming" construction industry would be the perfect opportunity to diversify its financial portfolio.

The feasibility study, commissioned by the BDC and completed by ICA, showed that a clay products factory in Botswana looked like an excellent investment for both partners. The long-term construction cycle looked promising, there was a high-quality clay deposit only 50 miles from the capital city, the BDC was willing to put up two-thirds of the equity for the company, and private bank loans would be secured by the BDC.

The overall risk to ICA was low compared to joint venture opportunities in other developing countries. The need for residential construction was growing for the foreseeable future, and no other clay products factory in Botswana produced high-quality clay products. So, on balance, ICA made the best business decision, given the political and economic situation when the joint venture agreement was signed.

4. What political forces guide BDC activity?

The BDC was created by the national government to create economic diversity and wealth for the citizens of Botswana. The BDC uses funding from the government to invest in new industry, expand employment, and lessen the country's dependence on foreign-owned companies, particularly South Africa, for products and services.

The political need to lessen dependence on South Africa is a major influence on what industries the BDC will become involved. Lobatse Clay Works was created to lessen the amount of bricks being imported and to utilize an indigenous resource. The new industry also created more employment for Batswana.

5. Should the BDC have been involved with ICA in the joint venture?

Given ICA's experience with building and operating clay product manufacturing facilities throughout the developing world and the political considerations regarding South African companies, the BDC chose to contact ICA. ICA had completed a professional feasibility study for the BDC, and the management of both organizations had worked well together during the research phase of the study. The assumptions and numbers used by ICA in the study showed that a modern clay factory could compete against foreign-owned producers, and that the partners could make an excellent return on investment within four years. At the time,

neither the BDC nor ICA could have guessed that the Botswana Housing Corporation would totally stop construction activities for nine months.

The BDC had managed other investments without the assistance of an outside company, but there were no managers available in Botswana that had the education or experience to operate a modern clay production facility. Peter Williamson had an advanced degree in kiln technology and 25 years of experience in the industry.

6. What was the South African reaction to Lobatse Clay Works?

South African companies were angry that the BDC decided to create a clay factory that would compete against their products. Although the pula made South African products less expensive than Botswana products, the high transportation costs from South Africa equalized the price of LCW and South African bricks. Corobrik began predatory pricing to undercut the market price in Gaborone, the capital city. LCW management was concerned that Corobrik's large size could eventually force them out of the market with artificially low prices. Because "dumping" was so difficult to prove, LCW was not able to take its case to the Southern Africa Development Commission (SADC) for review.

Only Government of Botswana legislation giving indigenous companies preferential treatment during the bidding process for government contracts allowed LCW, and other local companies, to compete against South African products on price.

7. Should a joint venture have been created that relied so heavily on a single buyer for such a large percentage of sales?

Yes. Because of the wealth created by diamonds, the government controlled over 85% of the national economy. The government used its wealth to spur the entire economic and industrial base of the country. The BDC saw no let-up in the amount of housing that was being constructed by the BHC. Throughout the 1980s, the BHC had steadily increased the amount of houses, and the quality of the houses, it built. The BHC dominated the residential building market with a 90% share. Lobatse Clay Works was created to take advantage of BHC dominance in the construction industry.

The scandal that hit the BHC could not have been forecast by the BDC or ICA when the feasibility was completed.

8. What should LCW have done differently to prevent the loss of market share?

ICA should have understood that the use of the lowgrade coal available in Botswana would cause ash "lines" and off-color marks on the face bricks. ICA management should have insisted that the kiln heating system use a gas-fired kiln. Gas-fired kilns would not leave any residue or size variation of bricks because gas burns cleaner and with consistent temperature. The decision to use coal-fired burners created quality problems that made it very difficult to sell proper face bricks. The feasibility study stated that 80% of the factory's production of 25 million units per year would be dedicated to making face bricks (20 million face bricks). The coal burner were only producing 40% of the planned face brick production (8 million face bricks). The lack of proper face bricks hurt the company's image of providing high-quality bricks, and it reduced sales.

LCW should have increased its market share in the private sector in Botswana and South Africa. New home owners in Botswana needed bricks to make driveways, walkways, and patios. The South African market had a critical shortage of clay roof tiles. LCW should have perfected their tiles and begun selling this high value-added item immediately after the factory began operating. LCW did not have enough sales from nongovernment sources to off-set the loss of sales to the BHC.

9. What are the implications for other foreignowned companies seeking joint venture partnerships in Botswana, or elsewhere in the developing world?

The situation at Lobatse Clay Works shows the difficulty of entering into any type of business arrangement. Despite the positive findings of the feasibility study, and historic factors that were presented to both joint venture partners, LCW was almost forced to close after less than one year in business. Other companies looking at investing in developing countries need to realize that any venture, no matter how well researched, can fail. Of course, this philosophy applies to any business opportunity, not just opportunities in developing countries.

All of the business indicators used to make a decision about the prospects for a clay manufacturing facility were positive. The construction "boom" was projected to continue through the next century; there was a high-quality clay deposit near the capital city, and lower transport costs would allow the company to compete against South African suppliers. And yet, the company nearly went bankrupt.

10. What should Peter say to the BDC, ICA, and his wife?

To BDC—LCW needs an immediate injection of new equity to pay the bank loans due next week. It also needs enough equity to pay its fixed operating costs until the company can find markets for its products. LCW is already in heavy debt with the bank, and Peter does not want the company to become more indebted. The additional equity will allow the company to survive until the company is financially self-sufficient.

The company needed approximately \$250,000 per month to pay its fixed costs.

To ICA—Peter realized that ICA was cash "poor" and did not want to inject more equity into the joint venture. Elmer Salgo, President of ICA, preferred to secure additional bank loans. The BDC management convinced Mr. Salgo that additional loans would only put the company into more indebtedness, and that a heavier debt burden would make it extremely difficult for the company to make a profit for the joint venture partners.

The BDC also stated that the BHC scandal would end in the next few months. Once the BHC began ordering bricks, the prospects for LCW's long-term survival would be excellent.

ICA did agree to invest enough equity to allow the company to pay its fixed costs for three months, through January 1993.

To his wife—Peter wanted to stay at Lobatse Clay Works for the next five years. After travelling all over the world for the past 25 without his wife, Peter wanted to have a "normal" life. Peter was ready to do all possible to keep LCW operating and his position as General Manager secure.

Peter could have left his position as General Manager of Lobatse Clay Works and returned to ICA, but he

wanted to stay in one location until he took an early retirement back to his home in England.

12. What would you do if you were Peter?

There is no correct answer to this question. The student is expected to use the information presented in the case to form a personal opinion about options available to Peter.

Subsequent Events

NEW EQUITY INVESTMENT

The BDC and ICA decided to inject more equity into LCW. Although the present situation was highly volatile, and no immediately revenues were forecast, the BDC knew that the BHC scandal would end, and it would purchase construction materials again. ICA was cash "poor" at the time the equity was requested by Peter Williamson, so Elmer Salgo, President of ICA, did not want to put more money into the joint venture. The BDC management had to convince Mr. Salgo that the long-term profitability of the company would increase if LCW could survive the next several months. Salgo agreed to maintain its equity position in LCW and inject more money into the company. Both joint venture partners agreed to invest enough equity into the company in October 1992 to give LCW a reprieve of three months, through January 1993. If sales did not increase, ICA would not inject any additional capital. Bank loans would have to be secured to keep the company operating. Fortunately, sales and revenues did rebound in January with orders from the BHC.

LEGISLATIVE REGULATION

The national legislature passed a regulation in early December 1992 that instructed all government agencies to give preferential treatment to indigenous companies when they put any construction project out for bidding. South African companies were using predatory pricing to maintain market share. The Government of Botswana was worried that the larger South African companies would adversely affect the competitiveness of indigenous companies. The new regulation required an indigenous company to have the best price, meet the quality standards needed for a project, and be able

to fulfill the entire order in a timely manner. But the companies were finally able to compete against foreign-owned suppliers on even terms because their transport costs were lower. Botswana architects and builders were so accustomed to using South African products and services that they would automatically choose those suppliers. The new regulation allowed LCW to be more competitive when bidding against South African suppliers.

NEW KILN HEATING SYSTEM

LCW recognized the quality problems it had with the face bricks coming out of the coal-fired kiln. In November 1992, the Board of Directors voted to allow the conversion to a coal gasification system that would alleviate the ash and size variation of the bricks. LCW was in-process of converting the heating system by July 1993. The new heating system would give LCW the ability to produce face bricks that met or exceeded the highest government standards set for bricks sold in Botswana.

BHC RESTARTS CONSTRUCTION

The Botswana Housing Corporation resolved its scandal in late December 1992 and began to place orders in mid-January 1993 for new construction projects. The BHC forecast steady growth for new housing projects, particularly low- and medium- cost units, through 1998. The majority of orders in early 1993 were placed by the BHC to restart their construction program that had been idle for nine months.

Current Situation

As of May 1994, LCW had almost completed the heating system conversion and was operating at maximum capacity, producing 28 million units per year. The additional production capacity was due to a partial conversion to gas heating that allows the kiln cars to move through the kiln tunnel at a faster rate, thus increasing the total number of units produced per year.

The outlook for the company was much better than it was in October 1992. Peter Williamson was still the General Manager, the factory was producing at maximum capacity, and the joint venture partners were making a profit from their original investment.