COMPETITIVENESS OF GEORGIAN AGRICULTURE: INVESTMENT CASE STUDIES

CONCLUDING POLICY PAPER

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ABSTRACT

This paper provides a summary of findings and policy recommendation from a series of eight case studies documenting foreign direct investment in Georgia's agriculture and food processing industry, including grape and wine production, hazelnuts, poultry, cereals and medicinal herbs, pickled fruit and vegetables, as well as apple concentrate and aroma. Each study includes a detailed discussion of relevant contextual factors concerned with the general policy and business environment such as protection of property rights; taxation; access to finance, land, labor and other production factors; range and quality of suppliers and service providers; and quality of infrastructure. Our analysis focuses on the strategies employed by foreign entrepreneurs in dealing with any existing shortcomings in the business enabling environment, on the one hand, and their impact on this environment, on the other. Specific recommendation are provided for the government, private investors, donors operating in Georgia's agricultural sector, agricultural universities, vocational colleges and other stakeholders.

ACRONYMS

USAID	United States Agency for International Development
CSR	Corporate Social Responsibility
EU	European Union
ISO	International Standards Organization
HACCP	Hazard Analysis and Critical Control Points (a risk-based approach to food safety)
MoESD	Georgian Ministry of Economic and Sustainable Development
MoJ	Georgian Ministry of Justice
PPP	Public-Private Partnership
QA	Quality Assurance
WEF	World Economic Forum

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I. EXECUTIVE SUMMARY

This paper provides a summary of findings and policy recommendation based on a series of eight case studies that document foreign direct investment in Georgia's agriculture and food processing sectors. The investors are in a variety of industries, including grape and wine production, hazelnuts, poultry, cereals and medicinal herbs, pickled fruit and vegetables, and apple concentrate and aroma. Each study includes a detailed discussion of factors concerned with the general policy and business environment, such as protection of property rights, taxation, access to finance, land, labor and other production factors, the range and quality of suppliers and service provider networks, and quality of infrastructure. The analysis focuses on the strategies investors employed, and the effectiveness of those strategies, in dealing with shortcomings in the business enabling environment and other challenges they faced investing in Georgia.

The studies also look at the positive impact of these investments on the Georgian economy, examining qualitative benefits like job creation, workforce development, and the introduction of new products or processes (including technology spillovers) that might positively affect suppliers, competing agribusinesses, and smallholder farmers. The studies also look at how these investments affect the range and quality of products available to Georgian consumers, including substitution of imports. Addressed to both government and investors, the recommendations drawn from the case studies and summarized in this report are focused on addressing deficiencies in the business enabling environment and, for investors, strategies to overcome these deficiencies.

Given the significant positive contribution that foreign-capitalized and -managed agribusinesses make to Georgia's economic development, current and proposed **policies that damage the business investment climate should be reviewed and amended or repealed.** This includes potentially excessive bureaucratization as part of the drive to approximate EU anti-trust legislation, labor market regulations and immigration laws. It also includes the moratorium on farmland purchase by foreign-invested entities and the seemingly arbitrary enforcement of visa restrictions upon existing farmland investors from abroad. Georgia has been attractive to foreign investors because of a relatively liberal regulatory and investment environment. For domestic and foreign investors to risk their capital in Georgia's agricultural sector, the Georgian government should continue to support (and improve) a business friendly policy and enabling environment, including protection of investors' property rights.

The eight case studies also offer numerous lessons learned for investors. Investors should seek reliable Georgian partners to help them navigate the environment. Recognizing the cost and pitfalls of early missteps with local populations, investors should perform rigorous due diligence to avoid conflicts with the community and proactively engage in targeted CSR and extension activities. Even with constructive outreach and engagement, investors should also invest in security and theft prevention. Finally, investors should invest in their human resources, both in terms of bringing the right expertise to bear on business challenges, but also in building up the capacities and capabilities of local staff. Not only will investors discover that they can unlock a great deal of potential in Georgian employees, but foreign investors increase their positive ties to the community.

Recommendations to the Georgian Government

The GoG should introduce policy initiatives to:

- Rationalize the use of land and formalize procedures for land repurposing and privatization
- Continue to improve access to basic infrastructure and machinery
- Enhance the role and incentives of local government in dealings with investors
- Facilitate PPPs and offer tax concessions to encourage food processors to integrate smallholders into their supply chains
- Encourage closer cooperation among educational institutions serving the agricultural sector and large agribusinesses in order raise professional labor qualifications
- Reform inefficient welfare payments that create disincentives for seasonal employment
- Rredesign the VAT administration system and undertake other FDI-friendly measures matching those offered by competing jurisdictions
- Take a phased approach to implementing EU-style food safety and traceability requirements while offering financial assistance and training along the way.

II. APPENDICES

A. BACKGROUND

B. METHODOLOGY

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E. ADDITIONAL INFORMATION

A. BACKGROUND

From 2003-2012 the Georgian economy had been steadily growing, averaging 6.1 percent annually over the period. The World Bank attributed the growth to “structural reforms that stimulated capital inflows and investment … and helped improve the business environment.”[1] The same study pointed to productivity gains in “non-tradables” sectors, and GDP per capita increased from USD 920 in 2003 to USD 3,500 in 2012. Consistent with these data, Georgia has also been climbing many international rankings reflecting the quality of the local business environment. The most dramatic of these was ranking 8th of 189 countries in the World Bank’s Doing Business survey, but Georgia has also done well in World Economic Forum (WEF)’s Global Competitiveness Index and Transparency International’s Corruption Perceptions Index.

Despite these positive trends, though, Georgia's agricultural sector has failed to attract sufficient investment or improve productivity, either per worker or per hectare, since the collapse of the Soviet Union in 1991.[2] Indeed, agriculture accounts for more than half of Georgia’s workforce but less than a tenth of its GDP, a dismal state of agricultural development that translates into very low income levels, unemployment (or underemployment often disguised in official statistics as “self-employment”) and very high incidence of poverty.

Largely neglected through the first ten years of economic reforms since the Rose Revolution of 2003, the agriculture sector topped the Government of Georgia’s policy agenda since the change in national government in October 2012. Massive changes in government policy intended to turn around and rejuvenate the rural economy, were introduced in 2013 and 2014. These included:

- A new cooperatives law that offered assistance with the creation of formal farmer organizations for smallholders. The law, supported by the EU, included income and land tax exemptions for co-operatives;
- An expansion of the previously implemented voucher system for farm inputs to smallholders;
- Income support payments and income tax rebates for low-income individuals;
- Offsetting wine grape price controls with subsidized credit to wineries for grape purchase;
- Provision of subsidized credits to existing rural enterprises for capital works associated with expansion, and recurrent expenses;
- Introduction of the “Made in Georgia” scheme in 2014, involving free factory plots and subsidized credits for food processors establishing new deep processing or vertically integrated enterprises;
- Acceleration of the renovation of the country's dilapidated irrigation system;
- A change in VAT administration on farm activities, exempting farm-gate produce from VAT and allowing VAT paid on inputs (such as imported machinery, packaging and diesel) to be offset against profits tax;
- Mending of fences with Russia, resulting in the opening of the Russian market for Georgian wine, mineral water and agricultural products;
- Signing of the Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU, improving Georgian agribusinesses and farmers’ access to the European market, subject to implementation of EU food safety standards.

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[1] http://www.worldbank.org/en/country/georgia/overview#1

[2] See Adam Pellillo “The Puzzle of Agricultural Productivity in Georgia (and Armenia)”, http://www.iset.ge/blog/?p=836

In parallel, beginning in summer 2013, the Georgian parliament started introducing legislation aimed at restricting foreigners' access to Georgian agricultural land and the labor market. A law suspending the right of foreign individuals or foreign-invested enterprises to acquire Georgian farmland, or shares in companies that own Georgian farmland, was introduced in late July 2013. An unintended consequence of this law was a ban on financial institutions with foreign shareholdings taking a mortgage over Georgian farmland. The legislation was ruled unconstitutional by the Georgian Constitutional Court in On June 24, 2014,[3] but implementing government agencies are yet to be instructed to register land transactions involving foreign legal and physical persons.

Restrictive land legislation was complemented by a repeal of Georgia's liberal immigration policy, barring foreign labor from entering the Georgian agribusiness sector, frequent refusals to renew temporary residency visas for foreign investors and managers in Georgian agricultural enterprises, and generally more restrictive immigration policy coming into effect on September 1, 2014.

While motivated by a desire to approximate EU immigration legislation and a well-grounded concern for Georgian smallholders,[4] these policy innovations had a deleterious effect on investor sentiment and private investment in the Georgian countryside. Luckily for Georgia, the negative impact of these policies on foreign and domestic investment may have been offset in the immediate term by more positive policy measures and market opportunities arising from thawing relations with Russia and closer association with the EU.

This series of eight case studies focuses on the strategies employed by foreign entrepreneurs in dealing with any existing shortcomings in the business enabling environment, on the one hand, and their impact on this environment, on the other. The cases include:

- **Foodland and Landmark.** Established by an Indian-Canadian entrepreneur, these two enterprises produce potato, cereals, and novel crops in the pulse, spice and medicinal herb segments. While the enterprise in Tsalka, Landmark, is still operating , Foodland's activities in Shida Kartli have been suspended due to occupation of the property by violent squatters. This issue remains unresolved despite numerous appeals to police, local and central government.
- **Agrowest and Habibco Agriculture**. Established by an Egyptian industrialist and his family, these two enterprises produce cereals, sunflower, innovative forage crops, spices, and pulses. One of the two enterprises has successfully overcome difficulties in enforcing its private property rights over its 1700 Ha estate in Sighnagi district. Major capital works in planting 250 Ha of grapevines and developing a large vertically integrated dairy business are scheduled over the next five years. The other 700 ha enterprise in Bolnisi, Kvemo Kartli, has been operating smoothly.
- **Hipp Georgia.** Established in Shida Kartli in 2006 as part of the global baby food group owned by the Hipp family of Germany, the company developed a supply chain of 1,000 certified smallholders in neglected uplands areas and processes apple into conventional and organic juice concentrate and aroma in a process adhering to one of the most rigorous organic food production regimes in the world. The company takes advantage of the GSP+ free trade agreement with Europe to incorporate its products in Hipp's organic baby food production.
- **Chateau Mukhrani.** Established by a Swedish investor in partnership with Georgian entrepreneurs, this vertically integrated wine business is associated with the 19th century chateau built by the father of modern Georgian winemaking. The enterprise produces mid-market wines derived from both indigenous and European grape varieties, targeting both domestic and foreign markets. Wine tourism activities are a rapidly growing source of revenue.

[3] http://transparency.ge/en/node/4410.

[4] Conflicts involving foreign investors and smallholders are discussed in two case studies analyzing Foodland's activities in Shida Kartli and those of Habibco in Sighnagi district. See also Eric Livny, "Moratorium on Foreign Ownership of Agricultural Land. Xenophobia, Myopia or what?" http://www.iset.ge/blog/?p=2090.

The history associated with the estate and the quality of the wines are attracting substantial interest from abroad, and the enterprise is seen as a showcase for the Georgian wine industry, being a primary port of call for foreign wine traders and investors in the wine sector.

- **Georgian Wine and Spirits (GWS).** Previously a GSSR state-owned enterprise, later privatized by a Georgian entrepreneur, the firm passed through the hands of global beverage giant Pernod Ricard and, following the closure of the Russian market to Georgian wine in 2006, was acquired by a Paris-based, Swedish-owned beverage maker and distributor. The enterprise owns a stable of budget and middle-market wine brands, mostly targeted at FSU markets, and sources over 2/3 of its grape from small- and midsized-vignerons in the Alazani and Iori Valleys of Kakheti.
- **Chirina.** A fully integrated broiler, slaughterhouse and distribution operation, Chirina was established in summer 2013 by a wealthy Georgian entrepreneur who made his fortune in Russia and returned home to invest in his home country. Using modern Israeli technology and management, and state-of-the-art poultry genetics and nutrition, Chirina achieved an unprecedented degree of vertical integration and economies of scale, causing the price of chicken to drop substantially over the past year. Co-operating with large-scale Georgian graingrowing operations (with countertrade in grain and straw bedding from one party, and poultry manure from the other) Chirina created synergies that lead to strategic competitive advantages.
- **AgriGeorgia (Ferrero-Georgia).** Established by Italian food industry giant Ferrero, AgriGeorgia is cultivating Georgian and European hazelnut varieties on 4000 Ha of farmland in Samegrelo. The company encountered stiff opposition from locals claiming that some of the land belonged to them. After many years of negotiation resulting in agreed upon land swaps and compensation, this issue has been resolved, with patience on the part of the enterprise and flexibility on the part of the government key elements to success. The enterprise produces nut-in-shell hazelnuts at a high level of efficiency and quality for the global market, and co-operates with aid agencies to teach smallholder hazelnut growers how to improve their efficiency and quality.
- **Marneuli Food Factory (MFF).** Established by Swiss and Georgian entrepreneurs in 2009 as part of a larger holding company built around Tskali Margebeli (producer of Nabeghlavi, the leader in the Georgian mineral water market), MFF produces a wide range of canned foods for the domestic market. With sister companies engaged in large-scale horticulture, mineral water bottling, and food and beverage distribution, the enterprise has developed both operational and strategic strengths in the marketplace. Relying on small and mid-sized farmers for 60% its raw material supply, the company has pioneered a cooperative approach with its supply chain partners, recommending seeds and other inputs conducive to production of the desired commodity with high levels of efficiency, and providing training activities on its own farms for suppliers.

Addressed to both government and investors, our recommendations are concerned with deficiencies in the existing business environment. Some of these deficiencies can be addressed through adjustments in policies concerning e.g. access to land, property rights, and tax administration. Others require extra investment and continuous accommodation on the part of businesses through vertical integration (both upstream and downstream), proactive community engagement, and cooperation with international technology partners, donors and government.

B. METHODOLOGY

ISET Policy Institute made contact with the target enterprises through its own contacts, as well as through the existing networks of its collaborator in this project, Dr. Simon Appleby of Georgian agribusiness company YFN Georgia LLC. Interviews were conducted with senior management of each of the participating companies and, in many cases, their owners.

In cases where Dr Appleby's firm had a track record of professional activity, site visits were not required. In other cases, ISET-PI personnel visited the site. Particularly in cases where conflict between investors and local community had arisen, interviews with neighboring villagers have been conducted to cross-reference statements made by management. In one case, that of AgriGeorgia, additional hazelnut processing ventures were interviewed, and in the case of Chirina, their supply chain partner also was briefly interviewed.

The case team developed eight case studies, with analysis and findings focused on (i) the business enabling environment, (ii) the effects of investment in Georgia, and (iii) community relations and the role of government. Each study offers general conclusions and lessons learned, and specific recommendations for investors and government.

C. FINDINGS AND RECOMMENDATIONS

This chapter brings together the main findings and recommendations from the eight case studies. The first section reviews they key impacts of foreign-invested agribusinesses, providing examples and suggesting ways to further strengthen the synergies between foreign-owned (and foreign-managed) enterprises and other operators in relevant value chains.

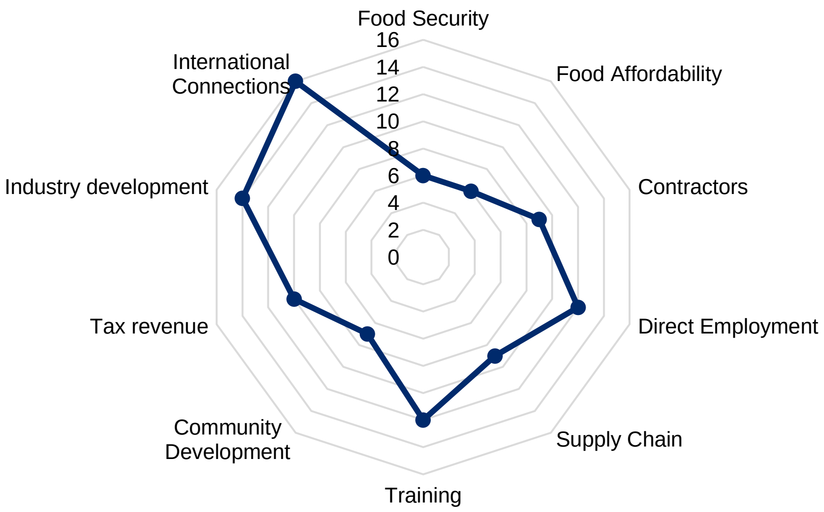
The following two sections focus on (i) **external productivity factors** such as the policy context and market conditions, and (ii) **internal productivity factors and strategies** pursued by businesses in setting up their operations and overcoming any shortcomings in the business enabling environment. Again, we identify general lessons learned and formulate specific recommendations for policymakers, investors and other relevant stakeholders.

THE EFFECTS OF INVESTMENT

This section documents the positive contribution of foreign capital, labor and knowhow to Georgian economy and society. Specifically, we look at the **impact** of foreign-invested businesses on job creation and workforce development, product and process innovation (including technology spillovers affecting suppliers, competing agribusinesses and smallholders), expansion in the range and quality of products available to Georgian consumers, import substitution and improvement in access to international markets, and last but not least, work ethic and the general culture of doing business in Georgia.

To graphically illustrate the effect of foreign investment on the Georgian economy, we developed a taxonomy of impacts and assigned them a score on a simple scale from “no impact” (0 points) to “strong impact” (2 points). A score of 1 was used to denote an investment that demonstrated a moderate impact on the economy. Figure 1 below depicts the **cumulative scores** of the eight enterprises along specific dimensions, including food security, supply chain development, employment, etc. With the combined scores of eight enterprises, the **aggregate impact** along each dimension runs from 0 (no impact) to 16 (strong impact).

Figure 1: The Aggregate Impact of the Eight Investments on the Georgian Econonmy



From the limited but representative sample of the eight case studies, foreign-invested businesses play an extremely important role in helping to **set industry standards** and **promoting international linkages** (14/16 and 16/16, respectively). They have a moderate effect on **direct employment** and **general workforce development** (10/16), and moderate-to-weak impact on tax revenue (many enterprises report positive EBIDTA, but are yet to turn a profit given the amount of upfront investment they had to undertake), community development and other aspects of the business environment.

ACCESS TO INTERNATIONAL KNOWHOW, TECHNOLOGY AND EXPORT MARKETS

All enterprises in our sample had significant **international connections** that were beneficial to their own operations, and often for the broader sector. Five of the businesses are effectively local subsidiaries of larger international holdings.[5] This has been a major factor in their ability to quickly adopt modern technology and management practices, allowing to meet the most stringent food safety and (in the case of Hipp) or organic certification requirements. Also, not surprisingly, four of these companies are predominantly focused on supplying their mother companies (Hipp and Ferrero) or exporting to the global market with the help of sister distribution companies abroad (GWS and Chateau Mukhrani).

While Marneuli Food Factory, Chirina, Landmark/Foodland and Habibco/Agrowest are mainly or exclusively supplying the local market, their international standing and connections were instrumental in achieving a very high level of technological sophistication and integration. Chirina, which relied on Israeli knowhow for its fully integrated design, construction and staff training, stands out in this regard. All eight companies are continuously experimenting with new agricultural products and technologies with the help of international seed companies and technology partners. Their innovations are quickly propagated through imitation and purposeful capacity building efforts targeting suppliers of agricultural inputs. AgriGeorgia/Ferrero, Marneuli Food Factory/Marneuli Agro, and Hipp are the leaders in this regard.

With its quality wine pioneered by a veteran of the Australian wine industry and, later, experienced Bordeaux vignerons, Chateaux Mukhrani's international management team is having a great impact on the reputation and international recognition of Georgian wines. The company is a member of various international wine associations and is responsible for bringing senior management of the

[5] AgriGeorgia/Ferrero, Hipp, Habibco, GWS and Chateau Mukhrani.

world's top twenty wine companies (by sales volume) to Georgia in September 2014. Their hope is that some will engage in global distribution of Georgian wines and/or acquire existing Georgian firms.

Likewise, Hipp and Ferrero's reputation as global food industry giants attracted other European food companies to visit Georgia to investigate opportunities and establish contacts with Georgian government and businesses.

APPLYING COMPETITIVE PRESSURE AND SETTING INDUSTRY STANDARDS

Foreign-managed or foreign-invested enterprises often have high expectations of infrastructure and support services from government agencies, and they are usually forthright in **communicating** their concerns to state bodies. Even if occasionally irritating, in a healthy environment this flow of information between industry and government is mutually beneficial, helping make sure that Georgia's agricultural sector can modernize and meet European norms of productivity and food safety.

An excellent example is Chateau Mukhrani's CEO (and later GWS General Director) Jacques Fleury serving as a Director of the Georgian Wine Association. There, he has been a determined advocate for the wine industry, campaigning against negative government interventions, encouraging government to learn appropriate regulatory approaches from other small countries with successful export-oriented wine sectors, and lobbying for "a future in which the government and the private sector work hand-in-hand to support small vine growers and promote Georgian wines to new markets."[6] It is unlikely the Georgian government would have received this feedback had GWS and Chateaux Mukhrani not been acquired by prominent foreign investors with many years of wine industry experience.

Importantly, enhanced communication, sharing of best practices, and industry-wide cooperation are not the only means of promoting industry standards. By **applying competitive pressure**, foreign-invested commercial agribusinesses force competing domestic enterprises and importers producers to reform management processes and implement new technologies to compete, or withdraw from the market. A good case in point is Chirina's fully-integrated chicken meat plant. The company's ability to operate at international norms of productivity, with fresh and frozen meat products falling within predictable limits of variability and consistently meeting or exceeding customers' expectations allowed the company to very quickly gain market share at the expense of smaller industry incumbents such as Dila and Koda. With its production volumes expected to double by the end of 2014, Chirina may be able to revert to more aggressive pricing in order displace lower quality frozen Brazilian chicken to the benefit of Georgian consumers.

Most enterprises in our sample are relatively new, and their effects on competitors are still to be observed. Somewhat exceptional is GWS, the first Georgian wine enterprise in the post-Soviet period to produce bottled wine instead of bulk wine in drums. The company's approach has been replicated by almost all of its competitors. Moreover, many senior managers of rival wineries have been trained at GWS in the past, so the enterprise has been **acting as an incubator for indigenous Georgian winemaking talent**.

Whether encouraged or not, **imitation** is the most powerful method of propagating new ideas and production methods. In particular, it is by imitating M-Agro practices that Georgian smallholders are gradually adapting modern drip irrigation systems and improved seedlings. Likewise, Italian varieties of hazelnut trees are now increasingly common in Samegrelo thanks to AgriGeorgia's agricultural activities and nursery. Château Mukhrani, the first Georgian enterprise to combine French-style fully integrated wine production with wine tourism and luxury hospitality services, is no longer the only "château" in Georgia. Its business model has since taken off in Georgia, with Château Mere, Royal Batoni, and (potentially) the Radisson Wine Resort in Tsinandali serving as excellent examples.

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[6] Jacques Fleury, "The Georgian Wine Industry: Recent Past and the Way Forward", The ISET Economist, http://www.iset.ge/blog/?p=1789 and http://www.iset.ge/blog/?p=1841.

EMPLOYMENT, WORKFORCE AND SUPPLY CHAIN DEVELOPMENT

Foreign-invested ventures in many cases have contributed to workforce development in their own enterprises and the broader community. This effect, however, is not as pronounced as far as semi-skilled agricultural labor is concerned. In developed societies like Europe and Australia, rural labor is expensive, up to USD 20 an hour for semi-skilled labor. As salaries are a huge overhead, worker productivity is a key determinant of business success and there is a major commitment amongst employers to invest in enhanced worker productivity (structured workforce training expenses may account for 1-2% of turnover per year). In Georgia, labor is a much smaller proportion of total overhead, with hourly rates generally around USD 1.50. Hence, it is uncommon for rural employers to spend any money on structured training at all, preferring to rely on informal in-house training.

This was still definitely the case with the two smaller enterprises in our sample that are focused on agricultural production: Landmark/Foodland and Habibco/Agrowest. All other enterprises we analyzed have devoted considerable resources to staff training. Marneuli Food Factory, GWS and Château Mukhrani have invested substantially in management training, but not labor training. Hipp Georgia did very rigorous training in-house, particularly related to food safety, utilizing professionals from the group's other enterprises abroad. Chirina has retained an Israeli technology partner, Agrotop, on annual contract to transfer knowledge and train local management and staff. Last but not least, Ferrero/AgriGeorgia not only trained own staff (many of whom have been promoted to management position) but undertook a massive capacity building program targeting thousands of smallholders.

Leaving the issue of workforce development aside, the target enterprises have created a substantial number of permanent full-time jobs, as well casual and seasonal labor in rural districts where over half of working age adults declare themselves to be unemployed. In addition to direct employment, food processing enterprises such as Hipp, MFF, Chirina and GWS cause a positive ripple effect amongst surrounding farmers and smallholder communities from which they source raw materials, as well as local traders, service providers and contractors.

In four cases, most notably in that of Foodland, but to some extent also in those of Habibco/Agrowest Mukhrani and AgriGeorgia[7], the arrival of foreign investors was at least initially associated with negative externalities and tensions with the surrounding smallholder communities. In the Foodland case, a major conflict erupted between a cereal cropping enterprise owned by an Indian entrepreneur who came into possession of a land plot which has been hastily repurposed and privatized to the detriment of the local community. The conflict was aggravated by his insistence on hiring Indian laborers and the Georgian police harshly treating protestors in an effort to enforce the owner's property rights.

Most target businesses employed a variety of CSR and community engagement tactics to preempt or mitigate conflicts with the local communities (and local government). Hipp and M-Agro, for example, undertook vigorous initiatives before any conflicts have arisen; in other cases enterprises reacted to a crisis. For example, the above mentioned capacity building program targeting hazelnut growers in Samegrelo, which Ferrero/AgriGeorgia implements in partnership with USAID, has followed a protracted conflict over access to land (which in the meantime has been resolved through land swaps arranged by the Georgian government to the mutual satisfaction of all parties involved).

GOVERNMENT REVENUES, FOOD SECURITY AND AFFORDABILITY AND OTHER IMPACTS

The target enterprises contribute to **government revenues** through taxes on land[8], property[9], fees for irrigation[10], excise on alcohol sales, as well as income[11], value added and profit taxes[12]. Services

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[7] As a rule, conflicts with the local community are rare in case of food processing plants, horticultural/viticultural and intensive livestock operations that are i) more labor-intensive and (ii) occupy a smaller geographic footprint than broadacre cereal cropping enterprises. This may account for the keenness of government to encourage the establishment of these enterprises in their jurisdictions.

[8] About GEL90/Ha/year for land owners holding more than 2 Ha of farmland (other than co-operatives)

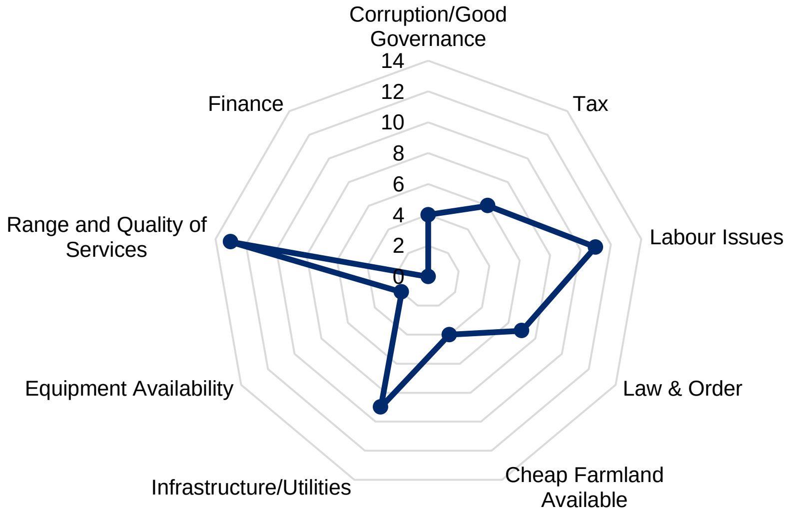
provided by foreign companies have 10% withholding tax levied upon the customer in Georgia. That said, given the early stage in their development, the vast majority of enterprises in our sample are yet to pay profit tax. Likewise, since wages are as a rule not a very high component in their cost structure, their volume of income tax remitted is not very substantial either. Finally, most enterprises are able to benefit from VAT exemptions applying to agricultural activities.

Four enterprises in our sample – GWS, Château Mukhrani, Ferrero/AgriGeorgia and Hipp – do not contribute to Georgia's **food security**. They do not produce basic foodstuffs, and they focus on supplying their mother companies and global markets. The other four – Chirina's poultry enterprise, MFF's cannery and production of wheat for bread, barley for winter feeding of livestock, and sunflower for cooking oil by Habibco/Agrowest and Foodland/Landmark – pursue an import substitution strategy and significantly reduce Georgia's dependence on imports for basic foodstuffs. It is worth noting in this context that both Chirina and MFF are not in pure foreign ownership. Chirina is controlled and managed by Revaz Vashakidze, a Georgian-Russian entrepreneur who repatriated a part of his fortune to Georgia in late 2000s, and MFF is part of a Georgian-Swiss group and is under Georgian management.

BUSINESS ENABLING ENVIRONMENT AND RECOMMENDATIONS FOR GOVERNMENT AND DONORS

This section provides a brief overview of the most important aspects of the **context** for foreign and domestic investment in Georgia's commercial agriculture, including any **bottlenecks** related to recent legislative changes restricting access to farmland, new labor and immigration laws. We follow with recommendations for policymakers and donors operating in the Georgian agricultural sector concerning possible improvements in the business enabling environment.

Figure 2:Challenges and Constraints in the Business Enabling Environment



To graphically illustrate the severity of various **external constraints** facing foreign investors in Georgia's agribusiness sector (e.g. availability of farmland, labor cost and quality, taxation, etc.), we

[9] Capital improvements on the property such a sheds, warehouses and offices are taxed at 1% of value each year

[10] GEL70/Ha/Year for use of irrigation water. Enterprises using wells or springs, even if built at their own expense, are typically billed per cubic meter of water discharged**.**

[11] Income tax of 20% on employees' salaries and contractor fees is withheld and remitted to the Revenue Service each month

[12] Profits tax of 15% is levied on profit after interest and depreciation are deducted

used each of the eight case studies to rank nine key external factors on a similar 0-2 scale. A score of 0 indicated that a factor was "not a constraint," a score of 1 indicated a factor that was "moderately problematic", and scores of 2 were assigned for a "binding constraint." In Figure 2 above, the project team **added up** the (negative) values associated with each factor for each enterprise in the sample. Again, each factor can take a value running from 0 (not an issue) to 16 (binding constraint).

Figure 2 clearly indicates that a key binding constraint for foreign-invested businesses is the **quality and range of suppliers and business services**. The issue is so severe that most businesses are forced to vertically integrate – both upstream and downstream – to be self-sufficient in input supply and distribution. Other, moderately problematic issues are **infrastructure** (irrigation and electricity) and **labor supply quality and availability** (in addition to a complete absence of certain technical occupations, businesses report shortages of seasonal workers as a direct result of current welfare policy). Since all of these enterprises were self-financed, it is not surprising that none reported access to finance as an issue, even though this factor tops the list of problematic factors for Georgian entrepreneurs in most business surveys.[13]

MAINTAINING A LIBERAL POLICY FRAMEWORK AND ENSURING REGULATORY STABILITY

Practically none of the enterprises in our sample would have been initiated had Georgia not implemented a series of reforms liberalizing foreigners' access to farmland, improving border management, eliminating violent crime and petty corruption, reducing the level and number of taxes, and improving access to basic infrastructure, such as electricity.

Beginning in late 2012, Georgia has started on a path of reforms seeking to approximate EU legislation and global "best practices" on labor regulation, competition policy, immigration control, food safety, and access to farmland. If fully implemented, many of the new regulations would involve considerable bureaucratic requirements that may not be affordable for Georgian businesses. Some of the recent measures have been introduced without consulting businesses affected by the new regulations. The moratorium on land acquisition by foreigners, to take one specific example, has seriously impaired investor confidence and hampered the ability of commercial enterprises to expand and/or borrow against collateralized assets. It also damaged asset valuations, effectively expropriating future capital gains by government fiat.

While the moratorium has since been repealed by Georgia's constitutional court, the recent wave of legislative activity sends a signal of regulatory instability and, as such, is a major concern for businesses with long term interests in the Georgian economy. It is necessary for both parliament and the executive to consider that if policies dramatically change every election, investors will factor this risk into their valuations and be less likely to commit.

RATIONALIZING THE USE OF FARMLAND

There are a number of measures Georgia could undertake to rationalize the use of its farmland. First, it has to address the land registration issues that have never been resolved after post-Soviet land reforms. Almost a decade after the initial distribution of land, many families have not received their full entitlement of land, and many who did failed to go through a formal registration process. This is a powder keg that can and does blow up in the face of investors in Georgia when aggrieved smallholders are confronted with a new investor, such as Châteaux Mukhrani or Ferrero, attempting to access their land.

Second, land taxes in Georgia need to be streamlined. Taxes on grazing land are many times higher than in other countries competing for investment in the pastoral industry, such as Australia. The high

[13] For example, access to finance is second on the list of the most problematic factors for doing business in Georgia in the Executive Opinion Survey of the 2014-2015 Global Competitiveness Report by the World Economic Forum (WEF). "Inadequately educated workforce" and "inadequate supply of infrastructure" are incidentally ranked first and third, respectively.

level of land tax on arable land is a substantial impost creating a disincentive for landowners to formally register their land on the state cadastral map, enabling inadvertent or deliberate expropriation by the state (and conflict).

Third, to avoid unmitigated disasters like the one experienced by Foodland, the government may want to introduce an efficient and transparent approvals system for any repurposing and privatization of pasture and arable land over a reasonable threshold. The system should consider i) impacts upon the environment, ii) effects upon low-income citizens making informal use of the land assets, and iii) the revenue, employment, subcontracting opportunities and technology transfer implications of the proposed investment.

IMPROVING ACCESS TO INFRASTRUCTURE AND MACHINERY

Georgia performs extremely poorly against its peers in areas such as quality paved roads, irrigation infrastructure, stability of water and electricity supply, and availability of rental farm equipment piloted by skilled machinery operators and in good working order. In addition to paying for the "last mile" of all essential communications such as road, gas and electricity, businesses are forced to invest in expensive equipment to protect their production lines and machinery from malfunctioning electricity transmission infrastructure. Agribusinesses are also overinvesting in machinery and on-farm infrastructure – e.g. cold stores and grain stores – than would be the case in Europe.

The Georgian government is certainly investing in critical road, electricity and irrigation infrastructure, yet the pace of improvement is naturally constrained by the amount of funding available for this purpose. Still, there are low-cost measures the government could do to relieve the pressure on businesses. In particular, it would be highly desirable to privatize state-owned Meqanizatori LTD, which cannot satisfy its customers in terms of timeliness or quality of work, does covering its costs, and crowds out private farm service centers from the marketplace. Given that large-scale farm machinery is not cost-effective to use on smallholders' plots of 1-2 Ha, the government may consider some soft loan programs for smallholders to acquire 2-wheeled tractors and relevant attachments, such as are used in most developing countries, rather than relying on sophisticated equipment designed for 1000 Ha broadacre estates.

ENHANCING THE ROLE OF LOCAL GOVERNMENT

The current system of regional and municipal government does not endow local authorities with sufficiently strong incentives to support business development in their jurisdictions. In a number of problematic cases we analyzed, foreign investors felt that local authorities did not exert sufficient effort in settling conflicts with the local communities and brokering access to critical irrigation infrastructure. The root cause of the problem may be excessive centralization of tax revenues.

If regional and local governments were allowed to retain a part of the tax revenue from enterprises operating in their districts, local government officials would be incentivized to perform a cash flow analysis of projected tax revenues from proposed new business ventures vs. short-term costs such as income support payments for affected households (until such time as these ventures can employ or otherwise compensate them). Candidates competing for elected office would then run on their track record of attracting investment and generating benefits for the community.

FACILITATING SMALLHOLDERS' INTEGRATION INTO BUSINESS SUPPLY CHAINS

Acquiring a stable raw material supply base is a key concern for food processing enterprises such as MFF cannery, GWS winery, or Hipp apple processing plant. The difficulty of integrating many hundreds of smallholders into their supply chains forces enterprises to develop substantial vertically integrated production while at the same time sourcing raw materials from traders, small and medium size farmers. M-Agro, providing for up to 40% of MFF's total needs, is an excellent example of this business model.

Given this situation, there is a win-win opportunity for the Georgian government and donors to co-operate with technically advanced processing enterprises trying to integrate individual smallholders and farmer organizations into their supply chains. Such companies may be willing to invest own resources and knowhow to lift yields and enhance product quality, as is currently done by AgriGeorgia/Ferrero and M-Agro. The government (and donors operating in the Georgian agricultural sector) could establish Public Private Partnerships (PPP) or provide subsidies or tax concessions in order to encourage “the work of the angels” by commercial agribusiness. Thus, when engaging with their smallholder supply chains (in small-scale capital lending, technology transfer, and monitoring of food safety) businesses could partially offset the cost of their programs through income tax concessions, accelerated depreciation, and state-backed guarantees against supply contract default.

Partnering with commercial entities should be seriously considered by government and donors when planning to execute technical training programs for smallholders. In many cases, commercial enterprises will have in-house training capacities and personnel with experience in both commercial and smallholder systems. Modest funding of training, with some additional local or foreign experts supplementing the efforts of the private sector professionals, may achieve very good results for the donors (in achieving their development objectives), for corporations (in improving community relations and developing raw material supply base), and for smallholder beneficiaries (in improving productivity and livelihoods on their farms).

Importantly, using the PPP mechanism to develop smallholder agriculture and farmer organizations appears to be superior to the government’s current use of agricultural policy as a means of achieving social policy objectives. Instead of trying to subsidize smallholder agriculture it may be desirable to encourage investment into large/medium size food processing businesses, which will in turn create demand for agricultural products, integrating smallholders or providing jobs for those not able to survive in agriculture. Indeed, by working *with* businesses, the government would be in a better position to **develop and sustain farmer organizations and, in the longer term, promote the establishment of EU-style food safety regulations, including traceability.**

An example of a promising PPP would involve Georgia's packers and processors of **orchard products** (such as hazelnut, apple, peaches, nectarines, kiwi and table grapes) in which Georgia has strategic competitive advantages. Companies such as Hipp-Georgia could collaborate as technology partners on a program seeking to assist smallholders in replanting aged, diseased trees and vines with modern disease-free varieties. While eventually expanding and strengthening the companies’ supply chain, the program would improve the livelihoods of smallholder farmers. To make it work, income support payments would have to be made contingent upon smallholders meeting milestones for watering, fertilizing and pruning trees on their small plots. Such payment should be phased out as trees reach productive maturity after 6-7 years.

RAISING LABOR QUALIFICATIONS

Lack of skill in veterinary science, agronomy and food science is a major constraint for international businesses operating in Georgia’s agricultural sector. Businesses are to some extent able to address existing gaps through on-the-job training and short-term internship for their senior staff. In quite a number of cases, such as Chirina, Hipp, AgriGeorgia/Ferrero and MFF, we observed businesses engaging international technology partners and machinery suppliers in the training of staff. Nevertheless, the Georgian government work with the Georgian Agrarian University, Georgia Technical University and vocational colleges to dramatically overhaul programs and syllabi in order to provide students with an appropriate balance of theoretical knowledge and practical skills. Internships in commercial enterprises must be made mandatory for all students during vacations, with graduation not conferred until the quota of work experience has been performed.

In particular, universities and vocational colleges should be encouraged (if not required) to **partner with private businesses** in order for the latter to help with the design of curricula, provide professional placement and internship opportunities, participate in teacher trainings, and engage private sector professionals in teaching and research activities at the university/college. An example of a budding partnership seeking some of these objectives is provided by Chirina and the Georgian Agrarian University.

Universities should seek to embed their students as **paid interns in commercial agribusinesses abroad** (for 1-2 semesters) and advocate for their graduates to undergo **advanced training** in Europe, USA, Canada, Australia, New Zealand, South Africa, China and Japan, with as much commercial exposure as possible during their doctoral and post-doc studies.

As far as vocation colleges are concerned, there is a substantial misconception as to what vocational training is amongst Georgian policy makers (most of whom are university graduates). Vocational education is not delivered by professors or academics; rather, it is performed by industry professionals with the capacity to train others. Vocational colleges would do well to draw upon the services of experienced Russian-speaking agricultural vocational teachers from Poland and Czech Republic to develop new programs, attract and train new Georgian trainers. Vocational colleges in many cases could partner with European institutions and receive capacity building assistance with funding by the EU and bilateral donors.

Lack of skill in farm machinery operation is a major weakness in Georgia. Vocational schools should take advantage of the IT resources that major agricultural machinery firms have at their disposal. All agricultural vocational schools in Europe, USA and Australia are equipped with simulator programs for tractor and harvester operations, and many have full simulator cabin facilities co-funded by machinery manufacturers. These should be installed here as a matter of urgency.

ELIMINATING DISINCENTIVES FOR LABOR MARKET PARTICIPATION

A number of companies in our sample reported difficulties in hiring seasonal workers due to disincentives created by the Georgian income support system implemented by the Social Service Agency (SSA). Since even a few days of seasonal work stand in the way of whole households receiving the SSA allowance (60GEL per household member per month), people are not willing to take formal seasonal jobs, wreaking havoc in labor-intensive rural industries. Paradoxically, rural districts with very high unemployment are now suffering acute labor shortages for this reason. Employers willing to pay cash-in-hand with no Revenue Service filing may be fined heavily; workers injured or killed on the job are not covered by insurance in this case.

This system clearly has to be reevaluated taking 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. Many attempt to go around existing regulations (and associated taxes) by opting for informal employment. 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 temporary labor – like seasonal farm work – and other forms of employment.

ENCOURAGING FDI, IMPROVING TAX ADMINISTRATION AND RESPONDING TO BUSINESS CONCERNS

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 and subsidies. Georgia does not have the resources for sizeable subsidies, but it could 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.

Georgia's investor aftercare services are reported to be in need of urgent improvement. In the case of Foodland, neither the Georgian National Investment Agency, the Ministry of Economy, nor the Ombudsman have been of assistance to the owner's plight of his property being occupied by squatters. Likewise, Agrowest has had to resolve their problems with little support from the government. The Revenue Service should establish a mechanism to swiftly review, and react to, complaints about inefficiencies in the tax administration issues. For example, the lack of established standards for broiler production losses is reported by Chirina as a drag on the company's performance.

Georgia's VAT regime for agricultural enterprises went through several iterations in recent years. Some of the changes are quite positive from the business perspective (e.g. the ability to obtain credit for input VAT payments made for machinery and other supplies against future tax liabilities). Other changes, however, present an administrative burden and are a drag on the companies' cashflow. VAT is currently being levied on imported materials or equipment at the border. It is to be offset by sales 6-12 months later, which presents a substantial cash flow issue and a disincentive to startups in Georgian agribusiness. By tying up an additional 18% of operating expenses in what is effectively an interest-free loan to the government, this change in VAT administration represents a substantial impost in an environment where the cost of capital ranges between 1-2% a month. It reduces the amount of cash available to companies in order to create jobs and invest in productive activities.

Some inputs like seed and fertilizer are currently VAT-exempt. It might make sense to extend input VAT exemption to other capital goods and inputs such as farm machinery, diesel, food processing equipment, food factory shells, and grain storages. Likewise, we recommend that VAT on imported packaging be abolished or at very least payable in the month of sale of the final packaged product. Such improvements in VAT administration would dramatically improve cashflow for startups and increase their chances of survival. They could also accelerate the development of well-resourced enterprises as more of their startup capital could be invested in operations that employ people, instead of remitting 18% of the capital budget to the state. As investment in agribusiness is still rather small, VAT exemption on agricultural inputs will have a small effect on government revenue while saving on collection costs and increasing the rate of fixed capital investment.

HELPING BUSINESSES ADOPT EU-STYLE FOOD SAFETY NORMS AND GAIN MARKET SHARE

The Georgian government is advised to exercise great care in the implementation of the EU-compliant regulatory framework concerning food safety and quality standards. The main concerns in this regard should be i) to provide Georgian businesses with sufficient time, knowhow and resources to make necessary adjustments, and ii) make sure that the new standards uniformly and simultaneously apply to all businesses in the each sector (to incentivize compliance and ensure fairness).

As far as access to the EU market under the DCFTA is concerned, the low-hanging fruit are wine and hazelnut exports. However, the main issue for Georgian wine is weak brand awareness in the EU and price relative to local product of similar quality. In addition to industry-coordinated marketing and export promotion activities, the government should facilitate the adoption of EU-standard food safety standards by providing incentives for firms and co-operatives to engage in training and adopt modern recording systems and traceability programs. The current "cheap loans" policy framework should be maintained, possibly with the help of EU and other donors, to facilitate the implementation of (expensive) food safety and quality standards, investment in productivity-enhancing cultivation and appropriate post-harvest treatment technologies.

As far as import substitution is concerned, the adoption of EU-style food safety and quality standards may help reduce the import of low quality foodstuffs and have them gradually replaced by Georgian products of superior quality, such as *fresh* meat. At present, Georgia's extremely liberal trade policy framework does not do enough to prevent low quality products from being imported to Georgia, making it difficult for Georgian startups to compete with the much larger vertically integrated foreign companies in Turkey and elsewhere, which have the advantage of scale, and very often enjoy implicit and explicit government subsidies.

D. INTERNAL PRODUCTIVITY FACTORS AND RECOMMENDATIONS FOR INVESTORS

Most of foreign-invested enterprises in Georgian agribusiness sector operate subject to the “Desert Island Syndrome”: if you don't bring it with you, you do without. The acute shortage of reliable farm machinery and operators, post-harvest treatment contractors, cold stores and grain stores, and specialist food industry logistics is compelling foreign investors to spend considerably more on on-farm infrastructure and specialized machinery than would be the case in more developed jurisdictions. The goal in most cases is to achieve self-sufficiency in farm machinery, post-harvest management equipment and product storage. Scarcity of these elements makes access unreliable and adds substantially to operational risk.

EITHER START BIG, OR DON'T START AT ALL

The high capital cost per hectare resulting from this means that enterprises must has sufficient scale to make their investment prudent. In the absence of tariff and/or non-tariff measures to protect startup businesses, achieving economies scale is particularly important in sectors that are subject to competition with large, vertically-integrated producers in Turkey and elsewhere, who are often supported by explicit and implicit government subsidies. This, for instance, has been the strategy behind Chirina’s chicken meat operation. While not subject to competitive pressures, AgriGeorgia's investment in agricultural machinery and service center, backup generators and UPS systems served the same goal of achieving self-sufficiency.

SEEK RELIABLE GEORGIAN PARTNERS

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. 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.

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. Mixing patriotism, ethics and business, this Swiss-Georgian alliance has withstood the test of time, political upheavals, financial storms and business mistakes. Likewise, Chateau Mukhrani originated in a successful partnership between Frederic Paulsen and a group of Georgian investors.

On the other hand, the decision by Foodland and Habibco to at least initially operate the business without a reliable local partner (manager), may have been a strategic mistake leading to conflict with the local community. In case of Foodland, this mistake led to the business unraveling.

Perform Rigorous Due Diligence before Investing, Trust But Verify After

If establishing an agricultural enterprise, investors are advised to make sure that no outstanding land claims are still extant, and that any **conflict over land rights** has been resolved. It would make sense to discreetly ascertain the local attitude towards foreign investment in the community.

If establishing operations on a large property where there is some risk of antipathy from locals, **engage in local community service activities** before ground is broken. This may involve renovation or construction of churches, school halls, recreational facilities or cultural sites. Such activities may be somewhat expensive, but not as expensive as dealing with property invasions, blockades or other disruptions due to community hostility. Further down the line, investors could consider liaising with the Ministry of Agriculture and donors in order to provide demonstration and operate basic extension services. This could be as simple as a quarterly field day and barbecue for neighboring farmers, to professionally developed training programs in production, post-harvest management, documentation and food safety administration.

Likewise, investors may want to **liaise with local government** prior to breaking ground and acquaint them with the investment timeline for the project, including labor requirements (full-time and seasonal), likely tax remittances, and expected local subcontracting arrangements. This would help ensure local government support in resolving future issues with the community, and other government agencies.

In any case, investors should be aware that **security and theft prevention** are a much larger issue in Georgia than in Europe or North America. Lawlessness in the Georgian countryside has been an issue for many decades and continues to be so. Multiple strategies must be enacted to cope with this. Boundary fencing of the property, while expensive, acts as a physical and psychological barrier to intruders (particularly graziers), and is necessary. Security patrols are required, particularly around harvest time. A proper ERP system with inventory management functions, skilled auditors and administrative personnel behind it, will substantially reduce losses due to theft and embezzlement. GPS systems and fuel level monitors on vehicles and tractors will reduce fuel theft and freelance taxi-driving or unauthorized contract work by drivers and machinery operators.

ENGAGE INTERNATIONAL MANAGEMENT EXPERTISE AND TECHNOLOGY PARTNERS IN THE STARTUP PHASE

Foreign-invested business would do well to engage international technology partners in the design and construction of production facilities. Chirina's cooperation with Israel's Agrotop is an excellent illustration of this approach. Foreign managers and consultants should be engaged as well if skills deficits are identified.

While expensive this should be seen as a startup capital cost rather than a recurrent expense. A plan to gradually make the transition from expatriate management to local management should be developed, and substantial resources devoted to training of interns, cadet managers and local division managers to develop the technical capability, experience, confidence and people management skills to successfully take over the enterprise.

The learning-by-doing approach used by MFF (the company relied on the learning capacity of its Georgian management and has avoided hiring expensive foreign experts on the permanent basis), has led to numerous mistakes, resulting in losses of money and product. In particular, 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.

EMPLOY GEORGIAN LABOR

While labor productivity in Georgia is very low, it can be improved through careful hiring, training, and financial incentives or bonuses (MFF experience with linking bonuses to EBIDTA rather than profit is worth studying). On the other hand, using foreign labor for activities other than staff training or capital works commissioning is guaranteed to create resentment in the local community (Foodland experience is quite telling in this regard).

Georgian managers well respected in the local community can be a valuable asset in anticipating conflict and pre-empting it with appropriate interventions. They also may be a conduit for local supply chain development activities amongst surrounding smallholders and SME's.

Most enterprises in our sample exclusively relied on **in-house labor training** (Chirina's cooperation with Agrotop being a notable exception). A shortage of reasonably-priced vocational training may be at the root of this, as there is a perception amongst some managers that the quality of training provided is not worth the cost.

Management training in also performed largely in-house, but Chirina, GWS and Chateau Mukhrani has begun the process of seconding managers to other enterprises in Israel and Europe for work experience, and funding the MBA courses of some senior managers. Hipp Georgia used training resources from its sister companies abroad to improve managerial capability to an international standard.

INTEGRATE UPSTREAM AND DOWNSTREAM

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. The success of this strategy is demonstrated by Chirina and Marneuli Food Factory/M-Agro, both of which operate on the basis of own raw material base combined with long-term supply contracts with Georgian farmers and operate in tandem with downstream distribution businesses. Hipp demonstrates an interesting approach to sustaining a network of smallholder suppliers based on organic certification.

GET READY TO IMPLEMENT RIGOROUS FOOD SAFETY AND QUALITY STANDARDS

Food safety in Georgia is currently being driven by regulation rather than market demand. With inspections increasing and fines for non-compliance expensive, training in food safety and implementation of certification programs such as HACCP and GlobalGAP, will be needed to prevent shutdown by state authorities in case of a breach. Eventually, maintaining these standards will yield dividends in greater access to EU and Persian Gulf state markets, where product prices are far superior to those of legacy markets like Russia, Ukraine and Belarus.

Implementation of an Enterprise Resource Planning (ERP) system, either for production or manufacturing operations, is essential to monitor quality, productivity and food safety. Traceability is extremely difficult to manage with paper records or spreadsheets and a purpose-built database program is required to manage this function.

To meet certification requirements, manufacturing enterprises should seek to transform themselves into vertically integrated conglomerates by investing in their own land and/or developing long-term contractual relationships with commercial farms, farmer organizations and smallholders, with rigorous safety and traceability protocols as part of such contracts.

III. GENERAL CONCLUSIONS AND LESSONS LEARNED

It is within the power of the Georgian government to improve the food security, employment, and general economic situation in the Georgian countryside through a careful revision of the policy context and operational activity. A mixture of smallholders, farmer co-operatives, SME's, and foreign-invested large commercial enterprises are likely to be the beneficiaries of sound policy.

For domestic and foreign investors to risk their capital in Georgia's agricultural sector, a stable regulatory environment is required and concrete steps must be taken to enhance investor confidence. In some cases this involves **repealing policies that damage the business climate**, such as the moratorium on farmland purchase by foreign-invested entities, draconian visa restrictions upon existing farmland investors from abroad, and harsh administration of welfare payments discouraging rural dwellers from taking seasonal work when it is available.

In other cases it involves **introducing new initiatives**, such as PPPs or tax concessions to encourage food processors to invest in their smallholder supply chain, reforming the VAT administration system, and financing workfare programs to encourage under-employed smallholders to develop modern small-scale orchards to support their families. Issues identified as inhibiting the Georgian business enabling environment must be addressed as a matter of urgency, in particular infringement of private property rights.

Investors in Georgia's agribusiness sector likewise can improve their competitiveness domestically and internationally through investment in staff training, quality assurance and food safety systems, implementation of modern ERP systems that control inventory and raw material traceability, and achievement of international quality and food safety certifications.

Careful and prudent dealings with local communities before and during investment phases is essential to success. Co-operation with government and donors can yield substantial dividends in community relations and accelerate the social and economic integration of a new venture into the community, be it through non-commercial social projects or investment in the smallholder supply chain of the enterprise, such as finance, technical support, help with machinery and guaranteed markets for commodities.

Finally, Georgia's economic "home run" will be difficult to accomplish without an effort to bring home and re-integrate some of the best and brightest that left the country during many years of out-migration. The diaspora is as a goldmine of financial resources, entrepreneurial talent and skills to be harnessed. Georgia should be actively courting dozens of diaspora investors and entrepreneurs, the likes of Chirina's Rezo Vashakidze, creating the conditions for them to come back and invest their financial and human capital in Georgia's young economy. First and foremost, the country should make this a top priority. As to specific policy tools, Georgia should learn from the experience of Israel and China how to create incentives for diaspora professional to come back and take the country forward.

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