The World's Largest Open Access Agricultural & Applied Economics Digital Library

This document is discoverable and free to researchers across the globe due to the work of AgEcon Search.

Help ensure our sustainability.

Give to AgEcon Search

AgEcon Search
http://ageconsearch.umn.edu
aesearch@umn.edu

*Papers downloaded from **AgEcon Search** may be used for non-commercial purposes and personal study only. No other use, including posting to another Internet site, is permitted without permission from the copyright owner (not AgEcon Search), or as allowed under the provisions of Fair Use, U.S. Copyright Act, Title 17 U.S.C.*

Supplier Relationship Development in the Food Industry of Transition Economies: The Case of Interbrew

Jack Cocks and Hamish R. Gow

This paper discusses a process of supplier relationship development and evolution within the agri-food chain of Central and Eastern Europe during transition. We use the case of Belgian multinational brewing company Interbrew to suggest that independent facilitators holding sufficient private enforcement capital with local farmers can be used to facilitate the required supply base of local raw materials. Traditional business models for local product procurement have been found to be inappropriate for operating within business environments characterized by financially distressed local farmers who possess limited trust in processors, lack the necessary relationship-specific assets, and face weak external enforcement. In such environments the presence of sufficient initial private enforcement capital is necessary to facilitate exchange and assist in the development of a sustainable local supply base. When the processors lack sufficient capital, we argue that independent facilitators can be successfully employed to provide the link between farmers and processors. Further increases to the private enforcement capital through provision of inputs, technical assistance, and guaranteed payments widen the self-enforcing range of the contract and reduce the risk of contractual breach. Thus the presence of sufficient private enforcement capital was critical in facilitating the development of a sustainable supply that, once established, enabled Interbrew to continue divesting of malting facilities and to focus on the core competencies of brewing and marketing beer.

Agricultural transition in Central and Eastern European Countries

During the 1990s economic reforms in the Central and Eastern European Countries (CEEC) induced substantial declines in gross agricultural output across the region (OECD 1999). The socialist system had badly distorted the input, output, and trade-marketing channels. The consequential reorganization and associated institutional changes to these channels that followed the initial reforms caused major disruptions and, thereby, declines in investment and output (Gow and Swinnen 1998). Price and trade liberalization were important contributors to these output declines (Swinnen and Macours, 2000). However, Gow and Swinnen (1998) argue that an instrumental cause was institutional disruptions caused by the privatization, reorganization, and break-up of the previously vertically integrated and centrally planned up- and downstream sectors of the agri-food chain. The combined effect of these disruptions was that numerous hold-ups[1] occurred between producers and processors, mostly in the form of excessive payment delays, as financially distressed processors struggled to secure external working capital. As a result, farmers faced extreme financial distress and watched the private enforcement capital which they had previously held with the up- and downstream sectors erode. Consequently farmers were highly reluctant to enter into any form of rigid or long-term supply contracts for fear of rent appropriation, instead shifting their scarce resources toward spot markets, as there were few incentives to improve quality or make the necessary relationship-specific investments that food processors required (Gow and Swinnen 1998).

Multinational food manufacturing and processing firms operating within Central and Eastern Europe (CEE) as a consequence are faced with the difficult task of establishing and developing a sustainable high-quality supply base that is able to consistently meet their exacting private supply standards when supported by a financially distressed

The authors are, respectively, graduate research assistant and assistant professor of International Food and Agribusiness Management at the University of Illinois at Urbana-Champaign, USA.

The authors gratefully acknowledge the financial support of the European Union Center at the University of Illinois at Urbana-Champaign and research assistance provided by Johan Swinnen, Robert Persyn, Rodolfo Hirsch, and various staff of Interbrew. The authors are solely responsible for the views expressed in this paper and any remaining errors.

[1] Hold-ups are when one of the parties in a relationship has incentives to initiate ex-post renegotiations of the contractual terms in an attempt to extract a greater proportion of the quasi rents accruing to the relationship-specific investment (Gow & Swinnen 1998).

agricultural-production sector lacking the necessary relationship-specific assets.

In this paper we develop a simple contract-enforcement framework that argues that private enforcement capital is a necessary requirement for the facilitation of transactions and enforcement of contracts between multinationals and farmers in transition agriculture where public enforcement mechanisms are weak. However, to achieve this cost-effectively an external facilitator is required in the initial establishment and development of self-enforcing relationships with farmers. Empirical evidence is provided by a case study of Interbrew, a Belgian multinational brewery, and Semper Production Management, a Belgium-based production-management firm contracted to provide the linkages between farmers and Interbrew in the CEE malting-barley sector. In this case the initial private enforcement capital present between the farmer and the contractor is sufficient to enable a fast and effective means for meeting the quality and quantity requirements of the multinational food processor. Further private enforcement capital is created through the formation of producer groups, guarantees of assured payment, and provision of credit, technical assistance, and inputs, thus widening the self-enforcing range of the agreement and reducing the event of contract breach by farmers.

The increase in private enforcement capital enables further development of the business model. This further development is through Interbrew's deassetization of malting facilities to focus on their core competencies of brewing and marketing beer, thus providing the opportunity for greater value creation. Further development occurs when the consultant takes greater control of the supply chain. Further business-model development is facilitated through increasing trust, security, and reputation through the development of private enforcement capital.

Contract Enforcement and Private Enforcement Capital

In a world where all events could be fully anticipated, contractual-enforcement mechanisms would be unnecessary, as contracting for all possible contingencies would be costless (Klein 1996). However, in a world characterized by uncertainty all contracts are naturally incomplete (Hart 1995). This contractual incompleteness results in the contracting parties exposing themselves to the occurrence of ex post hold-ups. Consequently, a necessary condition for efficient economic exchange is the presence of a suitable contractual-enforcement mechanism or institution. This is particularly true for the agri-food chain, which is characterized by high uncertainty and a requirement for high levels of relationship-specific investment (Gow et al. 2000). In order to facilitate exchange, governments usually establish *public* enforcement mechanisms; however, in numerous transitional economies the public enforcement mechanisms are extremely weak, so transacting parties are required to resort to the use of *private* enforcement mechanisms (Gow et al. 2000; Gow and Swinnen 2001).

Klein (1996) shows how private enforcement mechanisms can be used to support transactions and reduce the probability of a hold-up occurrence, associated with any necessary sunk relationship-specific investments, by establishing what he refers to as "the self-enforcing range of a contract." The self-enforcing range of a contract measures the extent to which market conditions can change without precipitating a hold-up by either party. Contractual breach or 'hold-ups' will occur when the benefits gained from contractual breach for one party are greater than the costs of breaching the contractual terms (Klein 1996). As long as the relationship remains within the self-enforcing range, where each transacting agent's benefits of a hold-up are less than the costs, hold-ups will not occur. Hold-ups therefore only occur when a sufficiently large unanticipated event shifts the underlying market conditions beyond the self-enforcing range. Thus hold-ups would never occur in a fully anticipated world (Klein 1996; Gow et al. 2000).

To prevent hold-ups, both parties to a contract can increase the self-enforcing range by making "depository investments" in the relationship as a show of good will, signaling trustworthiness to the other party. These depository investments increase the self-enforcing range of the contract and reduce the probability of a hold-up (Figure 1). These investments can effectively be viewed as the building of private enforcement capital.[2]

[2] See Gow and Swinnen (1998) for a complete explanation of hold-ups and the role of private enforcement capital in supporting exchange relationships in transition agriculture.

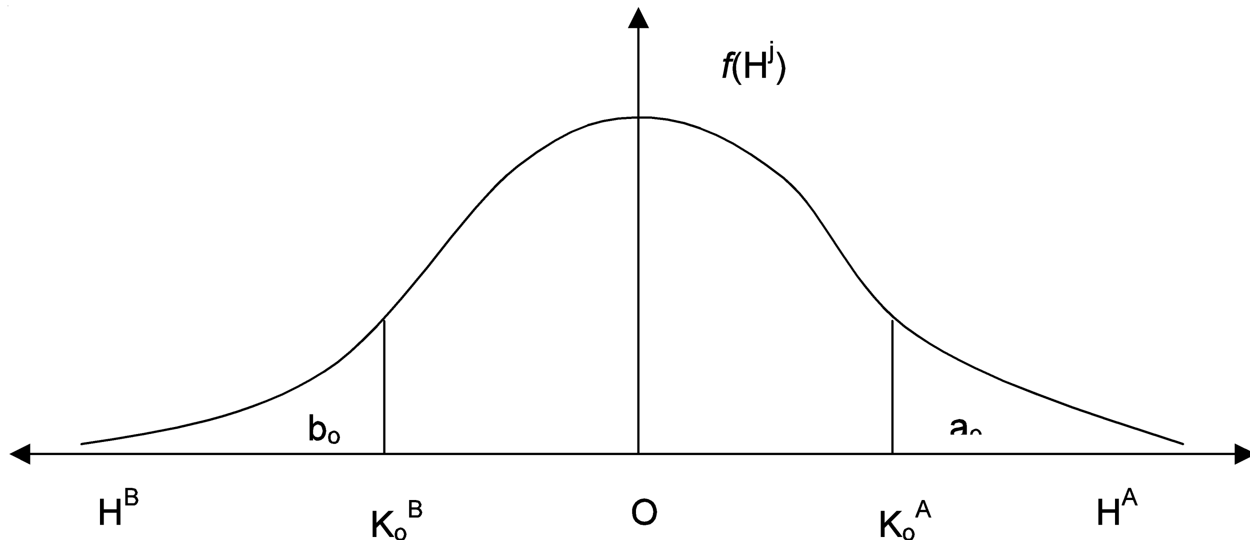

Figure 1. The Probability of Contract Self-Enforcement.

Source: Klein (1996), Gow et al. (2000).

Oliver and Gow (2002) use private enforcement capital as a workable definition of trust, encompassing both capital loss and reputation. Klein (1996) states that private enforcement capital consists of a combination of privately enforceable sanctions that influence the partners to a transaction to abide by the agreement they have made. These sanctions have two parts. One is the discounted present value of all future relational rents accruing to nonsalvageable relationship-specific investments. The other is the transactor's reputation in the market place; this sanction includes the potential exclusion from further transactions with the current party to contract, plus either exclusion from or increased costs of doing business with other transactors in the market place (Klein 1996).

Interbrew

The origins of Belgium-based multinational brewing company Interbrew can be traced back to 1366. Since its formation in 1987 it has grown to be the second-largest brewing company in the world, with global employees totaling 37,617, annual beer production of 96.9 million hectoliters, and net annual turnover of 7.3 billion Euros. They now have global operations are in 20 countries in North America, Europe, and Asia with beer exported to 120 countries.

Interbrew was formed in 1987 with the merger of the two largest breweries in Belgium, Brasseries Artois and Brasseries Piedboeuf. The principal brands of the two breweries were Jupiler, Stella Artois, and Leffe. In 1989 and 1990, respectively, Interbrew acquired Belgian breweries Hoegaarden and Belle-Vue. Since 1990 the company has entered a phase of rapid expansion, with 30 acquisitions and joint ventures completed. Key acquisitions and joint ventures have been Labatt in Canada, Oriental Breweries in South Korea, SUN Interbrew in Russia, Whitbread Beer Company in the United Kingdom, Diebels and Beck & Co. in Germany, and Rolling Rock in the United States.

Interbrew, as part of their international growth strategy, either acquires the leading brewer in the market they are entering or a smaller brewery that is then expanded into a leading position. Interbrew recognizes the very *regional* nature of beer consumption and thus tailors their strategies toward capturing *local markets* through purchasing established local brands. This is best illustrated through their strategy of strengthening their position as "The World's Local Brewer." They aim to become first or second in every country or market segment they are present in. They currently have this position in Belgium, Bulgaria, Canada, the Jiangsu province of China, Croatia, Cuba, the Czech Republic, Hungary, Luxembourg, Mexico, Montenegro, the Neth-

erlands, Russia, Slovenia, South Korea, the Ukraine, United Kingdom, and the United States.

Interbrew considers their brand portfolio to be their key asset. They consider the brand image as being essential for consumers purchasing beer, with brand promotion and advertising essential to building a brand image. Their strategy in building a brand is "to promote a domestic lager brand to be our primary brand in each market," then support this lager brand with at least one other brand and to promote Stella Artois as their international flagship brand (Interbrew 2002). They recognize the long brand cycles of beer with brands being built over many years and lasting decades. Interbrew uses the local knowledge and expertise acquired from the acquisition of a local brewer to grow the sales of Stella Artois in the new markets they enter.

When entering new markets Interbrew attempts to apply best practices on production, marketing, and distribution to lower total costs and build sound supplier relationships. They continually look for innovations to improve their technology and marketing and apply these internationally to each of their local beers where applicable. These innovations are focused on new products and on brewing and packaging technologies. The final result is improvements in turnover and quality and reductions in delivery costs. Over the last ten years they have successfully used this strategy to transform themselves from a small privately owned regional brewer to a leading publicly traded global marketer of branded beers.

Interbrew's Supplier-Relationship Strategies in Central and Eastern Europe

Private Enforcement Capital

Interbrew entered the CEE market with the initiation of their strategy of becoming "The World's Local Brewer." In executing this strategy they have attempted to gain a leading market share in each of the countries they entered by purchasing established local brands (Table 1). They recognize that brewing and marketing beer are their core businesses; however, some privatization agreements forced them to purchase malting facilities along with the desired brewing facilities and local brands.

Once the facilities had been purchased, Interbrew faced the problem of obtaining a sufficient quantity of malting barley that consistently met their stringent quality requirement to produce high-quality malt and in turn produce high-quality beer. Traditionally, the vertically integrated centrally planned socialist system had sourced barley locally through collective and state farms. Although using these sources was an option, the initial quality of the local malting barley was well below any acceptable standards for Interbrew to produce a high-quality product that would carry their brand and name. There were also risks associated with establishing contractual arrangements with financially distressed local farmers, as financially distressed CEE farmers would regularly break their arrangements with processors and swiftly sell the

Table 1. Interbrew's Position in Central and Eastern Europe and the Former Soviet Union.

Country	Voting rights	Market Position	Market Share	No of Breweries
Bosnia-Herzegovina	59 %	4	9 %	1
Bulgaria	85 %	1	31 %	3
Croatia	72 %	1	43 %	1
Czech Republic	97 %	2	14 %	3
Hungary	99 %	1	30 %	1
Montenegro	73 %	1	84 %	1
Romania	50 – 100 %	2	13 %	3
Slovenia	26 %			1
Russia	34 %	2	12 %	8
Ukraine	34 %	1	35 %	3

Source: Interbrew (2001).

contracted malting barley to spot markets, due to the lack and cost of external enforcement. Consequently, Interbrew initially negotiated tax windows with the host-country governments and imported their barley and malt requirements through familiar channels in Western Europe.

In the long run, however, the development of a locally produced product was more desirable for tariff, logistical, operational, and social (local product) reasons. After a period of trial and error, Interbrew found it necessary to establish a relationship with an independent facilitator, Semper Production Management, a Belgium-based agricultural consultant and agronomist who operated production-management companies in various grain and seed sectors in CEE. The consultant had numerous contacts with farmers and industry in CEE, and through the private enforcement capital he had developed with these contacts he was able to identify potential producers capable of meeting Interbrew's exacting requirements. The consultant only dealt with farmers with whom he had sufficient private enforcement capital from either previous or current relationships or from referral from reliable sources. Thus the consultant had a high level of confidence that farmers would not breach their contracts. The consultant's familiarity with the ways of conducting business in CEEC and dealing with CEE farmers was an advantage to Interbrew when operating in a different business environment.

A number of initiatives and programs further increased private enforcement capital between the consultant and farmers, and therefore widened the self-enforcing range of the contracts. The consultant set up production contracts whereby he provided the inputs and technical assistance and purchased the barley from the farmers to on-sell to Interbrew. This shifted risk away from farmers and gave them greater security in the uncertain transition environment. Also, by utilizing Western technical-assistance standards and crop-husbandry practices, product quality improved at a more rapid rate than if local practices had been applied. The consultant guaranteed prices and payment times, which was a new experience for many of the farmers and one which quickly widened the self-enforcing range.

The consultant initiated breeding programs with local private and state-owned breeding companies. By breeding for local conditions, the varieties retained desirable local characteristics suited to the CEE environment, with the brewing potential of the barley improved through the introduction of characteristics from Western European varieties. The improved varieties improved product quality and reduced costs and risks for farmers, thereby increasing farmers' margins and further widening the self-enforcing range.

The consultant initiated producer groups, which gave farmers a feeling of importance and also assisted in building social capital. The widening of the self-enforcing range between farmers and the consultant reduced the risk of contractual breach by farmers, increased security for all agents, and increased Interbrew's security of quantity and quality of raw materials.

Evolution in the Business Model

After a period of operating in each country, Interbrew began divesting their malting facilities. This coincidently came at a time when the trend for brewing companies worldwide was divestment of malting facilities to focus on their core competencies of brewing and marketing beer. This freed capital for investment in business sectors more closely aligned with the core competencies of the business. The strategy of reducing assets also increased flexibility and responsiveness.

The sale of malting facilities to specialist malting companies created the opportunity for more value to be created within the chain through the efficiencies gained from focusing on core competencies. In some cases the specialist malting companies built new malting facilities on separate sites. The divestment of malting facilities shifted the supply relationship from Interbrew to the malting companies, and as a consequence shortened the involvement of Interbrew in the supply chain from barley–malt–beer to only malt–beer.

The business model underwent further change as the consultant began taking ownership of the barley at an earlier stage in the chain. To ensure greater control over the quality of the product and logistics, the consultant took ownership of the barley as it entered the farmers' on-farm storage facilities. This shifted further risk away from farmers, thereby widening the self-enforcing range further.

Conclusion

The traditional business models for local product procurement in both Western and Central and Eastern Europe are inappropriate for operating within a business environment characterized by financially distressed local farmers who possessed little trust in processors, lacked the necessary relationship specific assets, and faced weak external enforcement. In such an environment the presence of sufficient initial private enforcement capital is necessary to facilitate exchange and assist in the development of a sustainable local supply base. When the processors lack sufficient capital, independent facilitators who possess sufficient private enforcement capital can be successfully employed to provide the link between farmers and processors. Further increases to the private enforcement capital between the transacting parties widen the self-enforcing range of contracts, therefore further reducing the chance of contract breach and increasing security for all agents.

Over time, Interbrew was able to shift toward their Western European model, where deassetization and shifting control of the malting and procurement processes to external-chain parties reduces risk, increases security, and provides improved quality. This allows them to focus on their core competencies of marketing and brewing beer and increases value creation throughout the chain. Thus we argue that the presence of private enforcement capital is a necessary condition in the development of a sustainable supply base. In business environments where insufficient private enforcement capital is present, the use of an independent facilitator with sufficient private enforcement capital can assist in the establishment of these relationships by providing both parties to the transaction increased trust, security, and reputation.

References

Gow, H. R., D. H. Streeter, and J. F. M. Swinnen. 2000. "How private contract enforcement mechanisms can succeed where public institutions fail: the case of Juhockur a.s." *Agricultural Economics 23: 253-265.*

Gow, H. R. and J. F. M. Swinnen. 2001. "Private Enforcement Capital and Contract Enforcement in Transition Economics." *American Journal of Agricultural Economics 83(3):686-690.*

——. 1998. "Up- and Downstream Restructuring, Foreign Direct Investment, and Hold-Up Problems in Agricultural Transition." *European Review of Agricultural Economics 25: 331-350.*

Hart, O. 1995. *Firms, Contracts and Financial Structure.* Oxford University Press, Oxford.

Interbrew. 2002. *Brandy Policy.* http://www.interbrew.com/content/content-ob-01.html. November 21, 2002.

——. 2001. *Interbrew Annual Report 2001.* Leuven, Belgium: Interbrew.

Klein, B. 1996. "Why Hold Ups Occur: The Self-Enforcing Range of a Contractual Relationships." *Economic Enquiry 34: 444-463.*

Langlois, R. N. and Robertson, P. L. 1995. *Firms, Markets, and Economic Change: A Dynamic Theory of Business Institutions.* New York: Routledge.

OECD. 1999. *Agricultural Policies in Emerging and Transition Economies: Centre for Co-operation with Non Members.* OECD, Paris.

Oliver, L. D. and H. R. Gow. 2002. "Successful Alliance Establishment and Evolution in a Volatile Business Environment: The Case of Cellars of Canterbury." Paper presented at the 2002 American Agricultural Economics Association meetings, Long Beach, CA.

Swinnen, J. F. M. and K. Macours. 2000. "Causes of Output Decline in Economic Transition: The Case of Central and Eastern European Agriculture." *Journal of Comparative Economies 28:172-206.*