Université Saint-Joseph Faculté de sciences économiques	Année universitaire 2005-2006 Semestre 2	Test d'Inve.directs à l'étranger Date : 11/05/06 – 2h30

Documents interdits

1 - Questions (5 points)

a - What are the two broad categories of foreign direct investment?

b - What is the Fisher international relation?

c - What are transfer prices?

d - What is a concession?

e - What is relative purchasing power parity?

2 - Case Study (15 points)

PIZZA HUT AND THE BRAZILEAN REAL

In 1994, Pizza Hut celebrated the opening of its 10,000th restaurant worldwide by featuring the former Brazilian soccer star, Pele, kicking an autographed soccer ball through a ceremonial ribbon to open a store in Sao Paulo, Brazil. This event was viewed by people in twelve countries in Europe and the United States via an international satellite broadcast. Over the next six years, however, Pizza Hut came under increasing pressure in Brazil and was trying to decide if it should continue to operate there or pull out and invest in other countries.

Prior to October 7, 1997 Pizza Hut was part of the restaurants division of PepsiCo. However, poor operating performance forced PepsiCo to spin off its restaurant division into a new company in 1997, Tricon Global Restaurants, Inc. Tricon has four major divisions: Pizza Hut, Taco Bell, KFC, and Tricon Restaurants International.

There are 29,000 Tricon restaurants around the world generating $10 billion in revenues and $20 billion in system-wide sales, making their total sales and revenues larger than those of McDonald's, Pizza Hut has more than 7,200 units in the United States and 3,000 units in more than 82 other countries. It operates through franchises (51.3 percent of total Pizza Hut sales and revenues), company-owned stores (25.9 percent), joint ventures (16.7 percent), and licenses (6.1 percent). However, Pizza Hut's five-year growth ending in 1998 was 0 percent, compared with 6 percent for Taco Bell and 4 percent for KFC.

What role will Brazil play in the growth of Pizza Hut worldwide? The three largest markets for Pizza Hut internationally are (1) the United Kingdom, (2) Canada, and (3) Australia. However, Pizza Hut's ten-year plan in the mid1990s would put Brazil as the second or third largest market in the world by 2005. Brazil offers a number of location-specific advantages. First is its massive size. In 1 998, Brazil was the fifth largest country in the world in GNF', but it ranked only 103rd in per capita income. It was also the seventh largest country in the world in land mass. Brazil is very urbanized, with Sao Paulo and Rio de Janeiro two of the largest cities in the world. The population is clustered in the major cities on the coast so Brazil ranked only 175th in population in the world density even lower than that of the United States.

From an economic standpoint, Brazil is a land of tremendous opportunity. Historically, Brazil's governments pursued an economic policy based on import substitution and the transition from agriculture to industry. Protective tariffs and import quotas were essential to stimulate domestic industry. State-owned enterprises were established in steel, oil, infrastructure, and other industries, and they received subsidized, long-term credit to expand.

When the military took over in 1964, power was centralized from the states and from congress to the executive branch of government. As the economy began to heat up during the late 1960s and early 1970s, inflation also began to rise, averaging about 20 percent per annum. The government tried traditional means of slowing down inflation, such as raising interest rates, but the large concentration of industrial power resulted in price inflexibility, the indexing of prices above costs, and the passing on of higher interest rates as an additional cost. Due to the protection, foreign trade remained a small percentage of CDP.

The first oil shock in 1973 created problems for Brazil, because in spite of its wealth of natural resources, Brazil relies on imported oil. Economic growth expanded the demand for oil, and the rise in prices worsened Brazil's trade balance. However, import controls gave the government some breathing room. In spite of this, the government was forced to borrow money from abroad, and about 50 percent of the foreign debt was tied to state-owned enterprises, inflation during the latter 1970s increased to an annual rate of about 40 percent, and the private sector was beginning to show significant resentment to the favoritism shown to the state-owned enterprises. The second oil shock in 1979 was accompanied by rising interest rates on foreign debt and Brazil went into more severe shock. The economy actually fell 2 percent in 1981, and Brazil was hit by recession, devaluation of the currency rising real interest rates, real wage reductions, and a widening federal deficit.

The elected governments of 1985 and 1990 focused on foreign debt, inflation, and exchange-rate policies. Real per capita incomes actually fell 6 percent over the 1980's, and cumulative inflation during the 1980's reached 39,043,765 percent!

Before he resigned from office in a corruption scandal in the early 1990s, President Collor had begun to tackle Brazil's serious economic problems, but he ran out of time. However, Fernando Henrique Cardoso instituted a new economic plan while he was finance minister that slowed down Brazil's inflation and stabilized the exchange rate. Prices that had been rising 30 to 50 percent per month suddenly slowed to single-digit figures and Cardoso's popularity soared, allowing him to win the election in 1994 with 54 percent of the vote. However, Brazil continues to face serious economic and social problems. The state is still a dominant force in the economy and privatization has been difficult. The vast gap between the rich and poor has widened in recent years, and there are problems with decent housing, clean water, and good sewage systems. However, trade restrictions have fallen, and Brazil is attracting a lot of foreign investment.

Pizza Hut first entered Brazil in 1938 during a period of high inflation and economic instability through a franchisee who contacted Pizza Hut. At that time, Pizza Hut did not have a specific strategy for Brazil. In 1989, Pizza Hut opened a mall unit in Sao Paulo, and in 1991, it set up an office in Brazil dedicated to establishing a plan for Brazil. In addition to Pizza Hut, KEC was also operating in Brazil. However, the two restaurants were operating under different strategies. KFC expanded in Brazil through unit-by-unit franchising, whereas Pizza Hut expanded through corporate franchises. In a unit-by-unit franchise, an individual restaurant is franchised to a particular franchisee. In a corporate franchise, the corporate franchisee is given a whole territory generally the same as a state boundary with the exception of Sao Paulo, and is not allowed to subfranchise (sell a franchise to someone else). The initial idea of using strong corporate franchises made sense to Pizza Hut because it wanted franchisees with strong financial backing and experience in operating in an inflationary environment. However, the franchisees wield a great deal of power, hampering Pizza Hut's implementation of a Brazilian strategy.

Pizza Hut established targets for all franchisees in terms of how they must grow the business in order to maintain the franchise. Because of its size, 55o Paulo was divided up into five different franchises~. One of Pizza Huts original franchisees in Sao Paulo, United Food Companies (UW), also became a supplier of cheese products to the franchisees, allowing UFC to move down the value chain and the other franchisees to get access to cheese. Pizza hut diversified to other suppliers, and imported cheese from abroad.

By 1993, UFC had established 35 stores in Sao Paulo, generating sales per store unit that were between 33 and 50 percent greater than at its U.S. counterparts. However, Brazil was also the only region in the world serviced solely by franchises—Pizza Hut had no equity interest in any of its stores. Management decided that it needed to own some stores in order to develop operating knowledge and expertise that it could share with its franchisees. The franchise value exists when the franchiser can make a valuable contribution to the franchisees, and Pizza Hut felt that it was lacking an important piece of operating knowledge. it was fairly easy to track the revenues and taxes of its franchisees, but it did not have a good understanding of the cost structure of the business. Therefore, Pizza Hut decided to buy UFC's 35 units in December 1993. Management soon found out that the restaurants were not very cost efficient, but they could get away with their inefficiencies due to the high prices they were charging.

In the first six months of Pizza Hut's operations, several problems arose. The first was management culture. Store managers had been operating relatively independently without any outside control, and now they had to adopt Pizza Hut's control process, not an easy thing to do. They rebelled against the outside control and did not appreciate having to manage differently and beheld accountable for their actions. Second, staff at the stores was more numerous than Pizza Hut management realized, It was easy for the original franchisee to hide costs and employees during the initial negotiations, but Pizza Hut soon found out that it had hidden costs, and it could not go back to the original owners and complain.

The third major problem was inflation. Between 1964 and 1993 when Pizza Hut bought its first 33 units, the annual increase in the consumer price index in Brazil had been less than 20 percent only twice—in 1972 and 1973. In the 1990s, inflation had been out of control, 2,938 percent increase in 1990, 441 percent in 1991, 1,009 percent in 1992, and 2,148 percent in 1993. In early 1994, the CPI was rising at the rate of 1 percent a day. Then in June 1994, the government instituted the Real Plan, and inflation began to slow down. The new currency, the real, was pegged to the U.S. dollar, meaning that the government established an exchange rate between the real and dollar and would not allow the exchange rate to change as it had in the past. In addition, inflation dropped from an annual rate of 4,060 percent in the third quarter of 1994 to 33.4 percent by September 1995. The slowdown in inflation and implementation of the Real Plan affected business in many different ways. When the new currency came in and inflation slowed down, the stores took a big payroll hit. Although store managers had a fixed salary, they also received a bonus based on sales. Previously the bonus was delayed 45 days, and the price increases allowed stores to cover the bonuses with cheaper money, and inflated sales were immediately invested so that the store could generate interest income. However, the inflationary benefit disappeared, effectively increasing bonuses by the lost inflation—as much as 45 percent in that period. The same problem hit purchases and mall leases. In the case of purchases, Pizza Hut used to collect sales immediately, because the stores operate on a cash and carry basis, and delay the payment of supplies, thereby allowing them to pay for supplies with inflated sales revenues. However, this benefit disappeared once inflation slowed down. Mall leases are based on 6 percent of sales and are typically delayed 30 to 45 days, thus allowing them to use inflated revenues to pay for the leases. However, the drop in inflation meant that mall lease payments basically went up 30 to 45 percent. In addition, the slowdown in inflation made consumers more knowledgeable. When inflation was running wild, no one really knew how to compare prices. Prices were changing daily and salaries were going up as well, so people did not have a good reference point. With the implementation of the Real Plan, however, people—as well as franchises—were able to compare prices and make more informed decisions. At approximately $19 to $20 for a medium pizza, many consumers wondered if Pizza Hut was worth the price, given the alternatives.

Beginning in 1995, Pizza Hut Brazil was faced with adapting to the new Brazilian operating environment, Because of the stabilization of prices and the exchange rate between the U.S. dollar and the Brazilian real, sales in Pizza Hut's Sao Paulo units dropped by nearly one-half from December 1994 to December 1995, even though the number of units increased. As people realized that the prices of Pizza Hut pizzas were high, store traffic fell. Although Pizza Hut's target increase in volume annually in Brazil was 19 percent, it was growing only 6 percent.

To stimulate sales, Pizza Hut tried two different strategies. PRI told the franchisees to reduce prices by 25 percent to be more competitive. McDonald's, the leading fast-food chain in Brazil, increased prices by 40 percent in January 1992 to catch up to inflation but later reduced them by 20 percent and advertised the drop as a vote of confidence in Brazil. The campaign was successful and helped McDonald's to grow. Many Pizza Hut units, however, dropped prices in the last week of November and first week of December 1995, and used the samba (a Brazilian dance of African origin) to announce the decision. However, the campaign failed. The press covered it as a desperation move to keep pace with McDonald's, and many felt that in adopting the samba, Pizza Hut adopted a strategy very inconsistent with the U.S. brand image that it had worked so hard to cultivate. One franchisee in Rio maintained that Pizza Hut would be better off putting more money into marketing than in dropping prices. Using that strategy he was able to increase his volume, while those that dropped prices found that volume initially went up but then dropped back to the previous level.

In 1997, just as Tricon came into being, the bottom fell out of the Brazilian economy The Asian financial crisis put serious pressure on the Brazilian real, which had already weathered the Mexican peso crisis in 1994 and 1995. Although the real is considered to be an independently floating currency it actually uses inflation to target its value. Since the implementation of the Real Plan in June 1995, the real has depreciated against the dollar at a very steady and predictable rate as can be seen in Figure 10.3. When the Asian financial crisis hit in the fall of 1997, there was serious pressure against the real. Instead of devaluing the currency, the government decided to raise interest rates to over 40 percent. That saved the real, but it threw the Brazilian economy into a recession. As economic activity slowed down, sales at Pizza Hut plummeted. Then by mid-i 998, the global economy seemed to be on the verge of recovery and the Brazilian government was able to lower interest rates and get the economy moving again. However, that did not last long. In the summer of 1998, the Russian financial crisis, followed by a collapse in global capital markets, knocked the wind out of the sales of Brazilian recovery. Interest rates went up again, but the real was still in trouble. In January 1999, the real collapsed again. The final straw was the refusal of the governor of the state of Minas Gerais to pay off state debt to the federal government, which was a loss of confidence in the government's ability to control its debt. The governor of Minas Gerais, Itomar Franco, was the President of Brazil after Color's impeachment

and during the time when Cardoso established the Real Plan. Cardoso defeated Franco in the election, so the events of January 1999 were political payback.
However, the one-time devaluation of the real did not turn into a full-fledged drop in the currency. The government was able to gain control of the economy quickly and the steady, predictable trend line of the real started up again. In the fall of 1999, inflation began to pick up in Brazil, hut the Brazilian government ruled out an increase in interest rates, instead stating that it would be willing to intervene in currency markets to support the currency

Questions :

1- Do you think it makes sense for Pizza Hut to get out of Brazil, or should it try to weather the storm and stay in? Justify your position.

2- Knowing that the Brazilian real is in an independently floating system, what does that imply in terms of how you would predict future values of the real?

3- Discuss whether or not you think the Brazilian government should dollarize its economy and get rid of the real.

4- What are some of the ways that instability in the Brazilian real might be affecting Pizza Hut's operations in Brazil?

5- Make a comparison between Brazil during the case's period and Lebanon at present days.