Cuba Market Report

U.S. - Cuba Normalization Update

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BG Consultants, Inc.

La Habana, Cuba

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Background

On December 17, 2014, President Barack Obama announced significant changes in US policy toward Cuba. Since then, seismic changes in US-Cuba relations have reshaped the landscape of each country's interactions with Latin America and the global community.

US policy toward the island is in transition. In light of the President's executive orders in December, we are now seeing movement in Congress. Support is growing for removal of the travel ban. Trade, telecommunications, finance, and compensation for nationalized property will all be part of the agenda, as will human rights.

History was made again in Washington July 20, 2015. The diplomatic thaw between the United States and Cuba took a dramatic turn when, after 54 years Cuba raised its flag and officially reopened an embassy in US soil, but the U.S. trade embargo with the island remains the greatest impediment to truly open relations between the two countries.

The embargo, which began to be imposed in 1960, has been a point of contention for South Floridians on both sides of the debate. Supporters argue that without concessions from the Castro regime and a commitment toward democracy, lifting the embargo will only worsen conditions for Cubans on the island. Opponents argue that after 54 years of keeping the island isolated from American trade, nothing has changed and Cubans are suffering the repercussions.

But since President Barack Obama's Dec. 17 announcement of his desire to normalize relations with Cuba, opinions on the embargo have also shifted. Travel restrictions have diminished, embassies have opened and cruises and ferries are preparing to travel across the Florida Straits.

In July 2015, a full 54 years after the United States first severed its ties with Cuba; diplomatic ties were restored between the two countries. The events seem to draw the curtain on an unfortunate period between the two nations in a world which has moved on significantly since the Cold War. Perhaps more importantly from an investment perspective, the thawing of relations between the two opens up exciting investment opportunities in Cuba for the foreseeable future.

Current Events

Although the decades-old trade embargo is still in effect and business between the United States and Cuba is proceeding slowly, there is significant movement. Just recently, the first formal correspondent relationship between a US bank and Cuba's *Banco Internacional de Comercio* was formally established and implemented. Airbnb now offers several thousand listings for places to stay throughout the country of Cuba. American companies are at last permitted to sell computers and telecommunications equipment to the Cuban market. Netflix, American Express and others have now entered the market in a country just 90 miles from the United States.

Several sectors could see immediate benefits from the Obama administration's revisions to the Cuban Assets Control Regulations and Export Administration Regulations. One potential boon sector is travel. Although general tourism for US citizens remains prohibited under the embargo, Americans can now book online travel directly with US airlines and travel agents if traveling to the island for one of a number of authorized reasons.

The easing of sanctions also has implications for US telecommunications firms looking to invest in Cuba, with the sale of some specific personal communications equipment and services now permitted. Additionally, US companies are permitted to work on projects to improve Cuba's outdated internet and telecom infrastructure. In February, New Jersey-based IDT Corp announced that it had reached an agreement with *Empresa de Telecomunicaciones de Cuba* (ETECSA), the island's national telecom provider, to exchange international long-distance traffic (previously banned). IDT will also be able to sell its interconnection service to other US carriers that provide service to Cuba. However, opportunities are limited by the lack of internet penetration, and the cost remains prohibitive despite a recent discount in state-determined rates. It is also unclear how committed the government is to the liberalization of the sector given political sensitivities surrounding greater internet access.

Longer-term prospects are far more positive. Most polls show a strong majority of Americans, even within the Cuban-American population, support not only the restoration of diplomatic ties but also the lifting of the embargo. Many younger Cuban Americans born in the US do not have the same animosity for the Castro's as their parents and see the embargo largely as a geopolitical relic in need of revision. Obama's actions appear to have set in motion an unstoppable momentum offset only by time.

There are considerable challenges that will likely persist much longer than the embargo. Cuba's infrastructure is deficient, even by the standards of its Caribbean neighbors. Roads are in a state of constant disrepair and power outages are common. Banking infrastructure is extremely weak, with a dearth of ATMs, particularly outside of Havana, while the vast majority of local businesses do not have the capability to handle US credit and debit cards. Public-sector corruption is rampant, a particular problem given that most investment opportunities are only available through a local joint venture with a state-owned entity.

Impact of US Policy Change

The new US policy toward Cuba comes at a critical moment, with its impact reaching far beyond the Florida Straits. Since President Obama's historic announcement in December 2014, Havana has welcomed the Presidents of France and Turkey, the Foreign Ministers of Japan and the Netherlands, the Director of Diplomacy for the European Union, the Governor of New York, and a host of other policymakers and entrepreneurs from the United States. Pope Francis is scheduled to visit later this month.

The Cuban government is cognizant of the imperative to allow the "non-state," or private sector, to grow. It is the only way to slim down the public sector without massive unemployment.

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US Congress bill

A Congressional bill introduced in the final week of July by Minnesota Rep. Tom Emmer (Republican), H.R. 3238, dubbed the Cuba Trade Act of 2015, would remove the longstanding restrictions that prevent Americans from conducting business in Cuba and traveling to the island. Additionally, the bill seeks to amend the laws created by the passing of the Helms-Burton Act in 1996.

Passed in 1996, Helms-Burton essentially strengthened the original Cuban embargo. It also took the dropping of the embargo out of the President's hands, ensuring that only an act of Congress can completely lift the embargo, and only if Cuba meets certain criteria: holding free and fair elections, releasing political prisoners and guaranteeing the rights of workers and free speech. The bill is cosponsored by six other Republican representatives and one Democrat.

Cuba Response

Cuba is also in a historic period of transition. President Raúl Castro plans to step down in 2018. To jumpstart Cuba's economy, he will need to accelerate the fiscal and monetary reforms started in 2008. International financial institutions (IFIs), including the International Monetary Fund (IMF), the World Bank, and the Inter-American Development Bank (IDB), hold the key to easing Cuba through a tough transition to a more stable economic model that will better the lives of its people.

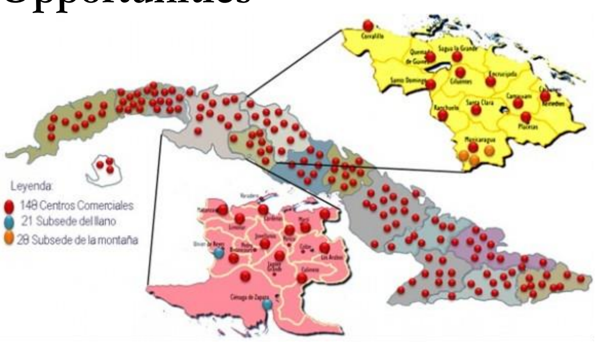
Since 2008, when Raúl Castro took office as President, Cuban society has been changing. The economy is undergoing market liberalizations and macroeconomic adjustments. While the process may be at an early stage, reforms have already tripled the number of private and cooperative businesses, state lands have been distributed to farmers, the purchase and sale of vehicles and houses is now permitted, and consumer options (including hotels and cell phones) continue to grow.

From a macroeconomic perspective, the government has advanced toward reestablishing fiscal and balance of payments equilibriums, maintained low inflation, and promoted a more rational public expenditure. Cuba is now diligently fulfilling international financial commitments and making progress in renegotiating its international debts. Raising the level of aggregate investment is a top priority—in fact, it is the primary objective of the strategy for reviving GDP growth.

In March 2014, Cuba approved a new foreign investment law with the goal of attracting needed foreign capital to the country. The law cuts taxes on profits by half, to 15%, and exempts companies from paying taxes for the first eight years of operation. Employment or labor taxes are also eliminated, although companies still must hire labor through state-run companies, with agreed-upon wages. A fast-track procedure for small projects reportedly will streamline the approval process, and the government has agreed to improve the transparency and time of the approval process for larger investments. It remains to be seen to what extent the new law will attract investment. Over the past several years, Cuba has closed a number of joint ventures with foreign companies and has arrested several executives of foreign companies reportedly for corrupt practices. According to some observers, investors will want evidence, not just legislation that the government is prepared to allow foreign investors to make a profit in Cuba.

Although any change to the government's one-party communist political system appears unlikely, Cuba is moving toward a post-Castro era. Generational change in Cuba's governmental institutions has already begun. Under Raúl and beyond, the Cuban government is likely to continue its gradual economic policy changes, moving toward a more mixed economy with a stronger private sector, although it is uncertain whether the pace of reform will produce major improvements to the Cuban economy.

Opportunities



In 2014, Cuba had a population of more than 11 million people and a land area of about 111,000 square kilometers, which is comparable to the population and land area of the U.S. State of Ohio. In 2013 (the latest year for which data were available), Cuba's per capita gross domestic product (GDP) at 6,985 (Nominal GPD) at purchasing power parity (PPP) in 2010 was $10,200; this amount was three times less than that of Mississippi, which was the U.S. State with the lowest per capita GDP (United Nations Economic Commission for Latin America and the Caribbean, 2014; U.S. Central Intelligence Agency, 2014).

In 2013, Cuba was estimated to be among the world's top 10 producers of cobalt and nickels, which are the country's leading mineral exports. Cuba exports ammonia, nitrogenous fertilizer, and zeolites to Europe and to other Latin America and Caribbean (LAC) nations, but most other mineral commodities are consumed domestically. Production at most mineral processing facilities is significantly below those facilities' design capacities and the quantity of output is not sufficient to support an export market (Kuck, 2014; Shedd, 2014; Soto-Viruet, Country Specialist, U.S. Geological Survey, unpub. data, February 2014). For substantial reserves of manganese, chromium, kaolin, and other ores, the opening of the US market is all important.

A million Canadians now visit the island annually but only about 100,000 Americans. In November 2014, the Cuban government presented an extensive project wish-list to foreign investors. The "Cuba Portfolio of Opportunities for Foreign Investment" includes critical sectors such as biotechnology, construction, energy, food and pharmaceuticals.

It also puts an emphasis on the Mariel Zone development. Cuban officials hope to transform the Mariel Bay – 28 miles west of Havana and 112 miles from Florida – into a major cargo traffic hub, including a free-trade zone and a container port able to host some of the world's largest cargo ships. By offering low tax and few regulations, the Cuban government expects to attract enough foreign capital to build industrial factories and enlarge the Mariel Zone's import-export services.

Foreign Direct Investment Trends

Cuba's real GDP was $70 billion in 2013, relatively low compared with larger LAC economies, but greater than LAC countries of similar area, GDP, and (or) population, including Bolivia, the Dominican Republic, and Guatemala. Among these countries, Cuba had the highest GDP each year from 1990 through 2013. The Government of Cuba passed law No. 77 (Foreign Investment Act) in 1995, which allows foreign direct investment (FDI) in the country. Economic growth rebounded as a result of this change and followed a positive trajectory similar to that of the other small economy countries in the region. Economic growth remained constrained in Cuba owing partly to the limitations of its small economy, but even more so to Government controls on FDI, pricing, and the labor market (United Nations Economic Commission for Latin America and the Caribbean, 2014).

The leading sectors to receive FDI in Cuba have been agriculture, natural resources, and tourism. From 1990 through 2009, Cuba received about $3.5 billion in FDI, of which 86% was received from only 20 of about 250 foreign investors. In the 1990s, the Government of Cuba granted foreign partners majority control, but starting in 2011, the Government has sought a 51% or more share in joint ventures. In Cuba, law No. 77 allows for 100% foreign ownership of businesses, but as of 2011, only six wholly foreign-owned firms were operating in the country. The average maximum share of foreign ownership allowed in mining and oil and gas for LAC countries as of 2010 was about 96% and 86%, respectively. In Cuba, foreign joint venture investors are granted dominant market shares and the Government restricts competition and profit margins. Also, FDI firms in Cuba must pay wages to an employment agency in hard currency, but the agency compensates workers in local currency, which essentially devalues the wages by as much as 90% (Feinberg, 2012).

From 1990 through 1999, the mining sector was the 2d-ranked sector for FDI, receiving on average 15% to 20% of the total. Europe was Cuba's leading trade partner with 47% of total trade, followed by countries from North America and South America (37%) and Asia (14%). Sherritt International was the second largest foreign investor in the country through its production of nickel and cobalt at Moa Bay and its investments in agriculture, oil and gas development, power generation, telecommunications, and tourism. In 2014, the company continued to be the largest independent energy producer in Cuba through nationwide petroleum and power operations. By 2000, the value of mining and quarrying had increased by 127% to $614 million, or by 1.4% of the GDP, from that of 1993, when it accounted for 0.9% of the GDP; the value decreased again to $396 million in 2002 and remained flat through 2013, when the value was $434 million (0.6% of the GDP). During the same period, the value of Cuba's industrial manufacturing sector increased to $10.9 billion in 2013 from $5.8 billion in 1993. The percent share of industrial manufacturing in the GDP, however, decreased to 15.6% in 2013 from 18.3% in 1993, reflecting growth in other sectors (Torres, 2001; United Nations Economic Commission for Latin America and the Caribbean, 2014). Further potential for increase in Cuba's Mining products are linked with the opening of the US market for Cuban ores and construction materials.

China and Venezuela

In the 2000s, the Government of Cuba focused on state-backed projects involving China and Venezuela, the latter of which primarily involved the trade of Venezuelan crude petroleum in exchange for Cuban medical personnel. In 2013, China and Venezuela each received between 10% and 20% of Cuba's exported goods. From 2009 through 2013, the annual growth rate in the value of mineral exports from Cuba was about 9%; China, Belize, and Estonia were the top three recipients of Cuba's mineral exports, together accounting for a 90.6% of the total. In 2013, China, the United Kingdom, and Belgium together received 73.3% of Cuba's total mineral exports. The annual percentage growth rate in the value of exported basic manufactures was 29.5%. In 2009, the Dominican Republic, Brazil, and Honduras together received 62.1% of Cuba's basic manufactures, and in 2013, Togo, Venezuela, and the Dominican Republic together received 66.5% of Cuba's basic manufactures (Feinberg, 2012).

Over the past decade, growth has been led by the export of professional (principally medical) services, which have become the primary source of foreign currency income. Cuba's dependence on this activity—tied to its reliance on oil imports from Venezuela under very favorable terms—has become a cause for deep concern in Cuba as the economic and political crisis in Venezuela worsens.

A Frontier Economy

One fundamental problem of the Cuban economic model is its inability to generate sufficient investment. The level of aggregate investment, according to official figures, has languished at around 10 percent of GDP for the past two decades: only half the regional average and less than a quarter of China's rate.

The government has accepted that it needs more foreign investment. In 2014, in the hope of attracting an estimated $8 billion in new foreign investment, a foreign direct investment law was introduced, a "Special Development Zone" at the upgraded and expanded Mariel port was inaugurated, and a prospectus of proposed projects was published. Although the targets for new contracts have yet to be met, foreign business interest has grown. A major factor in this renewed attention appears to be the rapprochement with the United States.

As a summary of economy related issues, there are a number of changes that have taken place over the last two years which substantially change the economic landscape of investing in Cuba-The three main changes are as follows: (i) the progressive easing of the economic restrictions by the US; (ii) a new Cuban law promoting foreign investments; and (iii) the launch of the 'Cuba Portfolio of Opportunities for Foreign Investment'.

Economy changer #1: The easing of economic restrictions imposed by the U.S.

The removal of Cuba from the US "States Sponsors of Terrorism" list (SSOT list) at the end of May 2015, and the subsequent easing of the economic restrictions (embargo) imposed by the US are undoubtedly the most critical game changers for the Cuban economy. They will boost trade with the US and greatly improve the access to foreign financing. Although the complete lifting of the embargo requires a vote in Congress, we expect the restrictions to continue easing throughout the remainder of Obama's mandate (ending January 20, 2017).

Economy changer #2: The new law for foreign investment.

Though some clauses remain highly constraining, and control by the State is to remain prominent, the new law adopted in March 2014 provides a much more favorable and pragmatic framework than the previous 1995 regulations for foreign investment, especially in the Mariel Trade Zone.

Economy changer #3: New investment opportunities.

The 'Cuba Portfolio of Opportunities for Foreign Investment' includes 246 projects seeking over USD 15bn dollars of capital. It covers critical sectors for the Island such as energy, food, construction, pharmaceuticals and biotechnology, and others, while giving a particular emphasis on developing the Special Zone of Mariel.

Risks

Our position continues to be to carefully plan entry into the emerging market. Cuba will remain a high-risk market for the foreseeable future, and any successful venture will require astute risk mitigation measures. For instance, due to Cuba's complex exchange rate system, currency and financing risks will increase. The dual currency system remains an enormous burden on the Cuban economy, distorting all decision-making, negatively affecting the management of companies and increasing financial risk. The over-valued official exchange rate of the Cuban peso, artificially pegged to the American dollar, has warped corporate balance sheets, skewed prices, and reduced competitiveness. Currency unification has been predicted and postponed countless times, contributing to uncertainty on the future value of the exchange rate and inflation levels. But unification is imminent. The result is that—no matter the attractiveness of foreign investment laws—the dual exchange rate creates a high level of risk for foreign investors. In addition, access to credit will remain limited in the short-term as the inter-bank payment system and distribution channels need to be re-established.

Political and business climate risks will remain high. Foreign investments will remain tightly controlled by the state, with most foreign ventures requiring majority Cuban ownership. Despite the economic improvements, the private sector is projected to develop only gradually. Additionally, in the short-term, non-payment risks by Cuban companies will remain high.

The risks issues can be summarized as follows:

Risk #1: Currency and financing risks will increase.
The Cuban exchange rate system is complex, featuring two coexisting official currencies (the CUP and the CUC) with different (fixed) exchange rates. In addition, financing the real economy, especially access to credit for companies will remain limited in the short-run as the interbank payment system and distribution channels need to be reestablished.

Risk #2: Political and business climate risks to remain high.
The desired 'upgrade [of] the Cuban economic model' by President Castro will require strong support from the Party. The possibility of political and social tensions, as well as full-fledged protectionism along the way cannot be ruled out, especially after the 2018 elections, when Raul Castro committed to step down. Foreign investments will remain tightly controlled by the State, with most foreign ventures (but not all) requiring majority Cuban ownership while large government holding companies will continue to dominate the market. Despite the positive developments, the Cuban economy will remain rationed and mostly State-driven, as labor, wages and price controls will remain in place. The development of the private sector will only be very gradual, as the public sector accounts for ¾ of the labor force. Workers in the projects are expected to be mostly filled by Cuban nationals employed and paid by a local public employment company.

Risk #3: Credit risk to be watched intensely.
In the short - run, non -payment risks by Cuban companies will remain high. Credit risk source, "Euler Hermes" rates Cuba D4 when it comes to getting paid.

Conclusion

The Obama Administration's major shift in US policy toward Cuba is likely to open up engagement with the Cuban Government in a variety of areas, including on the issue of US property claims in Cuba dating back to the 1960s. Trade and travel linkages with Cuba will likely increase because of the policy changes, although to what extent is uncertain given that the overall embargo and numerous other sanctions against Cuba remain in place. The human rights situation in Cuba will likely remain a key US concern. With diverse opinions in Congress over the Administration's policy shift, continued debate over many aspects of US relations with Cuba will likely continue in the 114th Congress on such issues as the US economic sanctions on Cuba, especially on restrictions on tourism travel, credit, and targeted trade issues.

About us

BG Consultants' business advisory services exist to help clients with every aspect of their Cuba business needs. Our advisory group is comprised of individuals with years of experience in all facets of business, from engineering, mining, shipping, finance operations, and other. Our partners bring our clients the real-world wisdom of having sat on numerous boards of directors and advisory boards for public, private, and not-for-profit companies. We can help clients identify investment opportunities, navigate through bureaucracies, key regulations and current restrictions, and provide creative solutions. We can help clients evaluate ways to enter the market, get ahead of the competition, and help not only reach goals, but perhaps develop new ones.

It's through personalized relationships with our clients that we are best able to understand and address the complex business challenges they may face. We provide recommendations and comprehensive answers to solve those needs, such as preparing business, and marketing strategies to help maximize profits.

Principals

Dr. Teo Babun (CEO and Managing Director). Dr. Babun is the founder and CEO of BG Consultants, one of America's largest providers of strategic services related to Cuba. Dr. Babun is the author of more than 100 manuscripts and reports on Cuban business, political, and economic issues, including *The Business Guide to Cuba*. Dr. Babun was also the Director at Intercontinental Bank, where he served as Chair of the Investment Committee. He is a graduate of Michigan Technological University with a major in Electrical Engineering, and a Master's in Business Administration. In 1981, he received the Outstanding Alumni Award from the University for his innovative business efforts. He earned a Doctor of Philosophy, Ph.D., from Vision International University, 2006, and a Doctor of Letters, D. Litt., from Miami International Seminary in 2002. In 2007 he was elected to the MTU Electrical and Computing Engineering Academy.

Dr. Jose Oro (Director and Senior Vice President). Dr. Oro is a Director and Senior Vice President of BG Consultants. Previously, Dr. Oro was a Director of Ministry of Basic Industries of Cuba from 1987 to 1991, leading the research and technical studies for ports, highways, railways, marine transportation, energy (including nuclear), construction materials and mining. After leaving Cuba, Dr. Oro has served as Chief Operating Officer and SVP at Gran Colombia Gold Corp, a gold mining Company operating in Colombia and VP and country manager of Galway Resources in Colombia, VP at Kirkland Lake Gold in Canada. Dr. Oro also spent time on the Latin American Corporate Finance team of Coopers & Lybrand in the Latin America Division. He is a geologist and an engineer by training, with doctoral studies in Geology from the Institute of Geology-Academy of Sciences of the Soviet Union, 1987, a Master in Science in Remote Sensing from the Institute of Sciences of the Earth and Space in the Netherlands in 1983 and a BS in Geological Engineering from the University of Pinar del Rio, Cuba in 1980.

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