



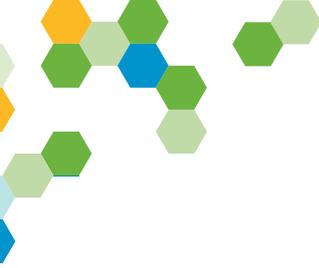
SPECIAL REPORT

10 Business Trends for Cuba in 2017

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1. INTRODUCTION
 2. CUBA IS FASHIONABLE
 3. THE ECONOMY'S ACHILLES HEEL
 4. CONFRONTING INEVITABLE CHALLENGES
 5. TEN TRENDS FOR CONSIDERATION IN 2017
- AUTHORS

I. INTRODUCTION

For Cuba, 2016 has been an intense year. Its image has shone brightly across the world and the country has become fashionable, but it has also been a year of contradictions and a good share of bad news. Donald Trump's victory in the U. S. presidential elections, the death of former President Fidel Castro and the deterioration of an already ailing economy jeopardized the last quarter of the year and the new direction President Raul Castro seemed to be taking.

Nevertheless, Cuba has returned to its former status as the “Pearl of the Antilles” for some people. For them, Cuba is now showcasing its charms internationally and demonstrating unusual interest in not only politics, but also economics and tourism. This trend has mainly been driven by the thaw in relations with its powerful neighbor: the U. S. The relationship between the two nations has improved, particularly with former President Barack Obama’s symbolic visit to the island March 21, 2016. A cascade of globally-significant events has followed, such as the mythical Rolling Stones concert and the Chanel fashion show, in which the luxury brand launched its new collection, in Havana; these are examples of the momentum building the island experienced throughout the year.

“Cuba is again generating interest that is inversely proportional to its size and economic potential”

2. CUBA IS FASHIONABLE

Cuba has also been experiencing particularly good times relating to its political and institutional fields. Hundreds of high-level government delegations from every continent have landed in Havana to rekindle political relations. They have also shown special interest in positioning companies in potential deals and contracts in light of new reforms, known as the renewal of the economic model in Cuban political terminology.

Cuba is again generating interest that seems inversely proportional to its size and economic potential. In addition to the appearances made by the former U. S. president and those of Cuba’s traditional allies and partners, such as former Venezuelan President Hugo Chavez, or Bolivian leader Hugo Morales, leaders of G-20 member countries have also visited Cuba. The list includes leaders from Canada (Cuba’s prime investor), China, Japan, Mexico and Italy, as well as leaders from emerging powers like Iranian President Rohani.

President Raul Castro's visit to France in the beginning of 2016 also deserves special mention. His visit to Paris marked the strengthening of relations and reciprocated the French president's May 2015 visit to the island. Despite not having an official public agenda, President

François Hollande welcomed him with all official honors given to a head of state.

The result is strengthened bilateral relations and increased French interests in the island. Only a few months after that meeting, the French consortium formed by Aeroports de Paris and construction company Bouygues—which already had a strong presence on the island—won the renovation and expansion of Jose Marti International airport in Havana.

Finally, the culmination of the peace agreements between the Colombian government and the FARC (Revolutionary Armed Forces of Colombia), sponsored by the Cuban government, has ratified its political role in the region, serving as an international diplomatic success for the Cuban government. These agreements in Colombia end 50 years of armed conflict, which have been responsible for more than 220,000 deaths, 50,000 disappearances and 5 million displaced people.

3. THE ECONOMY'S ACHILLES' HEEL

Despite the apparent good times Cuba is experiencing, the economy has once again proven to be the country's Achilles' heel. The huge expectations created by the U. S.-Cuba thaw; the receptiveness to foreign investment; the announced

“The country can be defined by its chronic inadequacy and low efficiency in most of its economic sectors”

arrival of North American companies such as Starwood Hotels, Marriott, Airbnb or Google; and a record-breaking 4 million tourists have not been enough to accelerate the country’s economic development and growth.

The Cuban government originally forecasted 2 percent growth in GDP for 2016, which was reduced to 1 percent at the midyear point. This was justified, mainly, by the volatile international economic situation: the crisis in Venezuela—Cuba’s principal commercial partner, supplier of reduced-priced oil and professional services client—and the slump in both the export and prices of raw materials such as nickel.

Finally, at the Dec. 27, 2016 presentation of the National Assembly of People's Power, Vice President of the Council of Ministers the Economy and Planning Ricardo Cabrisas Ruiz announced that the economic results for that year were going to be poor, with an expected downturn of 0.9 percent of the GDP. Consequently, financial resources will be scarce, putting a strain, once more, on the country's foreign currency balance, meaning that opening up to foreign investment will be more necessary than ever.

4. CONFRONTING INEVITABLE CHALLENGES

The events and statistics from 2016 have revealed some inconvenient truths, as well as new challenges the country inevitably must face to release the island’s full economic and social development potential.

On the one hand, Cuba must learn to support a modern and productive structure; the country can be defined by its chronic inadequacy and low efficiency in most of its economic sectors. Though this is in part attributed to the U. S. economic embargo, it is also due to mismanagement methods that are no longer in use. Low production, lack of production incentives and a deficient management and distribution system, together with the state’s enormous bureaucratic machine, all hinder any effort to get the country’s economy off the ground.

On the other hand, official statements and public interventions by the country’s senior leadership are trying hard to stimulate new methods and practices to promote, facilitate and improve the production structure’s efficiency. Nevertheless, this is all in conflict with the dynamics, inertia and culture of a centralized and tightly-controlled economy.

“The country holds great potential if it unlocks a good part of the talented capacity it already has”

It will require new measures and incentives for facilitating modernization and improving the economy’s efficiency. This is especially overwhelming considering former President Barack Obama’s decision, made during his last days of office, to end the “wet feet, dry feet” policy that had been in effect since 1995.

This executive order allowed Cubans who arrived on U. S. soil (dry feet) to remain legally and obtain residency in the country, but if they were intercepted at sea (wet feet), they would be returned to Cuba. This was a policy that provided an escape valve from the scarce opportunities on the island and that generated a constant flow of economic refugees to the U. S. This is now history, and will now oblige authorities to seek solutions to allow new forms of economic and social development outside of the public-sector framework.

Cuba is a small market with only 11 million habitants and 4 million tourists a year and numerous shortcomings and contradictions. Nevertheless, the country holds great potential if it unlocks some of the talent capacity it already has; the important assets that make it unique in the region could create a “runway” for the economy to take off from in coming years, offering many interesting opportunities. Also, the country’s labor force

possesses extraordinary skills; the ingenuity and creativity of the Cuban people could bring about a brilliant future if the country manages to deploy a comprehensive strategy for the development and exportation of professional services.

Even so, some believe this process is impossible if the country does not broaden its political boundaries. The socialist-planned economy is not expected to collapse in the short term, despite its problems; and neither is it expected to immediately open up to a free market system to match its immediate neighbors. The success of this new transition will largely depend on its capacity to create a virtuous growth cycle, generating prosperity for the Cuban people, while removing the obsolete foundations of an outdated economic system. What, then, are the key points and trends for Cuba's immediate future? Where are the main opportunities? What are the risks foreign investors face?.

5. TEN TRENDS TO CONSIDER IN 2017

1- POLITICAL STABILITY

The death of Fidel Castro, commander-in-chief of the Revolutionary Armed Forces (FAR) and former president of the country, coincided with the 60th anniversary of the guerrilla

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group’s arrival in a yacht named Granma. All this has generated a massive institutional and social mobilization and demonstrations of grief in the country. In the same vein, outside of Cuba, Castro's death has brought about an avalanche of analysis about the country’s political future and a possible transition, or even end to the regime. Nevertheless, the regime’s political and institutional stability seems to be guaranteed in the short to medium term. The government and institutions have now been working for 10 years without Fidel Castro, and the current president, Raul Castro, has been developing a discrete but efficient strategy to replace the political and corporate frameworks with people with FAR backgrounds who will guarantee the control and stability of the country. Raul Castro's anticipated withdrawal from the presidency, planned for 2018, implies a handover at the core of the government and a generation change for natural reasons, giving power to a new ruling group that holds his trust—perhaps with a shared leadership. In any case, Raul Castro will continue as first secretary of the Communist Party for at least another mandate.

2- SLOW ECONOMIC GROWTH

Though measures taken by President Raul Castro in recent years have resulted in a clear change in the country’s

economic direction, they have also proved to be insufficient. The country maintains an enormous dependence on its main commercial partner, Venezuela, both in terms of oil supply and the export of professional services. As a result, the Cuban economy is likely to continue to experience a slow rate of growth in relation to its potential, and should continue to explore new policies and measures. The island’s Minister of Economy and Planning Ricardo Cabrisas predicted a 2 percent growth for 2017, but the financial limitations that have weighed on the GDP in 2016 are not going to dissipate so easily. This could imply a curb in growth, especially if the country continues to suffer from huge limitations in the energy and foreign exchange fields.

3- METHODS FOR ATTRACTING FOREIGN INVESTMENT

The disappointing economic and growth statistics from 2016 mean the Cuban government must introduce new measures to streamline and facilitate foreign investment and boost its economy. The country urgently needs to stimulate its industrial and agroindustrial sectors—in addition to tourism—to substitute national production imports and relieve pressure on the country's foreign currency balance. To this end, the country has designed a roadmap and identified priority investment sectors in the Portfolio of

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Opportunities published by the Ministry of Foreign Trade and Investment (MINCEX). However, even though some investments are beginning to materialize, especially in the Mariel Special Development Zone located 45 km west of Havana and intended to consolidate businesses that contribute to innovation, clean technology and generate industrial concentration, statistics show the country must streamline negotiations and procedures to ensure these new investments become reality.

4- THE AGRO-FOOD SECTOR AS A NECESSITY

The agro-food sector stands out among the several productive sectors the island needs to develop; low production and deficiencies in agricultural and agro-industrial distribution mean the island must import 70 percent of the products it consumes. This costs about \$2 billion a year, resulting in a huge economic burden and a foreign currency hemorrhage for the country. The need for modernization and its priority level makes this sector an interesting opportunity for foreign investment. This could even include a fast-track scheme for investors wishing to take a chance on a country that needs not only capital, but also know-how and technology, and benefit from the millions of untapped acres of land all over the country.

5- THE TOURIST BOOM IS SET TO CONTINUE

The tourism sector has become the country’s economic engine. With 4 million visitors, 2016 was the best year in Cuba’s history, being 13 points higher than 2015 and resulting in a year-end figure above the most optimistic forecasts. It was a year marked by new tourists, mainly from the U. S. and Europe, and the launch of hundreds of new airline routes to Cuba. Finding a hotel room on the island, whether for tourism or for a business trip, is an increasingly difficult task. The Cuban government has become more open to foreign companies’ capital and their experience in this sector to alleviate the lack of accommodations in the short term. The strategy is part of an ambitious hotel construction plan with investment projects to build 67 hotels with over 32,000 rooms in the coming years. Most of the international hotel chains are looking to Havana, searching for opportunities.

6- THE RISE OF THE SERVICE SECTOR

The service sector is emerging as one of the most important development sectors in the country. Tourism, the arrival of foreign companies and investors, and new forms of consumption mean the country must develop a whole

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range of new professional services. Some years ago, the government allowed the concept of self-employment to help development, and at the end of 2016 there were more than 535,000 people running bars, businesses and restaurants, according to the Ministry of Labor and Social Security (MTSS). Nevertheless, this is not allowed in many other sectors, and there are no financing mechanisms for new businesses. Only those who can obtain financing from their families abroad have the possibility to start a business, which greatly slows Cuba's entrepreneurial potential and talent development. This current situation is not enough to meet the growing demand in the country, and the informal economy occupies the space that should belong to small- and medium-sized companies (SMEs). For this reason, authorization for SMEs is expected in the near future, representing one of the great opportunities for economic development and employment. At the current time, the establishment of nonagricultural service cooperatives is already permitted to respond to the needs Cuba's public companies cannot efficiently meet (construction gangs, management agencies, transport services, furniture craftsmen, etc.).

7- OPENING THE WHOLESALE DISTRIBUTION SECTOR

The absence of the wholesale market is one of the country's bottlenecks for business development and distribution improvement for a wide range of products. Hence, the government wants to develop the sector, focusing on ZED Mariel as a great wholesale platform. Interesting opportunities exist in the wholesale distribution of food and construction materials, as well as in the retail sector. On the other hand, even though retail is not currently expected to be opened up to foreign investors, it's likely this sector will soon see the development of shopping centers developed through foreign know-how and financing.

8- FRANCHISING: A MODEL OF OPPORTUNITY

One of the country's emerging niche markets is the development of the franchising model a la Cubana, or rather, franchising constituted by a public company with one local partner. Several companies in the retail sector and dollar stores (TRD) are already starting to finalize agreements to open stores with international brands. It's practically an unexplored market, presenting real opportunities in light of tourism, the population's growing demands and the increasing number of Cubans with purchasing power who are eager to consume.

“Trump initially supported Obama’s policies towards Cuba, he changed his stance during the electoral campaign, mainly looking for support from Florida’s Cuban-American community”

9- A NEW CUBA-U. S. DIALOGUE

The Trump’s victory in the November 2016 U. S. elections has shaken the roadmap for gradually normalizing the relationship initiated by Barack Obama and Raul Castro in recent years. The new Trump administration will take a much more demanding position toward Cuba, even though it may not be as radical as it seems. Since the beginning of the thaw, U. S. companies now export merchandise with a value of almost \$380 million to the island, according to official statistics from the United States Census Bureau. There is huge potential here; in 2016, Commerce Secretary Penny Pritzker stated that her department had awarded 490 licenses, with a value of \$43 billion, to companies interested in doing business with Cuba. While Trump initially supported Obama’s policies toward Cuba, he changed his stance during the electoral campaign, mainly looking for support from Florida’s Cuban-American community. There is still uncertainty about his strategy for Cuba, though it is likely he will adopt a strict approach that is somewhat more lenient; *Business is Business*.

10- EUROPE’S NEW ROLE

A new Political Dialogue and Cooperation Agreement was signed between Brussels and Havana December 2016. This ended 20 years of the European Common Position, which has

tainted and marked relations between the island and the continent, to re-establish normal relations. Among the objectives highlighted in this agreement are the strengthening of commerce and development cooperation and support during the process of economic and social updating. This opens new windows of opportunity and suggests a competitive advantage for European companies and investors over their U. S. counterparts, especially at a time when the new U. S. administration, with its new rhetoric, could generate uncertainty and slow the entry of new North American investors.

Hence, 2017 will be a crucial year for Cuba’s future development. The country will continue to take a leading role in the international scene and pursue foreign investors, thanks to its virtually unexplored consumption and industrial market, an enviable geostrategic position and a highly-trained and qualified population.

However, despite offering interesting business opportunities in the short- and medium-term, the Cuban market has extremely complex characteristics from a political, institutional and operational point of view. Thus, achieving success on the island requires expert guidance and support, helping the country deploy an intelligent strategic approach with a sensitive concentration of effort.

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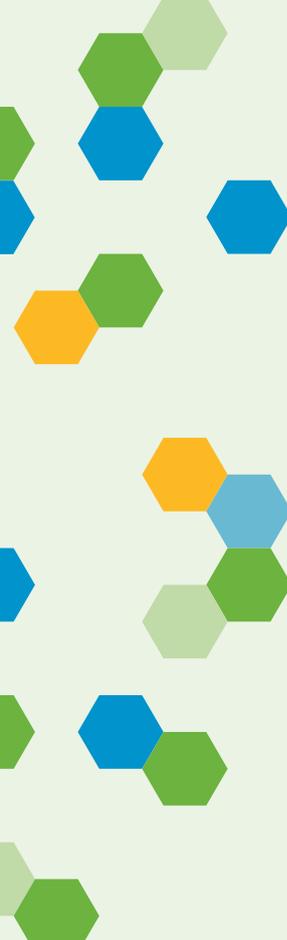
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