LET THERE BE LEAF

While most countries are trying to extinguish their tobacco industries, Azerbaijan wants to build one from scratch.

By Taco Tuinstra

When it comes to drinking, a simple "cheers" or *gambei* won't suffice in Azerbaijan. Toasting in this country requires elaborate praises for the person in whose honor the glass (usually vodka) is being raised, or profound reflections on the issues of life. And there is an endless supply of people and causes worthy of drinking to: those present, the ancestors of those present, those *not* present, the glorious Caucasus Mountains, international friendship and so on. If you survive that long into the evening, you might even be asked to drink to "the success of your most hopeless venture."

That last toast seems appropriate in a region beset by challenges. Azerbaijan shares all the formidable problems of the former Soviet republics in making the transition from a command economy to a market economy. In the early 1990s, it fought a war with Armenia over Nagorno-Karabakh. That confrontation ended in a ceasefire 13 years ago, but thousands of Azerbaijani and Armenian troops continue to face off across minefields. The conflict also spawned some 600,000 refugees on a population of just 8 million.

On the bright side, Azerbaijan sits on vast and largely unexplored oil and gas resources, the earnings of which should grease its transition. In 2005, a new pipeline began pumping Caspian Sea oil across Georgia to a Turkish port, and a new gas pipeline was scheduled to open this year. By 2010, oil production is expected to triple, to 1.3 million barrels per day, and gas output to quadruple, to 18 billion cubic meters per year. If energy prices remain at their current levels, this small nation can look forward to massive revenues for years to come.

Foreign investments are transforming the capital, Baku, where gleaming Lexus sport utility vehicles compete for asphalt with smoky Ladas, and construction cranes dominate the skyline. But sudden wealth from natural resources presents challenges of its own. Although the country is at an early stage of its oil boom, it is already showing signs of "Dutch disease," with energy exports driving up the value of its currency and rendering the non-energy sector less competitive. Managing gushing revenues has bedeviled many other resource-rich countries, and it is too early to predict how Azerbaijan will fare. There is an opportunity to become like Norway, and a risk of becoming like Nigeria.

Eager to diversify its economy and reduce its dependence on oil, the government is encouraging local companies to invest in other sectors, notably agriculture. Azerbaijan is blessed with a favorable climate and fertile soils. Prior to independence, it was a leading supplier of fruits and vegetables to its fellow Soviet republics and a major cotton producer. Together with Bulgaria

Photos: Taco Tuinstra

Ismail Hidayatzadah, general director of Intertobacco (left), inspects one of his company's receiving stations in northwest Azerbaijan. Intertobacco is in the process of creating a fully functioning tobacco infrastructure out of nothing. The company will inaugurate a brand-new leaf-processing factory in spring 2008.

By September 2007, Intertobacco had installed 24 computer-controlled curing barns manufactured by Ronus of Bulgaria. It intends to double that number by next season.

and Moldova, it was also the Soviet bloc's main source of leaf tobacco. Azerbaijan produced between 60,000 and 70,000 tons annually of immuni tobacco, an inexpensive semi-oriental variety that requires little care, is dried in the sun and found a ready market at USSR cigarette factories. During the 1980s, Philip Morris grew flue-cured Virginia tobacco at collective farms in the country's northwest.

But as the Soviet Union disintegrated, so did Azerbaijani leaf production. Western multinationals snapped up the Soviet factories, upgraded their cigarette brands and started importing tobacco from elsewhere. Philip Morris, whose contract was with the Soviet government, lost its partner and abandoned its growing project. The country's sole cigarette manufacturer with local production, European Tobacco, imports all of its leaf requirements.

BREATH OF LIFE. Now, 16 years after independence, tobacco is stirring again in Azerbaijan. Or perhaps stirring is the wrong word, because the country's plans are downright ambitious.

Last year, a group of well-connected entrepreneurs established a new company, Intertobacco, to breathe life into the country's moribund leaf tobacco sector. In a few years from now, the firm wants to be producing and exporting some 2,000 tons of flue-cured Virginia and 400 tons of burley—up from zero in 2005. To this end, Intertobacco has purchased agricultural equipment, irrigation systems, greenhouses and curing barns—all brand new. It is also in the process of constructing a state-of-the art leaf processing factory in Zakataly, near the Russian border, which is scheduled to come online in spring 2008.

The company is not cutting any corners. All told, it will be investing some $24 million in creating a fully functioning leaf tobacco infrastructure out of nothing. The factory is a greenfield project and all the equipment will be brand new. "They definitely intend to have a first-class operation," says David Coleman of David Coleman International Inc., who served a consultant during the start of the project. "As an advisor, I am obliged to find the most cost-effective solutions for my clients, but the company's representatives did not want me to focus too much on price considerations."

One reason might be that making profits is only part of Intertobacco's mission. The primary goal of its investment, says general director Ismail Hidayatzadah, is generating employment in Azerbaijan's rural areas, which are not benefiting from the country's oil boom. Because the company's objectives are in line with the government's policy of spreading wealth, the loans for its investments have all been guaranteed by the International Bank of Azerbaijan, a financial institution that is 51 percent owned by the state. ▶

Above: Intertobacco broke ground for a processing facility in mid-2007. The factory will be built around the equipment, rather than the other way around, which is the ideal way to do it. Below: Workers at one of Intertobacco's receiving stations relax in between shifts.

Intertobacco has been recruiting farmers in the northwest of the country—the same area where Philip Morris grew tobacco 20 years ago. The company currently contracts with 300 individual farmers, whom it provides with seeds, fertilizers and tobacco plants. It has also hired prominent local agronomists to assist in the project.

Because the current generation of Azerbaijani farmers has little experience growing flue-cured tobacco, they face a bit of a learning curve. Flue-cured leaf attracts higher prices than does the native tobacco, but it is also more demanding in terms of cultivation. The greatest challenge, according to Hidayatzadah, has been convincing farmers that they won't lose by switching to flue cured. "We are getting to the point that they are becoming convinced," he says. After encountering skepticism at first, the company is now receiving unsolicited requests from growers who want to be part of its project.

To create goodwill, Intertobacco has also been purchasing small quantities of native tobacco, which is still used in certain low-end cigarette brands in Russia and Ukraine.

In addition to working with individual farmers, Intertobacco operates two cooperatives—one with 60 hectares of land and one with 44 ha. Eventually, the company would like all its farmers to work in cooperatives, because they create benefits of scale and are more manageable. "It's easier to deal with a single entity than with hundreds of individual farmers growing between 0.5 ha and 2 ha each," says Hidayatsadah. "In addition, farmers can share equipment and help one another in a cooperative."

AND IT WAS GOOD. Intertobacco produced 300 tons of flue cured and 150 tons of burley during its first growing season, in 2006. With farmers getting accustomed to a new

crop and much of the agricultural equipment still under way during the growing season, there were obviously some start-up issues. Nevertheless, a leaf sample sent to the United States for analysis evoked favorable feedback. The examiner called the smoke "very acceptable" and predicted there would be a market for this style of leaf. Visiting experts compared Azerbaijan's flue-cured tobaccos to the filler styles produced in Italy, Croatia and the Philippines.

The tobacco's only negative characteristic, according to the American examiner, was its low nicotine content, a problem he suspected could be solved through improved agricultural practices and proper fertilization—steps that Intertobacco intends to implement during the next growing season.

"With better production practices, I am sure that Azerbaijani tobacco has an opportunity on the world market," says Hidayatzadah, who expects the country's leaf to be internationally competitive in two years' time. Hidayatzadah is confident Intertobacco will be able to sell its leaf to independent factories in Russia and Ukraine. But his ultimate objective, he says, is selling to the multinationals.

The country's debut as a leaf source comes at a time when other regions are cutting their output. Without subsidies, tobacco production has become unviable in many European countries, and Azerbaijan—which doesn't subsidize its leaf cultivation—is eager to fill the void. Compared with Europe, the country enjoys a significant advantage in terms of labor and fuel cost.

GO FORTH. Competing on the world market, of course, also requires efficient curing barns and processing facilities. Here, too, Intertobacco is going all out. The company has already installed 24 modern, computer-controlled curing barns, manufactured by Ronus of Bulgaria, and plans to double that number by next season. Eventually, it wants to operate 120 barns.

And recently, Intertobacco broke ground for a processing facility equipped with the latest machinery from U.S.-based Evans MacTavish and Godioli e Bellanti of Italy. Under the agreement, Evans MacTavish will supply all pre-threshing equipment, including threshers, separators, shakers and environmental dust collection systems, while Godioli will supply post-threshing machinery, such as presses, dryers and packaging equipment. Evans MacTavish will install the controls for the pre-threshing and threshing segments of the factory, and Godioli will provide the controls for the post-threshing operations.

Needless to say, representatives of both companies are elated about the project. It's not often that a country decides to create a tobacco industry from scratch—and opts to purchase all-new equipment to boot. As Sam Levy of Evans MacTavish points out, "Most countries are killing their tobacco industries, but Azerbaijan is giving birth to one." And starting from scratch has its advantages. Intertobacco is building its factory around the equipment, rather than the other way around, as is usually the case. "This is the best way to do it," says Levy.

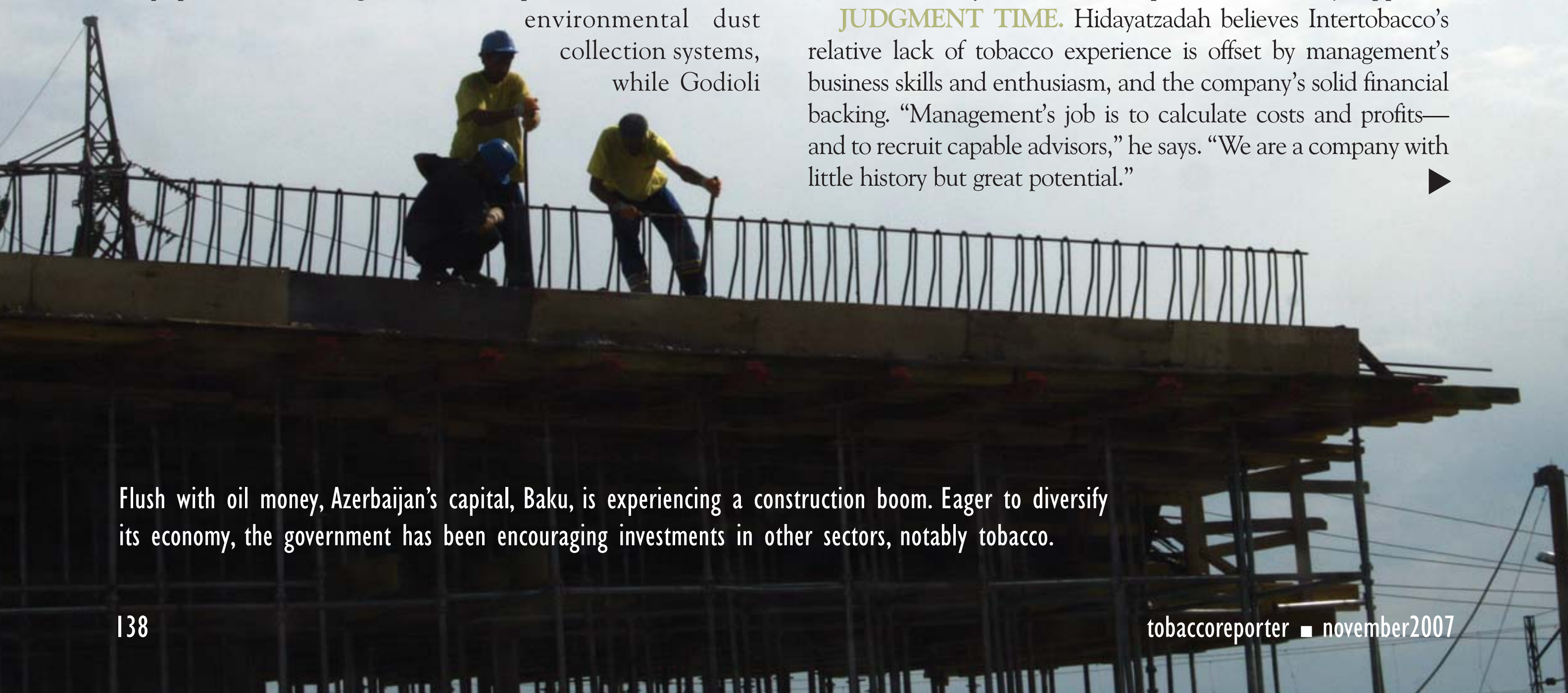
While building a full-fledged processing factory at this early stage of Azerbaijan's tobacco renaissance might strike some as premature, Hidayatzadah insists that Intertobacco is not jumping the gun. "We are moving step by step in order to avoid mistakes," he says.

The equipment should start arriving next month, and the factory is scheduled to commence operations in April 2008. Hidayatzadah intends to use the company's first harvest to stabilize the plant's equipment, which should be accomplished by September 2008. The factory will have an initial capacity of 2,500 kg per hour, which can easily be increased should demand require it. By adding only two pieces of equipment—the thresher and redryer sections—Intertobacco can boost its capacity to 4,000 kg per hour.

To ensure the installation of equipment proceeds smoothly, the company has retained Evans MacTavish's Yordan Yaramov as project manager.

In the meantime, Intertobacco is busy recruiting operators for its factory. Hidayatzadah concedes this is a bit of a challenge. "While there are plenty of people with technical skills in Azerbaijan, it is impossible to find somebody who knows *this* job," he says. Because the Zakataly plant will be the only factory of its kind in the entire Commonwealth of Independent States, Intertobacco will have to train its workers on the job, with the help of its machinery suppliers.

JUDGMENT TIME. Hidayatzadah believes Intertobacco's relative lack of tobacco experience is offset by management's business skills and enthusiasm, and the company's solid financial backing. "Management's job is to calculate costs and profits—and to recruit capable advisors," he says. "We are a company with little history but great potential." ▶



Flush with oil money, Azerbaijan's capital, Baku, is experiencing a construction boom. Eager to diversify its economy, the government has been encouraging investments in other sectors, notably tobacco.

And those who have interacted with the firm tend to agree. "Intertobacco is a young company managed by young people from different sectors of industrial agriculture. They are very motivated and focused on making good business," says Lorenzo Curina of Godioli e Bellanti.

The company is also eager to cooperate with established players in the industry. "To succeed, we need good tobacco, a well-functioning plant and a bit of luck—and we need to get in touch with players at the international level," says Hidayatzadah. He believes Intertobacco will make for a good partner. "We are backed by a serious financial institution, knowledgeable advisors and first-rate suppliers. And we have good land. Philip Morris could have picked any place in the former USSR, but they picked the northwest of Azerbaijan—the same area where we will be growing."

Hidayatzadah's sentiment is echoed by Jahangir Hajiyev, chairman of the board at the International Bank of Azerbaijan. Although this is the first time the bank is investing in tobacco production—the majority of its dealings have been in the energy sector—Hajiyev is confident of the venture's potential. "We have no worries about Intertobacco's ability to recover its investment or our ability to recover our loans. The tobacco it intends to produce represents only a small portion of worldwide requirements and should be competitive on quality and price."

While new to flue-cured tobacco, Intertobacco's farmers have managed to produce a very acceptable crop, according to company officials. With improved agronomic practices, they expect it to be internationally competitive on both price and quality.

Of course, entering the leaf tobacco business at a time when the tobacco industry is under attack from many sides carries a risk. But Hidayatzadah is unconcerned. "People will continue smoking," he says. "Factories will continue to make cigarettes and leaf merchants will continue buying tobacco. While places of tobacco cultivation might change, the total volumes should remain relatively stable. In the next 10 to 20 years, I expect no loss of demand—only a shift in sourcing areas."

Clearly, Intertobacco is betting the shift will be in the direction of Azerbaijan. If that happens, it will help the nation reduce its dependence on energy revenues, create employment in the countryside and bring economic activity to areas where there was none before. The global tobacco industry, in turn, will have a new sourcing area, and its suppliers will have an additional customer to service.

While many challenges remain, Intertobacco is determined to prevail. Unlike some of the hopeless undertakings Azerbaijani drinkers like to toast to, the project appears to hold considerable potential. As Intertobacco brings its facilities online, many will be raising the glass to the success of its ambitious venture. TR