



THE INKERMAN GROUP

## Where Angels Fear to Tread

The “pink tide” and investment in Latin America

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### *Executive Summary*

- There are serious concerns about investing in Latin America, following the “pink tide” of socialist governments which have swept to power across the continent, however it is important to distinguish between the “centre-left” and the “populist-left”.
- The “populist-left”, most notably in Venezuela, Ecuador and Bolivia, have enforced policies of expropriation, the voiding of contracts, and the implementation of legislation which increases taxation or is unfairly prejudicial against multinationals vis a vis domestic enterprises.
- Populist leaders such as Hugo Chávez may actually exacerbate existing factors such as conflicts between indigenous peoples and their respective governments and the operation of militant groups such as Colombia’s FARC, further complicating the situation in the region for investors.
- The implications of political change for the businesses operating in Latin America emphasises the need to closely monitor political developments, for the better or the worse, not just during elections but in the longer term, so that companies may make the most of their investment opportunities.

*In May 2009, the government of Venezuelan President Hugo Chávez expropriated sixty oil field service companies, among them four foreign companies, once again vindicating concerns about investment in the region, and contributing to Lloyd's of London's decision to withdraw maritime war-risk policy coverage for the country in June 2009. Latin America is rich in natural resources: with abundant oil, gas, minerals, agricultural produce and land. The benefits of investing in order to gain access to such resources are both obvious and undeniable. However, in the past decade the region has been the scene of a political transformation, as a wave of socialist governments have swept to power as part of a so-called "pink tide". This revolution has had explicit and very startling implications for both the political and economic dealings of these countries. Governments, such as that of Chávez, have pursued policies towards foreign companies which are of grave concern to anyone considering investing in the region. However, the countries comprising the "pink tide" are by no means a homogenous bloc, and for investors to treat them as such would be unwise, and ultimately, costly. This paper examines why this resurrection of the political left has caused such concern, before clearly distinguishing between what can broadly be termed the "two lefts" in the region and the implications each have for investment therein. By looking at these two distinct entities within the left in Latin America, it is possible to explain the treatment of foreign investors in the countries concerned, and thereby predict, to a certain extent, which countries pose a far greater risk.*

### **Where Angels Fear to Tread**

Hugo Chávez began the trend in Venezuela in 1998 and was followed by Luiz Inácio Lula da Silva in Brazil (2002); Nestor Kirchner in Argentina (2003); Tabaré Vázquez in Uruguay (2004); Evo Morales in Bolivia (2005); Michelle Bachelet in Chile (2006); Daniel Ortega in Nicaragua (2006); Rafael Correa in Ecuador (2007); Fernando Lugo in Paraguay (2008), and most recently, the 01 June 2009 election of Mauricio Funes in El Salvador. All of the aforementioned Latin American leaders represent political parties of the left of the political spectrum, and have led to descriptions of a "pink tide" sweeping the region. The term "pink tide" was cleverly coined in order to differentiate these modern administrations and the politics they practice from the more "hardline" socialist political parties in the region during the Cold War and the "red scare". So, you may quite reasonably ask, why the concern? If these countries and their politics are considered relatively moderate, why would this be a cause for concern?

Politics of the left tend to emphasise social improvements over macroeconomic orthodoxy, egalitarian distribution of wealth over its creation, and sovereignty over international cooperation, none of which is

incompatible with the idea of foreign investment-providing the operation of a foreign entity within the country benefits the many rather than few and the people see a demonstrable benefit. However, herein lies the rub. Latin America has seen the development of two leftist governing philosophies, one which is entirely compatible with foreign investment, and one which is entirely perilous.

The left flourishes in the region for a number of reasons. The extreme inequality, poverty and concentration of wealth and power among certain ethnic groups in Latin America mean that left-wing policies tend to be supported by vast swathes of the population. Furthermore, with the end of the Cold War it is now acceptable for governments to pursue a more socialist agenda without being condemned as a "Soviet beachhead", which by its very existence was a challenge to the US. With the emergence of widespread democratisation in the region the natural predisposition towards the left has been allowed to come to the fore, unencumbered by Cold War considerations and interference. All of the left wing governments currently in power in Latin America came to power via the ballot box, and in a number of cases have reaffirmed their legitimacy through re-elections and popular referenda. This

represents a significant break with the past and has conferred greater legitimacy upon these governments. However, legitimacy does not always translate into what is in the best interests of the country. This electoral legitimacy has undermined the traditional “military veto” on the left taking power, and it has also emboldened leaders, some of whom have pursued radical policies safe in the knowledge that they are able to rely on their democratic mandate.

There are two discernable leftist movements in the region: what may be termed the centre-left, and a populist-left. Whilst there is nothing incompatible in the former to suggest that investment in the country would be unwise based upon considerations of the political stance of the government, this is most certainly not the case in the latter.

#### ***Centre-left***

The centre-left countries, such as Chile, Brazil and Uruguay, largely appear to have developed from the traditional Communist movements in the region, by adapting to the changing global environment and learning from past errors in both policy and practice. When leaders within this tradition have come to power they have often maintained economic policies which are largely similar to those of their immediate, more right wing, predecessors. The centre-left emphasises social policy, implementing programmes for education, antipoverty initiatives, health care and housing projects, but broadly speaking this has been done within a market framework. It has also sought to rationalise relations with the US, traditionally the target of the left’s ire. Far from being a cause for concern for would-be and current investors in Latin America, the governments comprising this transformed traditional left are largely beneficial for their countries, and therefore a positive for investors. In this case, these responsible social programmes are highly beneficial to investors. Efforts to decrease inequality will increase stability in the country, thus making investment far less perilous. Increasing education programmes means that

foreign corporations have access to a more skilled work force, meaning that greater value can be added to the goods produced as a result of increased efficiency and ability. The shoring up of democratic institutions and the continuing good governance which emerges from this is leading to a decrease in corruption, once again making foreign direct investment (FDI) more attractive and profitable.

#### ***Populist-left***

The populist-left in Latin America is spearheaded by Venezuela, Bolivia and Ecuador. The leaders of these countries owe much to the traditional populist movement in the region, typified by Juan Perón of Argentina. They represent a very different, and far more unpredictable, left. These administrations tend to use policy as an instrument for attaining and conserving power rather than power as a tool for making policy. This left pursues widespread programmes of nationalisation as a means not to provide for the people, but in order to gain the money necessary to ensure they can “buy” and maintain their position. In its quest to “get rich quick”, the populist-left has resorted to a series of measures which have raised serious concerns for investors. These include programmes of expropriation, most recently in Venezuela in May 2009; legislation which expressly favours domestic companies over foreign competitors, most recently in Bolivia, and a host of tax and policy reforms which have further diminished the profit margin of foreign firms. To quote one observer, these leaders are “more intent on maintaining popularity at any cost, picking as many fights as possible with Washington, and getting as much control as they can over sources of revenue, including oil, gas, and suspended foreign-debt payments”. This inadequacy when dealing with domestic politics means that vital infrastructure projects, necessary to support a company operating in country, are left undone, education initiatives are not implemented, inequality is not tackled and economic growth and prosperity is not considered to be a

priority. This makes such countries far more complex and risk intense targets for FDI.

Below are case studies of the Chilean and Venezuelan experiences, which are instructive in looking at the type of system investors are likely to find themselves operating in:

### ***Chile vs. Venezuela***

#### *Chile*

Most observers consider Chile to be a model of good governance for the region. President Bachelet, of the Partido Socialista, heads the Concertacion coalition, the policies of which have brought about high rates of economic growth, significant reductions in poverty alongside simultaneous improvements in education and housing. The subsequent drop in inequality in the country has made it a far more stable prospect for foreign companies. Vitality for those considering investing in Chile, the government has invested in large scale infrastructure projects vital to supporting any significant FDI. A strong relationship with the US has led to the signing of a series of free trade agreements. In June 2009 it was reported that authorized foreign investment in Chile jumped to US\$4.391 billion in the first half of 2009, the highest in eight years for a similar period. Despite the global economic crisis there was increased investment in retail, energy, services, construction and aquiculture. In the first half of the year, planned investments in electric power generation accounted for 16% of the total and included US\$250 million by Australia's Pacific Hydro, US\$150 million by SN Power Holding Chile, US\$180 million by HydroChile and US\$95 million by Suez. US retailer Wal-Mart was authorised to invest US\$2.8 billion to acquire Chile's biggest supermarket chain, D&S, while Spanish firm Abertis was given the go ahead to invest US\$326 million in toll highways. In 2008 foreign investment came to US\$10.5 billion, the highest in almost a decade. The policies implemented by the centre-left are continuing to attract investment, even at a time when creditors are

being all the more cautious regarding the money they spend.

#### *Venezuela*

In contrast, Venezuela's Hugo Chávez is the poster child for the populist-left, and he is precisely the type of leader that foreign investors should be wary of. Chavez is leading the charge against good sense, challenging the Free Trade Agreement of the Americas (FTAA), taking every available opportunity to antagonise the west, and making life exceptionally miserable for foreign companies. Through shunning and mistreating foreign companies, he is driving his country into the ground. Social programmes of any real long term value are ignored, with infrastructure sorely lacking and unwise "instant gratification" policies implemented. Chávez's rule has led to inflation, greater poverty and inequality.

The lack of sensible government investment, the continuing inequality and a series of shambolic decisions are all of concern to anyone considering investment in Venezuela. However, the most serious concern has to be the round of expropriations which have made the country one of least desirable places to invest, despite the country's abundant oil riches.

In May 2009 the government seized sixty oil field service companies, among them four foreign companies, and put them under the remit of the Venezuelan state oil company, Petróleos de Venezuela (PDVSA). This seizure, coupled with the March 2009 decision to seize seaports in those Venezuelan states hosting major petroleum-exporting installations and the general climate of uncertainty, prompted Lloyd's of London to withdraw maritime war-risk policy coverage for the country in June 2009. The removal of war-risk cover means vessel operators in the country may no longer be able to insure against asset confiscation, a move that will affect all water-borne vessels including tankers and containerships. This serves as an excellent example of the current

unease felt about doing business in and around Venezuela.

The latest corporate seizure was allegedly conducted to “cover up” the PDVSA’s mounting debts to oil field service contracts, which are believed to total some US\$13 billion. Compensation disputes across all industries in Venezuela are now estimated to be in the region of US\$15 billion in unsettled claims. In the oil sector, the most significant disputes are with the world’s biggest oil conglomerate, ExxonMobil, and another US oil giant, ConocoPhillips, with both disputes originating from the loss of their controlling interests in the heavy oil fields in the Orinoco Basin. The ill advised nature of the latest round of expropriation illustrates how mismanaged Venezuela truly is: whilst the current seizure may save the country money in the short term as it does not have to pay its debts, it is likely that as the PDVSA is widely believed to have insufficient capacity to run the additional fields, oil production in the country, and therefore government revenue, is going to decrease. What is most interesting about the latest round of expropriation is the speed with which it was done. The new law extending Chávez’s expropriation rights to the oil field service sector was published in the state newspaper *Gazeta Oficial* on the day that the seizures took place, however, by the President’s own claim 84% of the industry had been nationalised by 0600hrs in the morning, at a time when the newspaper was unlikely to be on sale. Thus the first the vast majority of companies knew of the legislation was when the expropriations began. The legislation itself had been rushed through the National Assembly at a velocity that was surprising even by Venezuelan standards. Chávez signed and then promulgated the law within hours, before swiftly embarking on the takeover. The speed with which these companies were expropriated serves as a further warning to prospective investors: there was no long and steady build up, this was a short, sharp, expensive shock. There was little or no time to mitigate the damage, a factor which greatly increases the risk of investing in the country. It also appears that there was a political

element to the seizures. Zulia state, where the companies that were expropriated were concentrated, has consistently opposed Chávez and it is likely the case that the new legislation, as well as benefiting the PDVSA financially, was intended to punish dissenters. Here once again is a point which emphasises the unpredictability of Chávez’s regime: it is not even necessarily the industry in question or financial motivations which may compel the government to act, but the desire to force the people to cower in fear of the President and “get in line”. Investors may find themselves the victim of a political agenda.

Chávez, like Correa in Ecuador who has also implemented policies of expropriation, argues that the practice of expropriation is consistent with the philosophy of seizing important sectors of the economy as a means to direct more of the country’s wealth to the poor. Other industries which have been nationalised include electricity, steelmaking, cement and telephone enterprises, in a supposed effort to “strengthen the revolutionary drive towards building a socialist nation”. In reality it is apparent that the true motivation is ensuring that Chávez has sufficient funds to preserve his position of power, by effectively bribing the poor, whilst simultaneously dismantling any group which may have the power to oppose him. According to the UN Conference on Trade and Development (UNCTAD), direct foreign investment in Venezuela amounted to US\$400 million in 2007, the lowest recorded for any country in South America. In comparison, neighbouring Colombia had investment of US\$8.2 billion, and Brazil had US\$37.4 billion.

### ***Beyond the political dimension***

It is evident however, that there are a number of other factors which, alongside the political persuasion of the government, have a significant impact upon investment, and the wisdom thereof, in Latin America.

### *Ethnic tension*

There are a series of issues associated with ethnicity and ethnic tension in Latin America which have manifested themselves in the form of, often violent, protests. Recent years have seen the emergence of indigenous movements in the Americas (mainly South America). These are rights-driven groups that organise themselves in order to achieve a degree of self-determination, the preservation of their culture for their peoples and to campaign for their rights to resources and against discrimination. The most recent example of this was witnessed in 2009 with a series of protests held in Peru.

From April to June 2009, Peruvian authorities were embroiled in a conflict with indigenous protesters demonstrating over the rights to natural resources in the country. Indian groups, drawn mostly from the vast Peruvian Amazon, objected to a myriad of laws that would open their region to oil and gas drilling, hydroelectric projects and biofuels farming-measures regulating FDI which were to be introduced in an effort to bring the country's economic framework in line with a US-Peru free-trade accord. The conflict saw oil facilities occupied, tourist destinations cut off and roads blocked, and, in an exceptionally concerning development on 05 June 2009 clashes between authorities and protesters resulted in the deaths of fifty people, including twenty-two police officers. Following months of controversy, which began in April 2009, the Peruvian government overturned the legislation. There have been a number of disruptive protests on President Garcia's watch, including demonstrations in Tacna department in late 2008, during which protesters shut down roads and breached the border into Chile in an effort to gain a greater share of revenue from mining projects in the area. Indeed, the overarching theme of the protests against Garcia has been issues related to foreign investment. Whilst indigenous groups will undoubtedly celebrate the overturning of the legislation as a victory, it is unlikely that this will be the end of the government's attempts to make the country

more appealing to FDI. However, such attempts bring with them the spectre of further protests, with demonstrators emboldened by their latest success meaning that the scale and ferocity of the inevitable protest actions could increase with significant implications for anyone wishing to invest in the country.

### *Armed militias*

Latin American countries have historically been blighted by a vast array of militant groups operating within their borders. Although their prevalence has diminished significantly in recent years, prominent groups, including Shining Path and most notably the Revolutionary Armed Forces of Colombia (FARC) remain a significant threat. The operations of such groups significantly increase the risk of FDI in the affected countries, including the destabilising impact this has upon governments and society as a whole. Militant attacks upon infrastructure can hamper production; create an increased risk to personnel and increase related costs for security and insurance as businesses attempt to mitigate the risk.

### *Cartels and Organised Crime*

The narcotics trade in Latin America is thriving, and with it, so too are the prominent drug cartels. The increase in violent drug related crime and the widespread corruption this brings with it is of significant concern, undermining the rule of law, significantly increasing the physical safety risk to personnel, and decreasing the reliability of public officials.

Whilst the three factors named above, "ethnic tension", "armed militias" and "cartels and organised crime", were at play in Latin America prior to the emergence of the pink tide, arguably the populist-left has exacerbated them, further illustrating how this group of political leaders is making the region more perilous for FDI. Once again we may look to our shining example of a populist leader, Hugo Chávez, to illustrate the point.

During the recent protests in Peru, the chairman of the Peruvian Congress' National Defence Committee Edgar Nunez said that his committee has evidence that Venezuelan funds appear to be flowing to the protesters through ALBA houses, grass-roots support centres named after Chávez's alternative trading bloc, known as the Bolivarian Alternative for the Americas (ALBA). Chávez has been known to use his country's oil wealth to back "like-minded" politicians and activists throughout the region, particularly those whose objectives would thwart US efforts and trade agreements, and it is believed that his government provided Peruvian protesters with supplies in order to allow them to continue their struggle.

Chávez has previously demonstrated support for the FARC, thus aiding in the destabilisation of Colombia, and imperilling investment projects there. As such groups are known to use the narcotics trade to fund their operations, it may further be concluded that Chávez is implicitly condoning such operations, despite their highly destructive impacts upon the countries in which they operate.

### ***So who might invest?***

There are few issues with investment in countries such as Brazil and Chile. However, the unholy trinity of Venezuela, Bolivia and Ecuador pose far more startling concerns. Particularly in the case of Venezuela, most foreign investors, already wearied by the current economic crisis, are shying away. Investors from certain countries however, are feeling no such hesitancy. China, Iran, and to a lesser extent Russia, have all invested in the populist-left regimes. These countries benefit from the fact that they lack the historical baggage carried by much of the West, that is, they cannot be accused of imperialism and therefore are less likely to be the victim of a populist-left propaganda campaign. Furthermore, increasing ties with these "outsider" countries furthers the agenda of building a counter bloc to the US, and therefore there is an added geopolitical

aspect to increasing trade links between the countries. This again makes the investments of countries such as China less vulnerable, as political considerations may supersede the impetus to enact short-sighted policy decisions intended to increase revenue such as seizing assets.

A further point worthy of consideration from the perspective of western purveyors of FDI, is that the current economic crisis may be forcing some of the populist administrations to play by the rules. As falling commodity prices have significantly reduced the money available to their governments, the leaders of these countries may be forced to offer assurances that they will not resort to the dirty tricks seen in the past. The pressure to attract greater funds so that they may continue to finance the programmes which ensure the loyalty of their support base may compel them to strike a more conciliatory tone. The expropriations in Venezuela in May 2009 are believed to have left as many as 10,000 people unemployed, and in the current economic climate these people are unlikely to be able to find new jobs. If the policies of the government are seen to be detracting from the good of the people, then their leaders may be compelled to encourage investment in an effort to prevent a wave of popular discontent against them, discontent that could threaten the very foundations of their power.

However, the leaders of the populist-left are not renowned for making rational decisions for the good of their countries, and therefore a trivial matter such as the worst economic crisis in eighty years, will not necessarily dictate a change in stance. It may, in fact, prompt more radical, unpredictable, and therefore far less investment friendly, behaviour. Furthermore, with oil prices recovering significantly by the end of June 2009 to highs of over US\$70 a barrel from lows of just over US\$30 at the end of 2008, the strain on Venezuela's budget has eased considerably, illustrating that the gamble Chávez made in not risking alienating his supporters by cutting expensive social

initiatives despite financial constraints, has paid off. This will also provide some reassurance to his allies, who receive significant sums of aid and oil subsidies which are essential to maintaining their own positions.

### ***Looking to the future***

Whilst there are undoubtedly risks involved in investing in countries governed by the populist-left, there are instances when the rewards may still be deemed to outweigh the risk, particularly if the commodity at stake cannot be obtained from anywhere else. One resource which is to be of significant interest in the near future is Lithium. Beneath the expansive nothingness of the Salar de Uyuni salt desert in Bolivia are huge deposits of Lithium. In fact Bolivia is believed to possess 5.4 million tonnes of the metal; half of the world's known deposits. The reason this is of interest is that the world's lightest metal is about to become one of the world's most valuable commodities with the advent of the 'green revolution'. Currently tiny amounts of Lithium are used in laptops, BlackBerrys and other staples of 21<sup>st</sup> century western life, however, in the near future a surge in demand is anticipated as the metal is used in batteries for electric cars. However, Bolivia, like Venezuela, has a long history of turbulent relations with foreign investors, having previously confiscated assets and torn up contracts. The 2006 nationalisation of the oil and gas industry in the country is likely to loom large in the memories of those considering investing in the potentially lucrative resource. It was announced on 14 June 2009 that the government intends to mine for Lithium on its own account and without partners, however President Evo Morales has acknowledged the need for a partner to provide the technological equipment necessary for the processing and industrialisation of the metal. Despite this acknowledgement, a deal is yet to be made. Morales has further stated that he will not grant a lithium "monopoly" to any firm and that he will demand that the state have a majority stake in the income from the

business. With a world lithium shortage forecast for 2015, Morales may have the upper hand, however investors are right to be wary. The worst case scenario is that one of Latin America's poorest countries misses the opportunity to develop, and the resource goes unexploited because of the posturing of the country's leader, whilst an opportunity to significantly reduce greenhouse gases, and therefore the damage caused by climate change, is also lost. The case of Lithium will be interesting as an illustration as to whether it is possible for a populist-left leader to strike a deal with a foreign multinational, which satisfies both partners, and then, most crucially, play by the rules of the game.

### ***Political Change***

In terms of future elections and the perpetuation of the "pink tide" across Latin America, by looking at "what type of left" it is generally possible to predict which way a country will go in terms of prospects for investment. This should therefore give companies the opportunity to adjust their investment plans accordingly.

In countries with an incumbent leader who is a flag flying member of the populist-left, such as Hugo Chávez, who has used democratic means to protect and preserve his position, things will only change if the standard of living of the people deteriorates to such an extent that a movement develops which is of sufficient strength to remove him. Therefore, in the short term, the question for investors is whether the potential gains of operation in a country outweigh the undeniable risks.

### ***Foreign Investors***

The somewhat stunning indictment of the policies of the populist-left, should by no means be taken to imply that companies operating in Latin America bear no responsibility for the position in which they find themselves. It is all too easy for Latin American leaders to accuse foreign companies of questionable business practices, as they have been guilty of committing them

previously. Indeed, some companies continue to practice irresponsible corporate governance which may be highly detrimental to the host country. However, the solution may be this: to set a new example operating in countries with the “right” left. If companies work responsibly, with sustainable investment policies which benefit the people, such as education and training programmes, whilst simultaneously respecting and preserving the environment in which they operate, such business practices will make it far more difficult for a company to be ejected or have its assets seized. Whilst these policies may cost more in the short term, they are offset by the diminished risk of expropriation. Furthermore, they will likely result in the people in neighbouring countries with similar resources clamouring for the same deal and lobbying the government to adopt more FDI friendly policies. This all adds up to a more stable environment for investment, and increased opportunities.

### **Conclusion**

Despite concerns which have emerged about the “pink tide” sweeping across Latin America, investment in the region is not necessarily a fool’s errand, and may in fact be highly lucrative. Countries such as Brazil and Chile are implementing sensible policies and are reliable business partners. This is not to say that they will simply acquiesce to the terms and conditions put forward by investors, however, once terms and conditions are agreed upon, they will be honoured. In stark contrast, there are a number of countries where a dangerous combination of populism, nationalism and exceptional arrogance will triumph over such “trivial” considerations as contracts and legal requirements. In Bolivia, Venezuela and Ecuador there are significant concerns about asset seizures, the voiding of contracts, and the implementation of legislation which increases taxation or is unfairly prejudicial against multinationals vis a vis domestic enterprises. Whilst other factors are at play which increase the risk associated with investment in the region, it may be argued that populist leaders such as Chávez

may actually exacerbate these trends, making an already turbulent situation far more complicated, particularly in the case of tensions between indigenous peoples and their respective governments. Concerningly, these leaders are making moves to ensure that they remain in power for the long haul, and thus any change in the investment climate is reliant upon a movement developing which either forces the leader to change tactics to maintain power, or forces him from power altogether. The implications of political change for the businesses operating in Latin America emphasises the need to closely monitor political developments, for better or for worse, not just during elections but in the longer term, so that companies may make the most of their investment opportunities.

### **PREVIEW OF INKERMAN MONITOR AUGUST 2009**

Despite twenty years of relative stability in Yemen the convergence of economic, political and secessionist challenges are arguably testing the Government’s capacity to rule effectively. This carries grave risks for not only Yemen’s political, sectarian and social equilibrium but also for the potential destabilisation of the greater Middle-East. Yemen has become a strategic hub for Islamic insurgents calling themselves al Qaeda in the Arabian Peninsula, and terrorist and kidnapping activity has risen markedly in recent times. This comes at a critical time for the country affected by the marked drop in oil prices deeply cutting into revenue streams and a growing democratic movement which has the potential to lead to regional instability among Yemen’s wealthier Arab neighbours. The August Inkerman Monitor will seek to address the current security situation in the country, reasons for the perceived instability and the jihadist attraction, whilst seeking to analyse the policies being pursued by Sanaa and implications this has for businesses operating in the region.

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