Modernisation of a Steel Mill

Summary of the Operation Performance Evaluation Review (OPER)

February 2004

THE PROJECT

In 2000, the Sponsor approached the Bank for working capital financing of approximately USD 25 million for its subsidiary. The Company is a relatively small, legally ring-fenced company, which was spun off from a much larger plant in the context of the privatisation of the metallurgical plant which started in November 1996. The Sponsor has a co-operation agreement with the metallurgical plant which regulates the exchange of services between the two companies. In September 2001, the Bank's board approved a Credit Facility to the Company.

PROJECT RATIONALE

The Sponsor wanted to develop an international calibre modern mini-mill with state-of-the-art equipment and improved technology ensuring efficient, low-cost operations. Therefore, the Sponsor participated in the privatisation of the metallurgical plant and committed its funds to the substantial capital investment programme (of some US$ 75 million) for a new mini-mill and related upgrades of the previous outdated and highly polluting equipment. EBRD's working capital facility will assist the Sponsor in building up its global sales presence and delivery reliability. The main rationale for the Bank's involvement was to support this initial and promising modernisation effort in the hope that this involvement would also give a clear demonstration effect to other steel producers of the steps that need to be taken to attract such financing at a comparable stage of their operations.

ACHIEVEMENT OF OBJECTIVES

The operation had as its main objectives: (i) Prove that it is possible to assist with the development of some of the more forward looking companies in the more traditional industries, such as steel production, (ii) contribute as truly additional party to the extension of working capital facilities for a longer period, and (iii) introduce a short-term Environmental Action Plan which is to be implemented over an initial two-year period. The OPER Team is of the view that these objectives have been achieved.

OVERALL ASSESSMENT

Based upon its independent review of the Project's performance to date, the OPER Team assigns it a ***Successful*** performance rating. During the first two years of operations the Company has responded swiftly to the changing steel market. With a slightly longer observation period it may be possible to even allocate a higher rating if the Company continues to manage its production profile, further improve productivity and manage its financial performance. The transition impact of the Project is *Good*. The project financial performance is rated as *Good*. The environmental performance is rated as *Good.* The extent of environmental change is *Substantial.* E.g. the Sponsor's approach to minimising exhaust to the atmosphere from such areas as their melt shop has encouraged the adjacent metallurgical plant to completely refurbish one of their two blast furnaces and add a comprehensive "bag house" to minimise exhausts. The company financial performance is *Good* especially considering the extremely difficult steel market situation in 2001. Due to the Company's flexible response to the market (by very quickly changing the production profile to market needs) the Company has been able to achieve a good financial performance. The fulfilment of objectives is rated as *Good*. The Bank's additionality is classified as *Verified in all Respects.* The Operation Team's handling of the project is rated *Excellent* and the Bank's investment performance is *Satisfactory.*

TRANSITION IMPACT AND THE BANK'S ADDITIONALITY

The OPER team rates the overall transition impact *Good*. The introduction of new technical and management know how combined with new standards for business conduct (accounting, business codes and environmental practices) has a good demonstration effect on other companies in this sector. However, due to the limited scope of the Bank's working capital facility and also due to the very small size of the Company, the impact on the sector and the entire economy is relatively small. Further projects with the Sponsor for efficiency improvements as well as possible projects with the metallurgical plant (supporting their planned switch from open hearth furnaces to electric arc furnaces or converters) are being discussed.

OCE had rated the ex-ante transition impact potential as *Good* and the risk as *Medium.* The OPER team has confirmed this rating and is of the view that the risk rating may deteriorate to medium also from an ex-post point of view if the Government is not able to address the systemic issues (e.g. VAT reimbursement) in a satisfactory way.

BANK HANDLING

The OPER Team rates the Bank handling as *Excellent.* The Operation Team started the dialogue with the Company in November 1995, EBRD hired the consultancy firm, E&E which developed a series of recommendations which were all taken on board by the Company. The Operation Team contributed substantially during the structuring process (in particular regarding the need to set up a ring-fenced structure and adequate infrastructure service contracts between the metallurgical plant and the Company. The Bank had also made the availability of its facility dependent on the Company's prior installation of state-of-the-art steel making equipment. The approach taken by the Bank to insist on a clearly ring-fenced structure with the Sponsor as majority owner and the metallurgical plant as minority shareholder was sensible.

LESSONS LEARNED

Ring-fenced projects can provide positive demonstration effects. The careful definition of the fence and the type of cooperation agreements between the company inside the ring and the conglomerate outside the fence are crucial factors for a successful cooperation and ultimately a positive demonstration effect. This can be enhanced also by having regular coordination committee meetings and fair pricing of services provided by either party.

Importance of good co-operation and open relationships in shared facilities in a large industrial complex. Where companies need to work together in the same industrial complex it is an essential requirement to define suitable structures which facilitate this. In the Sponsor/metallurgical plant instance, daily meetings are held and management information is exchanged in a very open relationship. This clearly keeps the exchange of services at the correct levels at which they should be handled, avoiding or minimising problems.

The need for production flexibility in capital intensive industries to adapt to market circumstances. It is essential to ensure that in addition to having an efficient and low cost production facility, a company also has in place the flexibility to meet varied demands in the market place. The flexibility should incorporate such aspects as alternative products, flexible working arrangements, good marketing techniques and market knowledge, good and regular management information etc.

Small efficiency improvements in steel mills can produce significant financial returns. It is essential that all personnel are fully aware of the need to maximise production benefits such as yield and plant availability. In the case of yield the return of product to the scrap pan in case of steel manufacturing is an expensive exercise and often production operators are not fully aware of the cost of such losses. In many cases incentive bonuses are set against production targets only, whereas yield and prime product incentives can bring good rewards to both employees and companies.

Raw material availability as driving factor for plant utilisation and profitability. The assessment of raw material (ferrous scrap) availability and minimum on site storage of key raw materials needs to consider also country specific factors (abuse of VAT schemes, preference for export of raw materials) which may obstruct raw material supplies. In some of the modern continuous casting machines/plants shortage of raw materials can lead to costly production interruptions and damages to the plant or higher maintenance costs.

Sizing of working capital requirements of exporters in cases of delayed payments due to lack of Government funds. Lack of clarity in the application of local laws as well as shortage of Government funds may lead to strains in legally prescribed reimbursement mechanisms (e.g. VAT refunds on exported products) and needs to be considered when determining working capital requirements and/or seeking of assurances from the Government prior to project approval.