Pharmaceutical company

Summary of the Operation Performance Evaluation Review

THE PROJECT

The project involved a joint stock pharmaceutical company (the Company) based in south-eastern Europe. The Company was founded in the 1930s as a private company with 15 employees for the production of narcotics using the morphine extracted from locally grown poppies. Later it was converted into a state-owned factory. In the mid 1990s, the Company was privatised through a management/employee buy-out, under the *Law on Transformation of Enterprises with Socially-Owned Capital*. The Company has currently four profit centres: (i) pharmaceutical products; (ii) fine chemicals and cosmetics; (iii) botanical; and (iv) coating.

In 1997, the Company embarked upon its largest ever investment programme, over €30 million to upgrade and modernise its pharmaceutical facilities in pursuit of Good Manufacturing Practice (GMP) certification. To assist with this programme, the European Bank for Reconstruction and Development (the Bank) approved a senior loan with a convertibility option of over €8 million in July 1999. The International Finance Corporation (IFC) approved a loan for the same amount under the same conditions.

During the project's appraisal, the Bank's Board and Operations Committee highlighted the risks associated with the Company's trade receivables from the National Health Fund representing a considerable proportion of its sales. In mid 2000, the National Health Fund stopped undertaking its monthly off-take obligation. This adversely affected the Company's liquidity position. Despite the liquidity problem, the Company declared dividend payments to its shareholders breaching the financial covenants. The liquidity was highly constrained in 2001, at the end of which the Company borrowed more than twice the maximum short-term loan permitted in the loan agreement.

The project facilities under Phase 1 were substantially completed in early 2003. Shortly afterwards, the Company obtained the GMP production certification pursuant to the European Union Directives and the World Health Organization.

The Company was the first in the country to use a factoring scheme to collect overdue trade receivables. This action increased its cash in hand and enabled it to prepay part of the loans to the Bank and IFC in December 2003. At the same time, the Company requested the Bank and IFC to release part of the mortgaged assets in order to reduce the financial costs on the short-term domestic borrowings. While the Bank and IFC were consulting with each other about the request, the Company sent a prepayment notice for the outstanding amount of the loans. It also requested to cancel the commitment for Phase 2. The Bank exited from the project in July 2004.

PROJECT RATIONALE

The project was justified for its significant transition impact from the transformation of a conventional local industry leader into a proactive market player of Western standards, and due to the positive environmental impacts from the upgrade of production facilities and the implementation of the Environmental Action Plan (EAP).

From the client's viewpoint, the Bank's investment was expected to provide the Company with the capacity to perform ahead of its competitors in the region and to compete in the Western market.

ACHIEVEMENT OF OBJECTIVES

The objectives of the project were as follows:

1. Upgrade and modernise Phase 1 facilities to Good Manufacturing Practice (GMP) standards.
2. Upgrade and modernise Phase 2 facilities to GMP standards.
3. Establish a partnership or other form of cooperation with an international pharmaceutical company.
4. Penetrate into new markets, particularly in western Europe.

Phase 1. Phase 1 was completed with a 34-month delay. In late 2000, the enlarged project scope increased the project costs by about €5 million, part of which was offset by savings from competitive bidding. The construction and upgrade were completed at the cost of €22 million, which was about 30 per cent higher than the original cost estimate. The increase of the costs and the delay were attributable to achieving full compliance with the current GMP. EvD considers that the objective was satisfactorily fulfilled despite the 34-month delay and the 37.3 per cent increase in costs.

Phase 2. The Company did not intend to execute Phase 2 under the EBRD investment and tranche 2 was accordingly cancelled in July 2004. The delay of Phase 1, coupled with the renewed GMP requirements in 2002, made the scope of Phase 2 outdated. The Company has decided to review the investment programme against the current GMP and launch a new project in the near future. The Bank's assistance is being sought for the new project.

Strategic partner. A search for a suitable strategic partner is in progress. The IFC's Industry Advisor provided guidance to the Company and the EBRD also encouraged the Company to identify a potential strategic partner. Some deals were considered during 2000-02, but none of these came into fruition. From the latter half of 2003 to 2004, some offers for acquisition were made, but did not reach a mutually agreeable condition. Therefore, the objective has not yet been achieved to date.

Based on all the above assessment, EvD has rated the achievement of the project objectives as *Marginal.*

OVERALL ASSESSMENT

An overall rating of *Partly Successful* was given to the project. The achievement of objectives was *Marginal* given that strategic partners have not fully emerged yet and that Phase 2 was not implemented and the loan was prepaid in full. In addition, direct equity investment through the conversion did not take place, although it was an important investment agenda. The financial performance of the Company was *Marginal* with stable sales and limited cash flow. The Bank's investment return, given 3.7 per cent against 4.1 per cent at appraisal, due mainly to relatively high administrative costs and the prepayments of the loan, was rated as *Marginal*.

During the investment period, the Company experienced a turnaround, giving an overall transition impact rating of *Good.* As the Company enters into Western markets, risks associated with transition potential are *Low* and the longer term transition potential is considered *Satisfactory.* The Bank's additionality was rated *Verified in all respects.* The project has been properly monitored by the Bank and the Bank Handling was rated *Good.*

The environmental performance of the project was overall rated *Satisfactory,* although part of the EAP and the company-wide environmental agenda were not implemented. The induced environmental change of the project was *Substantial* because of the significance of the GMP standard on the Company's core business.

TRANSITION IMPACT AND THE BANK'S ADDITIONALITY

EvD's assessment of transition impact was *Good* and risk to transition potential was *Low*.

Positive transition impact at the corporate level has set standards for corporate governance and business conduct. This comprises:

(i) the shift of accounting standards from the country's accounting rules to the International Accounting Standard (IAS) (achieved with the assistance of BAS consultants)

(ii) the introduction of a cost accounting function to assess the production costs, which will be used for sales and marketing strategy

(iii) the segmentation of the business and divestment analysis with the assistance of TAM consultants

(iv) the ongoing lay-off programme using an early retirement scheme.

Compared with the appraisal period in 1998, the number of employees has reduced by 30 per cent and the productivity increased by 52 per cent in 2003.

Transition impact at the industry level was manifold. This has encompassed the demonstration effects, the establishment of new domestic standards for corporate governance and business conduct. In addition, there has been skills transfer derived from (i) the country's first GMP certification; (ii) the search for an international strategic alliance; and (iii) an international standard insurance coverage.

Transition impact on the economy as a whole was also considered significant. This included a demonstration effect of the EBRD loan on the country's financial market; the economic benefits from the cash injection and job creation in the local economy; enhanced competition on the quality of products; and market expansion as a new entrant from the region.

EvD considers that the Bank's additionality has been *Verified in all respects*. The unavailability of long-term debt financing was a serious problem in the country's capital market at appraisal time. The Company's management advised EvD that the cooperation with the lenders has been served as a credential and has increased the presence of the Company in the region.

ENVIRONMENTAL IMPACT

EvD evaluated the environmental performance of the project and the Company as *Satisfactory* and the extent of environmental change as *Substantial*.

At appraisal, the Project fully integrated the environmental components, which were expected to raise the Company's environmental awareness and compliance with international standards through the implementation of the EAP. The EAP consisted of the two components (the lenders' component and the company's component). The lenders' component,[1] which was included in the new facilities, was successfully implemented. The original cost estimate was €2 million, which compares with €2.4 million of actual costs. On the other hand, the achievement of the component financed solely by the Company was considered disappointing despite the high environmental profile of the project. In monetary terms, the actual implementation of the Company's component was 4 per cent (about €50,000). Due to the investment priority to the new facilities and financial constraint, the gap in the environmental standards is widening between the GMP facilities and the existing facilities in three other business segments.

BANK HANDLING

EvD assessed Bank Handling as *Good* overall.

MAIN OPER ISSUES AND LESSONS LEARNED

A client's reasonable request to amend the Bank's collateral requirement should be considered. The circumstances of a project change over time. The relevance of some conditions set at appraisal may diminish during the implementation of a project and may sometimes require adjustment. In this case, the borrower is compelled to prepay the loan since the release of part of the mortgage had not been accepted by the lenders within reasonable time. In the Bank's countries of operations, collateral on immovable assets is often required to secure a short-term loan, which would otherwise be costly. In the project, alternative ways could have been sought for taking up the client's justifiable request while ensuring the Bank's security requirements.

Co-financing could reduce the Bank's flexibility. Co-financing terms and conditions need to be carefully designed, when several strategic decisions, such as an equity conversion, are anticipated during the implementation of a project. During the long implementation period, the co-financier may change the strategy of the project. As a result of a change of the project officer, the distance to the client, or a shift of investment strategy, for instance, the co-financier may divert from its original aspiration for the project. Co-financing terms require a long-sighted perspective. Maintaining the shared approach with the client is important when the lending terms require collective decisions.

The borrower's commitment to financing the environmental component of a project may result in uncertain implementation when financial constraint occurs. The implementation of the environmental component, which, in this case, was supposed to be financed from the borrower's own funds, could be uncertain in

[1] This component was financed from the Lenders' loans and Alkaloid's own funds.

financing terms and inadequate in technical terms. Therefore the borrower may require professional guidance and the assurance of budget at appraisal.

A site change can require a review of special measures needed for the environment. In cases where a site change takes place during the implementation, for instance from brownfield to greenfield, specific attention needs to be drawn to environmental issues. A review can be done to establish whether special measures are required in respect of the environment, which may lead to changing the Bank's project environmental classification. For this particular project, however, no adverse impact of the site change has been seen and the lender's supervisor advised that the site was clear.

Differences in the calculation methods used by the auditor and the Bank, or unavailable financial figures, may lead to a different judgement of the financial statements of the borrower. Different accounting practices could make the monitoring of the financial covenant difficult. The Bank needs to ensure the monitoring readiness for financial covenants during financial due diligence, particularly the availability of necessary figures and consistency of the calculation method with the Bank's own practices in the context of the financial accounts of the borrower.