Food company multi-project facility  
Summary of the Operation Performance Evaluation Review  
August 2005

THE PROJECT

The Company is one of the leading food companies in the world. Under a US$ 100 million multi-project facility (MPF), the Bank has the right to participate in any investment contemplated by the Company in eastern Europe and the former Soviet Union, with a contribution between 20 per cent and 35 per cent of the individual projects’ share capital. The Bank has a put option on the Company to be taken between five and eight years after the investment date. The put option will be exercised at fair market value (FMV) to be determined by an independent expert appointed jointly by both parties. When the MPF was last renewed, the Company requested and obtained an amendment referred to as the “cherry picking” option, a departure from its former obligation to offer the Bank a participation in every new investment made in the Bank’s countries of operations. Presently, the Bank’s equity investments are concentrated in four subsidiaries involving eight operations.

PROJECT RATIONALE

When the MPF was approved, the Bank’s involvement was motivated by:

• its ability to finance, through the MPF approach, projects of a small size that would otherwise not have justified the Bank’s investment
• its additionality, since the Company would be induced to invest more aggressively in countries where it requires the political comfort afforded by the Bank
• its contribution to the transition process, including the development of the domestic market, restructuring, privatisation and modernisation of key sectors of the food industry, the introduction of forward and backward linkages with the distribution, packaging and agricultural sectors and the transfer of significant technological and managerial know-how.

ACHIEVEMENT OF OBJECTIVES

All investments under the MPF have achieved their objectives, with varying degrees of success depending on the relevant subsidiary. The Evaluation Department (EvD) has given the project a rating of Good for the achievement of objectives, taking into consideration that very few situations of under-achievement have been observed while an overwhelming majority of objectives have been achieved and in some cases over-achieved.

OVERALL ASSESSMENT

EvD’s overall rating for project performance is Successful, based on the following considerations:

• Transition impact is Good given the uneven performance of some of the projects. It should be noted that a better rating is warranted for the projects where the Bank’s exposure is higher.
• Environmental performance is rated Good due to the lesser number of greenfield projects and their better performance compared with brownfield projects.
• Environmental change is Substantial.
• The Bank’s additionality for the MPF deserves the highest rating from a historical perspective. However, the MPF is renewed every three years and, in the present period, the absence of new opportunities under the MPF is indicative of the Bank’s deteriorating
additionality. The assigned rating is therefore *Verified at large*.

- On average, the financial performance of projects under the MPF is moving from marginal to *Satisfactory*. This is due to a combination of poor equity rates of return on the project which the Bank has exited and the uneven performance of projects which are still on the books. The largest project under the MPF which the Bank has invested in, however, is performing above expectations. The Bank has some flexibility in managing the timing of its exits. At present, the underperforming projects are showing clear signs of improvement. It is, therefore, reasonable to expect that a *Satisfactory* rating for financial performance will eventually be demonstrated.
- Both fulfilment of objectives and bank handling are rated *Good*, a commendable achievement in the context of several projects in different sectors and different countries.

The MPF has had a significant demonstration effect and has been replicated by the Bank with a number of foreign sponsors in the agribusiness sector. In several instances this was at their own request, based on the visibility acquired by this MPF.

**TRANSITION IMPACT AND THE BANK’S ADDITIONALITY**

EvD has rated the MPF’s overall transition impact as *Good*. Some of the less successful operations are still struggling to break even. One is now well into its recovery phase, while the Bank has exited from another with nil return on equity. This has slowed the implementation and associated benefit of the Company’s standards in management, competition, market expansion, product development or skills transfer. The inherent demonstration effect of both the Company’s and the Bank’s investments are more convincing in the successful operations. The uncertainty over new opportunities for the Bank to co-invest casts a slight shadow over the long-term prospect for the higher rating to prevail.

**BANK HANDLING**

The Banking Team has selected a first-class food and packaging conglomerate. The Company’s commitment to the Bank’s countries of operations has delivered investment opportunities in size and volume broadly in line with expectations, with an 82 per cent utilisation of the MPF at present. This MPF pioneered the framework approach in the Bank and as such must be on record as a successful structure that paved the way for many more framework agreements subsequently put together. EvD notes that the agreement provides for the FMV of equity investments, at the time the Bank exercises its put option to the sponsor, to be determined by a third party expert. Implementation of this expensive provision would have been particularly unrealistic for small investments. This was indeed recognised by both parties when they agreed to start direct negotiations at the time of the Bank’s first exit.

The introduction of the “cherry picking” option is to a large extent justified by the significant change in the credit and political risk perception of the countries where the Bank co-invests with the Company. The relationship between the Bank and the Company is efficiently organised with the appointment of a relationship co-ordinator by each party. This person helps keep the broad interest of the overall relationship at the top of the agenda, even when difficult negotiations on specific points take place. The Bank’s return on equity is likely to be satisfactory but far from the original expectations of 18-28 per cent under each sub-project.

The Bank, under the MPF, has delegated environmental due diligence to the Company, subject to summary reporting to the Bank. Such a delegation appears to be justified on the basis that the
environmental policies and standards implemented by the Company meet the Bank’s requirements.

Evd notes that all disbursements under the MPF have been approved either through a reporting or a no-objection basis. This conforms to the approval process given under the original MPF. One facility was approved on a no-objection basis on grounds that the new commitment of €17.5 million was below the €20 million limit. From a credit standpoint, approval for the second investment should consider the aggregate amount of both investments and this rule ought to apply to the approval process by the Board. This would have required full approval by the Board for that facility.

**MAIN ISSUES AND LESSONS**

**Lesson:** Enhanced environmental performance can be achieved through greenfield investments. The Bank stands a better chance of achieving higher environmental performance with greenfield projects. Reputable FDI investors are better able to ensure performance standards in plants designed and built to their standards, while working with existing plants presents a different set of challenge.

**Lesson:** The Bank is better protected if it engages in negotiations on the value of an investment when a put option is exercised. Generally, the Bank has a window of opportunity during which a put option can be exercised. It should therefore apply the same rationale to optimise the value of its equity as it made when determining the timing of the put. Second guessing how a third party expert will value such an investment is not satisfactory when deciding the timing to exercise the put option. Third party expertise is therefore best used as a last resort solution to remedy a possible deadlock situation.

**Lesson:** When the Bank has a put option on true equity investments, the methodology for future valuation should, whenever possible, be stipulated in the documentation. While this may be difficult to negotiate when investments are made simultaneously with the sponsor, it should be easier in situations where the Bank is purchasing shares in an existing company. In this case, the same criteria/multiples that have been used for purchasing the shares could be used in the valuation of the put.

**Lesson:** Where the Bank is a minority shareholder along with a strategic majority shareholder, the Shareholders Agreement should seek to clarify the treatment of all inter-company charges. This should take into account the future valuation of the minority shareholders’ equity. The agreement should also protect the equitable share of income distribution among shareholders. Although domestic accounts may not reflect all inter-company charges, this should not become an issue at the time of exit since their legitimacy would have been established at the outset.

**Recommendation:** Risk correlation should be regarded as the key factor in determining the appropriate level of Board approval required for sub-projects signed under framework operations. This would allow the Board to apply greater scrutiny to sub-projects that are not ring-fenced and are built in successive phases, while assuming similar types of credit risk. It would be appropriate for the Bank’s Risk Management Department to indicate on a case-by-case basis the extent to which a new operation under a framework agreement is closely correlated or not to an existing one.