Summary of the Operation Performance Evaluation Review
Review evaluation of an equity portage investment in a tyre manufacturing plant
October 2006

THE PROJECT
In December 2001 the Board approved an equity portage investment by the Bank for a maximum amount of US$ 20 million to take a share in a tyre manufacturing company.

The operation consisted of the acquisition of an old factory to create a new tyre manufacturing plant after renovating the old building. This was one of the first direct investments by a foreign manufacturer entering the market on its own. Competitors were until then either selling imported tyres or attempting to set up joint venture production facilities with local tyre manufacturers. Total project cost, including US$ 8 million working capital, was estimated to reach US$ 71.7 million, of which US$ 40.1 million (56 per cent) would be financed through equity, US$ 8.6 million through internally generated cash and US$ 23 million (32 per cent) would be financed by commercial banks. The company planned to produce two types of tyres: a top brand and an intermediate brand. The target was the car replacement market for premium and medium segments. As the company was already marketing its products in the country, the locally produced tyres would be substituted for imported tyres, while some of the local production would fit the company’s range of tyres sold in neighbouring countries. Some segments of the market would still need to be supplied from outside the country. The company’s pre-existing marketing activity was included in the project.

PROJECT RATIONALE
At the time of approval, there was virtually no involvement of foreign tyre manufacturers in the manufacturing sector in the country. Local production was based on outdated equipment and technology, serving the lower to medium quality segments of the market. The company’s decision to pioneer foreign direct investment in the sector on its own was expected to have significant transition benefits. More specifically, the following potential transition impacts were identified:

- Demonstration effect associated with the entry of the first strong strategic investor into the sector with important signals for both the other large multinationals currently considering investing in the country and the domestic participants.
- Strengthening competition within the project sector especially in the medium and premium segments of the market mainly through higher product quality, innovation, technological know-how, marketing, environmental and other industry standards.
- A gradual shift of raw material procurement from almost exclusively importing at the beginning to a more local content balanced situation over time.

ACHIEVEMENT OF OBJECTIVES
The targets set at approval were not met within the planned time. By 2005, the company was to reach full production capacity of 2.1 million tyres p.a., become profitable with EBIT of US$ 23 million and a net profit of US$ 17 million. Due to delayed start up and a change in marketing strategy to adjust to a more upscale demand from the market than had been anticipated, total production in 2005 was only 1 million tyres. By the end of the year, annualised daily production was actually 1.5 million tyres. The company posted a net loss of US$ 4.8 million with an EBIT of US$ 8.4 million. Such an underperformance is not however a structural problem. The estimated 11-month delay is to be compensated by a production with higher value added, which ought to generate larger revenues than planned. The company’s latest forecast call for full 2.1
million units production to be reached in 2006, with a net profit of €3 million (approximately US$ 3.75 million). Since the company is well on track to achieving, with some delay, its original quantitative objectives with greater potential due to the higher value of the goods produced, this objective can be regarded as being achieved.

The decision to speed up investments in the mixing shop allowed for better quality tyres to be produced locally. The company is competing in the first two lines of the replacement car and truck market, which is where all foreign manufacturers are positioned. The winter tyre has been specially conceived to suit the car market in the country. The company believes that it can significantly increase its market share by producing tyres domestically that have been tested to perform at least as well than competing imported winter tyres, at a lower price than imported foreign products. The objective of qualitative performance has also been achieved in the development of the company’s points of sales through its network of dealers and branded partnerships. In 2006, 120 points of sale for car tyres and 30 points of sale for trucks will have been established throughout the country. Considering the improved quality of the company’s domestic production, compared with original plans, and the fast spread of its points of sales in the country, the qualitative objectives have been over-achieved.

The company’s intention was to select local suppliers of raw material gradually although it owns two rubber plantations and will also source non synthetic rubber through imports. Other inputs such as carbon black, synthetic rubber and steel could in turn be procured locally. Only two years after initial production, the company is already sourcing approximately 50 per cent of its raw materials domestically. While no specific target had been set for this objective, it clearly is a significant achievement, in the context of very strict quality controls implemented at the plant.

Notwithstanding almost one-year delay incurred in the implementation of the project EvD assigns a good rating to the project’s achievement of objectives in view of over achievements in terms of higher value of production and impact on the domestic economy.

OVERALL ASSESSMENT

As will be seen in the next paragraph, transition impact is only rated good although the project would have intrinsically deserved a higher rating, had it not been for the administrative harassment of which it remains the unwilling target. Objectives are being fulfilled albeit with some delays. The project’s environmental performance would also have scored a better rating than good if the expansion of the mixing shop had received appropriate clearance from ED. It was noticed, however, that it does not appear to have resulted in any particular nuisance and the extent of environmental change is unquestionably substantial, given the state of the site prior to its acquisition by the company. The Bank’s additionality is verified at large as the company highly values the comfort provided by the bank’s visible presence as a stakeholder in the project, a critical condition for the sponsor to originally move ahead with the investment. The project financial performance is still only satisfactory but this is due to the operating delays incurred at the outset and it is well on track to meeting or exceeding original targets; the overall profitability of the company, including its marketing activities across the country through a rapidly expanding retail outlets network, is stronger and rated good. The insufficient attention paid by the team to the environmental implications of the expansion of the mixing plant caused the bank handling rating to score no better than good but the Bank’s Investment Performance is rated excellent1. EvD therefore regards the project as deserving an overall successful rating.

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1 This is somewhat overrated by the EvD standard model, as it results primarily from a cost allocation lower than forecast at approval. Please refer to the relevant explanatory note in Appendix 2.
TRANSITION IMPACT AND BANK’S ADDITIONALITY

In most respects, the project has been a strong contributor to transition impact, at the corporate as well as at the industry and the local economy levels. This is largely due to the favourable market conditions that created the right environment for the project to be economically and financially successful. The delays in reaching targeted levels of production will not be significantly detrimental to the company’s performance as it will be compensated by the higher value of the production. This has a strong demonstration effect through delivering same quality standards as imported products. The company, on the other hand continues to be faced with an unexpectedly high level of inspections and bureaucratic harassment, as was the case when it first sought to buy land and to obtain planning permission for expatriate housing. In spite of very high standards of corporate governance and business conduct, a degree of transfer pricing is known to exist in the handling of intra group imports and exports, though necessarily mitigated by the highly competitive market environment. Transition impact is assigned an overall good rating while it could be expected that this would improve in the future, particularly if a follow-on investment materialises.

At approval, the banking team justified the Bank’s additionality on two grounds: the non-availability of long-term financing in the country and the political comfort derived by the company from its partnership with the EBRD in a country where bureaucratic harassment and loose regulations could complicate matters, particularly for a first direct investment. The long-term financing obtained from the Bank through portage equity with a put on investment grade counterparty does not make a very convincing case for financial additionality.

No decision has been made yet regarding a possible expansion of the facilities but the company has initiated discussions with the regional authorities to secure land acquisition rights in case the go-ahead is given in 2007. The Bank would expect to play a role in the possible financing of such potential further investments. This would confirm that EvD’s verified at large rating of the Bank’s additionality at the time of approval is still justified.

BANK HANDLING

Project selection was excellent: the sector was undergoing significant restructuring and benefited from the positive demonstration effect of a leading international manufacturer who, in turn, was comforted in its investment in the country by the support provided by the Bank through its equity portage. Other major tyre manufacturers have followed the company’s example and this resulted in new business opportunities for the Bank.2 The project was structured with an unconditional put option after five years on an investment grade counterparty, which significantly mitigates the Bank’s risk. Nevertheless, compliance with applicable environmental and workers health and safety laws and regulations has been duly covenanted.

The relationship with the company appears to be excellent as was confirmed by the local finance director to the OPER team, in a telephone interview. The Bank’s initial support to the project is very much appreciated; regular contact has been maintained with the previous as well as the more recent OL. The Bank discussed local currency term financing to the company but commercial banks appear to be more competitive. Similarly, since the company has been allowed to borrow directly from its parent holding company it benefits from intra group foreign currency funding at conditions that could not be matched by the EBRD, and presumably by commercial banks, even with a parent guarantee. There is scope for the Bank to participate in a

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2 It is noteworthy that none of the competing clients appear to have objections to the fact that the same OL is their relationship manager including as well as the Bank’s nominee to the board of one of them.
possible follow on project, should the company move ahead with an expansion project next year. The finance director did not rule out a new equity investment by the Bank.

In the absence of appropriate clearance of environmental issues relating to the expansion of the mixing shop, bank handling is only assigned a good rating as opposed to the highest one.

LESSONS LEARNED

When modelling the cash flow forecast of a project, it is important to assess the risks associated with administrative delays and to account for the relevant contingent cost. Such a contingency is different, and additional to, the typical contingencies for higher cost of procurement, FX variations and standard delays in construction. It is most likely to materialise as a start up delay but could also be felt in the course of the project which is more costly as running financing cost are then higher.

The Bank’s additionality in portage equity is unlikely to be justified by the unavailability of term financing in the country of investment. It is misleading to emphasise the lack of long-term funding alternatives from other lending sources as evidence of the Bank’s additionality when exit from portage equity is structured on a cost-of-fund basis. The Bank’s risk is equivalent to making a term loan to the put option obligor. There would normally be no scarcity of availability in respect of amount, currency or maturity in this context. The Bank’s additionality should therefore be analysed on the basis of the comfort that the sponsor is seeking out of the Bank’s partnership as a stakeholder in the investee company. The most obvious test of additionality would be the premium over cost of fund that the sponsor is prepared to accept through the pricing of the put option, in relation with the spread quoted for similar maturities by the commercial banking sector on debt of the same obligor. Other relevant tests can also be met through design and functioning.

The banking team must refer any significant contemplated CAPEX affecting EH&S to ED. This is important as the creation of potential new hazards could be regarded as a material change in the project. ED would need to have an opinion on the level of approval required as well as on the process to be followed such as the requirement for public consultation or an EIA. Even if the financial impact on the project profitability is positive and credit considerations are of little concern, such projected investments must be scrutinised by ED.