Investment in a local cosmetic company

Summary of the Operation Performance Evaluation Review

October 2006

THE PROJECT

The Bank made an equity investment via a regional venture fund into a local cosmetics company in order to assist in a major restructuring process. The old style commodity type products, outdated technology and production driven management, resulted in declining sales and low levels of capacity utilisation. A local businessman acquired control of the company and built a strong new management team. He was able to fundamentally restructure and modernise the production facilities as well as make acquisitions abroad. The company managed to position itself as one of the country leaders in the perfumery and personal products industry with significant shares in skin, hair and dental care, perfumery and household goods (detergents) markets. The restructuring of the company and the move from commodity products to a majority of own branded products were highly successful, as illustrated by the excellent result of the IPO in 2004 and the good performance of the company's share price.

PROJECT RATIONALE

The main rationale of the majority owner was to seek a financial investor to participate in the restructuring of the company, with the target of a future IPO. The Bank supports regional venture funds and was seeking regional investment opportunities in Companies willing to restructure to international standards, with a highly motivated management that would ultimately achieve successful growth and excellent financial performance. One of the Bank-supported Venture Funds was well positioned to make this investment and provide the active supporting role that both sides were seeking. The Fund's main objective was to make equity and equity-related investments principally in medium-sized companies in the country with the objective of achieving long-term capital growth.

The Bank's rationale was to support a profitable mid-sized company in the country where the owners are committed to business expansion and modernisation. The continued support of a company undergoing successful post-privatisation restructuring was considered to have a positive demonstration effect. The company had already adopted and maintained high standards of corporate governance, transparency and environmental management under the Bank's prior equity investment. The Bank was also of the view that the financing of the capital expenditure programme would improve product quality and production efficiency allowing the company to reach up-to-date technology standards and to compete with the best international and local producers.

ACHIEVEMENT OF OBJECTIVES

The Venture Fund was able to prepare, negotiate and successfully support various improvements in Corporate Governance, accounting systems, Management Information Systems etc. As per the original intentions, the equity exit by the venture fund took place within the 3-5 year timeframe. The Venture Fund sold its shares for approximately US$ 21 million and achieved an excellent return on the initial US$ 10 million investment. One of the two independent Board Directors nominated by the Venture Fund continues even after the Fund's equity exit as Chairman of the Board of the company. The company has successfully implemented a substantial upgrading programme of production facilities and packaging lines. State of the art machinery from leading international manufacturers was imported and installed and workers were retrained in order to operate this highly automated equipment. The company was not able to acquire the Target on the basis initially defined. The company requested a change of utilisation of this portion of the Bank Loan to finance additional plant upgrades. This was approved by the Bank. The corresponding upgrades of creams and shampoo production and packaging lines were also successfully undertaken by the company.

OVERALL ASSESSMENT

On the basis of its independent review of the Operations Performance (both equity and loan operations) to date EvD assigns it a *highly successful* performance rating. The overall transition impact is rated *excellent* based on the transformation of a stagnating previously state owned company into a transparent and state of the art modern company with a strong market position with branded products. The Operations have had a strong effect during the restructuring and subsequent consolidation phases. The Bank's earlier decision to consolidate several EBRD sponsored venture funds under one fund manager made it possible to make a sizable investment as requested by the majority owner. The continued support of the company through the loan operation was useful in order to achieve the desired demonstration effect that successfully restructured companies meeting the international requirements (e.g. regarding accounting and transparency standards) are better able to secure international long term debt financing. The operation ratings are summarized in Appendix 2. The company's financial performance rating is *excellent.* The fulfilment of objectives is *excellent.* The environmental performance of the company is *good* and the amount of environmental change is *some.* The Bank's additionality is *verified at large.* Fulfilment of objectives and the Bank's investment performance is *excellent.*

TRANSITION IMPACT AND THE BANK'S ADDITIONALITY

The OPER Team rates the overall transition impact as *excellent*. Progress on the skills transfer is *good* since the company decided to offer its existing staff retraining opportunities and higher qualified jobs in the new production lines incorporating latest technology. The company has achieved international standards at all levels of its operations at headquarters and has created important demonstration effects. The company is in the list of 50 most transparent companies in the country. The introduction of independent directors to the Board was a positive signal, as well as the broadening of the private ownership through the IPO and subsequently by reducing the majority shareholder's stake to below controlling level.

BANK HANDLING

The Bank had set up various Regional Venture Funds (RVFs) in the country and by the end of 2001, the Bank's funds had invested over US$ 530 million in more than 150 companies. The RVF program was streamlined in the late 90s to increase efficiency and prepare for conversion to funding predominantly by private capital. A new management team took over the management of three funds targeting Siberia and the Volga region. The advantage of this consolidation was that the fund managers were now able to make investments of up to US$ 10 million per opportunity rather than a maximum of US$ 4.5 million per investment as was the case before.

The loan operation originated from close contact with EBRD and the fact that the company was familiar and comfortable with EBRD requirements. The long term loan was sought to finance capital investments and/or target company acquisition. The Bank's team was responsive to the client's requirements and the Bank offered a loan with larger size and longer maturity than other commercial banks at that time. The team was able to convince the Opscom and Credit that this was a well structured operation with an appropriate risk/reward relationship.

The OPER Team rates overall bank handling as *good*. The Bank's investment performances of the equity is *excellent*, the investment performance of the loan is good.

LESSONS LEARNED

Selection of the appropriate partner for restructuring and value optimisation. The majority shareholder of the company decided to restructure the company with a financial partner rather than with an international technical/or industry partner. This can sometimes contribute to better align interests among shareholders. In this case the financial partner also had as its main focus the preparation of a successful IPO within a 3-5 year time period. It was felt at the time that an industry partner might have had other objectives too and might in particular seek a majority stake at an earlier stage, which might not always lead to a value optimisation in the interests of the initial shareholders.

Careful planning of plant modernisation programme in a locally owned manufacturing company can improve product output, quality control and productivity. The selection, procurement and installation of new production lines of the latest standards in locally owned manufacturing companies can facilitate achieving improved output, quality control and higher productivity. Experienced engineers of the supplier can train the operating personnel and ensure the adherence to international standards. These plant upgrades enabled this domestic company to start immediately with the production of branded products with the latest design, formula and technology in order to compete successfully with multinationals.

Definition of acquisition criteria in order to achieve cost reductions. The definition of detailed acquisition criteria was undertaken prior to the identification of a suitable target company. The target-oriented acquisition of a German cosmetics company contributed fairly quickly to improved financial results, costs reductions and increased sales in the country and Europe.

Positive influence of venture capital partner on investee company. The board presence of the venture capital partner can increase management efficiency and facilitate implementation of Western business practices. In this case, the independent directors were accepted as equal partners bringing in a balancing effect on the strategic decision making. They contributed to the implementation of proper monitoring and steering processes that contributed to an improved perception and valuation of the company.

The importance of regular interaction between venture capital investor and investee company. Intensive and regular interaction at all levels between the venture capital investor and the investee company is crucial for a successful outcome. In this case the venture fund manager was committed to supporting change in the business culture of the investee company and set up regular communications at different levels: Board, Finance Department etc. Initially Board Meetings took place once per month then every two months thereafter. More regular meetings took place with the financial analysts. Through this intensive interaction at different levels from the outset, the venture fund management was part of the team that influenced and changed the business culture. It was also easier to identify issues early on and to contribute to solutions.

The importance of branded products for company growth in the highly competitive cosmetics products sector. Branded products are essential for expanding market share in the fast growing consumer market. International brand names have aggressively entered and defined new standards. In this case, the company's strategy to give priority to branded products turned out to be the key to success. Globally the consumer market has moved to local and global brand names. Local producers that cannot invest heavily into branded products are at risk to lose market share especially when the global brands start building up distribution systems supported by advertising campaigns. The introduction of branded products was supported by concentrating on combined measures from the plant modernisation programme, continuing quality improvements and extension of the product range. The modernisation programme increased productivity and operating efficiency and reduced manufacturing personnel by 20 per cent. New packaging machines also facilitated the adoption of international standards for presentation and packaging.

Prerequisites for a successful IPO of a local consumer products company. Prerequisites for a successful IPO include a highly motivated management which strives for product innovation and positive sales growth in the main markets, sound financial performance, adoption of international accounting standards and corporate transparency. In this operation the company's approach from the outset was focused on a successful IPO in 3-5 years time. This meant giving high importance to all crucial ingredients, international accounts, modern management systems, improved sales and market share with mainly branded products. The successful IPO confirmed the validity of this approach.

Importance of flexibility in the use of loan proceeds. Changes in the utilisation of loan proceeds may be in the interest of borrower and lender. In this case, obtaining an early change of utilisation of proceeds allowed the company to step up plant modernisation measures in order to increase the range of brand production for immediate market penetration which was important in the positioning against the pressures from multinationals entering the domestic market. This timely and successful step increased internal cash generation which then was used for the acquisition of a German cosmetics company which added further international experience, brand products and access to interesting markets.