Loan to edible oil manufacturer

Summary of the Operation Performance Evaluation Review

April 2006

THE PROJECT

The Company was established in 1949 as the largest sunflower oil manufacturing plant in the country. It was privatised in July 1993 as a private closed joint stock company. The EBRD has developed several projects with the borrower over the past decade, the latest receiving approval in 2005. This evaluation concerns the fourth project and refers to the impact of the third project as it is relevant to the project.

In July 2001, the Company gained a new foreign owner. In late 2002, the foreign owner was acquired by a global agribusiness giant (listed on the New York Stock Exchange) planning to expand its edible oil operations in central and eastern Europe and the Commonwealth Independent States. It considered the Company to have a stronghold in those target regions.

PROJECT RATIONALE

The large international sponsor acquired the Company to take advantage of the Bank's preferred credit status in uncertain markets and the difficult investment climate in the country. The Bank saw the strengthening of regional cooperation with large international sponsors as the project's primary rationale. Secondly, the Bank wanted to advance the momentum gained from the previous projects further in the country's agribusiness sector.

ACHIEVEMENT OF OBJECTIVES

The project objectives were as follows:

1. provide working capital to allow the borrower to purchase sufficient seeds
2. raise brand awareness in the country's edible oil market
3. support the borrower's exports.

Overall, the Evaluation Department (EvD) rated the fulfilment of project objectives as *Good*.

OVERALL ASSESSMENT

The overall performance of the project was rated *Successful*. Except for difficulties encountered during the 2004-05 season, the Company managed to procure the necessary seeds and crude oil at reasonable prices for its full operation. Due to greater competition in the country, the borrower's brand share has declined although it remains a strong market leader. At the time of project appraisal, the outlook of the Company's export market was positive with much optimism. However, the lowered market price and sales priority to the domestic market have reduced the Company's market share abroad.

Overall, the achievement of objectives was *Good*. Transition impact of the project was rated *Satisfactory*. Although backward linkages with suppliers were expected to be strengthened, the project was not devised to deliver tangible and verifiable results. Regulatory risks to transition, such as an unstable political environment and red tape, are still considered high. The degree of risk is *High*. The environmental performance of the project was rated *Satisfactory,* derived from a combination of the borrower's good environmental initiatives and the Bank's marginal environmental monitoring. The project's working capital financing and refinancing did not impact environmental changes in a direct manner. The borrower's financial performance was rated *Satisfactory* mostly exceeding the appraisal forecast in current prices. The Bank's additionality was *Verified at Large* leaving a concern about pricing of the Bank's products. Bank handling was assessed overall as *Good*.

TRANSITION IMPACT AND THE BANK'S ADDITIONALITY

Skills transfer and the introduction of new business standards from several international shareholders occurred during previous projects with the Company. Impacts included improving technical production processes, marketing expertise and efficient seed procurement. In order to strengthen backward linkages and to provide economic sustainability to the receiving-end farmers, the Company previously provided pre-harvest loans directly to farmers as suggested by the Bank. This, however, caused two distinct problems: (i) many farms which received cash soon disappeared; and (ii) the Company experienced a large administrative burden to maintain each tiny loan. As a result of this lesson, the fourth project anticipated no pre-harvest loan to suppliers. Instead, the Company intended to strengthen backward linkages by providing fertilisers and fuel to assist farmers in growing high quality seeds. However, this endeavour was not undertaken. Transition impact through backward linkages during a previous project with the Company was dynamic but ended in failure. For this reason, the Bank toned down the transition impact under this project. Transition impact at industry and economy level was considered *Satisfactory* and the regulatory risks and associated weak and non-transparent administrative mechanism were still considered *High* as an impediment to transition.

The Bank's financial additionality was reduced due to the reduced margin to the prevailing market level. Given no incremental built-in value added in the project design for this project, the additionality is not verified in all respects. Overall, EvD considered the Bank's additionality of the project was *Verified at large*.

BANK HANDLING

Throughout the implementation period, the operation team and other departments handled a change of sponsor and subsequent documentation and amendments, covenant breaches, and internal and external waivers in a professional manner. However, the environmental Bank handling was marginal.

MAIN OPER ISSUES AND LESSONS LEARNED

Appropriate arrangements with local stakeholders for implementing agricultural support services are crucial to realise expected transition impact. The intended transition impact is not delivered alone as evidenced in this project due to lack of financing for farmers' expenditures on agricultural inputs. Innovative ideas to realise agricultural extension services requires good implementation arrangements with the local implementing entities. Local opportunities need to be reviewed during project preparation rather than deferring all arrangements to the borrower at the time of implementation. The monitoring mechanism and indicators should be agreed upon with the implementing entities, which could be the local authorities and suppliers of fertilisers, insecticides and other agricultural inputs. These initiatives should be concretised at the time of project appraisal.

The Bank, hearing the experiences of foreign direct investors, should strive for a tangible result from the government in respect of the VAT refund debate. A generic approach seems to have limited effect on problem solving in a stalemate political issue. Closer cooperation with the other international financial institutions for tax reforms and administrative transparency could be considered to tackle the problem in a serious manner. The Bank's possible success in a policy dialogue respectively could strengthen the Bank's additionality, generate positive and visible transition impact and increase further the presence in the local agribusiness sector.

A repeat financing with working capital for the industry could present a drawback in

environmental monitoring. For a repeat financing of such a nature, a mere desk-oriented monitoring could continue for years with no inspection of upgraded facilities. It might infringe on the lender's liability with regard to environmental risks. The Environment Department and the Operation Team should strengthen monitoring practices, particularly with respect to the physical facilities of a project. When the Bank discloses information of environmental compliance, this must be based on verified and internally adopted project briefs.

Recommendations:
Environmental due diligence should be made a requirement for repeat financing. A mandatory review of the completion status of the Environmental Action Plan should be part of the Bank's environmental due diligence for a follow-on investment when a repeat financing occurs. If any major issues remain unsolved under the current operation, those issues should be carried forward as specific conditions, the compliance of which can be monitored under the follow-on investment.