

Summary of the Operation Performance Evaluation Review (October 2008)

The project

In June 2005 the European Bank for Reconstruction and Development (EBRD) approved a €22.5 million senior loan for this company. The loan proceeds were to be used for the construction of state-of-the-art sawmill facilities. The company is a wholly owned sawmill subsidiary of a large pulp producer and produces sawn wood and wood chips.

Construction of the sawmill was completed on schedule. The total cost was slightly lower than the estimated costs at appraisal. Test production took place in December 2005 and the company produced its first sawn wood in the following month.

Project rationale

In 2004 the company announced its strategy and business development plan. It laid out the construction of a greenfield pulp mill in the country, which required large sawmills and several local logging companies. The company was the first stage of this ambitious investment plan. The Bank was approached due to its previous experience in financing the forestry sector.

From the Bank's perspective the project had a solid rationale. It not only comprised first-class sponsors with whom the Bank was eager to do business, but it could also contribute greatly to the development of the country's forestry sector, particularly by promoting sustainable wood procurement and environmental practices that are supported by the international community.

Achievement of objectives

The objective of the project was the construction of a greenfield sawmill in the project region as a first step towards establishing a pulp mill operation.

While the construction of the sawmill was successfully completed, the ensuing major investment is still being analysed and reviewed. This objective is in the process of being achieved. The sawmill facilities have been completed according to the description given in the board document at appraisal.

At appraisal, the project performance was set to be monitored according to the following indicators:

- environmental and corporate governance standards
- cost trends for the company
- support of the World Bank's collaborative action plan for facilitating foreign direct investment in the country's forestry sector.

The OPER Team has assessed the fulfilment of the objectives as ***Good***.

Overall assessment

The project involved a €22.5 million senior loan from the EBRD for a greenfield sawmill construction in this country. Both parent groups are global market leaders in forest product

manufacturing. The project is one of the Bank's few investments that have already realised most of the objectives set at appraisal. At appraisal, the project was considered the first step for the parent company towards a bigger strategy for the country. Ensuing investments were expected.

These investments constituted part of the Bank's additionality requirements, along with sustainable forest management and environmental practices. Hence, the Bank's additionality has been *Verified in all respects*. The sawmill was completed within budget and original schedule. It has also completed its first full year of operations in a satisfactory manner. The achievement of objectives is considered *Good*. The sawmill and its parent groups exercise good procurement practices and uphold high industry and business standards.

The transition impact is rated *Excellent*. As a successful greenfield construction and operation, *Some* environmental change (mainly positive) is recognised. The environmental performance of the project is *Satisfactory*. Likewise, the overall financial performance of the project is considered *Satisfactory*.

This rating is the result of the sawmill's *Satisfactory* financial performance to date and the parent groups' *Good* financial results. It is also based on the return on the Bank's loan, which is considered *Satisfactory* as it has sufficiently covered the Bank's necessary costs. The Bank has dealt with the project in a consistently *Good* manner. Given the above, the project is rated *Successful* overall.

Transition impact and Bank's additionality

The Bank's Transition Impact Monitoring System (TIMS) perceived expected transition impact to be *Good* with *Medium* risks for realisation. The latest review was conducted in February 2007 and maintained the same ratings. The TIMS expected transition impact to mainly arise from:

- a higher standard of corporate governance and business conduct introduced by the renowned parent groups
- market expansion through the procurement of wood from logging companies.

The OPER Team has endorsed the thrust of the TIMS reviews and has verified major impact eight months after the latest TIMS review. The OPER Team has thus rated the project's transition impact as *Excellent* with *Medium* risks. The Bank's additionality was emphasised at appraisal on the following grounds:

- political curve-out
- longer tenor provided to a registered company in this country
- the Bank's environmental policy and practices
- subsequent business opportunities in line with the company's corporate strategy for this country.

With the exception of the Bank's environmental policy and practices, whose additionality potential might develop in the future, the additionality opportunities set at appraisal have been verified. A door-to-door maturity of nine years is favourably long for a company in this country, even with a parent guarantee with political curve-out. Lending structure and terms and conditions seem very reasonable for the risks and returns.

One outstanding issue was that of financial additionality. The company was supported by strong parent groups and had no alternative financing from commercial/investment banks. The Bank's

financing offer was in fact competitive with a consortium of commercial banks. Having only two financial proposals would not normally be considered a fair competitive situation.

However, the OPER Team's interviews with banks confirmed that the EBRD could exercise its financial additionality in the forestry sector in this country. The company also emphasised that the Bank's product strength was the capacity of taking up the large amount, a longer tenor than the commercial banks' and the good understanding of sustainable forest management practices which it endeavoured to deliver.

Given the above, the Bank's additionality is *Verified in all respects*.

Bank handling

Bank handling is considered *Good*. The Operation Team has handled the project properly and diligently. The main tasks of the Operation Team were:

- monitoring of greenfield construction
- ensuring the initial operation, particularly the availability of working capital
- exercising the international environmental and wood procurement standards for sustainability
- a mid or long-term viability of the investment.

Such tasks have been and are being properly and diligently fulfilled by the Operation Leader together with other team members, including the Bank's environmental specialist. *Good* project formulation and documentation was noted. The client group assessed the Bank staff as responsive and their performance as highly satisfactory.

Main OPER issues and lessons learned

The Bank's support of a sustainable forest management promoter is essential in this country's forestry sector as it undergoes dynamic market consolidation. The Bank's cooperation with the sponsors of a forestry products manufacturing company has helped realise sustainable corporate policy and adequate practices in the sector. Such assistance is especially important since the forestry sector is likely to experience significant changes in the coming years. The Bank's support facilitates the client in inducing transition into a very traditional forestry product market which would otherwise be dominated by large and unsustainable players.

The Bank can mitigate uncertainty created by the new forest code through allowing long-sighted investment decisions and actions and thereby stimulating economic activities in the forestry sector. Continuous revision of the new forest code already creates uncertainty in the sub-sectors associated with the forestry sector. Bank intervention can mitigate the negative factors stemming from the lack of adequate implementation arrangements and help reduce uncertainty in the sector. Without the Bank's assistance, important investment decisions and actions would be on hold until the effects of the new legislation become clearer.

In greenfield projects the initial production period is usually crucial for reaching adequate performance levels. A disruption at the beginning of production could have serious and lasting consequences for the facilities. Such disruption could particularly hamper early financial sustainability. The need for working capital during an initial period of underperforming production can be substantial. The Bank has to insist that project stakeholders secure a smooth

start-up of the production. Procuring second-hand equipment locally with weak warranty from suppliers is far from ideal in a greenfield production facility and should be avoided.

Strong corporate vision and transfer of know-how by Western parent companies can help the borrower company generate long-term transition impact in a difficult market. The collaboration with experienced Western industry leaders, as was the case with this project, can optimise the effectiveness of investments in the early stages of a sector's development. Particularly the area of environmental sustainability requires a clear and shared corporate vision by the parent companies in order to generate long-term transition impact and to overcome transition challenges. This is especially pertinent for the forestry industry.