Summary of the Operation Performance Evaluation Review (May 2008)

1. The project

This company, established in 1920, is a large-scale integrated business that first became known to the European Bank for Reconstruction and Development (EBRD) as a successful TurnAround Management (TAM) participant (commenced in 1994). During this time the company partially substituted its hitherto command economy markets with Western markets, developed its own collections and established an agent distribution network.

It was operating profitably, and pre-privatisation was rightly considered a success by both the country's government and TAM since the company had addressed immediate challenges and restored profitability.

In the fourth quarter of 1999 the Board approved EBRD participation in the privatisation of this company through an equity investment. In addition to privatisation, the investors and lenders (a second international financial institution, an investment fund and two local banks) agreed a package of senior and subordinated debt to finance restructuring and new investment in the business.

Agreements were concluded with the state property fund in the first quarter of 2000. At the same time, the business was privatised and the restructuring plan initiated. Phase 1 disbursements were made over the following 12 months. However, even prior to signing the agreements, the business appeared to be experiencing an unexpectedly difficult trading environment.

From 1999 to 2004 the company generally performed at around only 15 per cent of base case earnings before interest, taxes, depreciation and amortisation (EBITDA). This had inevitable consequences for the cash flow. The Phase 2 tranche of the senior debt facility was cancelled without being drawn due to the unsatisfactory performance.

In 2003 the EBRD placed the company under the Corporate Recovery Unit (CRU). From this point on, the Bank intensified its engagement and pursued a combined strategy that involved

- cost control
- management changes
- maintaining stability between the lenders, although the company showed partiality towards its current local banks
- the introduction of external advisers
- the pursuit of strategic alliances with similar international companies.

In early 2006 the investors were approached by a private industrial group interested in acquiring the company. An exit was negotiated and completed in June 2006. The EBRD exit transaction was structured as a cash purchase of senior debt and equity holdings at a discount to nominal value.

The existing local lenders extended their facilities to the company under new ownership and were subsequently refinanced in full by the private industrial group's house bank. As of mid-2007, the company was continuing to trade and a new managing director (MD) was working alongside the private industrial group's personnel in identifying options for further restructuring.

2. Project rationale

The sector in which this business operates was one of the few non-utility sectors still under majority state ownership after the first phase of privatisation during the 1990s. The continuation of government majority ownership delayed sector restructuring, and the company was one of the last majority state-owned enterprises.

The company was a large employer and prime example for partially redirecting sales to Western markets. Hence the government was keen to ensure that privatisation would not result in an aggressive rationalisation programme of a profitable company. The prospect of transferring ownership to a group of financial investors and IFIs willing to back incumbent management and commit new money into the business was likely to appeal to government and helped smooth the path of privatisation.

Equally important in the project rationale was the capacity of the investors to introduce financial as well as sector experience. Rather than a large-scale re-equipping of the company, the agreed investment plan was geared towards selective investments. These investments supported a forward-looking product and marketing strategy that targeted product and market segments that had previously been out of reach for the company due to its technical endowment.

3. Achievements of objectives

The project had three core objectives:

- support the privatisation
- undertake a selective investment programme linked to the sales and marketing strategy that was agreed prior to investment
- identify and implement a restructuring plan.

Achievement of objectives is rated “Unsatisfactory” because the restructuring and investment plans have failed to establish this company as a competitive and sustainable business.

4. Overall assessment

This operation is rated overall “Unsuccessful” as the restructuring plan has failed.

5. Transition impact and additionality

Verified transition impact (TI) is rated “Unsatisfactory”. This rating was largely determined by the restructuring plan’s failure to address the basic operational inefficiencies of this business during privatisation. The longer-term potential TI will not change following the exit from the investment and is also rated “Unsatisfactory”.

Risk to Transition Impact is rated *Medium*. The risk rating reflects possible public criticism and further negative demonstration effect in the event that future closure of the main manufacturing operations is followed by profitable redevelopment of the city centre location at without revival of the business at one of the other possible manufacturing locations .

The Banks additionality is “Verified at Large”. While there had been other expressions of interest and bids received, the government decided that the EBRD investment proposed a superior post-acquisition investment plan and mobilised international co-finance from external funds. The senior debt provided by the EBRD and the International Finance Corporation (IFC) had a nine-year term and is beyond what could have been raised in the market at that time for this borrower.

6. Bank handling

Bank handling is rated as “Satisfactory”.

Banking and Credit identified the main risks and repeatedly made appropriate and open referral to Credit and the EBRD’s Operations Committee (OpsCom) before and after signing the agreement. The project always had a high risk rating and was actively debated as such in the OpsCom. Credit correctly identified all the key vulnerabilities of the project but, ultimately, a decision was taken to support it nonetheless.

This decision to support this investment was possibly influenced by the strategic importance attached by the Bank to concluding highly visible projects in this country at the time. Overall, the team handled some very difficult situations, especially post 2003, with great skill.

7. Main OPER issues and lessons learned

Take advantage of privatisation to change management, ensure strategic core ownership and establish state-of-the-art governance structures before privatisation. A wholesale change of ownership, whether by privatisation or mergers and acquisitions (M&A), is a decisive moment in a project. That moment offers the best chance to change management and install structures that support best practice before the deal is done. Participating in the deal endorses the management, shareholders and structures that come with the deal. If they are not optimal, they should be changed before entering the deal.

Incumbent management inherited from the command economy period has difficulty in adapting to market pressures. In this case progress was made in developing sales and meeting client needs. However, this was achieved without properly addressing the cost base and business model, making operations unsustainable.

Financial investors are likely to be less well equipped to turn around a business such as this than a strategic investor especially in an environment of growing costs and increasing competition. During the evaluation process, the Bank needs to take additional care to ensure such an investor has the required resources and expertise available to achieve the objectives.

Financial investors are not the best placed to carry out a successful restructuring of an “old economy” company. This is best effected by strategic investors. The experience shows that straight financial investors have often limited practice to oversee and even recognise the deep restructuring and cultural changes required by the company in which they invest.

Even opportunistic deals with apparently good business cases must demonstrate fundamentals for medium and long term international competitiveness. This is especially true of commodity products where weak players are prone to be shaken out in downturns.

A small, stand-alone company that produces a “commodity type” product does not have the purchasing power to ensure competitively priced inputs. Nor does it have the leverage with its customers to command attractive sales terms. Therefore the involvement of a large industry player that benefits from economies of scale is crucial.

The due diligence team must include sector experts able to contribute high-level commercial perspectives and benchmarks required for international competitiveness. Relying on a due diligence team of technical experts may lead to a thorough assessment of the investment's reliability. Subsequently, this may result in project preparation that, while technically sound, is insufficiently commercial. It thereby fails to establish a sound foundation for the future development of the enterprise. A detailed evaluation of the soundness of potential investments should therefore always include a consultant that appraises the commercial integrity of the due diligence and planning. The appropriate consultant is likely to have a successful and current track record that demonstrates bottom-line responsibility and evidence of advising on or addressing similar issues in comparable businesses in the sector.

Equal treatment of debt service obligations by the borrower. Where there is no inter creditor agreement, EBRD loan agreements should make clear the borrowers' obligations for equal treatment of debt service obligations at all times.

Where there are multiple lenders an inter creditor agreement should be established provided the number of banks is not unmanageably large. The inter creditor agreement should include banks outside the parallel lending of the project eg existing working capital providers and establish an agreed basis for sharing amongst creditors in the event that an obligor is not servicing debt in full but prior to an acceleration and enforcement of a security sharing agreement.

Inter creditor agreements must be as protective as possible of the Bank's rights when it is a majority lender in a parallel loan situation. It is particularly important to avoid giving lenders individual rights to accelerate their own loans; such a decision should in turn be subject to a majority vote based on every lender's outstanding claim. The same should apply to decisions regarding the enforcement of securities.

Local banks may have a different view on risks, and their actions may be influenced by central bank provisioning requirements. For example, they might not acknowledge a problem as long as interest payments are being made.

The Operations Team must ensure that enterprise management are well prepared for the new challenges that will be presented when moving from state ownership to a situation of private ownership and significant financial gearing. Part of this process should be establishing a clear understanding with management that IFI finance is not a soft participation and that any preferential treatment for local investors or lenders is not acceptable.

Monitoring formats should always include a cross-reference to the environmental action plan (EAP). Once an environmental plan has been agreed, a format should be established that allows actions agreed in the EAP to be tracked in the environmental monitoring.