Summary of the Operation Performance Evaluation Review (January 2009)

The project

In December 1997 the European Bank for Reconstruction and Development (EBRD) approved a multi-project facility (MPF) of US$ 50 million (€38.4 million) for a joint stock company. The facility was set up in order to provide debt, mezzanine or equity financing to sponsor-owned companies in the Bank's countries of operations. The main purpose of the facility was to support the sponsor's investment programme in eastern Europe.

This was to be done through the provision of financing for projects that involved

- the modernisation and expansion of existing processing operations
- the construction of new facilities for production.

At the time of approval the total financing requirements over the next four years were estimated at US$ 150 million. The Bank's maximum involvement was estimated at 33 per cent of financing requirements.

After a successful use of the facility in five well-performing sub-projects, the facility expired in July 2002. Subsequently, a second MPF of US$ 65 million (€49.9 million) was approved in December 2003. The purpose was to support the sponsor's second phase of investments in Ukraine, Kazakhstan, Russia and Romania.

In July 2007 a further facility in the amount of €20 million was approved.

The sponsor's business strategy is similar in most of the sub-projects. The Evaluation Department (EvD) decided to focus its field mission on the sponsor's operations in Ukraine (sub-project A), which is seen by the sponsor as a key country of operations in eastern Europe. Sub-project A provides a good overview of the sponsor's approach and the achieved results, in particular, regarding backward and forward linkages.

Sub-project A consists of the acquisition, modernisation and subsequent capacity expansion of the existing plant. The sponsor indirectly owns the company, holding a 66 per cent stake. The EBRD facility consisted of the purchase of approximately 24 per cent of the company's share capital and voting rights for a total cost of up to US$ 5.1 million (€3.9 million) and a subsequent loan of up to US$ 6.8 million (€5.2 million).

Project rationale

The project rationale encompassed a number of aims:

- support the development of the sponsor's core businesses in the Bank's countries of operations
- establish backward linkages and positively impact the primary agriculture through improving the primary production, in particular, of barley (introduction of higher quality seeds, fertilizer, agricultural extension services and finance using longer-term contracts)
- restructure and modernise malting industry
- stimulate competitive behaviour and market orientation of primary agriculture through interactions with suppliers and clients

- provide demonstration effects for both domestic and foreign investors associated with a variety of new ways of financing projects in the agribusiness sector.

Achievement of objectives

Improve local malting barley production in terms of quality and quantity

The sponsor's approach has been particularly successful in the Czech Republic, where the sponsor fully covers its local barley needs and also exports malting barley. In other countries much progress has been made in achieving similar objectives. In Ukraine, the company staff include eight regional agronomists who assist the farmers to reach better yields and quality through high quality seeds, plant protection products and growing technology.

The crop purchasing contracts define specific quality requirements and include some pre-financing arrangements. Through the acquisition of regional silos the company moved closer to the farmers who previously had to spend up to a day driving in order deliver to the company. The company has been able to source the entire barley requirements necessary for increasing malt production from 79,335 tons in 2006 to approximately 160,000 tons in 2008 (which corresponds to barley requirements of 210,000 tons). This objective has been achieved in full.

Support the development of the sponsor's core business in the region: improve malt house efficiency and malt quality to reach international standards

The company has achieved substantial progress by introducing the sponsor's code of good practices. The quality management system was developed in 2005 and 2006. International Organization for Standardization (ISO) 9001 and Hazard Analysis and Critical Control Points (HACCP) implementation were achieved in 2006. The company also participated in a global Institut Français des Boissons de la Brasserie et de la Malterie (IFBM) ringtest analysis with 60 laboratories and was ranked 12th. The improvement in quality is also illustrated by an impressive list of satisfied clients.

Regarding environment protection and labour safety, the company achieved the implementation of ISO 14001 and Occupation Health and Safety Assessment Series (OHSAS) 18001 in 2008. The installation of new equipment and upgrades allowed a doubling of production. At the same time the heat energy consumption per litre of malt was reduced by 60 per cent and the water consumption per litre of malt by 50 per cent. This objective has been achieved in full.

Overall assessment

The *Successful* overall performance rating is based on EvD's internal methodology, which takes into account transition impact, achievement of objectives, environmental impact, company and project performance, Bank handling of the project and investment performance. The fulfilment of the project objectives is rated *Excellent* given the successful restructuring of the malting facilities.

It achieved a 100 per cent increase of annual malt production and, most importantly, a corresponding increase of local barley collection. This was accomplished through strong backward linkages with various services to farmers and attractive long-term contracts combined with the sponsor's storage facilities for barley.

The environment performance of the project is *Excellent* and the extent of environmental change is rated as *Substantial*. The transition impact is *Excellent* considering the company's contribution to improved local barley production (both in terms of quality and quantity). This rating is also warranted by the production of higher quality malt that meets all the requirements of international domestic brewery groups active in Ukraine. The project financial performance is rated as *Good.* Bank handling and investment performance are also rated as *Good.*

Transition impact and additionality

EvD rates the project's overall transition impact as *Excellent*. This rating is based on the following factors:

- upgrading and expansion of facilities
- training of key staff, operators and management
- transfer of know-how from other operations of the sponsor and its group.

The company's profitability was restored through the implementation of the sponsor's know-how and the expansion of capacity. Demonstration effects were achieved through the successful restructuring and expansion of a previously loss-making enterprise. A local ceramics factory essentially copied the company's approach to restructuring.

The sponsor had stated that it would not pursue its investment programme without the involvement of the EBRD or the International Finance Corporation (IFC) as they provide political security and assume the political risk for its participations. The sponsor thought the MPF structure to be advantageous since it was expected to facilitate the processing of projects in different countries.

The sponsor also felt that an MPF would support its ability to advance quickly with investment opportunities. At that time the client's commercial banks were only interested in individual projects in certain countries. The sponsor also appreciated the longer maturities of the Bank as well as the possibility to use financing in the form of mezzanine or equity instruments.

Bank handling

The client found the banking team's support generally helpful. However, the client mentioned the slow processing speed, in particular, regarding:

- working capital lines
- extension of working capital lines
- redirecting working capital lines to different markets/countries in line with the local production outlook and finance requirements.

Main OPER issues and lessons learned

Advantages of an MPF with a client in the agribusiness sector

The client saw the advantage of working with the Bank in all countries of operations on an essentially similar basis while having the main terms and conditions pre-agreed. It was expected that the sub-projects could be processed more efficiently. The client, a family-owned group, was of the view that the Bank's involvement would, to some extent, also mitigate the political risk, which was considered as high at the beginning of the MPF.

During the establishment of the various facilities, discussions concentrated on how to make working capital facilities more efficient. These primarily pertained to

- the timing of the clean-up period
- different country focuses depending on harvest outlook.

The banking team is of the view that the sponsor had the opportunity, at the time of loan signing, to choose a period for the two-week clean up. Discussions are ongoing with the sponsor to address this issue.

Lesson
Multi-project facilities in the agribusiness sector provide a framework but need to be reviewed and adapted from time to time to the requirements of the clients. Multi-project facilities have the advantage that a group of smaller sub-projects, including working capital lines, can be more efficiently processed by the Bank.

In cases like this where the relationship extends over a long time, it may be important to periodically review, together with the client, how certain features can be further improved in order to fit into the client's use of the working capital facilities during harvest season. These reviews could also more quickly address the tailoring of facilities to other countries in case of changing harvest outlooks.

Macro-economic policy framework and sector policy dialogue with countries of operations

In view of the numerous institutional issues still pending in Ukraine, there appears to be a need for further engagement on the policy dialogue level. The EBRD should do this on its own as well as jointly with other international finance institutions (IFIs) and development institutions.

Lesson
Sector policy dialogue is a crucial ingredient for successful agribusiness operations by the Bank, and this activity cannot be delegated to other IFIs. The sector policy dialogue is challenging and time-consuming in large countries of operations where various political parties and industrialists have articulated different reform agendas.

Whilst a project-by-project approach can be effective in certain situations, it is essential to also forge a reform consensus at the level of sector policy. This can be done either by the EBRD alone or, preferably, in conjunction with other IFIs. The Bank's clients alone are often not able to successfully push for sector reforms such as value-added tax (VAT) reimbursement system reform or a timetable for the abolition of the moratorium on agricultural land sales.

Enhancing backward linkages over and above what is achievable by project sponsor

The Bank could achieve a reduction of entrance barriers and an improvement in the conditions for a functioning market by

- focusing on backward linkages
- targeting technical cooperation (TC) and other efforts towards sector reform that address sector-wide issues such as the lack of rural credit.

This would require a coordinated effort with the small and medium-sized enterprise (SME) team in order to target financial market failures in rural areas. There may also be legal issues involved that undermine the farmers opportunity to raise loans for inputs against appropriate collateral (rented land is normally not considered as collateral security by commercial banks or the EBRD).

Lesson
Enhancing backward linkages in the agribusiness sector cannot be left to the sponsors alone and should in selected projects be supported by TC and other operations by the Bank. The Bank should more actively use targeted TC and other operations to support backward linkages both related to a specific processor related Bank operation (for example, food processor, drinks manufacturer and so on).

This effort should ideally reach beyond the singular Bank operation and address entrance barriers for all market participants. It should be intended to reduce such barriers and to seek a broader transition impact as per the Bank's mandate.

This may involve cooperation with government programmes and a more active involvement in organisations that provide things such as rural credit and training. In this respect collaboration with other IFIs should be considered. In some cases the TC undertaken by sponsors might be supported and expanded to reach a broader group of farmers.

Risk-taking in primary agriculture

The OPER team is of the view that the Bank should undertake a few selected projects where it assumes more primary agricultural risk and addresses the important market shortfalls (extension services, rural credit availability, storage and functioning agricultural land market and so on). These projects should be carried out with the appropriate sponsor and, where possible, in coordination with other IFIs. In selected cases the Bank has financed farming and storage (silos) operations. This type of operation could be increased.

Lesson
The EBRD's risk taking appetite in the agribusiness sector should be reviewed. The objective of this review should be the support of more initiatives that are addressing key constraints faced by primary *agriculture.* The Bank's engagement in agribusiness has been very selective and, in essence, closer to the processor and distributor stages of agricultural products.

It is valid to say that processors ultimately have a beneficial impact on primary agriculture. However, one could argue that a portion of the Bank's agribusiness activities should target the higher risk primary agriculture in combination with a focus on rural credit, extension services and storage.

Importance of an international sponsor for upgrading malt production quality, efficiency and reliability of supply in times of harvest failures in local barley production

International and local beer brewers who operate large plants in EBRD countries of operations increasingly rely on improved barley production and malt quality from local sources. Typically, international brewers require similar high quality barley for their global brands. Furthermore, they need reasonable security of supply to fit their continuous beer production process.

Larger internationally active malt producers have proven abilities to foster local barley production as a basic input for their malting process. Furthermore, in times of local harvest failures, they normally have channels and access to source barley and/or malt from other countries. In this context the concentration of the malt production in fewer but internationally sized facilities is an important restructuring of the industry as it meets the requirements of the breweries in a cost efficient way.

Lesson
International sponsors involved in processing agricultural products have contributed to increased efficiencies through restructuring and upgrading of outdated processing plants. They have also contributed to quality improvements in primary agriculture in order to obtain raw materials (for example, barley, milk) which meet the quality requirements for further processing stages.

International sponsors have contributed to the consolidation and upgrading of outdated processing facilities and achieved longer-term supply contracts with farmers. In this case their production of more competitive and higher quality malt from local barley combined with higher supply reliability were key ingredients for achieving off take arrangements with leading breweries.