Operation Evaluation

Summary

Shopping mall (eastern Europe)

(A private sector investment operation)

September 2010

Evaluation Department (EvD)

European Bank for Reconstruction and Development

Executive summary

The project involved a loan to a company to develop, construct, own and operate a retail and entertainment complex ("the project"), involving site development of an area of approximately 25,000m^2 in the city centre with a modern multi-level design. Tenant mix was to include a wide representation of commercial retailers, entertainment and food providers. The sponsors were solid companies with experience in construction and retail distribution. The sponsors' strategy was to attract retailers from neighbouring countries and from further abroad.

Approximately 70 per cent of the total project costs corresponded to construction costs; the rest was spent on the purchase of the land plot, project design, VAT and other costs. The loan was disbursed in two tranches, with 40 per cent syndicated via an A/B loan structure. Tranche 1 would represent up to 70 per cent of total project costs. Tranche 2 would allow re-leveraging up to 80 per cent but has not been disbursed due to the breach of financial covenants.

As the construction of the site was already ongoing at the time of project approval, part of the funds were destined to finance the site retroactively by repaying part of the loans provided. A cost over-run guarantee from the sponsors was provided, capped at 20 per cent of construction costs, but it has now been released as the physical completion has been achieved. There was no provision made for completion or stabilisation guarantee, however due to breach of the financial covenants, which required a waiver from the Bank, the client has recently agreed to provide a stabilisation guarantee.

Table: Ratings summary

Overall rating	★★★☆	Successful
Achievement of objectives	●●●●●○	Good
Additionality	■■■□	Mostly verified
Bank handling	●●●●●○	Good
Transition impact	●●●●●○	Good (potentially excellent)
Environmental and social impact	●●●●○○	Satisfactory

Overall assessment

★★★☆ Successful

The project is rated overall as "*Successful*". The site was constructed on time and budget and to very high quality standards. The previous experience of the sponsors was key to this achievement. The lease out of the premises was optimal and reached high occupancy in a short time. The financial situation has been affected by the general economic downturn combined with the political upheaval, resulting in a substantial but temporary drop in consumption that impacted adversely the financial performance and resulted in the breach of financial covenants. However, the company is managing adequately the situation, renegotiating rents with clients for a limited period of time, and retaining high occupancy levels. The sponsors have provided additional capital to guarantee the service of the debt and are providing a stabilisation guarantee. The positive outcomes in terms of transition impact (TI) overcome the shortcomings derived from the challenging market situation (which should be considered in the context of the global economic crisis, are being addressed adequately by the company and are expected to be transitory).

Effectiveness

Achievement of objectives ●●●●●○ Good

The project was described as "*the financing of a site with a gross build up area of 72,000m² located a few km from the centre of a city (…). The site will be leased to reputable international and local tenants (…)*". Two separate objectives can be considered:

1. Successful construction completion – *Achieved*. Construction was successfully completed. Construction started in 2007, before the client obtained confirmation of EBRD funding, with short-term finance from the sponsors' group bank. When the Bank committed the financing, the site was in an advanced state of construction, which was a positive indicator of the success of this objective. The sponsors had already invested approximately €21 million and the works were around 40 per cent complete. The construction of the project was completed in 2008, on time and budget. Formal construction completion and physical completion have been confirmed by the lender's supervisor in 2009.

2. Commercial success and profitability – *Partly achieved* due to exceptional market conditions, but with expectations of positive achievement. By the time of Board approval, the sponsors had already signed agreements with 42 tenants for around 48 per cent of the space and currently the site is almost fully let (at 97 per cent occupancy) on long-term (5-15 year) contracts.

   Financial performance, however, has been affected by the economic situation. Consumption has decreased although the footfall is increasing steadily (seasonality effect discounted), especially from the end of 2009, but still remains below initial projections. This affected the profitability for the tenants, who asked for a renegotiation of the lease terms. The company is implementing a reduction of around one third, on a case-by-case basis, in line with the recommendation of the real estate consultant. The strategy is to retain tenants and adapt flexibly to market conditions, as a massive vacancy would have a negative impact.

Additionality ■■■□ Mostly verified

Additionality is rated "*Mostly verified*". The deal structure, close to project finance, would have been difficult to finance in the loan market at the time of project inception. However the sponsors' bank provided bridge finance and was in a position to continue supporting if financing had not been arranged with the EBRD, which seems to indicate that the EBRD's added value relied more on other Bank attributes than in the mere provision of funds. The Bank's contribution also allowed mobilising long-term funding from other banks in a 1:1 ratio by syndication of the loan.

Efficiency

Bank handling ●●●●●○ Good

Bank handling is rated overall as “*Good*”. Some elements of environmental due diligence, however, could have benefited from better attention. The client’s responses to the questionnaire raised several critical questions that were not followed up sufficiently, such as use of migrant labour, the high-voltage power lines, and construction based on local standards only. A full Environmental Impact Assessment had been prepared on the project for the Government that could have been reviewed to check that the project was “fit for purpose”. The Environmental and Social Action Plan could have been more specific and included a budget and time frame.

Structuring of the project was reasonable. Although a sponsors’ guarantee would have been desirable, it is understood that under the market conditions prevailing at the time of the project preparation, it was not uncommon to finance this kind of project without such guarantees.

Impact/sustainability

Overall transition impact ●●●●●○ Good (potentially excellent)

Transition impact has been “*Good”*, with a potential to be *“Excellent”* if the market situation recovers and other competitors and new developments start to replicate the new standards set.

Transition impact has been achieved mainly at the industry level, in line with the expected outcomes foreseen at project inception (that is, enhanced competition, market expansion and the demonstration effect of new ways of retail distribution). The demonstration effect has been excellent, and competition is only rated good to date due to the effect of the economic downturn (which has deterred actions by competitors) but has a potential to be excellent once the economic situation recovers. Transfer of skills and corporate governance practices from the sponsors have also been highly positive.

Environmental and social impact ●●●●○○ Satisfactory

Environmental and social impact is rated “*Satisfactory*” as the combined effect of “*Satisfactory*” environmental performance and “*Some”* environmental change. Environmental performance is rated “*Satisfactory*” based on the fact that the facility has been built to reasonable standards and there have been no major accidents reported during construction. Further, operation of the shopping mall appears to be as expected and the company has promoted various social and environmental objectives via various public events. However environmental reporting by the client lacks specificity and this issue should be resolved. Environmental change is rated “*Some”*. As the facility was built to local standards, as stated by the client, contribution from the Bank has been moderate.

Findings and recommendations

Importance of including a stabilisation guarantee in the deal structure

The lack of a stabilisation guarantee in the project exposed the Bank to unnecessary risks. A cost overrun guarantee protected only partially against risks related to the construction phase, but risks associated with the financial performance (either derived from commercial success, the economic situation or other risks) were left uncovered, despite strong financial sponsors.

The deal structure should take account of adequate risk mitigating measures for the Bank. Stabilisation guarantees should be included to the extent possible in projects in riskier markets to protect the Bank's interest from changes in market conditions that may affect financial performance and the debt service from the project cash flows.

Vulnerability of consumption in countries with high dependence on remittances for the economy

Remittances represent an important portion of GDP in this country and therefore may affect consumption significantly. The decline in revenues was partially due to the political and economic instability in the country, but also partially a result of the decline in remittances due to the deteriorating situation in the countries of origin of these.

It's important to look beyond the country's borders for possible economic and financial risks. In countries where a significant portion of GDP comes from remittances, it is important to consider not only the evolution of the economic situation and risks in the country, but also in the primary remittance countries, as a downturn in the economic situation may affect the flow of remittances.

Specificity in Environmental and Social Action Plans (ESAP)

Greater specificity in ESAPs should be aimed for. The ESAP for this project lacked concretion either about the project conditions or the performance standards to be applied. ESAPs should be specific enough to allow adequate monitoring of the environmental performance of the projects. The Environment and Sustainability department (ESD) must provide greater specificity in ESAPs, based on specific project related information, provide cost information and specific time frames for implementation.

Importance of the experience of the sponsors in similar projects in retail property developments

One of the sponsors was an experienced developer. This was the main factor in securing an adequate tenant mix and the transfer of skills to the management of the new company through exhaustive monitoring and supervision of the project during construction and the later phases of lease out and operation.

The experience of the sponsor in management of similar projects in the industry is a key to success. Compared with other types of similar developments, the tasks of the sponsors are usually not limited to the construction but to the later operation. Previous experience in management of similar developments and a portfolio of reliable clients are key to success.

Currency vulnerability

Financing to the company was provided from international lenders in hard currency (euro). The lease contracts between the company and the tenants were equally done in euro and annual increases fixed to a certain amount (3-5 per cent), rather than to the general CPI index, which is the common practice in the industry. In this way the company was apparently covered from currency exchange risks as its revenues were matched with the servicing of debt. However revenues of the tenants were in local currency, thus it is the tenants who are supporting the currency risk as they have to pay rents in euros, which translates into a commercial risk for the company. When lending in hard currency it is important to adequately identify, and mitigate to the extent possible, the currency exchange risk implications associated with the servicing of the debt at all the levels of cash flow generation.

Flexibility in adapting to market conditions

The project was started in a time of economic worldwide prosperity, but the opening of the premises in 2008 was characterised by the strongest worldwide recession in decades, which together with internal political conflicts led to a decrease in consumption and hence of revenues for the tenants. The company responded by renegotiating the lease terms, reducing rents and granting grace periods. The Bank also responded flexibly, acknowledging the special situation and waiving the non-compliance with certain financial covenants in exchange for additional guarantees from the sponsors (that is, a stabilisation guarantee).

It is essential to react in a timely and flexible way to changing market conditions. It is important for the borrowers to understand the cyclicality of economic trends and to adapt accordingly.

Energy efficiency (EE) early involvement in the project stages

The first contact with the EE team in this project and the first gathering of technical information on the project design took place at a stage where the design had been completely finalised and the works were in an advanced stage of construction. Although potential, economically viable energy efficiency savings were identified, the company decided not to go ahead with the next steps proposed (that is, to perform a detailed energy efficiency assessment). As a result, although the project contains some positive EE measures and is above national standards, the Bank's contribution and impact from an EE point of view was marginal.

There is value in the early involvement of the Bank's EE team when developing a project. Early involvement of EE can facilitate the implementation of identified potential EE improvements in the technical design of the project, and monitor that such changes are incorporated in the final construction.

Report prepared by:
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General

●●●●●● Excellent
●●●●●○ Good
●●●●○○ Satisfactory
●●●○○○ Marginal
●●○○○○ Unsatisfactory
●○○○○○ Highly unsatisfactory

Extent of environmental change

✱✱✱✱ Outstanding
✱✱✱✳ Substantial
✱✱✳✳ Some
✱✳✳✳ None/negative

Overall performance

♦♦♦♦ Highly successful
♦♦♦◊ Successful
♦♦◊◊ Partly successful
♦◊◊◊ Unsuccessful

Additionality

■■■■ Fully verified
■■■□ Mostly verified
■■□□ Partly verified
■□□□ Not verified