Operation Evaluation

Summary

A car manufacturer

(A private sector investment operation)

December 11

Evaluation Department
(EvD)

European Bank
for Reconstruction and Development

A car manufacturer

December 2011

Executive summary

The EBRD provided a syndicated loan to a company in one of our countries of operations to build a car assembly plant benefiting from specific trade incentives.

The evaluation presents three main findings: (i) risks from industrial policy schemes; (ii) supplier "localisation" challenges; and (iii) a need for clearer transition objectives when projects benefit from market-distorting policies.

(i) At the sector level, the government imposed tariffs to protect domestic car makers and give them time to modernise. These large employers build cars that are not globally competitive and their vertical integration has not fostered independent suppliers of scale and quality. The tariffs allowed global firms, pledging to locally procure one third of parts, to assemble cars from imported kits at sharply lower duties. It restricted competition and subsidised small production runs for a few assemblers, but not for suppliers whose business models usually target higher volumes. In early 2011, the government raised minimum volumes tenfold and doubled the parts localisation target while still protecting the local industry with high tariffs, including the now locally present global car firms. The desired outcome, a competitive car industry locally supplied, remains a future possibility exposed to many remaining challenges.

(ii) The localisation of suppliers and stimulation of backward linkages, including through a supplier's park that was not implemented, were critical to the transition impact (TI) rationale. However the TI risk analysis, project design, and due diligence did not cover the challenges to localisation. Critically, the project's volume target was half of the norm for car assembly plants, which reduced suppliers' ability to justify the required investments. Today, few local suppliers are able to meet the company's quality and cost standards. (The company imported even window glass and tyres, despite local availability.) The project is highly import-dependent and has achieved localisation of only 15 per cent to date, keeping localisation a potential source of transition impact subject to high risk.

(iii) The government required one third localisation, yet the EBRD's project targeted only 10 per cent for its TI benchmark. A target that exceeded the government's minimum might have strengthened additionality and led to higher transition impact. When projects benefit from explicit policy distortions, transition targets must be ambitious while realistic, and both specific and verifiable while giving scope for entrepreneurial creativity.

Table1: Ratings summary

Overall rating	♦♦◊◊ Partly Successful
Company financial performance	●●●●○○ Satisfactory
EBRD investment performance	●●●●○○ Satisfactory
Achievement of objectives	●●●●○○ Satisfactory
Additionality	■■■□ Mostly Verified
Transition impact	●●●●○○ Satisfactory
Environmental and social impact	●●●●●○ Good
Bank handling	●●●●○○ Satisfactory

Overall assessment

♦ ♦◊◊ *(Partly Successful)*

Overall project performance is *Partly Successful*, due to limited targeted and realised localisation and hence limited transition impact through backward linkages within a distorted market framework. Fulfilment of operational objectives was *Good* even though the financial crisis halved the car market in the country of operations in 2009. The company built the plant to the planned capacity on time and budget and tailored production to the market demand.

Additionality

■■■□ *(Mostly Verified)*

Additionality is *Mostly Verified*. The Bank stepped up to ensure syndication, assuming higher than planned risk. The sponsor confirmed that the project would not have been possible without the Bank's role as the lead lender. Still, the project targeted less localisation than the government required, weakening this dimension of additionality.

Effectiveness

Achievement of objectives

●●●●○○ *(Satisfactory)*

i) *Construct a large, flexible, low-cost and expandable plant in the country of operations to the company's standards capable of assembling a target number of vehicles.* This objective is rated as *Achieved*. The company constructed the plant on time and within budget. The plant build responds to the initial plan and production capacity in terms of volumes and range of models. The plant does not perform major industrial processes.

ii) *Launch assembly of two models.* This objective is rated as *Achieved*. Although adverse market conditions driven by the financial crisis affected both model mix and vehicle production timing, the plant has met the operational objective of producing a variety of models and reaching production levels after some delays.

Company financial performance

●●●●○○ *(Satisfactory)*

Project financial performance

●●●●○○ *(Satisfactory)*

The financial crisis, company issues and other factors disrupted the business plan. Higher vehicle launch costs, production mix changes, reduced demand and lower pricing all contributed to the performance shortfall.

Efficiency

Bank handling

●●●●○○ *(Satisfactory)*

Bank handling is rated *Satisfactory*. The project loan lacked recourse to the sponsor, exposing it during a bankruptcy to a potential disposal or liquidation of the borrower, which fortunately did not occur. Still, the Banking team adequately managed the project in difficult circumstances and ultimately recovered the Bank's funds. The due diligence, however, did not adequately assess the economic requirements of localisation, which were essential to the project's main transition impact benchmarks.

Bank's investment performance

●●●●○○ *(Satisfactory)*

Impact/sustainability

Overall transition impact

●●●●○○ *(Satisfactory)*

Transition impact is overall *Satisfactory*, with *Satisfactory* potential and *High* risk. The limited impact to date comes from the low level of targeted and realised localisation, the main driver for market expansion and transfer of skills. Potential is satisfactory because the larger production runs mandated by the revised government policy might encourage localisation in the long run at a cost to the consumer of higher prices and fewer models than an open, competitive market would permit. The risk of realising transition impact is high due to many challenges to localisation that the incentives may not overcome.

Company impact

The company transferred skills by training workers and local managers. They work for experienced company managers, applying modern assembly techniques. The company is grooming successors locally: citizens in the country of operations have filled the three most recent area manager openings.

Industry and wider impact

Competition and market expansion: By supplying high-quality competitive products, the project stimulated competition within the confines of government legislation, which protects the local industry while fostering its modernisation. Market expansion continues through the previously established company dealership network and through which the plant's two models are selling well.

Localisation and linkages: The low level of localisation has constrained the hoped-for supply chain market expansion, but potential is viewed as *Good* as the higher output required by law is meant to lead to two thirds localisation, subject to high risk. The company strongly supported its dealers during the crisis beyond its normal technical and economic support. Company dealerships offer small and medium-sized enterprise opportunities for entrepreneurs in the country of operations.

Skills transfer: The tight labour market in the country of operations and high turnover has transferred skills beyond the project, as leavers usually move to other car firms. Low localisation has limited skills transfer to suppliers.

Demonstration effect: The company has constructed a modern, safe, environmentally sound manufacturing facility, applying modern employee training techniques, providing a model for other industrial ventures in the region.

Environmental and social impact

●●●●●○ *(Good)*

The company has complied with the company's global environmental standards in the construction and operation of the facility and achieved ISO 14001 certification. The municipal government had yet to construct a promised wastewater facility to treat low-risk rain water run-off from the site, for which the company must pay fines.

Findings

Localisation challenges

Recommendation

The Bank needs to clearly understand specific localisation plans and the circumstances that will affect their success, especially when the project will benefit from market-distorting industrial and trade policies. The Bank should retain appropriate expertise for this assessment. The expert's terms of reference should require assessing the key aspects of the supplier business models, the transition path to the higher levels of targeted localisation, and the challenges to be overcome.

Risk mitigation

The Bank undertook a high-risk loan with limited security and recourse. An independent assessment indicated that the security might not generate realisable value to cover the loan amount.

The Bank should undertake such high-risk loans only if sufficient security to minimise the risk is available and/or the pricing is high enough to fund additional actions to limit the Bank's exposure. Credit recommendations to utilise the secondary market and to buy over-the-counter credit insurance should be heeded. If the Bank elects not to follow Credit's suggestions then the rationale for doing so should be clearly noted in the relevant approval documents.

Adequacy of collateral security

The post-construction security structure of the loan was confined to the venture itself even though it would not be a fully integrated business. In short, the company was simply an assembly factory with no up-stream or down-stream capability. The loan could only survive a possible failure of the company group if another car company took over the facility.

When funding projects in globally integrated businesses such as the auto industry, the Bank should recognise that the fate of the project is linked critically to the fate of the sponsoring auto company. Security limited to a manufacturing facility alone is of marginal value and does not provide a sound alternative source of repayment.

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