Executive summary

The projects were: a loan provided to a food retail company in Serbia ("Project A") and a loan provided to a food retail company in Bosnia and Herzegovina (BiH) ("Project B"), approved one year apart (both companies referred to as the "Companies"). Both loans were to: (i) finance the regional expansion of grocery stores, supermarkets and hypermarkets in the Companies' respective markets, and (ii) refinance their short-term debt. The Companies are wholly owned by one of the largest private companies in the West Balkans region (the "Parent"). The Parent is an experienced retail operator, with a dominant position and the Bank's long-standing client (two previous operations).

Project B has performed relatively well, while Project A has met few expectations, particularly in terms of its financial performance and the impact of its short-term debt refinancing. This evaluation has identified several findings of particular interest:

- Project A reflected an optimistic scenario derived from the company's "boom years" of 2006-07; this was not adjusted as the financial crisis unfolded, and proved extremely vulnerable. As a result, the actual expansion of the retail network was 60 per cent below target, while 2010 revenues were only half of those forecasted at approval. The Bank's Closing Certificate should capture material changes in the economic outlook which may happen between the Board approval and signing of a project and which are likely to have significant impacts on the project.
- In response to specific Board concerns about repeatedly unmet environmental investment commitments under previous operations of the Parent, the Operations team provided assurance to the Board that they were being addressed. Yet those commitments remain unfulfilled, and indeed it appears that no progress has been made. Assuring delivery on agreed commitments, particularly when carried as in this case across multiple transactions, requires an improved approach with respect to accuracy of reporting, and covenanting and enforcement.
- No provisions restricting Project A from incurring new short-term debt were imposed in the loan agreement. Shortly after completing its short-term debt refinancing with the Bank's loan, Project A incurred new large short-term debt and was in need of new "balance sheet restructuring". In cases where the Bank refinances short-term debt, certain limitations on the borrower should be considered to ensure the sustainability of the Bank's refinancing.
- There were gaps in Project A due diligence, including (i) no analysis of a local currency devaluation scenario (as the dinar devalued against the euro by one third, the company's financial performance suffered, since a large part of its merchandise come from the Parent company food processing plants in Croatia and is paid for in euros); (ii) no analysis of purchasing power/catchment area/shopping habits, with reliance being placed instead on the Parent's past success in the region.

Table 1: Ratings summary

Overall rating	*Partly Successful (A)*
	Successful (B)
Company financial performance	*Marginal (A)*
	Satisfactory (B)
EBRD investment performance	*Satisfactory (A)*
	Excellent (B)
Achievement of objectives	*Marginal (A)*
	Good (B)
Additionality	*Verified in all Respects (A)*
	Verified in all Respects (B)
Transition impact	*Good (A)*
	Good (B)
Bank handling	*Marginal to Satisfactory (A)*
	Satisfactory to Good (B)

Overall assessment

★★☆☆ *Partly Successful (A)*
★★★☆ *Successful (B)*

Overall, the project A is assessed as *Partly Successful*. The main factors contributing to this rating are that the restructuring of the balance sheet has not been achieved as planned, while the dramatic worsening of the economic situation, combined with the underestimation of competitive pressure, prevented the planned expansion and led to a significant financial underperformance. Also the achievement of transition impact (TI) objectives largely fell short of the expectations.

Overall, despite some shortcomings, Project B is rated as *Successful*. With the Bank's loan and the Sponsor's equity contribution, the balance sheet has been consolidated. The only debt remaining is the Bank's long-term syndicated loan. The economic crisis also had an adverse impact on company's financial results, however, due to its dominant position in the market and BiH's currency being pegged to the euro, Project B did not suffer as badly as Project A in Serbia. The regional expansion was well designed and had realistic objectives, which were exceeded. Most of the transition objectives, such as backward linkages, skills and know-how transfer have been achieved.

The environmental performance of both projects is rated as *Good*. A systematic approach was adopted by both Companies to the management of environmental, health and safety issues in their retail and wholesale operations. However, both operations were explicitly presented to the Board as opportunities finally to achieve delivery by the Parent on a specific, relatively uncomplicated and long unfulfilled environmental commitment from previous transactions – construction of a waste water treatment plant at the Parent's production facility. Yet fulfilment of this commitment has once again not been accomplished, nor indeed any meaningful progress made. This was the primary opportunity for these operations to accomplish "environmental change", and therefore this performance is rated as *None.*

The Bank's additionality is rated *Fully Verified* for both transactions due to unavailability of long-term financing in both countries, particularly during the financial crisis. The Bank handling of Project B is rated *Satisfactory to Good*, while that of Project A is rated *Satisfactory to Marginal* as, after approval but before signing, the Bank failed to modify the financial projections and reconsider the terms of the loan once the global financial crisis was underway. On the positive side, the Bank was instrumental and effective as an agent for the syndication of both loans at a time when banks were generally unwilling to lend.

Additionality ■■■■ Fully Verified (A and B)

The additionality of both Projects is rated *Fully Verified* as long-term financing at reasonable terms was not available in Serbia in 2008, and was even less realistic to arrange in BiH during the height of the financial crisis in 2009, when the loan to the Company in BiH was provided. The Bank was instrumental in syndicating the loans, which was achieved in both cases after the financial crisis fully emerged.

Effectiveness

Achievement of objectives ●●●○○○ Marginal (A) ; ●●●●●○ Good (B)

Project A has not achieved the planned expansion of retail stores. By the end of 2010 the Company had 132 stores, which was 71 fewer stores than the objective. Moreover, no new warehouses were opened, although four had been envisaged by that time. The main reason for this was that the loan was prepared during the first half of 2008, largely relying on the Company's performance in 2007 and based on the optimistic demand growth projections extrapolated from the "boom years" of 2005-07. The Board approved the project in Serbia on 9 September 2008, and it was signed on 17 October 2008. Despite the global financial crisis unveiling in full before the signing (Lehman Brothers collapsed in mid-September 2008), the loan was signed on the basis of the optimistic scenario. In terms of balance sheet restructuring, despite the Bank's loan and the Parent's contribution, which were to improve the structure of the balance sheet, due to low profitability and the growth of short-term debt during the crisis, the Company's capital structure is still not sustainable on a stand-alone basis. In 2010 the Company had short-term debt, accounting for nearly one third of its total debt and approximately equal to the financing provided by the Bank for "balance sheet restructuring" in 2008. The achievement of objectives under this project is rated *Marginal*.

Objectives of **Project B** were more conservatively set, as the impact of the financial crisis was known by then. The company exceeded the planned target of opening additional stores. By the end of 2010 it increased its store count in BiH by more than planned (moreover, during 2011 the Company expects to open additional stores). Project B has also successfully refinanced its existing short-term debt with the Bank's loan and refrained from incurring any more. By 2010 the Company had no short-term debt but only long-term liabilities. The achievement of objectives of Project B is rated as *Good*.

Company financial performance ●●●○○○ Marginal (A); ●●●●○○ Satisfactory (B)

The Companies' financial performance is rated *Marginal* for Project A and *Satisfactory* for Project B, primarily due to the 2010 key performance indicators being below those forecast at approval.

Efficiency

Bank handling ●●●○○○ Marginal to Satisfactory (A); ●●●●●○ Satisfactory to Good (B)

The optimistic financial projections prepared for Project A were based on company's performance in Serbia between 2005 and 2007, when it tripled its turnover. However this growth was achieved from a very low base and it was unrealistic to expect that such a fast rate of growth would be sustained. The Project team put too much faith in the Parent's past successes in its home market, assuming that the application of a similar strategy in Serbia would guarantee a similar result. Due to the sheer number of planned new store openings, no proper store-specific catchment area analysis, combined with purchasing power analysis, was prepared. Due to the lack of covenants limiting the Company's future short-term debt, the Company quickly incurred new large short-term liabilities and at the end of 2010 was again in acute need of "balance sheet restructuring". Despite the financial and economic crisis unveiling in full before the signing, Project A's loan agreement was signed, as prepared based on pre-crisis, optimistic assumptions. On the positive side, the Bank did well in syndicating half of the loan despite the escalating financial crisis.

The handling of Project B was better as the adverse impact of the economic crisis had been fully demonstrated by 2009 and the Project team was far more careful with its operating and financial projections. Also, the Company's competitive position in BiH has been much stronger than that of its sister company in Serbia, and the impact of the financial crisis less profound, due to the local currency being pegged to the euro. Despite the lack of covenants limiting short-term debt, Project B did not incur any new short-term debt. The Operations team did see the project as an opportunity to address unfulfilled commitments of the Parent under previous projects, however, the team applied the same instrument, the environmental action plan(EAP), which proved inadequate in the past; information provided in the Board report and during the Board discussion on the previous projects was not validated and turned out to be inaccurate.

Bank's investment performance ●●●●○○ Satisfactory (A), ●●●●●● Excellent (B)

Project A's profitability for the Bank (actual and forecast until the loan's repayment) was sufficient to cover costs but was 40%below projected. Whereas, Project B was 52% above that projected at appraisal, mainly due to low costs as the team achieved efficiencies by "piggybacking" on other dealings with the Parent.

Impact/sustainability

Overall transition impact ●●●●●○ Good (A and B)

Company impact

The Projects' impact on both Companies was primarily financial, enabling them to restructure their short-term debt, and even avoid possible bankruptcy, amid the lack of long-term financing in both countries during the financial crisis. Due to the provision of the Bank's funding for market expansion, their network of stores increased, achieving a critical mass and prompting the Parent's management to make substantial investments in their staff training and management systems. The Parent company, being the dominant grocery retailer in its home market, was able to develop close relations with the world's leading retailers and benefit from their training programmes. Subsequently, the Parent's managers trained by such international retailers run their own training courses, sharing knowledge with their colleagues in all three countries.

Industry and wider impact

The Projects made an impact on the retail trade practices in the countries, particularly in terms of better definition and organisation of the relationship between retailers and suppliers/producers, as well as the demonstration of modern management and marketing techniques. The Projects also contributed to improved hygiene standards in the food processing industry. However, the expected impact on lowering retail prices and increased employment was less certain. The share of locally produced food in the retail offer of the company in BiH exceed the target. The local suppliers raised standards to maintain or gain supplier contracts with the market leader. Both Companies provided training to suppliers, with the objective of having them hazard anaylsis and critical control point (HACCP) certified.

Environmental and social impact ●○○○○○ None (A and B)

The operations were presented to the Board as opportunities to finally achieve important, unmet environmental objectives from previous transactions with the Parent, mainly the construction of the waste water treatment plant (WWTP) at its Frikom production facility. The Operation team indicated in the Board report and in the response to the Directors' Advisers' questions, as well as confirmed during the Board discussion, that the design and contractor selection for the WWTP have been completed, while the investment in the WWTP was part of the Parent's capex plan for 2009, therefore it would be completed by then. The Environment and Sustainability Department (ESD) did work with the Parent with some success to minimise the amount of waste water produced by Frikom. However no progress has been made by the Parent in respect of WWTP, despite it being agreed twice in EAPs related to: (i) the Bank's loan to Frikom in 2003, and (ii) the Bank's equity investment into the Parent in 2006. For eight years the Parent has repeatedly ignored its commitment to the Bank, despite benefiting from substantial financing provided by the Bank to four projects.

Findings and recommendations

- **Taking the most recent economic developments into account before signing a financing agreement.** If there are sudden, profound changes to macroeconomic parameters after the Board approval but before the operation's signing, a prudent approach requires the revision of the operation's assumptions and the adjustment of the loan's parameters.

  Recommendation: Given the high volatility of the world's economy in recent years, the Bank should consider adding a provision to its Closing Certificate, requiring the signatory to verify that no major macroeconomic adverse change has taken place since Board approval that could have an impact on the operation.

- **Unmet previous commitments by the same client.** (i) The requirements for important environmental investments, on which a client has repeatedly failed to deliver under previous operations, should be covenanted in the main body of the loan agreement and detailed milestones leading to the completion of such investments agreed; (ii) while Environmental Action Plans (EAPs) can effectively codify and stimulate specific actions, they are not in themselves strong compliance instruments nor always as effective as intended; (iii) entrepreneurs often view environmental investments purely as an expense and may avoid undertaking them unless forced by direct and clear loan covenants; (iv) relatively large environmental investments, covenanted in the loan agreements, require a timetable for their gradual achievement.

Recommendation: The Bank should initiate a system for the more effective tracking of compliance with the provisions agreed under the EAPs. The Bank should also enforce more decisively the obligations stemming from EAPs.

- Importance of verifying information provided by the client. Operations teams must make a reasonable judgment as to when clients' claims should be communicated in good faith to the Board, or whether specific support for such claims is warranted. In case of repeated failure to deliver on a standing commitment, there likely should be a bias toward active verification.

- Refinancing short-term debt, without restrictions on future growth of such debt. If the Bank's loan is used to refinance short-term debt, the Bank should ensure that there are covenants limiting the client's ability to re-incur further unsustainable short-term debt.

- Financing operations with large exposure to imports. Due diligence for operations which involve large exposure to imports must include sensitivity analysis in respect of local currency devaluation, as well as propose measures to mitigate the adverse effects of a potential devaluation.

- Due diligence for retail operations. Past successes of a retail operator in its domestic market do not guarantee success in the new market, particularly when there are large differences in the purchasing power among countries. Thorough due diligence should be performed for all larger retail operations, comprising target population's purchasing power analysis, catchment area, competition and shopping habits analysis.

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

Additionality
■■■■ Fully Verified
■■■□ Largely Verified
■■□□ Partly Verified
■□□□ Not Verified

Overall Ratings
★★★★ Highly Successful
★★★☆ Successful
★★☆☆ Partly Successful
★☆☆☆ Unsuccessful