OPERATION EVALUATION

A mining company

Central Asia

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EBRD EVALUATION DEPARTMENT

European Bank
for Reconstruction and Development

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Executive summary

This Operation Evaluation summarises the evaluations from two closely related operations, an equity investment and a syndicated loan for a high quality coal deposit in Central Asia. Both operations are rated *Highly Successful*.

Key aspects of these operations are:

The Equity Project was well timed with clear limited objectives, and exit at Initial Public Offering (IPO). The objectives have been largely met. The mine is operating to international standards. In 2012 the IPO was successfully launched; however the EBRD decided to stay in for financial reasons. On-going transition impact (TI) was less clear. On a no-objection basis, the EBRD Board approved the conversion to listed shares. As a result, the Bank no longer has any covenants or reporting requirements. The Company has kept the EBRD Head of the Resident Office on their Board, but this is at their discretion.

A major finding of the equity project was that the design was based on a rail link for export, but Government approval was delayed. Therefore, with government agreement, the Company funded a paved toll road. While this was a necessary expedient, it was not to the approved design. The road has been built to reasonable standards, but falls outside the EBRD's concession and environmental policies. The new road is an asset owned by the company and essential to the operations, and while not included under "direct use of proceeds", should have been designed to meet the Bank's policy requirements.

For the Debt Project, the key objectives were largely met. All facilities are now in place and built to international standards. However, the project's transition impact rating was tied to a technical cooperation (TC) activity with the Government that has yet to happen.

Findings

- A "strong sponsor" typically implies involvement of an international sponsor: In this case a local strong sponsor hired a leading international contract miner, resulting in a very strong sponsor team. Not the usual approach, but very effective and is expected to be copied by the government as it further develops the government managed portion of the coal deposit.
- Transport decisions are tied to the larger picture: The government is responsible for providing transport for mining licenses in the area. It was reasonable to delay the decision until the decision on licensing awards which implied different exit routes. However, this resulted in a negative impact on the project, necessitating investment in an unplanned road, and currently increasing running costs.
- Chinese walls: In some respects Chinese walls between the debt and equity teams were weak and in other respects too strong. Support teams were unaware of the road development, yet documentation (for example monitoring reports) between debt and equity teams was too fluid.
- Overlapping objectives: There is overlap between operational objectives, transition impact objectives, and environmental and social impact objectives, resulting in double and triple counting. EvD argues that greater attention needs to be applied by the project approvals committee in distinguishing between the three sets of objectives.

Table 1: Overall ratings

	Equity	Debt
Overall performance (Highly successful, successful, partly successful, unsuccessful)	Highly Successful	Highly Successful
Project relevance		
Additionality (Fully verified, largely verified, partly verified, not verified)	Fully verified	Fully verified
Project effectiveness		
Achievement of operation objectives (Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory)	Good	Good
Company/Project financial performance (Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory)	Excellent	Excellent
Project efficiency		
Bank handling (Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory)	Good	Good
Bank investment performance (Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory)	Excellent	Excellent
Project impact and sustainability		
Transition impact (Excellent, good, satisfactory, marginal, unsatisfactory, negative)	Excellent	Good
Environmental and social performance (Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory)	Good	Excellent
Extent of environmental and social change (Outstanding, substantial, some, none/negative)	Negative	Negative

1. Overall assessment

The Bank's rationale for investing in both of these operations was based on a sound commercial decision with important transition impact elements. The primary rationale was to assist the Company to develop its coal deposit. In anticipation of further mine development in the area, this project offered a real chance for demonstration effect on future operators, some of which the Bank actively attempted to work with.

The debt operation was associated with the operation team's attempts to engage in policy dialogue with the government via the TC project. The objective of the TC was to create an open and transparent data source and to enhance competition for mineral resources, resulting in a greater return to the government. Unfortunately, the TC programme has been delayed.

Finally, the local community is meant to directly benefit from the substantive company royalty payments paid to the government, as required by local law. This has not worked because of what were described as "administrative hurdles". The result was that the government has not transferred any of the royalty payments to the local community. The company is to be commended; it has directly stepped in to respond to several of the local community needs.

2. Relevance / additionality

The EBRD took an initial equity position in the company as a start-up mining operation, followed by a large development loan. The Bank was willing to take equity with this local sponsor and offer longer-term lending whilst contributing to joint multi-lateral development bank efforts to increase transparency in the mineral and mining sector. The EBRD's Small Business Support programme was engaged in development of local micro, small and medium sized enterprises (MSMEs).

Table 2: Additionality ratings

	Equity	Debt
Additionality (Fully verified, largely verified, partly verified, not verified)	Fully verified	Fully verified

3. Effectiveness

Table 3: Effectiveness ratings

	Equity	Debt
Achievement of objectives (Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory)	Good	Good
Company financial performance (Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory)	Excellent	Excellent

3.1. Achievement of objectives

Proceeds of the Bank's equity injection was for the financing of earth moving equipment, transportation trucks, coal washing equipment, road infrastructure upgrade, camp construction and communication facilities; thereby assisting the company to become operational and commercially viable. The mining equipment was purchased and is fully operational. The company established a training facility for equipment operators and is very proud that they are the only company in the country of operations licensed to have female operators, whose performance has exceeded that of male operators. The commercial success is evident from the company's financial performance indicators. The Bank's partial exit at the IPO greatly exceeded its expectations. The expected IRR was 15-20 per cent while the current projected IRR is 168 per cent.

The main purpose of the project was primarily the financing of a Coal Handling & Preparation Plant (CHPP). The CHPP, the first such facility in the country, was expected to allow the Company to start producing higher quality coking coal, aiming at 3.5 mn tpa production by the end of 2011. The project was described as 'project financing' – involving the allocation of loan proceeds to specific assets and proportionate sharing between the Company, operating company, and the Bank. However statements about this allocation were unclear in the Board document, potentially misleading and therefore difficult to evaluate. In fact, the Board report purports that the Bank financed the operational costs, rather than the capital cost, and it is noted that the CHPP only accounts for 39 per cent of the loan. It is unclear the extent to which the remainder covered either other capital or operational expenses or general purpose working capital. Additionally, the appraisal document leaves it ambiguous whether or not the state-of-the-art power station formed an integral part of the CHPP or is a separate item that was (or was not) to be financed under the loan. The CHPP consists of three units. At the time of the evaluation, one unit was complete, the second was almost complete, and the third was under construction. The power plant, housing, camp facilities and water supply systems were all complete. Subject to the caveat noted above, the CHPP construction is on schedule and designed to deliver the targeted throughput.

3.2. Company financial performance

The EBRD Evaluation department rates company and project financial performance for both operations as *excellent*. Based on the size of the deposit and coal prices, it would appear that the equity was under-priced. Long term demand and price increases for coking coal have helped to ensure the financial viability of the company. The successful IPO in 2010 demonstrated the financial success of the company. The value of the Bank's equity investment increased over 10-fold in value from 2009 to 2010. The share price peaked in 2011, but has since declined by 50 per cent and by 30 per cent from the price at the time of the IPO. In retrospect, the decision not to exit at the time of the IPO appears unfortunate. High implementation risk was effectively mitigated by hiring an external operating company ensuring successful development of the mine. However, the changing political situation and increasing supply is having a negative effect on the share price.

4. Efficiency

Table 4: Efficiency ratings

	Equity	Debt
Bank handling (Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory)	Good	Good
Bank investment performance (Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory)	Excellent	Excellent

4.1. Bank handling

The Banking team worked closely with the company at all stages of the project cycle. Unfortunately, the government was unwilling to implement the TC programme, restricting the realised transition impact from this project. The Legal Transition Team is responsible for the TC. The Environment and Sustainability Department (ESD) has played a key role, addressing the concerns of Civil Society, promoting greater public disclosure, and ensuring international standards. For both operations, overall bank handling is rated *good*.

The importance of the decision to move from rail transportation to a road transportation scenario, with all the inherent issues identified, may have constituted a material change requiring Board Approval (on a no objection basis). This change memo could have raised the prospect of the concession, which, when circulated, would have allowed for the Procurement Department's consideration of the Bank's Concession Policy and to ensure that the tendering and contracting arrangements were at least fully identified. The subsequent notification of a change in equity structure might have been another opportunity to present this information to the Board. The operations team might have also used this as an opportunity to request derogation from the concession policy. The Board is required to approve business-related changes which threaten basic achievement of an operation's key objectives. Changes in basic design which effectively lead to fundamental changes in the scope of an existing project are similarly to be approved by the Board.

These projects also presented "Chinese wall" issues for the banking team. While there are separate operation leaders, key project information was openly exchanged within the banking team, but not with support teams. For example, early on the ESD should have been engaged in the decision on the new road, not once it was already completed. Similarly, the Procurement Department and perhaps the Transportation Team should have been engaged in the concession road decision. The equity and debt projects have very different objectives. The Expanded Monitoring Report (XMR) for the project does not adequately reflect the different operational objectives of each operation and, as noted above, it is unclear if the loan was project financed, working capital, or a combination.

4.2. The EBRD's investment performance

The value of the Bank's equity investment in the company is dependent on coking coal prices. There appeared to be clear financial incentives for remaining engaged; however, the price has subsequently declined, thus resulting in a net paper loss. The underlying transition rationale remains important given the potential demonstration effect on other projects, and the threat globally of resurgent resource nationalisation in the context of high commodity prices. The initial transition impact objectives have been largely met and the Bank retains leverage via the Phase II debt. Projected future coal prices suggest that the value of this equity may peak over the next 2 to 3 years. The loan is fully disbursed and the company is repaying on schedule.

5. Impact and sustainability

Table 5: Ratings of transition, environmental and social impacts

	Equity	Debt
Overall transition impact (Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory)	Excellent	Good
Environmental and social impact (Excellent, good, satisfactory, marginal, unsatisfactory, highly unsatisfactory)	Excellent	Good

5.1. Overall transition impact

The project-specific equity benchmarks have been largely realised; however, the larger economy-wide benchmarks are more problematic. The government delayed the rail decision resulting in an increased cost to the client. The EBRD established a benchmark of 50 per cent of all coal production from the private sector, which is (i) outside of the control of the company and (ii) it is unclear who within the client or the Bank was to actively monitor and promote this objective. Since project approval, the country of operation has become a country adhering to the Extractive Industry Transparency Initiative (EITI) and the Bank is working with the government on implementation procedures. The Bank has actively promoted (i) international accounting, (ii) EITI principles of publish-what–you-pay, and (iii) international environmental practices with the Company. However, the government is now considering a law requiring 51 per cent or greater local ownership which, if approved, would be considered as potentially negative Transition Impact.

The most significant aspect of this project's transition impact is its demonstration effect. In developing a new mine, the government initially took two approaches:

- one section was to be sold as a concession

– the other was to be owned by the government and operated by an international mining company - like the EBRD structure.

For the first section, an international tendering process took place and awards announced, then cancelled. The government then announced an IPO of the Government owner operator, which was listed in late 2011, but progress on that front has now stalled.

For the debt operation the project specific transition impact objectives have been largely met. Local development has been supported through a constructive engagement with the Small Business Support Team. Both the coal washing facility and the air cooled power plant are first-of-a-kind for the country.

The key transition impact benchmark was tied to the TC with the Mineral Resources Authority which has been delayed. As this TC was intended to assist the government in making mine data open and transparent, thus intended to enhance competition, its delay limits the rating of overall transition impact performance to *good*. The government sees the mineral data as integral to state security and as highly confidential. More limited access to these data potentially benefits a limited set of investors, particularly in the context of the proposed new 51 per cent or greater ownership law. This TC was integral to the Bank's approval decision and addresses a critical Transition Impact objective. The delay in implementation is cause for concern relative to EITI and is therefore one of the few negatives going forward.

Also of concern is the lack of royalty payments to the local community, paid by the Company to the government, a portion of which is meant to be transferred back to the local community. The local community is a beneficiary and is directly impacted by the project. Because of its isolation, changes over time can be attributed to the on-going impact of the project. This community would be an excellent candidate for a prospective "impact evaluation" measuring the impacts of a mining operation on a local community. Relative to changes that will result from development of the new mine in the area, current local community conditions could still be considered as close to ex-ante.

5.2. Environmental and social impacts

Both the ESD and banking team conducted thorough due diligence for this project. International standard ESIAs were prepared at the Bank's request and there has been constructive public disclosure throughout the project. A mine closure plan has been developed, but this has yet to be funded. The client has developed a very positive Corporate Social Responsibility programme, supporting the local community through:

- new airport and roads;
- support to the school;
- support to the health clinic;
- improvements to water and power supply and better management of the community solid waste site;
- support to local micro-enterprise; and
- support to the local annual festival.

While not all company investments were supported by the Bank (such as the power plant), the Bank needs to ensure that all required facilities are in full compliance with EU standards. This is particularly true for greenfield projects, where the Bank achieves transition impact through its demonstrative effect.

To this end, the issues around the road versus rail decisions are integral to the project. Without an exit route there is no project. Initially, at small volumes, it was acceptable to utilise local roads, even though the rail proposal was the correct long-term decision. Project production levels have increased to the point that local roads were no longer a viable option, thus the company as an interim measure constructed a paved road. This road is a project built facility, utilised by the company owned or contracted trucks, to transport coal to the company's transit facility near the border. Construction of this new road raises biodiversity and social issues that are in variance to the Bank's policy. It is almost always good practice for ESD to be engaged in the decision early in the process. For these reasons, Environmental and Social Performance of the equity project has been downgraded to *good*.

As both projects are greenfield involving mining activities, the success of environmental change can only be rated as *negative*; however, as greenfield projects, the EvD's rating of environmental and social impact is based solely on environmental and social performance.