

Operation Evaluation

Summary

A Wood Product Manufacturer

(A private sector investment operation)

March 2012

Evaluation department (EvD)



European Bank
for Reconstruction and Development

Executive summary

This project involved an investment to construct and operate a greenfield wood processing plant. Phase 1 comprised the construction and operation of a birch log sawmill and drying kiln. Phase 2 comprised the construction and operation of a veneer and plywood manufacturing facility. The EBRD planned to make an equity investment in Phase 1 and a loan at Phase 2. The project was intended to provide a positive demonstration effect for forestry sector reforms.

Forestry sector reform

The Government hoped to capture more value-added wood processing through sectoral reform inspired by the Finnish reforms of the 1950s.

- The Government planned to raise export duties on logs, slash tariffs and cancel customs duty for value-added products, and reduce the duty on imported wood-processing equipment.
- Forest leases were reformed to increase the term (from five to 49 years) and the obligations of lessees. The intention was that longer leases would encourage companies to invest in forest infrastructure.

In the event, only part of the planned tariff reform was implemented as the sector suffered following the 2008-09 financial crisis. An unforeseen effect of the longer leases was that many small-scale loggers, unable to afford the initial investment and hit simultaneously by a slump in demand, left the industry. This led to some short-term supply problems that affected both the financial performance and the transition impact of the Bank's project.

The Bank subscribed to the equity in December 2007. Phase 1 of the project was completed with some delay and trial production started in late 2007. The impact of the financial crisis from 2008 reduced demand in the construction sector and prevented the sawmill from achieving full production. The Sponsor entered into a restructuring with the support of its banks before Phase 2 was launched. The project experienced bureaucratic delays in obtaining necessary licences and approvals, as it found itself in direct competition with a much larger planned investment in the same region that occupied the attention of the authorities. Phase 2 was first delayed and then cancelled. The EBRD loan was never disbursed and has been cancelled.

The project provides clear examples of the types of business environment delays that can be experienced by investment projects. The initial capital subscription by the EBRD was delayed by some 14 months for monopolies approval, railway certification was held up for local bureaucratic reasons and difficulty was encountered in obtaining forestry licences. Supporting sector reform and providing demonstration effect for the new forestry code were fundamental to the transition rationale of this project, although none of the transition benchmarks were set around this. This issue is taken up in the first of the key findings discussed below.

Ratings summary

Overall rating	◆◆◆ Unsuccessful
Company financial performance	●●○○○○ Unsatisfactory
Achievement of objectives	●●●○○○ Marginal
Additionality	■ ■ ■ ■ Fully verified
Transition impact	●●●○○○ Marginal
Environmental and social impact	●●●●○○ Good
Bank handling	●●●●○○ Good

Overall assessment

◆◆◆ (Unsuccessful)

The project was badly affected by the unfortunate combination of direct competition from a much larger planned investment in the same region, and the subsequent economic downturn. As a result, only Phase 1 proceeded and fulfilment of project objectives was therefore *'marginal'*. This in turn limited the transition potential and, combined with unsatisfactory financial performance, it results in a rating of *'unsuccessful'* overall.

Additionality

■ ■ ■ ■ (Fully verified)

Additionality is rated *'fully verified'*. As a medium-sized Sponsor, the Client was not able to attract long-term financing for what would be its first major international investment. The size of the investment was relatively large for the size of Sponsor. The Client also benefitted from the Bank's support in its interactions with the authorities. The EBRD was able to assist with the licensing of the railway track in particular.

Effectiveness

Achievement of objectives

●●●○○○ (Marginal)

The achievement of the individual objectives is summarised below. Several of the project objectives have not yet been fulfilled and there are some doubts about the final outcome. The company increased the scope of Phase 1 to incorporate some of the construction work related to Phase 2 and to expand the potential of the project. This pushed up the cost of Phase 1. The changes were logical in the context of the entire project, but when Phase 2 did not go ahead the company was left with over capacity and an over-invested sawmill. Nevertheless, the sawmill is operating well (technically) and the infrastructure is in place to allow expansion and development in a recovering market.

Objective	Achievement
Physical objectives	
Phase 1: construction and operation of a greenfield birch log sawmill and drying kiln	Achieved
Phase 2: construction and operation of a veneer and plywood manufacturing facility	Not achieved
Financial performance of the Borrower, as measured by sales and cost	Not achieved
Transition objectives	
Setting new standards for the forestry industry	Partly achieved
Expansion of the market interaction with log suppliers	Not achieved
Overall achievement of objectives	Marginal

Company financial performance

●●○○○○ (Unsatisfactory)

Project financial performance

●●○○○○ (Unsatisfactory)

Company and project financial performance are identical in this case. Financial performance is far below what was expected. The sawmill has not yet achieved sufficient volumes to be profitable. The best estimate is that without the planned veneer plant, the sawmill and logging operations can generate an operating profit once they are functioning at full capacity, but not sufficient to cover the financing costs as well. The sawmill project was never intended to be an end in itself, but to supply more profitable plywood and veneer facilities. On its own, it is unlikely to be viable.

Efficiency

Bank handling

●●●●○○ (Good)

Bank handling is rated 'good'. The project and Sponsor were well chosen. The project was recognised at appraisal as risky. The main risks were identified and mitigated through careful structuring. The Bank has maintained good relations with the Sponsor through a difficult period and reporting has generally been satisfactory. The Bank assisted the Company with its dialogue with the authorities.

Impact/sustainability

Overall transition impact

●●●○○○ (Marginal)

Transition impact is 'marginal' overall. The project was undertaken in the context of the planned reform of the forestry sector, which has been partially implemented and had unintended short-term effects on the supply chain. The performance of the Company and Sponsor has been excellent in terms of maintaining high business standards, working with local staff and conforming to all their original undertakings. However, the limited commercial success of the project, the timber supply problems and the cancellation of Phase 2 have severely restricted the actual impact of the project to date. The project still has the long-term potential to achieve good transition impact even on the reduced scale of logging and sawmill alone, but this is dependent on business growth and successful commercial operation of the plant, which remain doubtful in the short term.

Company impact

Company impact is not applicable for a newly established company.

Industry and wider impact

Competition: The Client represented a significant new entrant into the market, setting high quality and technical standards.

Market expansion: The intended interactions with local suppliers did not come to fruition. Partly this was because many local suppliers have withdrawn from the market under the impact of increased tariffs and new leasing arrangements, and partly it was because the economic situation has limited production at the sawmill. With a much lower than expected requirement for wood supplies, the company has obtained only minimal quantities of wood from local suppliers. The reduction in competition has restricted its ability to impose additional standards on those remaining. Greater interaction remains a future possibility if demand picks up and local loggers resume activity.

Frameworks for markets: Supporting sector reform and providing demonstration effect for the new forestry code were fundamental to the transition rationale. The project achieved limited success in this area; indeed it provides clear examples of the types of business environment delays that can be experienced by investment projects.

Skills transfers: The project fitted well with an established local industry. All staff up to General Director level are locally recruited. Impact has been limited by the reduced scope, which has limited recruitment.

Environmental and social impact

●●●●●○ (Good)

Environment-related objectives are on track to be achieved. Health and safety standards are good and waste is well managed. The company has communicated transparently with the local community.

Findings and recommendations

Relevance of transition objectives to the project

While the transition objectives were logically linked to the investment programme, they missed the most important aspect of it. The principal transition challenges that the project faced were in the area of frameworks for markets. By contrast, the transition objectives established at approval largely addressed transition benchmarks at the company level. The transition objectives were predicated on the assumption that sector reform would take place. Building the transition objectives around the fundamental issues not only helps to focus the project on its key objectives, but might also stimulate an early policy dialogue on the pace and direction of reform when things are not progressing adequately.

Pursuit of the Bank's mandate in the region may necessitate challenging projects with mid-sized sponsors in cyclical markets

The Client is an example of the kind of project the Bank needs to undertake in order to fully discharge its mandate in the country of operations. It also illustrates the delays and obstacles that such projects may present when local stakeholders and authorities give priority attention to larger and higher impact investment projects. Bank-supported mid-sized projects will need to overcome bureaucratic and other barriers to foreign and domestic private sector investment. Future projects with small foreign and local sponsors in less developed parts of the country are likely to be a continuing feature of pursuing the mandate and the Bank should expect some setbacks.

Phasing the project as a risk mitigation measure

This project presents a good example of defensive structuring. The phasing provided effective mitigation of larger risk and allowed the company to review commercial viability and the stance of relevant authorities before making a final decision on the main investment. More widely, phasing projects around discrete, individually sustainable elements allows parts of a project to be cancelled or suspended without damaging the viability of the completed sections.

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